

NETSOL TECHNOLOGIES INC

Form S-3/A

January 19, 2007

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON JANUARY 18, 2007

REGISTRATION NO. 333-138103

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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AMENDMENT NO. 3 TO

FORM S-3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

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**NETSOL TECHNOLOGIES, INC.**

(Name of small business issuer in its charter)

Nevada  
(State or Other Jurisdiction  
of Incorporation or Organization)

2834  
(Primary Standard  
Industrial Classification "SIC" Code Number)

95-4627685  
(IRS Employer  
Identification Number)

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23901 Calabasas Road, Suite 2072  
Calabasas, CA 91302  
Phone: (818) 222-9195  
Fax: (818) 222-9197

(Address including the zip code & telephone number including area code, of  
registrant's principal executive office)

NAJEEB GHAURI  
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NETSOL TECHNOLOGIES, INC.  
23901 Calabasas Road, Suite 2072  
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(Name, address, including zip code, and telephone number, including area code,  
of agent for service)

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COPIES TO:

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APPROXIMATE DATE OF COMMENCEMENT OF PROPOSED SALE TO THE PUBLIC:  
As soon as practicable after the effective date of this Registration Statement.

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## CALCULATION OF REGISTRATION FEE

<b>Title of Each Class of Securities to be Registered</b>	<b>Number of Shares to be Registered(1) (2)</b>	<b>Proposed Maximum Offering Price Per Share(1) (2)</b>	<b>Proposed Maximum Aggregate Offering Price</b>	<b>Amount of Registration Fee</b>
Shares of Common Stock, \$.001 par value, issuable upon conversion of, and/or redemption of, and in lieu of cash dividends on Series A Convertible Preferred Stock (3)	5,000,000	\$ 1.47	\$ 7,350,000	\$ 865.06
Shares of Common Stock, \$.001 par value, issuable upon exercise of warrants (4)	1,933,334	\$ 1.47	\$ 2,842,001	\$ 334.49
<b>TOTAL</b>	<b>6,933,334</b>		<b>\$ 10,192,001</b>	<b>\$ 1,199.55</b>

- (1) Estimated solely for the purpose of calculating the amount of the registration fee pursuant to Rule 457(c).
- (2) Pursuant to Rule 416 under the Securities Act of 1933, as amended, there are also being registered such additional shares of common stock as may become issuable pursuant to anti-dilution provisions of the warrants and preferred stock.
- (3) 3,333,333 of the shares are currently issuable upon conversion of the preferred stock and 1,666,667 represent an additional number to be registered to account for changes to the conversion value and/or payments of the preferred dividend in common stock rather than in cash.
- (4) 1,666,668 and 266,666 of the shares are issuable upon exercise of the warrants by the investors and placement agent respectively.

If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box.

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans check the following box.

If this Form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the Commission pursuant to Rule 462(e) under the Securities Act, check the following box.

If this form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.E. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(a) OF THE SECURITIES ACT OF 1933 OR UNTIL THIS REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(a), MAY DETERMINE.



THE INFORMATION IN THIS PROSPECTUS IS NOT COMPLETE AND IS SUBJECT TO CHANGE OR AMENDMENT. THE SELLING STOCKHOLDERS MAY NOT SELL THE SECURITIES UNTIL THE REGISTRATION STATEMENT FILED WITH THE SECURITIES AND EXCHANGE COMMISSION IS EFFECTIVE. THIS PROSPECTUS IS NOT AN OFFER TO SELL THESE SECURITIES AND IT IS NOT SOLICITING AN OFFER TO BUY THESE SECURITIES IN ANY STATE WHERE THE OFFER OR SALE IS NOT PERMITTED.

**SUBJECT TO COMPLETION, DATED JANUARY 18, 2007**

**PROSPECTUS**

**6,933,334 SHARES OF COMMON STOCK**

**NETSOL TECHNOLOGIES, INC.**

The selling stockholders listed on page 10 of this prospectus are offering for resale up to 7,164,198 shares of our common stock, referred to as the "offered shares." All of the offered shares are issuable, or may in the future become issuable, with respect to securities issued in connection with the private placement of convertible notes with a principal value of \$5,500,000 (the "Convertible Notes") and warrants to acquire up to 1,666,667 shares of common stock (the "Warrants") that NetSol completed in June 2006 (the "Financing"). On October 30, 2006 ("Exchange Date") the Convertible Notes were exchanged for shares of Series A 7% Cumulative Convertible Preferred Stock (the "Series A Preferred Stock") which are in turn convertible into shares of our common stock. The shares of common stock being offered for resale by the selling stockholders pursuant to this prospectus include: shares of common stock issuable upon conversion and/or redemption of our Series A Preferred Stock; shares of common stock which may be issued in payment of dividends on the Series A Preferred Stock; shares of common stock issuable upon the exercise of the Warrants; shares of common stock issuable upon the exercise of warrants issued to our placement agent as part of the Financing (the "Placement Agent Warrants"); and, additional shares of common stock that may be issued to the selling stockholders as a result of conversion or exercise price anti-dilution adjustments applicable to the Series A Preferred Stock and/or the Warrants. In this prospectus, the terms "NetSol," "we," or "us" will each refer to NetSol Technologies, Inc.

We will not receive any proceeds from sales of the shares of common stock by the selling stockholders.

Our common stock is traded on the NASDAQ Capital Market under the symbol "NTWK". The closing price of our common stock on January 17, 2007 was \$1.47.

We will bear all expenses, other than selling commissions and fees, in connection with the registration and sale of the shares being offered by this prospectus.

**INVESTING IN OUR SECURITIES INVOLVES A HIGH DEGREE OF RISK. SEE "RISK FACTORS" BEGINNING ON PAGE 5**

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**NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR DETERMINED IF THIS PROSPECTUS IS TRUTHFUL OR COMPLETE. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.**

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January 18, 2007

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## **SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Some of the statements under "Prospectus Summary," "Risk Factors," in this prospectus are forward-looking statements. These statements involve known and unknown risks, uncertainties, and other factors that may cause our or our industry's actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by forward-looking statements. Such factors include, among other things, those listed under "Risk Factors" and elsewhere in this prospectus.

In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential," "proposed," "intended," or "continue" or the negative of these terms or other comparable terminology. You should read statements that contain these words carefully, because they discuss our expectations about our future operating results or our future financial condition or state other "forward-looking" information. There may be events in the future that we are not able to accurately predict or control. Before you invest in our securities, you should be aware that the occurrence of any of the events described in these risk factors and elsewhere in this prospectus could substantially harm our business, results of operations and financial condition, and that upon the occurrence of any of these events, the trading price of our securities could decline and you could lose all or part of your investment. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, growth rates, levels of activity, performance, or achievements. We are under no duty to update any of the forward-looking statements after the date of this prospectus to conform these statements to actual results.

## **PROSPECTUS SUMMARY**

The following summary contains basic information about NetSol and this prospectus. Because it is a summary, it does not contain all of the information that you should consider before investing in our securities. For a more complete understanding of the risks associated with investing in us, you should read the entire prospectus carefully, including the "Risk Factors" starting on page 5.

## **OUR COMPANY**

We are an end-to-end information technology ("IT") and business consulting services provider for the lease and finance, banking and financial services industries. Since it was founded in 1997, the Company has developed enterprise solutions that help clients use IT more efficiently in order to improve their operations and profitability and to achieve business results. Our focus has remained the lease and finance, banking and financial services industries. We operate on a global basis with locations in China, Europe, East Asia and the U.S. By utilizing our worldwide resources, we believe we have been able to deliver high quality, cost-effective IT products and IT services.

Our subsidiary, NetSol Technologies Ltd. ("NetSol PK") develops the majority of our software. NetSol PK was the first software company in Pakistan in 1998 to achieve the ISO 9001 accreditation and was again the first software company in Pakistan to obtain Carnegie Mellon's Software Engineering Institute ("SEI") Capable Maturity Model ("CMM") Level 4 assessment in 2004 and CMMi Level 5 now in 2006. As maintained by the SEI, maturity levels measure the maturity of a software company's methodology that in turn ensures enhanced product quality resulting in faster project turn-a-round and a shortened time to market.

During recent years, we have focused on developing software applications for the leasing and financial service industries. In late 2002, we launched a new suite of software products under the name LeaseSoft. The LeaseSoft suite is comprised of four major integrated asset based leasing/financing software applications. The suite, consisting of a Credit Application Creation System (LeaseSoft.CAC), a Credit Application Processing System (LeaseSoft.CAP), a Contract Activation & Management System (LeaseSoft.CAM) and a Wholesale Finance System (LeaseSoft.WFS), whether used alone or together, provides the user with an opportunity to address specific sub-domains of the



leasing/financing cycle from the credit approval process through the tracking of the finance contract and asset.

Our company is divided into three regions, North America, Europe and Asia Pacific. The North American region consists of operations of the company and of our subsidiary, McCue Systems, Inc. (“McCue”), and is headed by John McCue as President of the North America region. In June 2006, we acquired the shares of McCue. McCue has 35 years of experience in developing business solutions for the equipment and vehicle leasing industry as a provider of lease/loan portfolio management software for banks, leasing companies and manufacturers. Its flagship product, LeasePak, simplifies lease/loan administration and asset management by accurately tracking leases, loans and equipment from origination through end-of-term and disposition. The LeasePak brand is recognized in the US and Canadian marketplace and is configured to handle the unique tax and regulation requirements of North America. LeasePak is complementary to NetSol’s LeaseSoft offering and its geographic specificity complements LeaseSoft in regions in which LeaseSoft does not currently have coverage or domain support knowledge.

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Our Asia Pacific region is headed by Salim Ghauri as President of the region and consists of all of our Pakistani subsidiaries, NetSol Technologies, Ltd., Abraxas and our Beijing, China sales office. Our NetSol PK operation supports the worldwide customer base of the LeaseSoft suite of products and all other product offerings. NetSol is actively undertaking exercises for providing consultancy services for different software companies. The key aspects of these services would be CMMi introduction, gap analyses for ISO 9001:2000 compliant procedures, CMMi Level 2/3 pre-assessments, consultancies, evaluations and tracking/analyses of such improvements. There is a growing domestic business in Pakistan for the IT and IT enabled services, as stated above, and NetSol is strategically positioned to support a very stable and economically beneficial pipeline to win many more as well as major new projects in the public and private sectors. NetSol will continue to strengthen its position as a dominant IT solutions provider in this explosive growth market.

Our European region consists of our two wholly owned subsidiaries, NetSol Technologies, Ltd. and NetSol-CQ, Ltd. (formally CQ Systems Ltd.) In February 2005, NetSol acquired 100% of CQ Systems Ltd., ("CQ"), an IT products and service company based in the UK. As a result of this acquisition, NetSol has access to a broad European customer base using IT solutions complementary to NetSol's LeaseSoft product. NetSol plans to leverage CQ's knowledge base and strong presence in the Asset Finance market to launch LeaseSoft in the UK and continental Europe. CQ's strong sales and marketing capability would further help NetSol gain immediate recognition and positioning for the LeaseSoft suite of products. In November 2005, CQ was re-branded as NetSol-CQ and was launched into the UK market with new branding and logo. This was part of a global strategy to have consistency in our marketing collateral across the globe. All NetSol-CQ products have been re-branded as LeaseSoft and the Enterprise product would now be known as LeaseSoft Asset.

With the acquisition of Pearl Treasury System, whose product offering is now referred to as InBanking™, the Company expands its menu of software into the banking and other financial areas. The tremendous flexibility enabled by the comprehensive data model and multi-tier architectural design of InBanking™ has been fully recognized, identifying the potential to further develop InBanking™ beyond treasury and capital markets. Additionally, InBanking™ is modular and can therefore be implemented as best-of-breed solutions for, as an example, front-office trading, middle office credit or market risk, or back office settlement. InBanking™ can also be implemented to support all these areas, plus others, as a single fully integrated solution. The beta version of InBanking is now in the final stages of completion and NetSol is currently seeking a small number of banks and financial institutions to be pilot development partners for the beta version of InBanking™ to support their specific requirements.

We market our software products worldwide to companies primarily in the automobile finance, leasing and banking industries. Some of NetSol's customers include: DaimlerChrysler Services AG; DaimlerChrysler Asia Pacific - Singapore; Mercedes-Benz Finance - Japan; Yamaha Motors Finance - Australia; DaimlerChrysler Financial Services-Taiwan; Debis Portfolio Systems - UK; DaimlerChrysler Financial Services - Australia; DaimlerChrysler Leasing - Thailand; DaimlerChrysler Financial Services - South Korea; UMF Leasing Singapore; MCB Mauritius; Toyota Leasing Thailand; Toyota Motors Finance China; BMW Financial Services - China; Australian Motor Finance- Australia and, DaimlerChrysler Services New Zealand. In addition, NetSol provides offshore development and testing services to Innovation Group Plc UK and their blue chip global insurance giants like Allstate, Cendent, etc. NetSol is also a strategic business partner for DaimlerChrysler (which consists of a group of many companies), which accounts for approximately 11% of our revenue. Toyota Motors (which consists of a group of many companies) accounts for approximately 12% of our revenues. No other individual client represents more than 10% of the revenue for the fiscal year ended June 30, 2006.

We were incorporated under the laws of the State of Nevada on March 18, 1997. Our principal executive offices are located at 23901 Calabasas Road, Suite 2072, Calabasas, California 91302. Our telephone phone number is (818) 222-9195 and our website address is <http://www.netsoltek.com>.



## THE FINANCING

On June 15, 2006, we entered into an agreement with 5 accredited investors whereby Netsol issued 5 convertible notes for an aggregate principal value of \$5,500,000. These notes bore interest at the rate of 12% per annum and were due in full one year from the issuance date or on June 15, 2007 (the "Financing"). In connection with the Financing, the Company entered into the following documents: A Convertible Note and Warrant Purchase Agreement (the "SPA"); 12% Convertible Notes (the "Convertible Notes"); Common Stock Purchase Warrants (the "Warrants"); and, Investor Rights Agreement (the "IRA"). The Company also agreed to a form of Certificate of Designation for 7% Cumulative Convertible Preferred Stock (the "Preferred Stock") and, issued the Placement Agent Warrant Agreement (the "Placement Agent Warrant").

The proceeds of the Financing are being used by the Company to: (i) pay the initial cash consideration due to McCue shareholders as part of the acquisition of McCue Systems, Inc. by the Company; (ii) pay the final cash consideration due to former CQ Systems Inc. shareholders as part of the acquisition of CQ Systems, Ltd. (now NetSol-CQ); and (iii) provide working capital. The initial cash consideration due to McCue shareholders is \$2,117,864 and represents 38.51% of the total proceeds raised. The final cash consideration due to former CQ Systems, Inc. shareholders is £1,064,369 (which represents \$1,936,200.17 at the exchange rate of British pounds sterling into U.S. Dollars at June 28, 2006). The CQ payment represents 35.20% of the total funds raised in the Financing. The remaining funds are being used to pay fees due under the terms of the Financing and as working capital.

Pursuant to the terms of the SPA, each purchaser received a Convertible Note in the amount of their investment and a Warrant in an amount equal to 50% of the aggregate principal value of the Notes divided by the conversion value (currently \$1.65 per share). Based on an aggregate principal value of \$5,500,000, the investors were entitled to Warrants to acquire up to 1,666,667 shares of common stock at an exercise price per warrant of \$2.00. The Warrants were permitted to be exercised at any time, to the extent that such conversion did not violate Nasdaq Marketplace rules, and in full at such time after our stockholders approved the issuance of shares underlying such Warrants until five years from the issuance date of the Warrants, or June 15, 2011. On October 18, 2006, our stockholders approved the issuance of all shares of common stock underlying the Preferred Stock, the Warrants, the Placement Agent Warrants and such additional shares of common stock that may be issued in lieu of cash as dividends due to Preferred Stock holders. On October 18, 2006, the Company provided each investor notice to exchange its Convertible Notes for (a) such number of shares of preferred stock as equals the principal amount exchanged divided by \$1,000 and (b) cash equal to the amount of unpaid interest on the notes through the exchange date. The Convertible Notes were exchanged for Preferred Stock on the Exchange Date, October 30, 2006. As of October 30, 2006 there are 5,500 shares of Preferred Stock issued and outstanding. As of the Exchange Date interest in the amount of \$251,166.67 was due to the Selling Stockholders. The Selling Stockholders have accepted, in lieu of payment of interest in cash, 230,863 shares of common stock, on a pro rata basis due on the Exchange Date.

As part of the consideration paid for its services in facilitating the Financing, Maxim Group, LLC (the "Placement Agent") received warrants to acquire up to 266,666 shares of common stock of the Company at the exercise price of \$1.65 per share. Such warrants contain customary anti-dilution protection for stock splits, dividends and recapitalization consistent with the National Association of Securities Dealers, Inc. Rules of Fair Practice.

The Preferred Stock is convertible into shares of common stock at such time and at such value as is set forth in the Certificate of Designation. The initial conversion value shall be \$1.65. The conversion value is subject to adjustment as set forth in the Certificate of Designation. The holders of the Preferred Stock are entitled to receive cumulative dividends at the rate of 7% per annum from the date of issuance of each share of preferred stock until paid. The dividends may be paid, at the Company's option, in cash or in shares of common stock in arrears on the first business day of each calendar quarter of each year. The Company may force a conversion of the Preferred Stock in the event that the market price of the Company's common stock is greater than 200% of the conversion value. If any shares of

the Preferred Stock remain outstanding on June 15, 2009, the Company shall redeem such shares for an amount in cash equal to the liquidation preference plus all accrued but unpaid dividends. Anti-dilution protection is afforded to the holders by providing for an adjustment of the conversion price in certain circumstances. The conversion price is adjusted for dividends, subdivisions, combinations, distributions and issuances of shares, or securities convertible into shares, of common stock of the Company issued at an effective per share selling price which is the less than the greater of the fair market price or the conversion value as of the issuance date. Conversion of the Preferred Stock is subject to beneficial ownership caps of from 4.99% to 9.9% of the total number of shares of common stock of the Company then issued and outstanding.

The IRA requires the Company to register, on a registration statement to be filed with the SEC within 8 business days of the special shareholders' meeting, 150% of such number of shares of common stock into which the Preferred Stock is convertible and 100% of the number of shares of common stock issuable upon exercise of the Warrants. The IRA requires the registration statement to be effective within 120 days of the closing of the Financing. Since the registration statement was not effective by that date, each holder is entitled to cash compensation equal to 1% of its investment amount for every 30 days of non-compliance (or a proportionally smaller amount if less than 30 days).

## THE OFFERING

This prospectus relates to the offering for resale of NetSol Technologies, Inc. common stock by the selling stockholders named in this prospectus, who may use this prospectus to resell their shares of common stock. The shares of common stock being offered for resale by the selling stockholders include: shares of common stock issuable upon conversion and/or redemption of our Series A Preferred Stock; shares of common stock which may be issued in payment of dividends on the Series A Preferred Stock; shares of common stock issuable upon the exercise of the Warrants; shares of common stock issuable upon the exercise of warrants issued to our placement agent as part of the Financing (the "Placement Agent Warrants"); and, additional shares of common stock that may be issued to the selling stockholders as a result of conversion or exercise price anti-dilution adjustments applicable to the Series A Preferred Stock and/or the Warrants. We will not receive any proceeds from sales of our common stock by the selling stockholders. For further information about the selling stockholders, see "Selling Stockholders."

Common Stock Offered	This prospectus relates to the offering of 6,933,334 shares of our common stock, which may be sold from time to time by the selling stockholders named in this prospectus. The shares of our common stock are being registered to permit the selling stockholders to sell the shares from time to time in the public market. The selling stockholders will determine the timing and amount of any sale.
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Common Stock outstanding	We had 18,007,908 shares of common stock issued and outstanding as of January 15, 2007.
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Use of Proceeds	We will not receive any of the proceeds from sale of shares of common stock offered by the selling stockholders.
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Trading Market	Our common stock is currently listed on the NASDAQ Capital Market under the trading symbol "NTWK."
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Risk Factors	Investment in our common stock involves a high degree of risk. You should carefully consider the information set forth in the "Risk Factors" section of this prospectus as well as other information set forth in this prospectus, including our financial statements and related notes.
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## **RISK FACTORS**

An investment in our securities is extremely risky. You should carefully consider the following risks, in addition to the other information presented in this prospectus, before deciding to buy our securities. If any of the following risks actually materialize, our business and prospects could be seriously harmed and, as a result, the price and value of our securities could decline and you could lose all or part of your investment. The risks and uncertainties described below are intended to be the material risks that are specific to us and to our industry.

### **RISKS RELATED TO OUR BUSINESS**

#### **We May Have Difficulty Raising Needed Capital in the Future, Which Could Significantly Harm Our Business.**

We will require additional financing in order to support further expansion, develop new or enhanced services or products, respond to competitive pressures, acquire complementary businesses or technologies or take advantage of unanticipated opportunities. Our ability to arrange such financing in the future will depend in part upon the prevailing capital market conditions, as well as our business performance. There can be no assurance that we will be successful in our efforts to arrange additional financing on satisfactory terms. If additional financing is raised by the issuance of our securities, control of NetSol may change and stockholders may suffer additional dilution. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of opportunities, or otherwise respond to competitive pressures and remain in business.

#### **We Will Require Additional Financing; We May Not Achieve Profitability; We Anticipate Continued Losses; Current Liabilities Exceed Current Assets.**

As of the fiscal year ended June 30, 2005 and 2006, we had a positive working capital of \$3,458,300 and \$10,675,585. We have current short-term bank notes of \$662,800 due within six months. We had a net income of \$663,225 in fiscal 2005, but a net loss of \$1,353,053 in fiscal 2006. In addition, we continue to operate at a deficit on a monthly basis, which is not expected to change in the foreseeable future, even with the implementation of our current business plan. Notwithstanding that we raised \$5,500,000 in June 2006, we may need to raise additional funds to continue operations and to expand and invest in the growth of our business for the next year. Additionally, we required a minimum of \$1,058,932 to pay the second installment of the acquisition of McCue Systems in June 2007. We cannot assure you that we can achieve, sustain or increase profitability. If revenues grow slower than we anticipate, or if operating expenses exceed our expectations or cannot be adjusted accordingly, our business, results of operations and financial condition will be materially and adversely affected. Although we have improved our financials steadily in last few quarters, no assurance can be given that we will continue to improve our financial condition.

#### **We May Not Be Able To Realize The Benefits Of Our Strategic Plan.**

We have undertaken a business plan designed to optimize the alignment of our business into two divisions (Global Products and Global Services) and three regions (North America, Europe and Asia Pacific). Although our management is confident about our ability to realize some benefits from the restructuring, the level of benefits to be realized could be affected by a number of factors including, without limitation: (a) our ability to raise sufficient funds; (b) our ability to continue to operate as planned without further stockholder hostile takeover attempts; (c) our ability to prosper given the current uncertainty in the US technology industry; and, (d) our ability to react effectively to the global political and business effects of the political events around the world and particularly in Pakistan.

#### **We Depend Heavily On A Limited Number Of Client Projects And The Loss Of Any Such Projects Would Adversely Affect Our Operating Results.**



As of the fiscal year ended June 30, 2006, we derived approximately 11% of our net revenues from DaimlerChrysler (which consists of a group of companies and clients). DaimlerChrysler consists of a number of companies, each of which are uniquely different customers and none of which represents greater than 10% of our net revenues. We also derived 12% of our net revenues from Toyota Motor Finance. As with DaimlerChrysler, Toyota consists of a number of companies, each of which are uniquely different customers and none of which represents greater than 10% of our net revenues. We continue to enhance our relationship with DaimlerChrysler to provide software and support services to them on a global basis. This may increase our reliance on DaimlerChrysler as a revenue source. We also have other significant clients whose business is critical to our success. The loss of any of our principal clients for any reason, including as a result of the acquisition of that client by another entity, could have an adverse effect on our business, financial condition and results of operations.

**If Any Of Our Clients Terminate Their Contracts With Us, Our Business Could Be Adversely Affected.**

Many of our clients have the ability to cancel certain of their contracts with us with limited advance notice and without significant penalty. Any such termination could result in a loss of expected revenues related to that client's project. A cancellation or a significant reduction in the scope of a large project could have a material adverse effect on our business, financial condition and results of operations.

**If We Are Unable To Protect Our Proprietary Software, Our Business Could Be Adversely Affected.**

Our success as a company depends, in part, upon our work product being deemed proprietary software, along with other intellectual property rights. While both the LeaseSoft and NetSol trade names and marks are copyrighted and trademarked in Pakistan, we have not registered any trademarks or filed any copyrights in any other jurisdictions. We rely on a combination of nondisclosure and other contractual arrangements, and common law intellectual property, trade secret, copyright and trademark laws to protect our proprietary rights. As a matter of course, we generally enter into confidentiality agreements with our employees, and require that our consultants and clients enter into similar agreements. We also limit access to our proprietary information. There can be no assurance that these steps will be adequate to deter misappropriation of proprietary information or that we will be able to detect unauthorized use and take appropriate steps to enforce our intellectual property rights. In addition, although we believe that our services and products do not infringe on the intellectual property rights of others, there can be no assurance that infringement claims will not be asserted against us in the future, or that if asserted, any such infringement claim will be successfully defended. The cost of defending any such suit will have a negative impact, even if ultimately successful. A successful claim against us could materially adversely affect our business, financial condition and results of operations. If NetSol cannot protect its proprietary information, others could copy our software and compete with us in providing both software and services.

**We May Not Have The Right To Resell Or Reuse Software Developed For Specific Clients.**

A portion of our business involves the development of software for specific client engagements. Ownership of these solutions is the subject of negotiation and is frequently assigned to the client, although we may retain a license for certain uses. Some clients have prohibited us from marketing the software developed for them for specified periods of time or to specified third parties. There can be no assurance that our clients will not demand similar or other restrictions in the future. Issues relating to the ownership of and rights to use our software solutions can be complicated and there can be no assurance that potential disputes will not affect our ability to resell or reuse these software solutions. While we have not incurred such expense in the past, limitations on our ability to resell or reuse software solutions could require us to incur additional expenses to develop new solutions for future projects.

**International Expansion Of Our Business Could Result In Financial Losses Due To Changes In Foreign Political And Economic Conditions Or Fluctuations In Currency And Exchange Rates.**

We expect to continue to expand our international operations. As well as the two offices in the United States, we currently have offices in Pakistan, China, the UK and Australia. As of June 30, 2006 approximately 95% of our revenue is generated by non-U.S. sources. Our international operations are subject to other inherent risks, including:

- political uncertainty in Pakistan and the Southeast Asian Region, particularly in light of the United States' war on terrorism and the Iraq war;
- recession in foreign countries;
- fluctuations in currency exchange rates, particularly any continued weakness of the U.S. dollar and the effect this may have on U.S. off-shore technology spending;

- difficulties and costs of staffing and managing foreign operations;
- reduced protection for intellectual property in some countries;

- political instability or changes in regulatory requirements or the potential overthrowing of the current government in certain foreign countries;
- U.S. imposed restrictions on the import and export of technologies; and,
- U.S. imposed restrictions on the issuances of business and travel visas to foreign workers primarily those from Middle Eastern or East Asian countries.

**We Are Controlled By and Are Dependent On Our Key Personnel.**

Our management is currently controlled and operated by various members of the Ghauri family. Our success will depend in large part upon the continued services of those individuals including Messrs. Salim Ghauri, Najeeb Ghauri and Naeem Ghauri. The death or loss of the services of any one of them or of any one or more of our other key personnel could have a material adverse effect on our business, financial condition and results of operations. We do not have key man life insurance on these individuals. In addition, if one or more of our key employees resigns to join a competitor or to form a competing company, the loss of such personnel and any resulting loss of existing or potential clients to any such competitor could have a material adverse effect on our business, financial condition and results of operations. In the event of the loss of any key personnel, there can be no assurance that we will be able to prevent the unauthorized disclosure or use of our technical knowledge, practices or procedures by such personnel. We entered into employment agreements with Messrs. Salim, Najeeb and Naeem Ghauri effective January 1, 2004, for a period of three (3) years. Messrs. Salim, Najeeb and Naeem Ghauri have non-competition and anti-raid clauses in their employment agreements with us.

**Certain Of Our Management Team Have Relationships Which May Potentially Result In Conflicts Of Interests.**

In fiscal year 2002, certain of our management team loaned approximately \$141,893 to our Pakistani subsidiary company for operating costs. This loan accrued interest at the rate of 18% per annum and was to be repaid at such time as the Company could afford to repay the loan or through other methods that did not require a cash outlay by the Company, such as the exercise of options by the management team. Also, since 2002 our management team has, in the interest of improving the cash flow of the Company, elected to take only a portion of their salaries, deferring the remainder. In November 2003, the management team exercised options totaling \$200,973 the consideration of which was offset against funds due to the Company as repayment of the loan and as due but deferred compensation. In March 2004, the management team exercised options totaling \$75,000 of which all but \$24,512 was paid for with due but deferred compensation. The remaining \$24,511 was paid through the officers' normal salary deferral by the end of August 2004. In December 2004, the officers exercised options to acquire shares for which the officers mistakenly believed sufficient deferred compensation existed to pay for these exercises. When it was discovered that there was not sufficient deferred compensation, the shares were cancelled by the agreement of the Company and the officers. While these transactions were approved by the Board of Directors, which believes such transactions to be fair in their terms, and such transactions have not resulted in the management team choosing personal gain over Company gain, such transactions may have constituted a potential conflict of interest between our management members' personal interest and the interest of the Company in that management could be motivated to repay debts owed to the management team rather than using that money for the Company's growth. This, however, did not occur. Nevertheless, the errors related to the March 2004 and December 2004 transactions may constitute violations of Section 13(k)(1) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act") by the Company and/or the named officers. A possible violation of Section 13(k)(1) of the Exchange Act may result in an investigation by the SEC which may have a materially adverse effect on the Company. Violations of Section 13(k) (1) of the Exchange Act may expose the Company and the named officers to possible civil and criminal penalties.

**Certain Option Exercises May Result in a Violation of Section 13(k)(1)**

Officers of the Company have routinely either loaned funds to or deferred the receipt of consideration due to them at such times as the Company was in need of cash. These officers have frequently used these funds due to them to exercise options to acquire common stock of the Company. In March 2004, Najeeb and Naeem Ghauri exercised options to acquire shares of common stock of the Company. At the time of the exercise, they mistakenly believed that sufficient funds were due to them from the Company and compensation deferral to pay for these options. However, there was a deficit between the amount of funds due to the officers from the Company and the exercise price of the options. This deficit was repaid through the normal salary deferral to the Company by the end of May, in the case of Mr. Naeem Ghauri and, the end of August 2004, in the case of Mr. Najeeb Ghauri. In December 2004, certain officers exercised options against salary deferrals due to them. Upon discovering that sufficient liabilities were not available to offset the monies due for the exercise, these shares were immediately cancelled by the Company. Section 13(k)(1) of the Exchange Act prohibits companies from making loans to officers. The SEC may view the difference between the exercise price due and the amounts credited as a prohibited loan to these officers. The errors related to the March 2004 and December 2004 transactions may constitute violations of Section 13(k)(1) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act") by the Company and/or the named officers. A possible violation of Section 13(k)(1) of the Exchange Act may result in an investigation by the SEC which may have a materially adverse effect on the Company. Violations of Section 13(k)(1) of the Exchange Act may expose the Company and the named officers to possible civil and criminal penalties.

### **We Face Significant Competition In Markets That Are New And Rapidly Changing.**

The markets for the services we provide are highly competitive. We principally compete with strategy consulting firms, Internet professional services firms, systems integration firms, software developers, technology vendors and internal information systems groups. Many of the companies that provide services in the markets we have targeted have significantly greater financial, technical and marketing resources than we do, have greater name recognition and generate greater revenues. Potential customers may also have in house employees that can compete with or replace us. In addition, there are relatively low barriers to entry into these markets and we expect to continue to face competition from new entrants into these same markets. We believe that the principal competitive factors in these markets include:

- our ability to integrate strategy, experience modeling, creative design and technology services;
- quality of service, speed of delivery and price;
- industry knowledge;
- sophisticated project and program management capability; and,
- Internet technology expertise and talent.

We believe that our ability to compete also depends on a number of competitive factors outside our control, including:

- ability of our competitors to hire, retain and motivate professional staff;
- development by others of Internet services or software that is competitive with our solutions; and
- extent of our competitors' responsiveness to client needs.

There can be no assurance that we will be able to compete successfully in these markets.

### **RISKS RELATED TO INVESTING IN THIS OFFERING**

#### **Questions Raised About the Availability of an Exemption for a Private Placement of Interest Shares to Investors in the Private Placement of Our Convertible Notes May Give Rise to a Right to Rescission and We Could Be Liable For Up To The Amount Of The Purchase Price Of The Interest Shares."**

We have issued 230,863 shares of our common stock in lieu of cash interest payments to the holders of our convertible notes. The interest payments occurred after the filing of this registration statement and in lieu of receiving cash interest payments, the investors agreed to receive shares of our common stock. The issuance of these shares of common stock was made to 1 Qualified Institutional Buyer and 4 accredited investors and in reliance on an exemption from registration under Rule 506 of Regulation D of the Securities Act. A question regarding the availability of an exemption for the offering of the interest shares was raised when we added the interest shares in a pre-effective amendment to a pre-existing registration statement. The addition of the Interest Shares into a pre-effective amendment of a pre-existing registration statement may result in a loss of the availability of exemption from registration and thus a violation of Section 5 of the Securities Act. If Section 5 of the Securities Act was found to be violated, the recipients of such interest shares could have a right to rescind their purchases for a period of one year. Rescinding purchasers could seek to recover the purchase price paid, with interest, or if they no longer own the securities, to receive damages. As a result, the possibility exists that the exemption relied upon by us could be deemed to be not available and the consideration received by us in connection therewith, the interest amounts, may have to be

repaid. In such an event, we could be adversely affected and we may have an obligation to fund this rescission.”

**Our Stock Price Has Historically Been Volatile; Our Stock Price After This Offering Will Be Subject To Market Factors.**

The trading price of our common stock has historically been volatile. The future trading price of our common stock could be subject to wide fluctuations in response to:

- quarterly variations in operating results and achievement of key business metrics;
  - changes in earnings estimates by securities analysts, if any;
- any differences between reported results and securities analysts’ published or unpublished expectations;
  - announcements of new contracts or service offerings by NetSol or competitors;

- market reaction to any acquisitions, joint ventures or strategic investments announced by NetSol or competitors;
- demand for our services and products;
- changes of shares being sold pursuant to Rule 144 or upon exercise of the warrants; and,
- general economic or stock market conditions unrelated to NetSol's operating performance.

**Potential Future Sales Pursuant To Rule 144 May Have A Depressive Effect On The Trading Price Of Our Securities.**

Certain shares of common stock presently held by officers, directors and certain other stockholders are "restricted securities" as that term is defined in Rule 144, promulgated under the Act. Under Rule 144, a person (or persons whose shares are aggregated) who has satisfied a one year holding period, may, under certain circumstances sell within any three month period a number of shares which does not exceed the greater of 1% of the then outstanding shares of common stock, or the average weekly trading volume during the four calendar weeks prior to such sale. Rule 144 also permits, under certain circumstances, including a two-year holding period, the sale of shares by a person without any quantity limitation. Such holding periods have already been satisfied in many instances. Therefore, actual sales or the prospect of sales of such shares under Rule 144 in the future may depress the prices of our common stock.

**Provisions of Our Bylaws Hinder Change in Control.**

Our bylaws contain provisions that prevent actions being taken by shareholders by written consent. Shareholders actions may only be taken at special meetings called in accordance with our bylaws. Our bylaws limit the manner and timing of calling such meetings by shareholders. These provisions may effectively prevent shareholders from changing board composition and or management in a swift manner.

**USE OF PROCEEDS**

We will not receive any of the proceeds from the offering of common stock for sale by the selling stockholders. Proceeds received by us as a result of the exercise of the warrants by the selling stockholders will be used for working capital purposes.



**SELLING STOCKHOLDERS**

The following table and notes set forth the name of each selling stockholder, the nature of any position, office, or other material relationship, if any, which the selling stockholder has had, within the past three years, with NetSol or with any of our predecessors or affiliates, the amount of shares of NetSol common stock that are beneficially owned by such stockholder, the amount to be offered for the stockholder's account and the amount to be owned by such selling stockholder upon completion of the offering.

<b>Name of Selling Stockholder(1)(2)</b>	<b>Number of Shares of NetSol Common Stock Beneficially Owned Prior to the Offering(1)</b>	<b>Number of Shares of NetSol Common Stock Being Offered Hereby (3)</b>	<b>Number of Shares of NetSol Common Stock to be Beneficially Owned Upon Completion of the Offering(1)(2)</b>
The Tail Wind Fund Ltd.(4)	1,926,376	3,333,335	0
Solomon Strategic Holdings, Inc.(5)	227,273	303,525	0
Crestview Capital Master, LLC(6)	880,605	1,818,183	0
Whalehaven Capital Fund Limited(7)	454,545	606,060	0
Bristol Investment Fund, Ltd.(8)	454,545	606,060	0
Maxim Partners LLC(9)	446,718	266,666	0
<b>TOTAL</b>	<b>4,223,547</b>	<b>6,933,334</b>	<b>0</b>

- (1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to such securities.
- (2) None of the Selling Stockholders has held an employment, officer or director position with NetSol within the past three years. Assuming that all shares being registered hereby will be sold, all convertible notes will be converted and all warrants will be exercised, no selling stockholder will hold a percentage interest in the shares of NetSol in excess of 1 percent at the completion of the offering.
- (3) The IRA requires the Company to register 150% of such number of shares of common stock into which the Preferred Stock is convertible and 100% of the shares of common stock issuable upon exercise of the warrants. Accordingly, the number being registered hereby is in excess of the number held by each Selling Stockholder.
- (4) Tail Wind Advisory & Management Ltd., a UK corporation authorized and regulated by the Financial Services Authority of Great Britain ("TWAM"), is the investment manager for The Tail Wind Fund Ltd. ("Tail Wind"), and David Crook is the CEO and controlling shareholder of TWAM. Therefore, TWAM and Mr. Crook may be deemed to have voting and/or investment control over the shares of common stock owned by Tail Wind. Each of TWAM and Mr. Crook expressly disclaims any equitable or beneficial ownership of the shares being referred to hereunder and held by Tail Wind. Tail Wind is not affiliated with a broker-dealer and, acquired the securities in the ordinary course of business. At the time of the acquisition, Tail Wind had no agreements, arrangements or understandings with any other person, either directly or indirectly, to dispose of the securities. The shares of common stock consist of 1,666,667 shares underlying the Preferred Stock and 833,334 shares of common stock underlying the Warrants and 115,431 issuable in lieu of cash interest due under the Convertible Notes. Subject to the Ownership Limitation (defined below), Tail Wind would own a total of 2,615,432 shares of Common Stock, including 1,666,667 shares of Common Stock issuable upon conversion of 2,750 Preferred Stock, and 833,334

shares of Common Stock issuable upon exercise of Warrants issued to Tail Wind on such date and shares issuable as interest payments due under the Convertible Notes. In accordance with Rule 13d-4 under the Securities Exchange Act of 1934, as amended, because the number of shares of Common Stock into which Tail Wind's Preferred Stock and Warrants are convertible and exercisable is limited, pursuant to the terms of such instruments, to that number of shares of Common Stock which would result in Tail Wind having beneficial ownership of 9.9% of the total issued and outstanding shares of Common Stock (the "Ownership Limitation"), Tail Wind disclaims beneficial ownership of any and all shares of Common Stock that would cause Tail Wind's beneficial ownership to exceed the Ownership Limitation.

- (5) Andrew P. Mackeller has been authorized by the Board of Directors of Solomon Strategic Holdings, Inc. (“SSH”) to make voting and disposition decisions with respect to the shares on behalf of SSH. By reason of such delegated authority, Mr. Mackeller may be deemed to have voting and/or investment control over the shares of common stock owned by SSH. Mr. Mackeller expressly disclaims any equitable or beneficial ownership of the shares being registered hereunder and held by SSH, and he does not have any legal right to maintain such delegated authority. a corporation with a principal address in the Isle of Man. SSH is not affiliated with a broker-dealer and, acquired the securities in the ordinary course of business. At the time of the acquisition, SSH had no agreements, arrangements or understandings with any other person, either directly or indirectly, to dispose of the securities. The shares of common stock consist of 151,515 shares of common stock underlying the Preferred Stock; 75,758 shares of common stock underlying the Warrants; and 10,494 as payment of interest due under the Convertible Note.
- (6) Crestview Capital Master, LLC (“Crestview”) is a limited liability company whose sole manager is Crestview Capital Partners, LLC. Mr. Robert Hoyt is the Manager of Crestview Capital Partners. Mr. Stewart R. Flink and Mr. Daniel Warsh, as managers of Crestview Capital Partners, have voting and/or investment control over the Securities being registered for the account of Crestview Capital Master, LLC. Messrs. Flink and Warsh disclaim beneficial ownership of such shares. Stewart Flink, a manager of Crestview Capital Partners, is the controlling shareholder of Dillon Capital, Inc., a broker-dealer, registered under the NASD. All securities to be resold were acquired in the ordinary course of business. At the time of acquisition, Crestview had no agreements, understandings or arrangements with any other persons, either directly or indirectly, to dispose of the securities. The shares of common stock consist of 909,088 shares of common stock underlying the Preferred Stock; 454,546 shares of common stock underlying the Warrants; and, 62,962 as payment of interest due under the Convertible Note. In accordance with Rule 13d-4 under the Securities Exchange Act of 1934, as amended, because the number of shares of Common Stock into which Crestview’s Preferred Stock and Warrants are convertible and exercisable is limited, pursuant to the terms of such instruments, to that number of shares of Common Stock which would result in Crestview having beneficial ownership of 4.99% of the total issued and outstanding shares of Common Stock (the "Ownership Limitation"), Crestview disclaims beneficial ownership of any and all shares of Common Stock that would cause Crestview to exceed the 4.99% Ownership Limitation.
- (7) Arthur Jones, Trevor Williams and Derek Wood, directors; Michael Finkelstein, investment manager; and, Evan Schemenauer, Chief Financial Officer hold the right to disburse and vote shares held by Whalehaven Capital Fund Limited. Whalehaven Capital Fund is not affiliated with a broker-dealer and, acquired the securities in the ordinary course of business. At the time of the acquisition, Whalehaven Capital Fund had no agreements, arrangements or understandings with any other person, either directly or indirectly, to dispose of the securities. The shares of common stock consist of 303,031 of common stock underlying the Preferred Stock; 151,515 shares of common stock underlying the Warrants; and, 20,988 as payment of interest due under the Convertible Note.
- Bristol Capital Advisors, LLC (“BCA”) is the investment advisor to Bristol Investment Fund, Ltd. (“Bristol”). Paul Kessler is the manager of BCA and as such has voting and investment control over the securities held by Bristol. Mr. Kessler disclaims beneficial ownership of these securities. Bristol is not affiliated with a broker-dealer and, acquired the securities in the ordinary course of business. At the time of the acquisition, Bristol had no agreements, arrangements or understandings with any person, either directly or indirectly, to dispose of the securities. The shares of common stock consist of 303,031 shares of common stock underlying the Preferred Stock; 151,515 shares of common stock underlying the Warrants; and, 20,988 as payment of interest due under the Convertible Note.
- Maxim Partners LLC owns 98% of Maxim Group LLC, a registered broker dealer. MJR Holdings LLC owns
- (9) 72% of Maxim Partners LLC. Mike Rabinowitz is the principal manager of MJR Holdings and has principal voting and dispositive power with respect to the securities owned by Maxim Partners LLC. The number of shares

beneficially owned include: 266,666 warrants to acquire common stock which are being registered hereby and 180,052 shares as compensation for services provided to NetSol. Pursuant to the placement agent agreements by and between NetSol and Maxim Group LLC, Maxim Partners LLC, as nominee of Maxim Group LLC, received, as part of the compensation for their services, warrants to purchase up to 266,666 shares of our common stock at an exercise price of \$1.65 per share. These warrants may be exercised until June 20, 2008. Maxim Partners LLC acquired the securities being registered hereby to be resold in the ordinary course of business and, at the time of acquiring the securities, Maxim Partners, LLC had no agreements, understandings or arrangements with any other persons, either directly or indirectly, to dispose of the securities. In connection with its services as our placement agent, Maxim Group LLC also received cash compensation and expenses. In addition, Maxim Group LLC also received cash compensation from us for M&A advisory services provided to us in connection with our acquisition of McCue Systems, Inc. Such warrants contain customary anti-dilution protection for stock splits, dividends and recapitalization consistent with the National Association of Securities Dealers, Inc. Rules of Fair Practice. We have also granted Maxim Group LLC a right of first refusal to act as lead underwriter or placement agent or advisor for public and private equity and debt offerings and financial advisory services.

## PLAN OF DISTRIBUTION

We are registering the shares of common stock on behalf of the selling security holders. Sales of shares may be made by selling security holders, including their respective donees, transferees, pledgees or other successors-in-interest directly to purchasers or to or through underwriters, broker-dealers or through agents. Sales may be made from time to time on the Nasdaq Capital Market, any other exchange or market upon which our shares may trade in the future, in the over-the-counter market or otherwise, at market prices prevailing at the time of sale, at prices related to market prices, or at negotiated or fixed prices. The shares may be sold by one or more of, or a combination of, the following:

- a block trade in which the broker-dealer so engaged will attempt to sell the shares as agent but may position and resell a portion of the block as principal to facilitate the transaction (including crosses in which the same broker acts as agent for both sides of the transaction);
- purchases by a broker-dealer as principal and resale by such broker-dealer, including resales for its account, pursuant to this prospectus;
- ordinary brokerage transactions and transactions in which the broker solicits purchases;
- through options, swaps or derivatives;
- in privately negotiated transactions;
- in making short sales entered into after the date of this prospectus or in transactions to cover such short sales; and
- put or call option transactions relating to the shares.

The selling security holders may effect these transactions by selling shares directly to purchasers or to or through broker-dealers, which may act as agents or principals. These broker-dealers may receive compensation in the form of discounts, concessions or commissions from the selling security holders and/or the purchasers of shares for whom such broker-dealers may act as agents or to whom they sell as principals, or both (which compensation as to a particular broker-dealer might be in excess of customary commissions). The selling security holders have advised us that they have not entered into any agreements, understandings or arrangements with any underwriters or broker-dealers regarding the sale of their securities.

The selling security holders may enter into hedging transactions with broker-dealers or other financial institutions. In connection with those transactions, the broker-dealers or other financial institutions may engage in short sales of the shares or of securities convertible into or exchangeable for the shares in the course of hedging positions they assume with the selling security holders. The selling security holders may also enter into options or other transactions with broker-dealers or other financial institutions which require the delivery of shares offered by this prospectus to those broker-dealers or other financial institutions. The broker-dealer or other financial institution may then resell the shares pursuant to this prospectus (as amended or supplemented, if required by applicable law, to reflect those transactions).

The selling security holders and any broker-dealers that act in connection with the sale of shares may be deemed to be “underwriters” within the meaning of Section 2(11) of the Securities Act of 1933, and any commissions received by broker-dealers or any profit on the resale of the shares sold by them while acting as principals may be deemed to be underwriting discounts or commissions under the Securities Act. The selling security holders may agree to indemnify any agent, dealer or broker-dealer that participates in transactions involving sales of the shares against liabilities, including liabilities arising under the Securities Act. We have agreed to indemnify each of the selling security holders and each selling security holder has agreed, severally and not jointly, to indemnify us against some liabilities in connection with the offering of the shares, including liabilities arising under the Securities Act.



The selling security holders will be subject to the prospectus delivery requirements of the Securities Act. We have informed the selling security holders that the anti-manipulative provisions of Regulation M promulgated under the Securities Exchange Act of 1934 may apply to their sales in the market. The selling security holders must conduct their sales in accordance with all rules promulgated under the Securities Exchange Act of 1934, included those provided in Regulation M.

Selling security holders also may resell all or a portion of the shares in open market transactions in reliance upon Rule 144 under the Securities Act, provided they meet the criteria and conform to the requirements of Rule 144.

Upon being notified by a selling security holder that a material arrangement has been entered into with a broker-dealer for the sale of shares through a block trade, special offering, exchange distribution or secondary distribution or a purchase by a broker or dealer, we will file a supplement to this prospectus, if required pursuant to Rule 424(b) under the Securities Act, disclosing:

- the name of each such selling security holder and of the participating broker-dealer(s);
- the number of shares involved;
- the initial price at which the shares were sold;
- the commissions paid or discounts or concessions allowed to the broker-dealer(s), where applicable;
- that such broker-dealer(s) did not conduct any investigation to verify the information set out or incorporated by reference in this prospectus; and
- other facts material to the transactions.

In addition, if required under applicable law or the rules or regulations of the Commission, we will file a supplement to this prospectus when a selling security holder notifies us that a donee or pledgee intends to sell more than 500 shares of common stock.

We are paying all expenses and fees in connection with the registration of the shares. The selling security holders will bear all brokerage or underwriting discounts or commissions paid to broker-dealers in connection with the sale of the shares.

Pursuant to a requirement by the National Association of Securities Dealers, Inc., or NASD, the maximum commission or discount to be received by any NASD member or independent broker/dealer may not be greater than 8.0% of the gross proceeds received by us for the sale of any securities being registered pursuant to SEC Rule 415.

The 266,666 warrants issued to Maxim Partners, LLC are exercisable at \$1.65 per share and have been deemed compensation by the NASD and are therefore subject to a 180-day lock-up from the date of this prospectus pursuant to Rule 2710(g)(1) of the NASD Conduct Rules. Additionally, the warrants may not be sold, transferred, assigned, pledged or hypothecated, or be the subject of any hedging, short sale, derivative, put or call transaction that would result in the effective economic disposition of such securities, for a period of 180 days following the date of this prospectus. However, the warrants may be transferred to any underwriter and selected dealer participating in the offering and their bona fide officers or partners. Thereafter, the warrants will be transferable provided such transfer is in accordance with the provisions of the Securities Act. We have also granted Maxim Group LLC a right of first refusal to act as legal underwriter or placement agent or advisor for public and private equity and debt offerings and financial advisory services.

**LEGAL PROCEEDINGS**

To the best knowledge of Company's management and counsel, there is no material litigation pending or threatened against the Company.

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## DESCRIPTION OF SECURITIES

The Selling Stockholders are offering for sale shares of our common stock, par value \$0.001 per share. We only have one class of common stock. Our capital stock consists of 45,000,000 shares of common stock, par value \$.001 per share and 5,000,000 shares of preferred stock, \$.001 par value. Our board of directors has designated the rights and privileges of 7% Series A Cumulative Convertible Preferred Stock (the "Preferred Stock"). As of the October 30, 2006, there are 5,500 shares of Preferred Stock issued and outstanding. No other shares of preferred stock have been issued. The terms and rights of the preferred shares may be set by the board of directors at their discretion. Each share of common stock is entitled to one vote at annual or special stockholders meetings. There are no pre-emption rights. We have never declared or paid any dividends on our common stock or other securities and we do not intend to pay any cash dividends with respect to our common stock in the foreseeable future. For the foreseeable future, we intend to retain any earnings for use in the operation of our business and to fund future growth. The terms of the warrant agreements between the selling stockholders and NetSol contain anti-dilution protections.

The Preferred Stock is convertible into shares of common stock at such time and at such value as is set forth in the Certificate of Designation. The initial conversion value shall be \$1.65. The conversion value is subject to adjustment as set forth in the Certificate of Designation. The holders of the Preferred Stock are entitled to receive cumulative dividends at the rate of 7% per annum from the date of issuance of each share until paid. The dividends may be paid, at the Company's option, in cash or in shares of common stock in arrears on the first business day of each calendar quarter of each year. The Company may force a conversion of the Preferred Stock in the event that the market price of the Company's common stock is greater than 200% of the conversion value. If any shares of the Preferred Stock remain outstanding on June 15, 2009, the Company shall redeem such shares for an amount in cash equal to the liquidation preference plus all accrued but unpaid dividends. Anti-dilution protection is afforded to the holders by providing for an adjustment of the conversion price in certain circumstances as is set forth in the Certificate of Designation. The conversion price is adjusted for dividends subdivisions, combinations, distributions and issuances of shares, or securities convertible into shares, of common stock of the Company issued at an effective per share selling price which is the less than the greater of the fair market price or the conversion value as of the issuance date. The Preferred Stock bears voting rights in an amount equal to the conversion value of the Preferred Stock into common stock, without giving effect to any anti-dilution provisions of the Preferred Stock. Conversion and voting of the Preferred Stock is subject to beneficial ownership caps of from 4.9% to 9.9% of the total number of shares of common stock of the Company then issued and outstanding.

## EXPERTS

The audited financial statements for our company incorporated by reference in this prospectus and in the registration statement of which it forms a part have been audited by Kabani & Company, Inc., independent registered public accounting firm, to the extent and for the periods set forth in their reports incorporated herein and are incorporated herein in reliance upon such reports given upon the authority of said firm as experts in auditing and accounting.

The audited financial statements for our company as of the fiscal year ended June 30, 2005 is also reliant on the reports of Saeed Kamran Patel & Co., Chartered accountants, as stated in their reports therein, upon the authority of that firm as experts in auditing and accounting.

Patti L. W. McGlasson, Esq., General Counsel for our Company, has passed on the validity of the securities being offered hereby.

Kabani & Company, Inc. was not hired on a contingent basis, nor will it receive a direct or indirect interest in the business of the issuer. Neither Kabani & Company, Inc. nor its principals are, or will be, a promoter, underwriter, voting trustee, director, officer or employee of NetSol. Saeed Kamran Patel & Co, was not hired on a contingent basis, nor will it receive a director or indirect interest in the business of the issuer. Neither Saeed Kamran Patel & Co, nor its

principals are, or will be, a promoter, underwriter, voting trustee, director, or officer or employee of NetSol. Ms. McGlasson is an employee of NetSol. She has received, as part of her compensation with NetSol, options to purchase and grants of shares of common stock.

**DISCLOSURE OF COMMISSION POSITION OF  
INDEMNIFICATION FOR SECURITIES ACT LIABILITIES**

We have indemnified each member of the board of directors and our executive officers to the fullest extent authorized, permitted or allowed by law. Insofar as indemnification for liabilities arising under the Securities Act of 1933 (the "Act") may be permitted to directors, officers and controlling persons of the small business issuer pursuant to the foregoing provisions, or otherwise, the small business issuer has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable.

For the purpose of determining any liability under the Act, each post-effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

**WHERE YOU CAN FIND MORE INFORMATION**

We are subject to the information requirements of the Securities Exchange Act of 1934 and we file reports and other information with the SEC.

You may read and copy any of the reports, statements, or other information we filed with the SEC at the SEC's Public Reference Section at 100 F Street, N.E., Washington D.C. 20549 at prescribed rates. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains a website at <http://www.sec.gov> that contains reports, proxy statements and other information regarding issuers that file electronically with the SEC. The Nasdaq Stock Market maintains a website at <http://www.nasdaq.com> that contains reports, proxy statements and other information filed by us.

## INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

We have filed with the SEC, Washington D.C., a registration statement on Form S-3 under the Securities Act, covering the securities offered by this prospectus. This prospectus does not contain all of the information that you can find in our registration statement and the exhibits to the registration statement. Statements contained in this prospectus as to the contents of any contract or other document referred to are not necessarily complete and in each instance such statement is qualified by reference to each such contract or document filed or incorporated by reference as an exhibit to the registration statement.

The SEC allows us to “incorporate by reference” the information we file with them. This means that we can disclose important information to you by referring to other documents that are legally considered to be part of this prospectus, and later information that we file with the SEC will automatically update and supersede the information in this prospectus and the documents listed below. We incorporate by reference the documents listed below, and any future filings made with the SEC under Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 until the selling stockholders sell all the offered shares:

\* Our Quarterly Report on Form 10-QSB for the quarter ended September 30, 2006.

\* Our Definitive Proxy Statement filed with the SEC on September 18, 2006.

\* Our Annual Report on Form 10-KSB for the year ended June 30, 2006 filed with the SEC on September 27, 2006.

\* Our Current Report on Form 8-K filed with the SEC on January 3, 2007.

\* Our Current Report on Form 8-K filed with the SEC on July 5, 2006.

\* Our Current Report on Form 8-K filed with the SEC on July 24, 2006.

\* Our Current Report on Form 8-K filed with the SEC on September 11, 2006.

\* Our Current Report on Form 8-K filed with the SEC on September 25, 2006.

\* Our Current Report on Form 8-K filed with the SEC on October 6, 2006.

We will provide to each person at no cost, including any beneficial owner, to whom a prospectus is delivered, a copy of any or all of the information that has been incorporated by reference in the prospectus but not delivered with the prospectus upon the written or oral request to NetSol Technologies, Inc. attention: General Counsel, 23901 Calabasas Road, Suite 2072, Calabasas, California 91302; (818) 222-9195.

## **PART II**

### **INFORMATION NOT REQUIRED IN PROSPECTUS**

#### **Indemnification of Directors and Officers**

We are required by our Bylaws and Certificate of Incorporation to indemnify, to the fullest extent permitted by law, each person that we are permitted to indemnify. Our Bylaws it to indemnify such parties to the fullest extent permitted by Nevada law.

Nevada corporation law permits us to indemnify our directors, officers, employees, or agents against expenses, including attorneys fees, judgments, fines and amounts paid in settlements actually and reasonably incurred in relation to any action, suit, or proceeding brought by third parties because they are or were directors, officers, employees, or agents of the corporation. In order to be eligible for such indemnification, however, our directors, officers, employees, or agents must have acted in good faith and in a manner they r

Other nonearning assets

54,220

0

50,597

0

Less allowance for loan losses

(15,045

)

0

(13,692

)

0



Total assets

\$

1,839,041

\$

119,077

\$

1,698,471

\$

106,681

- (1) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2007 and 2006. The tax equivalent rate for tax exempt
- (2) Loan fees, which are immaterial in relation to total taxable loan interest income for the years ended December 31, 2007 and 2006, are included as taxable
- (3) Nonaccrual loans are included in the average balance of taxable loans.

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## DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY;

## INTEREST RATES AND INTEREST DIFFERENTIAL (Cont.)

(in thousands of dollars)

	Average Balance	2006 Interest Income	Yield (1)		Average Balance	2005 Interest Income	Yield (1)	
<b>ASSETS</b>								
Earning assets:								
Loans:								
Taxable (2)(3)	\$ 1,264,490	\$ 91,946	7.27	%	\$ 1,084,353	\$ 68,417	6.31	%
Tax exempt (1)	5,995	328	5.47		4,435	235	5.30	
Investments: (1)								
Available for sale	293,931	13,609	4.63		286,864	12,806	4.46	
Short—term investments	12,896	647	5.02		6,252	206	3.29	
Interest bearing deposits	3,269	151	4.62		4,027	127	3.15	
Total earning assets	1,580,581	106,681	6.75	%	1,385,931	81,791	5.90	%
Nonearning assets:								
Cash and due from banks	56,235	0			55,234	0		
Premises and equipment	24,750	0			24,977	0		
Other nonearning assets	50,597	0			44,681	0		
Less allowance for loan losses	(13,692 )	0			(11,668 )	0		
Total assets	\$ 1,698,471	\$ 106,681			\$ 1,499,155	\$ 81,791		

(1) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2006 and 2005. The tax equivalent rate for tax exempt

(2) Loan fees, which are immaterial in relation to total taxable loan interest income for the years ended December 31, 2006 and 2005, are included as taxable

(3) Nonaccrual loans are included in the average balance of taxable loans.



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## DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY;

## INTEREST RATES AND INTEREST DIFFERENTIAL (Cont.)

(in thousands of dollars)

	Average Balance	2007 Interest Expense	Yield		Average Balance	2006 Interest Expense	Yield
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>							
Interest bearing liabilities:							
Savings deposits	\$ 67,104	\$ 133	0.20	%	\$ 67,818	\$ 143	0.21 %
Interest bearing checking accounts	425,753	14,854	3.49		405,209	12,789	3.16
Time deposits:							
In denominations under \$100,000	295,328	14,289	4.84		264,087	10,787	4.08
In denominations over \$100,000	462,056	24,338	5.27		430,378	21,382	4.97
Miscellaneous short—term borrowings	177,343	7,239	4.08		144,637	5,594	3.87
Long—term borrowings and subordinated debentures (1)	30,972	2,628	8.49		30,973	2,529	8.17
Total interest bearing liabilities	1,458,556	63,481	4.35	%	1,343,102	53,224	3.96 %
Noninterest bearing liabilities and stockholders' equity:							
Demand deposits	226,484	0			219,997	0	
Other liabilities	16,234	0			13,418	0	
Stockholders' equity	137,767	0			121,954	0	
Total liabilities and stockholders' equity	\$ 1,839,041	\$ 63,481			\$ 1,698,471	\$ 53,224	
Net interest differential — yield on average daily earning assets							
		\$ 55,596	3.22	%		\$ 53,457	3.38 %

(1) Long-term borrowings and subordinated debentures interest expense was reduced by interest capitalized on construction in process for 2007.



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## DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY;

## INTEREST RATES AND INTEREST DIFFERENTIAL (Cont.)

(in thousands of dollars)

	Average Balance	2006 Interest Expense	Yield		Average Balance	2005 Interest Expense	Yield	
LIABILITIES AND STOCKHOLDERS' EQUITY								
Interest bearing liabilities:								
Savings deposits	\$ 67,818	\$ 143	0.21	%	\$ 70,875	\$ 95	0.13	%
Interest bearing checking accounts	405,209	12,789	3.16		342,438	5,622	1.64	
Time deposits:								
In denominations under \$100,000	264,087	10,787	4.08		228,689	7,236	3.16	
In denominations over \$100,000	430,378	21,382	4.97		319,697	11,378	3.56	
Miscellaneous short—term borrowings	144,637	5,594	3.87		154,949	3,790	2.45	
Long—term borrowings and subordinated debentures	30,973	2,529	8.17		40,891	2,232	5.46	
Total interest bearing liabilities	1,343,102	53,224	3.96	%	1,157,539	30,353	2.62	%
Noninterest bearing liabilities and stockholders' equity:								
Demand deposits	219,997	0			222,971	0		
Other liabilities	13,418	0			10,427	0		
Stockholders' equity	121,954	0			108,218	0		
Total liabilities and stockholders' equity	\$ 1,698,471	\$ 53,224			\$ 1,499,155	\$ 30,353		
Net interest differential — yield on average daily earning assets		\$ 53,457	3.38	%		\$ 51,438	3.71	%





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## ANALYSIS OF CHANGES IN INTEREST DIFFERENTIALS

(fully taxable equivalent basis)

(in thousands of dollars)

YEAR ENDED DECEMBER 31,

	2007 Over (Under) 2006 (1)			2006 Over (Under) 2005 (1)		
	Volume	Rate	Total	Volume	Rate	Total
<b>INTEREST AND LOAN FEE INCOME (2)</b>						
Loans:						
Taxable	\$ 10,045	\$ 849	\$ 10,894	\$ 12,269	\$ 11,260	\$ 23,529
Tax exempt	(211 )	49	(162 )	85	8	93
Investments:						
Available for sale	587	944	1,531	320	483	803
Short—term investments	224	(8 )	216	296	145	441
Interest bearing deposits	(82 )	(1 )	(83 )	(27 )	51	24
Total interest income	10,563	1,833	12,396	12,943	11,947	24,890
<b>INTEREST EXPENSE</b>						
Savings deposits	(1 )	(9 )	(10 )	(4 )	52	48
Interest bearing checking accounts	671	1,394	2,065	1,188	5,979	7,167
Time deposits:						
In denominations under \$100,000	1,368	2,134	3,502	1,233	2,318	3,551
In denominations over \$100,000	1,626	1,330	2,956	4,667	5,337	10,004
Miscellaneous short—term borrowings	1,321	324	1,645	(267 )	2,071	1,804
Long—term borrowings and subordinated debentures	0	99	99	(630 )	927	297
Total interest expense	4,985	5,272	10,257	6,187	16,684	22,871
<b>INCREASE (DECREASE) IN INTEREST DIFFERENTIALS</b>	<b>\$ 5,578</b>	<b>\$ (3,439 )</b>	<b>\$ 2,139</b>	<b>\$ 6,756</b>	<b>\$ (4,737 )</b>	<b>\$ 2,019</b>

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- (1) The earning assets and interest bearing liabilities used to calculate interest differentials are based on average daily balances for 2007, 2006 and 2005. The changes in volume represent "changes in volume times the old rate". The changes in rate represent "changes in rate times old volume". The changes in rate/volume were also calculated by "change in rate times change in volume" and allocated consistently based upon the relative absolute values of the changes in volume and changes in rate.
- (2) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2007, 2006 and 2005. The tax equivalent rate for tax exempt loans and tax exempt securities acquired after January 1, 1983 included the TEFRA adjustment applicable to nondeductible interest expense.

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## ANALYSIS OF SECURITIES

(in thousands of dollars)

The amortized cost and the fair value of securities as of December 31, 2007, 2006 and 2005 were as follows:

	2007		2006		2005	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:						
U.S. Treasury securities	\$ 1,201	\$ 1,206	\$ 1,002	\$ 965	\$ 1,002	\$ 966
U.S. Government agencies	18,539	18,555	31,249	30,525	31,285	30,484
Mortgage—backed securities	251,158	250,495	213,053	210,000	211,040	206,596
State and municipal securities	56,613	57,501	53,824	54,701	51,801	52,889
Total debt securities available for sale	\$ 327,511	\$ 327,757	\$ 299,128	\$ 296,191	\$ 295,128	\$ 290,935

At year-end 2007, there were no holdings of securities of any one issuer, other than the U.S. Government, government agencies and government sponsored agencies, in an amount greater than 10% of stockholders' equity with the exception of Residential Accredited Loans, Inc., which had a book value of \$22.6 million and a market value of \$22.3 million. These are all Alt A Whole Loan securities in the Super Senior tranches, which are the highest rated tranches with very high credit standards. In addition, the collateral of the Alt A Whole Loan Securities purchased must meet certain criteria set by the Company's Asset Liability Management Committee including maximum loan-to-value and minimum FICO scores. The Company does not feel there is any significant risk to holding these types of securities or with this issuer. At year-end 2006, there were no holdings of securities of any one issuer, other than the U.S. Government, government agencies and government sponsored agencies, in an amount greater than 10% of stockholders' equity.

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## ANALYSIS OF SECURITIES (cont.)

(fully tax equivalent basis)

(in thousands of dollars)

The weighted average yields (1) and maturity distribution (2) for debt securities portfolio at December 31, 2007, were as follows:

	Within One Year		After One Year Within Five Years		After Five Years Within Ten Years		Over Ten Years	
Securities available for sale:								
US Treasury securities								
Fair value	\$ 200		\$ 1,006		\$ 0		\$ 0	
Yield	5.50	%	3.38	%	0	%	0	%
Government agencies and corporations								
Fair value	2,999		15,556		0		0	
Yield	3.25	%	4.40	%	0	%	0	%
Mortgage—backed securities								
Fair value	210		9,933		92,659		147,693	
Yield	6.50	%	5.48	%	4.89	%	5.02	%
State and municipal securities								
Fair value	807		1,328		28,526		26,840	
Yield	6.50	%	4.36	%	4.66	%	4.58	%
Total debt securities available for sale:								
Fair value	\$ 4,216		\$ 27,823		\$ 121,185		\$ 174,533	
Yield	3.55	%	4.74	%	4.83	%	4.95	%

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## ANALYSIS OF LOAN PORTFOLIO

## Analysis of Loans Outstanding

(in thousands of dollars)

The Company segregates its loan portfolio into four basic segments: commercial (including agricultural loans), residential real estate mortgages, installment and personal line of credit loans (including credit card loans). The loan portfolio as of December 31, 2007, 2006, 2005, 2004 and 2003 was as follows:

	2007	2006	2005	2004	2003
Commercial loans:					
Taxable	\$ 1,238,623	\$ 1,081,420	\$ 960,046	\$ 784,591	\$ 667,672
Tax exempt	1,971	4,991	4,512	6,369	7,785
Total commercial loans	1,240,594	1,086,411	964,558	790,960	675,457
Residential real estate mortgage loans	124,107	109,176	74,820	54,361	44,172
Installment loans	49,185	52,548	67,964	53,138	58,722
Line of credit and credit card loans	109,760	105,762	91,426	104,927	92,653
Subtotal loans	1,523,646	1,353,897	1,198,768	1,003,386	871,004
Less: Allowance for loan losses	(15,801 )	(14,463 )	(12,774 )	(10,754 )	(10,234 )
Net deferred loan (fees)/costs	74	(60 )	(38 )	(167 )	(122 )
Net loans	\$ 1,507,919	\$ 1,339,374	\$ 1,185,956	\$ 992,465	\$ 860,648

The residential real estate mortgage loan portfolio included construction loans totaling \$5,252, \$8,636, \$7,987, \$6,719 and \$3,932 as of December 31, 2007, 2006, 2005, 2004 and 2003. The Bank generally sells conforming mortgage loans which it originates. These loans generally represent mortgage loans that are made to clients with long-term or substantial relationships with the Bank on terms consistent with secondary market requirements. The loan classifications are based on the nature of the loans as of the loan origination date. There were no foreign loans included in the loan portfolio for the periods presented.

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## ANALYSIS OF LOAN PORTFOLIO (cont.)

## Analysis of Loans Outstanding (cont.)

(in thousands of dollars)

Repricing opportunities of the loan portfolio occur either according to predetermined adjustable rate schedules included in the related loan agreements or upon maturity of each principal payment. The following table indicates the scheduled maturities of the loan portfolio as of December 31, 2007.

	Commercial	Residential Real Estate Mortgage	Installment	Line of Credit	Total	Percent	
Original maturity of one day	\$ 485,538	\$ 0	\$ 0	\$ 84,065	\$ 569,603	37.38	%
Other within one year	148,136	24,226	16,719	2,388	\$ 191,469	12.57	
After one year, within five years	526,978	25,927	30,434	20,459	\$ 603,798	39.63	
Over five years	72,920	73,936	2,032	2,848	\$ 151,736	9.96	
Nonaccrual loans	7,021	18	0	0	\$ 7,039	0.46	
Total loans	\$ 1,240,593	\$ 124,107	\$ 49,185	\$ 109,760	\$ 1,523,645	100.0	%

At maturity, credits are reviewed and, if renewed, are renewed at rates and conditions that prevail at the time of maturity.

Loans due after one year which have a predetermined interest rate and loans due after one year which have floating or adjustable interest rates as of December 31, 2007 amounted to \$533,869 and \$221,666.

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## ANALYSIS OF LOAN PORTFOLIO (cont.)

## Review of Nonperforming Loans

(in thousands of dollars)

The following is a summary of nonperforming loans as of December 31, 2007, 2006, 2005, 2004 and 2003.

	2007	2006	2005	2004	2003
<b>PART A — PAST DUE ACCRUING LOANS (90 DAYS OR MORE)</b>					
Residential real estate mortgage loans	\$ 155	\$ 0	\$ 89	\$ 117	\$ 160
Commercial and industrial loans	65	154	0	2,633	2,912
Loans to individuals for household, family and other personal expenditures	189	145	85	28	119
Loans to finance agriculture production and other loans to farmers	0	0	0	0	0
Total past due loans	409	299	174	2,778	3,191
<b>PART B — NONACCRUAL LOANS</b>					
Residential real estate mortgage loans	18	132	132	60	101
Commercial and industrial loans	7,021	13,688	7,189	7,152	452
Loans to individuals for household, family and other personal expenditures	0	0	0	0	0
Loans to finance agriculture production and other loans to farmers	0	0	0	0	0
Total nonaccrual loans	7,039	13,820	7,321	7,212	553
<b>PART C — TROUBLED DEBT RESTRUCTURED LOANS</b>					
Total nonperforming loans	\$ 7,448	\$ 14,119	\$ 7,495	\$ 9,990	\$ 3,744

Nonearning assets of the Company include nonperforming loans (as indicated above), nonaccrual investments, other real estate and repossessions, which amounted to \$9,859 at December 31, 2007.

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ANALYSIS OF LOAN PORTFOLIO (cont.)

Comments Regarding Nonperforming Assets

**PART A - CONSUMER LOANS**

Consumer installment loans, except those loans that are secured by real estate, are not placed on nonaccrual status since these loans are charged-off when they have been delinquent from 90 to 180 days, and when the related collateral, if any, is not sufficient to offset the indebtedness. Advances under consumer line of credit programs, are charged-off when collection appears doubtful.

**PART B - NONPERFORMING LOANS**

When a loan is classified as a nonaccrual loan, interest on the loan is no longer accrued and all accrued interest receivable is charged off. It is the policy of the Bank that all loans for which the collateral is insufficient to cover all principal and accrued interest will be reclassified as nonperforming loans to the extent they are unsecured, on or before the date when the loan becomes 90 days delinquent. Thereafter, interest is recognized and included in income only when received. Interest not recorded on nonaccrual loans is referenced in Footnote 4 in Item 8 below.

As of December 31, 2007, there were \$7.0 million of loans on nonaccrual status, some of which were also on impaired status. There were \$6.7 million of loans classified as impaired.

**PART C - TROUBLED DEBT RESTRUCTURED LOANS**

Loans renegotiated as troubled debt restructurings are those loans for which either the contractual interest rate has been reduced and/or other concessions are granted to the borrower because of a deterioration in the financial condition of the borrower which results in the inability of the borrower to meet the terms of the loan.

As of December 31, 2007 and 2006, there were no loans renegotiated as troubled debt restructurings.

**PART D - OTHER NONPERFORMING ASSETS**

Management is of the opinion that there are no significant foreseeable losses relating to nonperforming assets, as defined in the preceding table, or classified loans, except as discussed above in Part B – Nonperforming Loans and Part C – Troubled Debt Restructured Loans.

**PART E - LOAN CONCENTRATIONS**

There were no loan concentrations within industries not otherwise disclosed, which exceeded ten percent of total loans except commercial real estate. Commercial real estate was \$384.3 million at December 31, 2007. Nearly all of the Bank's commercial, industrial, agricultural real estate mortgage, real estate construction mortgage and consumer loans are made within its basic service area.

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**Basis For Determining Allowance For Loan Losses:**

The allowance is an amount that management believes will be adequate to absorb probable incurred credit losses relating to specifically identified loans based on an evaluation, as well as other probable incurred losses inherent in the loan portfolio. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrower's ability to repay. Management also considers trends in adversely classified loans based upon a monthly review of those credits. An appropriate level of general allowance is determined after considering the following: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentration, new industry lending activity and general economic conditions. For a more thorough discussion of the allowance for loan losses methodology see the Critical Accounting Policies section of Item 7.

Based upon these policies and objectives, \$4.3 million, \$2.6 million and \$2.5 million were charged to the provision for loan losses and added to the allowance for loan losses in 2007, 2006 and 2005.

The allocation of the allowance for loan losses to the various lending areas is performed by management in relation to perceived exposure to loss in the various loan portfolios. However, the allowance for loan losses is available in its entirety to absorb losses in any particular loan category.

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## ANALYSIS OF LOAN PORTFOLIO (cont.)

## Summary of Loan Loss

(in thousands of dollars)

The following is a summary of the loan loss experience for the years ended December 31, 2007, 2006, 2005, 2004 and 2003.

	2007	2006	2005	2004	2003
Amount of loans outstanding, December 31,	\$ 1,523,720	\$ 1,353,837	\$ 1,198,730	\$ 1,003,219	\$ 870,882
Average daily loans outstanding during the year ended December 31,	\$ 1,404,068	\$ 1,270,484	\$ 1,088,788	\$ 930,934	\$ 847,555
Allowance for loan losses, January 1,	\$ 14,463	\$ 12,774	\$ 10,754	\$ 10,234	\$ 9,533
Loans charged—off:					
Commercial	2,381	905	317	630	1,261
Real estate	16	0	8	20	47
Installment	537	145	164	271	353
Credit cards and personal credit lines	458	22	112	73	113
Total loans charged—off	3,392	1,072	601	994	1,774
Recoveries of loans previously charged—off:					
Commercial	252	53	37	121	21
Real estate	27	0	0	13	0
Installment	124	52	89	129	188
Credit cards and lines of credit	29	12	15	28	12
Total recoveries	432	117	141	291	221
Net loans charged—off	2,960	955	460	703	1,553
Provision for loan loss charged to expense	4,298	2,644	2,480	1,223	2,254
Balance, December 31,	\$ 15,801	\$ 14,463	\$ 12,774	\$ 10,754	\$ 10,234
Ratio of net charge—offs during the period to average daily loans outstanding:					

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Commercial	0.15	%	0.07	%	0.02	%	0.05	%	0.15	%
Real estate	0.00		0.00		0.00		0.00		0.00	
Installment	0.03		0.01		0.01		0.02		0.02	
Credit cards and personal credit lines	0.03		0.00		0.01		0.01		0.01	
Total ratio of net charge—offs	0.21	%	0.08	%	0.04	%	0.08	%	0.18	%
Ratio of allowance for loan losses to nonperforming assets	160.27	%	101.67	%	169.87	%	104.76	%	236.46	%

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ANALYSIS OF LOAN PORTFOLIO (cont.)

Allocation of Allowance for Loan Losses

(in thousands of dollars)

The following is a summary of the allocation for loan losses as of December 31, 2007, 2006, 2005, 2004 and 2003.

	2007			2006			2005		
	Allowance	Loans as		Allowance	Loans as		Allowance	Loans as	
	For	Percentage		For	Percentage		For	Percentage	
	Loan	of Gross		Loan	of Gross		Loan	of Gross	
	Losses	Loans		Losses	Loans		Losses	Loans	
Allocated allowance for loan losses:									
Commercial	\$ 13,659	81.42	%	\$ 12,185	80.24	%	\$ 10,870	80.46	%
Real estate	571	8.15		389	8.07		187	6.24	
Installment	421	3.23		690	6.20		509	5.67	
Credit cards and personal credit lines	828	7.20		561	5.49		688	7.63	
Total allocated allowance for loan losses	15,479	100.00	%	13,825	100.00	%	12,254	100.00	%
Unallocated allowance for loan losses	322			638			520		
Total allowance for loan losses	\$ 15,801			\$ 14,463			\$ 12,774		

	2004			2003		
	Allowance	Loans as		Allowance	Loans as	
	For	Percentage		For	Percentage	
	Loan	of Gross		Loan	of Gross	
	Losses	Loans		Losses	Loans	
Allocated allowance for loan losses:						
Commercial	\$ 8,696	78.84	%	\$ 8,634	77.56	%
Real estate	136	5.40		110	5.06	
Installment	398	5.29		440	6.72	
Credit cards and personal credit lines	789	10.47		696	10.66	
Total allocated allowance for loan losses	10,019	100.00	%	9,880	100.00	%
	735			354		

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Unallocated allowance for loan  
losses

Total allowance for loan losses \$ 10,754

\$ 10,234

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## ANALYSIS OF DEPOSITS

(in thousands of dollars)

The average daily deposits for the years ended December 31, 2007, 2006 and 2005, and the average rates paid on those deposits are summarized in the following table:

	2007			2006			2005		
	Average Daily Balance	Average Rate Paid	%	Average Daily Balance	Average Rate Paid	%	Average Daily Balance	Average Rate Paid	%
Demand deposits	\$ 226,484	0.00	%	\$ 219,997	0.00	%	\$ 222,971	0.00	%
Savings and transaction accounts:									
Regular savings	67,104	0.20		67,818	0.21		70,875	0.13	
Interest bearing checking	425,753	3.49		405,209	3.16		342,438	1.64	
Time deposits:									
Deposits of \$100,000 or more	462,056	5.27		430,378	4.97		319,697	3.56	
Other time deposits	295,328	4.84		264,087	4.08		228,689	3.16	
Total deposits	\$ 1,476,725	3.63	%	\$ 1,387,489	3.25	%	\$ 1,184,670	2.05	%

As of December 31, 2007, time certificates of deposit will mature as follows:

	\$ 100,000 or more	% of Total	%	Other	% of Total	%
Within three months	\$ 176,250	45.86	%	\$ 63,626	20.17	%
Over three months, within six months	61,853	16.10		107,385	34.04	
Over six months, within twelve months	71,734	18.67		82,513	26.16	
Over twelve months	74,443	19.37		61,910	19.63	
Total time certificates of deposit	\$ 384,280	100.00	%	\$ 315,433	100.00	%





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## QUALITATIVE MARKET RISK DISCLOSURE

Management's market risk disclosure appears under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7, below, and is incorporated herein by reference in response to this item. The Company's primary market risk exposure is interest rate risk. The Company does not have a material exposure to foreign currency exchange rate risk, does not own any material derivative financial instruments and does not maintain a trading portfolio.

## RETURN ON EQUITY AND OTHER RATIOS

The rates of return on average daily assets and stockholders' equity, the dividend payout ratio, and the average daily stockholders' equity to average daily assets for the years ended December 31, 2007, 2006 and 2005 were as follows:

	2007	2006	2005	
Percent of net income to:				
Average daily total assets	1.04	% 1.10	% 1.20	%
Average daily stockholders' equity	13.94	% 15.35	% 16.59	%
Percentage of dividends declared per common share to basic earnings per weighted average number of common shares outstanding (12,188,594 shares in 2007, 12,069,300 shares in 2006 and 11,927,756 shares in 2005)	34.49	% 24.19	% 30.46	%
Percentage of average daily stockholders' equity to average daily total assets	7.49	% 7.18	% 7.22	%

Cash dividends were declared on April 10, July 10, October 9, 2007 and January 8, 2008 for each quarter of 2007 and April 11, July 11 and October 10, 2006 and January 9, 2007 for each quarter of 2006.



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## SHORT-TERM BORROWINGS

(in thousands of dollars)

The following is a schedule, at the end of the year indicated, of statistical information relating to securities sold under agreement to repurchase maturing within one year and secured by either U.S. Government agency securities or mortgage-backed securities classified as other debt securities and other short-term borrowings maturing within one year. There were no other categories of short-term borrowings for which the average balance outstanding during the period was 30 percent or more of stockholders' equity at the end of each period.

	2007		2006		2005	
Outstanding at year end:						
Federal funds purchased	\$ 70,010		\$ 0		\$ 43,000	
Securities sold under agreements to repurchase	\$ 154,913		\$ 106,670		\$ 91,071	
Other short—term borrowings	\$ 90,000		\$ 80,000		\$ 75,000	
Approximate average interest rate at year end:						
Federal funds purchased	4.07	%	0.00	%	4.42	%
Securities sold under agreements to repurchase	3.20	%	3.59	%	2.91	%
Other short—term borrowings	4.31	%	5.36	%	4.26	%
Highest amount outstanding as of any month end during the year:						
Federal funds purchased	\$ 96,850		\$ 53,000		\$ 106,500	
Securities sold under agreements to repurchase	\$ 154,913		\$ 106,670		\$ 92,589	
Other short—term borrowings	\$ 90,000		\$ 80,000		\$ 89,900	
Approximate average outstanding during the year:						
Federal funds purchased	\$ 22,950		\$ 19,119		\$ 26,364	
Securities sold under agreements to repurchase	\$ 121,372		\$ 92,870		\$ 85,666	
Other short—term borrowings	\$ 32,247		\$ 31,726		\$ 41,902	
Approximate average interest rate during the year:						
Federal funds purchased	5.33	%	5.22	%	3.41	%
Securities sold under agreements to repurchase	3.52	%	3.20	%	1.67	%
Other short—term borrowings	5.09	%	5.13	%	3.31	%

Securities sold under agreements to repurchase include fixed rate, term transactions initiated by the Bank, as well as corporate sweep accounts. Other short-term borrowings consist of Federal Home Loan Bank advances.



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**ITEM 1a. RISK FACTORS**

In addition to the other information in this Annual Report on Form 10-K, shareholders or prospective investors should carefully consider the following risk factors:

**Our business is concentrated in and dependent upon the continued growth and welfare of our primary market areas.**

We operate primarily in four geographical markets, all of which are located in Northern Indiana and are further described in the “Business” section included under Item 1 of Part I of this Form 10-K. We have developed a particularly strong presence in the South Region, which includes Kosciusko County and portions of contiguous counties, the North Region, which includes portions of Elkhart and St. Joseph County, and the Central Region, which includes portions of Elkhart County and contiguous counties. These regions represent the more mature markets. In addition, we have experienced rapid growth in the East Region, which includes Allen and DeKalb Counties. The Company also operates a loan production office in Indianapolis, which is staffed by a commercial loan officer and was opened in 2006. Our success depends upon the business activity, population, income levels, deposits and real estate activity in these markets. Although our customers’ business and financial interests may extend well beyond these market areas, adverse economic conditions that affect these market areas could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations. Because of our geographic concentration, we are less able than other regional or national financial institutions to diversify our credit risks across multiple markets.

**We may experience difficulties in managing our growth and our growth strategy involves risks that may negatively impact our net income.**

As part of our general growth strategy, we may expand into additional communities or attempt to strengthen our position in our current markets by opening new branches and acquiring existing branches of other financial institutions. To the extent that we undertake additional branch openings and acquisitions, we are likely to continue to experience the effects of higher operating expenses relative to operating income from the new operations, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. Other effects of engaging in such growth strategies may include potential diversion of our management’s time and attention and general disruption to our business.

Although we do not have any current plans to do so, we may also acquire banks and related businesses that we believe provide a strategic fit with our business. We may also engage in de novo bank formations as we have in the past and intend to do in the Indianapolis market in the future. To the extent that we grow through acquisitions and de novo bank formations, we cannot assure you that we will be able to adequately and profitably manage this growth. Acquiring other banks and businesses will involve similar risks to those commonly associated with branching, but may also involve additional risks, including:

- potential exposure to unknown or contingent liabilities of banks and businesses we acquire;
- exposure to potential asset quality issues of the acquired bank or related business;

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- difficulty and expense of integrating the operations and personnel of banks and businesses we acquire; and
- the possible loss of key employees and customers of the banks and businesses we acquire.

### **We face intense competition in all phases of our business from other banks and financial institutions.**

The banking and financial services business in our market is highly competitive. Our competitors include large regional banks, local community banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market mutual funds, credit unions, farm credit services and other non-bank financial service providers. Many of these competitors are not subject to the same regulatory restrictions as we are and are able to provide customers with a feasible alternative to traditional banking services.

Increased competition in our market may also result in a decrease in the amounts of our loans and deposits, reduced spreads between loan rates and deposit rates or loan terms that are more favorable to the borrower. Any of these results could have a material adverse effect on our ability to grow and remain profitable. If increased competition causes us to significantly discount the interest rates we offer on loans or increase the amount we pay on deposits, our net interest income could be adversely impacted. If increased competition causes us to relax our underwriting standards, we could be exposed to higher losses from lending activities. Additionally, many of our

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competitors are much larger in total assets and capitalization, have greater access to capital markets and larger lending limits and offer a broader range of financial services than we can offer.

**Interest rates and other conditions impact our results of operations.**

Our profitability is significantly driven by the spread between the interest rates earned on investments and loans and the interest rates paid on deposits and other interest-bearing liabilities. Like most banking institutions, our net interest spread and margin will be affected by general economic conditions and other factors, including fiscal and monetary policies of the federal government, that influence market interest rates and our ability to respond to changes in such rates. At any given time, our assets and liabilities will be such that they are affected differently by a given change in interest rates. As a result, an increase or decrease in rates, the length of loan terms or the mix of adjustable and fixed rate loans in our portfolio could have a positive or negative effect on our net income, capital and liquidity. We measure interest rate risk under various rate scenarios and using specific criteria and assumptions. A summary of this process, along with the results of our net interest income simulations is presented at "Quantitative and Qualitative Disclosures About Market Risk" included under Item 7a of Part II of this Form 10-K. Although we believe our current level of interest rate sensitivity is reasonable and effectively managed, significant fluctuations in interest rates may have an adverse effect on our business, financial condition and results of operations.

**We must effectively manage our credit risk.**

There are risks inherent in making any loan, including risks inherent in dealing with individual borrowers, risks of nonpayment, risks resulting from uncertainties as to the future value of collateral and risks resulting from changes in economic and industry conditions. We attempt to minimize our credit risk through prudent loan application approval procedures, careful monitoring of the concentration of our loans within specific industries, a centralized credit administration department and periodic independent reviews of outstanding loans by our loan review department. However, we cannot assure you that such approval and monitoring procedures will reduce these credit risks.

The majority of the Bank's loan portfolio is invested in commercial and commercial real estate loans. These loans represent higher dollar volumes to fewer customers. As a result, we may assume greater lending risks than other community banking-type financial institutions that have a lesser concentration of such loans and are more retail oriented. Our lending activity and the risks commonly associated with such lending are further described in the "Management's Discussion and Analysis" section included under Item 7 of Part II of this Form 10-K.

**Commercial and industrial and agri-business loans make up a significant portion of our loan portfolio.**

Commercial and industrial and agri-business loans were \$1.241 billion, or approximately 81% of our total loan portfolio as of December 31, 2007. Our commercial loans are primarily made based on the identified cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. Most often, this collateral is accounts receivable, inventory, machinery or real estate. Credit support provided by the borrower for most of these loans and the probability of repayment is based on the liquidation of the pledged collateral and enforcement of a personal guarantee, if any exists. Whenever possible, we require a personal guarantee on commercial loans. As a result, in the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. The collateral securing other loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.



**Our loan portfolio has a large concentration of commercial real estate loans, which involve risks specific to real estate value.**

Real estate lending (including commercial, construction, and, to a much lesser extent, residential) is a large portion of our loan portfolio. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Although a significant portion of such loans are secured by real estate as a secondary form of collateral, continued adverse developments affecting real estate values in one or more of our markets could increase the credit risk associated with our loan portfolio. Additionally, real estate lending typically involves higher loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic events or governmental regulations outside of the control of the borrower or lender could negatively impact the future cash flow and market values of the affected properties.

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If the loans that are collateralized by real estate become troubled during a time when market conditions are declining or have declined, then we may not be able to realize the amount of security that we anticipated at the time of originating the loan, which could cause us to increase our provision for loan losses and adversely affect our operating results and financial condition.

**Our consumer loans generally have a higher degree of risk of default than our other loans.**

At December 31, 2007, consumer loans totaled \$50.5 million, or 3%, of our total loan and lease portfolio. Consumer loans typically have shorter terms and lower balances with higher yields as compared to one-to four-family residential loans, but generally carry higher risks of default. Consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on these loans.

**Our allowance for loan losses may prove to be insufficient to absorb potential losses in our loan portfolio.**

We established our allowance for loan losses pursuant to our established guidelines and practices and maintain it at a level considered adequate by management to absorb loan losses that are inherent in the portfolio. The amount of future loan losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, which may be beyond our control, and such losses may exceed current estimates. At December 31, 2007, our allowance for loan losses as a percentage of total loans was 1.04% and as a percentage of total non-performing loans was 212%. Although management believes that the allowance for loan losses is adequate to absorb probable incurred losses on any existing loans, we cannot predict loan losses with certainty, and we cannot assure you that our allowance for loan losses will prove sufficient to cover actual loan losses in the future. Loan losses in excess of our reserves may adversely affect our business, financial condition and results of operations. Additional information regarding our allowance for loan losses and the methodology we use to determine an appropriate level of reserves is located in the "Management's Discussion and Analysis" section included under Item 7 of Part II of this Form 10-K.

**Our continued pace of growth may require us to raise additional capital in the future, but that capital may not be available when it is needed.**

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. We anticipate that our existing capital resources will satisfy our capital requirements for the foreseeable future. However, we may at some point need to raise additional capital to support our continued growth. Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital, if needed, on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth, branching, de novo bank formations and/or acquisitions could be materially impaired.

**Our community banking strategy relies heavily on our management team, and the unexpected loss of key managers may adversely affect our operations.**

Much of our success to date has been influenced strongly by our ability to attract and to retain senior management experienced in banking and financial services and familiar with the communities in our market areas. Our ability to retain executive officers, the current management teams, branch managers and loan officers of our bank subsidiary will continue to be important to the successful implementation of our strategy. It is also critical, as we grow, to be able to attract and retain qualified additional management and loan officers with the appropriate level of experience and knowledge about our market areas to implement our community-based operating strategy. The unexpected loss of services of any key management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our business, financial condition and results of operations.

**Government regulation can result in limitations on our operations.**

We operate in a highly regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Indiana Department of Financial Institutions. Regulations adopted by these agencies, which are generally intended to provide protection for depositors and customers rather than for the benefit of shareholders, govern a comprehensive range of matters relating to ownership and control of our shares, our acquisition of other companies and businesses, permissible activities for us to engage in, maintenance of adequate

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capital levels and other aspects of our operations. These bank regulators possess broad authority to prevent or remedy unsafe or unsound practices or violations of law. The laws and regulations applicable to the banking industry could change at any time and we cannot predict the effects of these changes on our business and profitability. Increased regulation could increase our cost of compliance and adversely affect profitability. For example, new legislation or regulation may limit the manner in which we may conduct our business, including our ability to offer new products, obtain financing, attract deposits, make loans and achieve satisfactory interest spreads.

**We have a continuing need for technological change and we may not have the resources to effectively implement new technology.**

The financial services industry is constantly undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend in part upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations as we continue to grow and expand our market areas. Many of our larger competitors have substantially greater resources to invest in technological improvements. As a result, they may be able to offer additional or superior products to those that we will be able to offer, which would put us at a competitive disadvantage. Accordingly, we cannot provide you with assurance that we will be able to effectively implement new technology-driven products and services or be successful in marketing such products and services to our customers.

**There is a limited trading market for our common shares, and you may not be able to resell your shares at or above the price shareholders paid for them.**

Although our common shares are listed for trading on the Global Select Market of the NASDAQ Stock Market, the trading in our common shares has less liquidity than many other companies quoted on the NASDAQ Global Select Market. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the market of willing buyers and sellers of our common shares at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. We cannot assure you that volume of trading in our common shares will increase in the future.

**System failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities.**

The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from physical theft, fire, power loss, telecommunications failure or a similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms and other disruptive problems caused by hackers. Any damage or failure that causes an interruption in our operations could have a material adverse effect on our financial condition and results of operations. Computer break-ins, phishing and other disruptions could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us and may cause existing and potential customers to refrain from doing business with us. Although we, with the help of third-party service providers, intend to continue to implement security technology and establish operational procedures to prevent such damage, there can be no assurance that these security measures will be successful. In addition, advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms we and our third-party service providers use to encrypt and protect customer transaction data. A failure of such security measures could have a material adverse effect on our financial condition and results of operations.

**We are subject to certain operational risks, including, but not limited to, customer or employee fraud and data processing system failures and errors.**

Employee errors and misconduct could subject us to financial losses or regulatory sanctions and seriously harm our reputation. Misconduct by our employees could include hiding unauthorized activities from us, improper or unauthorized activities on behalf of our customers or improper use of confidential information. It is not always possible to prevent employee errors and misconduct, and the precautions we take to prevent and detect this activity may not be effective in all cases. Employee errors could also subject us to financial claims for negligence.

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We maintain a system of internal controls and insurance coverage to mitigate operational risks, including data processing system failures and errors and customer or employee fraud. Should our internal controls fail to prevent or detect an occurrence, or if any resulting loss is not insured or exceeds applicable insurance limits, it could have a material adverse effect on our business, financial condition and results of operations.

**If LCB Funding, Inc. fails to qualify as a real estate investment trust, we may be subject to a higher consolidated effective tax rate.**

The Bank holds certain commercial real estate loans, residential real estate loans and other loans, and mortgage-backed investment securities in a real estate investment trust through its wholly-owned subsidiary LCB Investments II, Inc., which is incorporated in Nevada. Qualification as a real estate investment trust involves application of specific provisions of the Internal Revenue Code relating to various asset tests. If LCB Funding, Inc. fails to meet any of the required provisions for real estate investment trusts, or there are changes in tax laws or interpretations thereof, it could no longer qualify as a real estate investment trust and the resulting tax consequences would increase our effective tax rate or cause us to have a tax liability for prior years.

**ITEM 1b. UNRESOLVED STAFF COMMENTS**

We have no unresolved SEC staff comments.

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The Company conducts its operations from the following locations:

## Location

Main/Headquarters	202 East Center St.	Warsaw	IN
Warsaw Drive-up	East Center St.	Warsaw	IN
Akron	102 East Rochester	Akron	IN
Argos	100 North Michigan	Argos	IN
Auburn	1220 East 7th St.	Auburn	IN
Bremen	1600 State Road 331	Bremen	IN
Columbia City	601 Countryside Dr.	Columbia City	IN
Concord	4202 Elkhart Rd.	Goshen	IN
Cromwell	111 North Jefferson St.	Cromwell	IN
Elkhart Beardsley	864 East Beardsley St.	Elkhart	IN
Elkhart East	22050 State Road 120	Elkhart	IN
Elkhart Hubbard Hill	58404 State Road 19	Elkhart	IN
Elkhart Northwest	1208 North Nappanee St.	Elkhart	IN
Fort Wayne North	302 East DuPont Rd.	Fort Wayne	IN
Fort Wayne Northeast	10411 Maysville Rd.	Fort Wayne	IN
Fort Wayne Southwest	10429 Illinois Rd.	Fort Wayne	IN
Fort Wayne Jefferson Blvd	6851 W. Jefferson Blvd.	Fort Wayne	IN
Goshen Downtown	102 North Main St.	Goshen	IN
Goshen South	2513 South Main St.	Goshen	IN
Granger	12830 State Road 23	Granger	IN
Huntington	1501 North Jefferson St.	Huntington	IN
Kendallville East	631 Professional Way	Kendallville	IN
LaGrange	901 South Detroit	LaGrange	IN
Ligonier Downtown	222 South Cavin St.	Ligonier	IN
Ligonier South	1470 U.S. Highway 33 South	Ligonier	IN
Medaryville	Main St.	Medaryville	IN
Mentone	202 East Main St.	Mentone	IN
Middlebury	712 Wayne Ave.	Middlebury	IN
Milford	State Road 15 North	Milford	IN
Mishawaka	5015 North Main St.	Mishawaka	IN
Nappanee	202 West Market St.	Nappanee	IN
North Webster	644 North Main St.	North Webster	IN
Piercetown	202 South First St.	Piercetown	IN
Plymouth	862 East Jefferson St.	Plymouth	IN
Rochester	507 East 9th St.	Rochester	IN
Shipshewana	895 North Van Buren St.	Shipshewana	IN
Silver Lake	102 Main St.	Silver Lake	IN
South Bend Northwest	21113 Cleveland Rd.	South Bend	IN
Syracuse	502 South Huntington	Syracuse	IN
Warsaw East	3601 Commerce Dr.	Warsaw	IN
Warsaw North	420 Chevy Way	Warsaw	IN
Warsaw West	1221 West Lake St.	Warsaw	IN
Winona Lake	99 Chestnut St.	Winona Lake	IN
Winona Lake East	1324 Wooster Rd.	Winona Lake	IN

The Company leases from third parties the real estate and buildings for its Milford and Winona Lake East offices. In addition, the Company leases the real estate for its four freestanding ATMs. All the other branch facilities are owned by the Company. The Company also owns parking lots in downtown Warsaw for the use and convenience of Company employees and customers, as well as leasehold improvements, equipment, furniture and fixtures necessary to operate the banking facilities.



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In addition, the Company owns buildings at 110 South High St., Warsaw, Indiana, and 114-118 East Market St., Warsaw, Indiana, which it uses for various offices, a building at 113 East Market St., Warsaw, Indiana, which it uses for office and computer facilities, and a building at 109 South Buffalo St., Warsaw, Indiana, which it uses for training and development. The Company also leases from third parties facilities in Warsaw, Indiana, for property management facilities, in Elkhart, Indiana, for computer facilities and office space in Indianapolis, Indiana, for a loan production office.

None of the Company's assets are the subject of any material encumbrances.

**ITEM 3. LEGAL PROCEEDINGS**

There are no material pending legal proceedings other than ordinary routine litigation incidental to the business to which the Company and the Bank are a party or of which any of their property is subject.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matter was submitted to a vote of security holders during the fourth quarter of 2007.

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
<b>2007</b>				
Trading prices (per share)*				
Low	\$ 18.25	\$ 20.05	\$ 20.71	\$ 21.85
High	\$ 25.00	\$ 25.98	\$ 23.81	\$ 25.92
Dividends declared (per share)	\$ 0.140	\$ 0.140	\$ 0.140	\$ 0.125
<b>2006</b>				
Trading prices (per share)* **				
Low	\$ 23.47	\$ 21.84	\$ 20.47	\$ 19.90
High	\$ 26.40	\$ 24.97	\$ 24.29	\$ 23.38
Dividends declared (per share)**	\$ 0.125	\$ 0.125	\$ 0.125	\$ 0.000

\* The trading ranges are the high and low prices as obtained from The Nasdaq Stock Market.

\*\* Share and per share data has been adjusted for a 2-for-1 stock split on April 28, 2006.

The common stock of the Company began being quoted on The Nasdaq Stock Market under the symbol LKFN in August, 1997. On December 31, 2007, the Company had approximately 458 shareholders of record and estimates that it has approximately 2,200 shareholders in total.

The Company paid dividends as set forth in the table above. The Company's ability to pay dividends to shareholders is largely dependent upon the dividends it receives from the Bank, and the Bank is subject to regulatory limitations on the amount of cash dividends it may pay. See "Business – Supervision and Regulation – The Company – Dividend Payments" and "Business - Supervision and Regulation – The Bank – Dividend Payments" for a more detailed description of these limitations.

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The following table provides information about purchases by the Company and its affiliates during the quarter ended December 31, 2007 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act:

### ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Appropriate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
10 /01/07-10/31/07	0	\$ 0.00	0	\$ 0.00
11 /01/07-11/30/07	672	19.88	0	0.00
12 /01/07-12/31/07	0	0.00	0	0.00
Total	672	\$ 19.88	0	\$ 0.00

The shares purchased during the periods were credited to the deferred share accounts of seven non-employee directors under the Company's directors' deferred compensation plan.

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**STOCK PRICE PERFORMANCE GRAPH**

*The stock price performance graph below shall not be deemed incorporated by reference by any general statement incorporating by reference this proxy statement into any filing under the Securities Act of 1933 or under the Securities Exchange Act of 1934, except to the extent the Company specifically incorporates this information by reference, and shall not otherwise be deemed filed under such Acts.*

The graph below compares the cumulative total return of the Company, the Nasdaq Market Index and a peer group index.

<b>INDEX</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Lakeland Financial Corporation	\$100.00	\$154.64	\$178.02	\$185.29	\$239.36	\$200.71
NASDAQ Market Index	100.00	150.01	162.89	165.13	180.85	198.60
Peer Group Index	100.00	136.54	165.62	164.90	187.53	133.13

\* Assumes \$100 invested on December 31, 2001 and dividends were reinvested.

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The peer group index is comprised of all financial institution holding companies in the United States with total assets between \$1.0 billion and \$3.0 billion dollars whose equity securities were traded on an exchange or national quotation service.

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	2007	2006	2005	2004	2003
	(in thousands except share and per share data)				
Interest income	\$ 117,973	\$ 105,551	\$ 80,616	\$ 60,182	\$ 60,517
Interest expense	63,417	53,224	30,353	16,833	18,137
Net interest income	54,556	52,327	50,263	43,349	42,380
Provision for loan losses	4,298	2,644	2,480	1,223	2,254
Net interest income after provision for loan losses	50,258	49,683	47,783	42,126	40,126
Other noninterest income	18,815	17,751	15,983	15,394	14,728
Gain on sale of credit card portfolio	0	0	863	0	0
Net gains on sale of real estate mortgages held for sale	676	581	934	987	3,018
Net securities gains (losses)	89	(68 )	(69 )	0	500
Noninterest expense	(42,261 )	(39,712 )	(38,057 )	(36,660 )	(37,679 )
Income before income tax expense	27,577	28,235	27,437	21,847	20,693
Income tax expense	8,366	9,514	9,479	7,302	6,828
Net income	\$ 19,211	\$ 18,721	\$ 17,958	\$ 14,545	\$ 13,865
Basic weighted average common shares outstanding*	12,188,594	12,069,300	11,927,756	11,735,410	11,639,832
Basic earnings per common share*	\$ 1.58	\$ 1.55	\$ 1.51	\$ 1.24	\$ 1.19
Diluted weighted average common shares outstanding*	12,424,137	12,375,467	12,289,466	12,128,154	12,002,898
Diluted earnings per common share*	\$ 1.55	\$ 1.51	\$ 1.46	\$ 1.20	\$ 1.16
Cash dividends declared*	\$ 0.55	\$ 0.38	\$ 0.46	\$ 0.42	\$ 0.38

\*Share and per share data have been adjusted for a 2-for-1 stock split on April 28, 2006.



Table of Contents**ITEM 6. SELECTED FINANCIAL DATA (continued)**

	2007	2006	2005	2004	2003
			(in thousands)		
Balances at December 31,					
Total assets	<b>\$ 1,989,133</b>	\$ 1,836,706	\$ 1,634,613	\$ 1,453,122	\$ 1,271,414
Total loans	<b>\$ 1,523,720</b>	\$ 1,353,837	\$ 1,198,730	\$ 1,003,219	\$ 870,882
Total deposits	<b>\$ 1,478,918</b>	\$ 1,475,765	\$ 1,266,245	\$ 1,115,399	\$ 926,391
Total short—term borrowings	<b>\$ 316,165</b>	\$ 187,484	\$ 211,542	\$ 185,650	\$ 184,761
Long—term borrowings	<b>\$ 44</b>	\$ 45	\$ 46	\$ 10,046	\$ 30,047
Subordinated debentures	<b>\$ 30,928</b>	\$ 30,928	\$ 30,928	\$ 30,928	\$ 30,928
Total stockholders' equity	<b>\$ 146,270</b>	\$ 130,187	\$ 113,334	\$ 101,765	\$ 90,022

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****OVERVIEW**

Lakeland Financial Corporation is the holding company for Lake City Bank. The Company is headquartered in Warsaw, Indiana and operates 43 offices in twelve counties in northern Indiana and a loan production office in Indianapolis, Indiana. The Company earned \$19.2 million for the year 2007 versus \$18.7 million for 2006, an increase of 2.6%. The increase was driven primarily by a \$2.2 million increase in net interest income and a \$1.3 million increase in noninterest income. In addition, the Company's effective tax rate decreased to 30.3% for 2007 compared to 33.7% for 2006. Offsetting these positive impacts was a \$2.5 million increase in noninterest expense and a \$1.7 million increase in the provision for loan losses. The Company earned \$18.7 million for the year 2006 versus \$18.0 million for 2005, an increase of 4.3%. The increase was driven primarily by a \$2.1 million increase in net interest income and a \$553,000 increase in noninterest income. Offsetting these positive impacts was a \$1.7 million increase in noninterest expense and a \$164,000 increase in the provision for loan losses.

Basic earnings per share for the year 2007 was \$1.58 per share versus \$1.55 per share for 2006 and \$1.51 for 2005. Diluted earnings per share for the year ended 2007 was \$1.55 per share versus \$1.51 per share for the year ended 2006 and \$1.46 for the year ended 2005. Diluted earnings per share reflect the potential dilutive impact of stock options granted under an employee stock option plan.

The Company's total assets were \$1.989 billion as of December 31, 2007 versus \$1.837 billion as of December 31, 2006, an increase of \$152.4 million or 8.3%. This increase was primarily due to a \$154.2 million increase in commercial loans from \$1.086 billion at December 31, 2006 to



\$1.241 billion at December 31, 2007.

## RESULTS OF OPERATIONS

### 2007 versus 2006

The Company reported record net income of \$19.2 million in 2007, an increase of \$490,000, or 2.6%, versus net income of \$18.7 million in 2006. Net interest income increased \$2.2 million, or 4.3%, to \$54.6 million versus \$52.3 million in 2006. Net interest income increased primarily due to increases in average earning assets, particularly a 14% increase in commercial loans as a result of our strategic focus on commercial lending. Interest income increased \$12.4 million, or 11.8%, from \$105.6 million in 2006 to \$118.0 million in 2007. The increase was driven primarily by increases in average earning assets, as well as a 14 basis point increase in the tax equivalent yield on average earning assets over the year. Interest expense increased \$10.2 million, or 19.2%, from \$53.2 million in 2006 to \$63.4 million in 2007. The increase was primarily the result of a 36 basis point increase in the Company's daily cost of funds over the year. The Company had a net interest margin of 3.22% in 2007 versus 3.38% in 2006. Average earning assets increased by \$148.7 million from \$1.6 billion in 2006 to \$1.7 billion in 2007. This loan

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growth was led by significant growth in Elkhart and Allen Counties and with balanced growth in the Bank's other regions. Deposits increased to fund the loan growth during 2007, driven primarily by increases of \$23.9 million in average brokered deposit balances, \$20.5 million in interest bearing transaction accounts and \$39.1 million in average other time deposit account balances. Management believes that the growth in the loan portfolio will likely continue in a measured fashion as a result of our strategic focus on commercial lending and in conjunction with the general expansion and penetration of the geographical markets the Company serves, as well as our expansion in the Indianapolis market.

Nonaccrual loans were \$7.0 million, or 0.46% of total loans, at year end versus \$13.8 million, or 1.02% of total loans, at the end of 2006. There were five relationships totaling \$6.7 million classified as impaired as of December 31, 2007 versus five relationships totaling \$13.3 million at the end of 2006. The decrease in impaired and nonperforming loans resulted from the transfer to other real estate of a single borrowing relationship, a residential and commercial real estate developer. Net charge-offs were \$3.0 million in 2007 versus \$955,000 in 2006, representing 0.21% and 0.08% of average daily loans in 2007 and 2006. Total nonperforming loans were \$7.4 million, or 0.49% of total loans, at year end 2007 versus \$14.1 million, or 1.04% of total loans, at the end of 2006. The provision for loan loss expense was \$4.3 million in 2007, resulting in an allowance for loan losses at December 31, 2007 of \$15.8 million, which represented 1.04% of the loan portfolio, versus a provision for loan loss expense of \$2.6 million in 2006 and an allowance for loan losses of \$14.5 million at the end of 2006, or 1.07% of the loan portfolio. The higher provision in 2007 versus 2006 was attributable to a number of factors, but was primarily a result of an increase in net charge-offs, general growth in the loan portfolio, as well as higher allocations on specific watch list credits. The level of loan loss provision is also influenced by other factors related to the growth in the loan portfolio, such as emerging market risk, commercial loan focus and large credit concentration, new industry lending activity, general economic conditions and historical loss percentages. In addition, management gives consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Management's overall view on current credit quality was also a factor in the determination of the provision for loan losses. The Company's management continues to monitor the adequacy of the provision based on loan levels, asset quality, economic conditions and other factors that may influence the assessment of the collectability of loans.

Noninterest income was \$19.6 million in 2007 versus \$18.3 million in 2006, an increase of \$1.3 million, or 7.2%. The 2007 increase was driven by a \$592,000, or 23.2%, increase in wealth advisory fees. Additionally, noninterest income increased due to a \$201,000, or 15.6%, increase in investment brokerage fees. Merchant card fee income increased due to higher volume activity in interchange and merchant fees as well as new business generation. Loan, insurance and service fees increased \$191,000, or 8.3%, driven by higher fee income on debit card activity. Offsetting these increases was a decrease of \$109,000, or 5.6%, in other income.

Noninterest expense increased \$2.5 million, or 6.4%, from \$39.7 million in 2006 to \$42.3 million in 2007. Salaries and employee benefits increased by \$1.4 million, or 6.4%, driven by normal salary increases and higher health care cost, which represented approximately \$542,000 of the total increase. Data processing fees and supplies increased \$449,000, or 18.3%, driven by higher data processing fees, software license fees and maintenance fees related to new services offered to clients. Net occupancy expense increased from \$2.5 million in 2006 to \$2.7 million in 2007, primarily as a result of higher maintenance and repair costs and higher property tax expense.

As a result of these factors, income before income tax expense decreased \$658,000, or 2.3%, from \$28.2 million in 2006 to \$27.6 million in 2007. Income tax expense was \$8.4 million in 2007 versus \$9.5 million in 2006. Income tax as a percentage of income before tax was 30.3% in 2007 versus 33.7% in 2006. The decrease in the tax rate was driven by the formation of a captive real estate investment trust in the fourth quarter of 2006, which provides the Company with an alternative vehicle for raising capital should the need arise. Additionally, the ownership structure of this real estate investment trust provides certain state income tax benefits which also lowered the Company's effective tax rate. Net income increased \$490,000, or 2.6%, to \$19.2 million in 2007 versus \$18.7 million in 2006. Basic earnings per share in 2007 was \$1.58, an increase of 1.9%, versus \$1.55 in 2006. The Company's net income performance represented a 14.8% return on January 1, 2007, stockholders' equity versus 16.5% in 2006. The net income performance resulted in a 1.04% return on average daily assets in 2007 versus 1.10% in 2006.

**RESULTS OF OPERATIONS**

**2006 versus 2005**

The Company reported record net income of \$18.7 million in 2006, an increase of \$763,000, or 4.3%, versus net income of \$18.0 million in 2005. Net interest income increased \$2.1 million, or 4.1%, to \$52.3 million versus \$50.3 million in 2005. Net interest income increased due to growth in commercial loans. Interest income

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increased \$24.9 million, or 30.9%, from \$80.6 million in 2005 to \$105.6 million in 2006. The increase was driven primarily by increases in average earning assets, as well as an 85 basis point increase in the tax equivalent yield on average earning assets over the year. Interest expense increased \$22.9 million, or 75.4%, from \$30.4 million in 2005 to \$53.2 million in 2006. The increase was primarily the result of a 121 basis point increase in the Company's daily cost of funds over the year. The Company had a net interest margin of 3.38% in 2006 versus 3.71% in 2005. Average earning assets increased by \$194.7 million from \$1.4 billion in 2005 to \$1.6 billion in 2006. The primary driver was a \$181.7 million increase in the average daily loan balance. This loan growth was led by significant growth in the Fort Wayne market and with balanced growth in the Bank's other regions. Deposits increased to fund the loan growth during 2006, driven primarily by increases of \$62.8 million in average interest bearing transaction accounts, \$38.1 million in average public fund deposits, \$33.0 million in average brokered deposit balances and \$75.1 million in the average other time deposit account balances.

Nonaccrual loans were \$13.8 million, or 1.02% of total loans, at year end versus \$7.3 million, or 0.61% of total loans, at the end of 2005. There were five relationships totaling \$13.3 million classified as impaired as of December 31, 2006 versus five relationships totaling \$6.9 million at the end of 2005. The increase in impaired and nonperforming loans resulted from the addition of a single borrowing relationship with aggregate loans totaling \$7.6 million. The borrower was engaged in commercial and residential real estate development in northern Indiana. Borrower collateral, including real estate, and personal guarantees of its principals supported this credit, although there could be no assurances that full repayment of the loans would result. Net charge-offs were \$955,000 in 2006 versus \$460,000 in 2005, representing 0.08% and 0.04% of average daily loans in 2006 and 2005. Total nonperforming loans were \$14.1 million, or 1.04% of total loans, at year end 2006 versus \$7.5 million, or 0.63% of total loans, at the end of 2005. The provision for loan loss expense was \$2.6 million in 2006, resulting in an allowance for loan losses at December 31, 2006 of \$14.5 million, which represented 1.07% of the loan portfolio, versus a provision for loan loss expense of \$2.5 million in 2005 and an allowance for loan losses of \$12.8 million at the end of 2005, or 1.07% of the loan portfolio. The higher provision in 2006 versus 2005 was attributable to a number of factors, but was primarily a result of general growth in the loan portfolio as well as higher allocations on specific watch list credits, including the large additional impaired credit relationship mentioned above. The level of loan loss provision was also influenced by other factors related to the growth in the loan portfolio, such as emerging market risk, commercial loan focus and large credit concentration, new industry lending activity, general economic conditions and historical loss percentages. In addition, management gave consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Management's overall view on current credit quality was also a factor in the determination of the provision for loan losses. The Company's management continued to monitor the adequacy of the provision based on loan levels, asset quality, economic conditions and other factors that may influence the assessment of the collectability of loans.

Noninterest income was \$18.3 million in 2006 versus \$17.7 million in 2005, an increase of \$553,000, or 3.1%. The 2005 noninterest income included a one-time gain of \$863,000 which resulted from the sale of the Company's retail credit card portfolio. The 2006 increase was driven by a \$727,000, or 23.4%, increase in wealth advisory and investment brokerage fees. Additionally, noninterest income increased due to a \$518,000, or 7.7%, increase in service charges on deposit accounts due largely to increased overdraft activity resulting in more overdraft charges as well as an increase in the per item fee implemented in 2006. Loan, insurance and service fees increased \$308,000, or 15.5%, driven by higher fee income on Visa check cards. Offsetting these increases were decreases of \$353,000, or 37.8%, in net gains on sales of real estate mortgages held for sale. As experienced by the industry generally, this decrease was the result of the decreased level of mortgage activity during 2006 resulting from rising mortgage interest rates during the year.

Noninterest expense increased \$1.7 million, or 4.4%, from \$38.1 million in 2005 to \$39.7 million in 2006. Salaries and employee benefits increased by \$1.8 million, or 8.9%, driven by higher incentive-based compensation as well as normal salary increases and staff additions. Net occupancy expense decreased from \$2.8 million in 2005 to \$2.5 million in 2006, primarily as a result of lower maintenance expense. Equipment expense decreased from \$1.9 million in 2005 to \$1.8 million in 2006, primarily as a result of lower depreciation expense. Depreciation expense was lower as a result of decreased depreciation on equipment leased under operating lease arrangements. Many existing operating leases became fully depreciated and there were few new operating leases during 2006.

As a result of these factors, income before income tax expense increased \$798,000, or 2.9%, from \$27.4 million in 2005 to \$28.2 million in 2006. Income tax expense was \$9.5 million in both 2006 and 2005. Income tax as a percentage of income before tax was 33.7% in 2006 versus

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34.5% in 2005. An increase in the Company's income derived from tax-advantaged sources contributed to the lower tax rate in 2006. Net income increased \$763,000, or 4.3%, to \$18.7 million in 2006 versus \$18.0 million in 2005. Basic earnings per share in 2006 was \$1.55, an increase of 2.7%, versus \$1.51 in 2005. The Company's net income performance represented a 16.5% return on January 1, 2006, stockholders' equity versus 17.7% in 2005. The net income performance resulted in a 1.10% return on average daily assets in 2006 versus 1.20% in 2005.

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**FINANCIAL CONDITION**

As of December 31, 2007, the Company had 43 offices serving twelve counties in northern Indiana and one loan production office in Indianapolis. The Company added a new full-service branch facility in Fort Wayne, Indiana during 2007. The new facility houses the Company's Fort Wayne based Wealth Advisory Services and serves the south western market of Fort Wayne. The new facility replaces a limited-service leased facility in downtown Fort Wayne. Since 1996, the Company has added seventeen new offices through acquisition and internal growth. The Company will consider future acquisition and expansion opportunities with an emphasis on markets that it believes would be receptive to its business philosophy of local, independent banking.

Total assets of the Company were \$1.989 billion as of December 31, 2007, an increase of \$152.4 million, or 8.3%, when compared to \$1.837 billion as of December 31, 2006.

Total cash and cash equivalents decreased by \$52.0 million, or 43.5%, to \$67.7 million at December 31, 2007 from \$119.7 million at December 31, 2006. The decrease was primarily attributable to a corresponding increase in the Company's loans.

Total securities available for sale increased by \$31.6 million, or 10.7%, to \$327.8 million at December 31, 2007 from \$296.2 million at December 31, 2006. The increase was a result of a number of activities in the securities portfolio. Paydowns from prepayments of \$40.0 million were received, and the amortization of premiums, net of the accretion of discounts, was \$473,000. Maturities, calls and sales of securities totaled \$35.1 million. These portfolio decreases were offset by securities purchases totaling \$104.0 million. The fair value of the securities increased \$3.2 million as a result of the falling yield curve environment during 2007. The investment portfolio is managed to limit the Company's exposure to risk and contains mostly collateralized mortgage obligations and other securities which are either directly or indirectly backed by the federal government or a local municipal government. As of December 31, 2007, the Company had \$45.3 million of collateralized mortgage obligations which were not issued by the federal government or government sponsored agencies, but were rated AAA by S&P and/or Aaa by Moody's. The investment portfolio did not contain any corporate debt instruments or trust preferred instruments as of December 31, 2007.

Real estate mortgages held for sale decreased by \$1.6 million, or 75.3%, to \$537,000 at December 31, 2007 from \$2.2 million at December 31, 2006. The balance of this asset category is subject to a high degree of variability depending on, among other things, recent mortgage loan rates and the timing of loan sales into the secondary market. During 2007, \$37.5 million in real estate mortgages were originated for sale and \$38.9 million in mortgages were sold, compared to \$38.6 million and \$37.1 million in 2006. As experienced by the industry generally, this lower volume of real estate mortgages originated was caused primarily due to the uncertainty in the residential real estate market.

Total loans, excluding real estate mortgages held for sale, increased by \$169.9 million, or 12.6%, to \$1.524 billion at December 31, 2007 from \$1.354 billion at December 31, 2006. The mix of loan types within the Company's portfolio continued a trend toward a higher percentage of the total loan portfolio being in commercial loans. The portfolio breakdown at year end 2007 reflected 82% commercial and industrial and agri-business, 15% residential real estate and home equity and 3% consumer loans compared to 80% commercial and industrial and agri-business, 14% residential real estate and home equity and 6% consumer loans at December 31, 2006.

At December 31, 2007, the allowance for loan losses was \$15.8 million, or 1.04% of total loans outstanding, versus \$14.5 million, or 1.07%, of total loans outstanding at December 31, 2006. The process of identifying probable credit losses is a subjective process. Therefore, the Company

maintains a general allowance to cover probable incurred credit losses within the entire portfolio. The methodology management uses to determine the adequacy of the loan loss reserve includes the following considerations.

The Company has a relatively high percentage of commercial and commercial real estate loans, most of which are extended to small or medium-sized businesses. Commercial loans represent higher dollar loans to fewer customers and therefore higher credit risk than other types of loans. Pricing is adjusted to manage the higher credit risk associated with these types of loans. The majority of fixed rate mortgage loans, which represent increased interest rate risk, are sold in the secondary market, as well as some variable rate mortgage loans. The remainder of the variable rate mortgage loans and a small number of fixed rate mortgage loans are retained. Management believes the allowance for loan losses is at a level commensurate with the overall risk exposure of the loan portfolio. However, if economic conditions would become unfavorable certain borrowers may experience difficulty and the level of nonperforming loans, charge-offs and delinquencies could rise and require further increases in the provision for loan losses.

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Loans are charged against the allowance for loan losses when management believes that the principal is uncollectible. Subsequent recoveries, if any, are credited to the allowance. The allowance is an amount that management believes will be adequate to absorb probable incurred credit losses relating to specifically identified loans based on an evaluation, as well as other probable incurred losses inherent in the loan portfolio. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrower's ability to repay. Management also considers trends in adversely classified loans based upon a monthly review of those credits. An appropriate level of general allowance is determined after considering the following factors: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentrations, new industry lending activity and current economic conditions. Federal regulations require insured institutions to classify their own assets on a regular basis. The regulations provide for three categories of classified loans – substandard, doubtful and loss. The regulations also contain a special mention category. Special mention is defined as loans that do not currently expose an insured institution to a sufficient degree of risk to warrant classification, but do possess credit deficiencies or potential weaknesses deserving management's close attention. Assets classified as substandard or doubtful require the institution to establish specific allowances for loan losses. If an asset or portion thereof is classified as loss, the insured institution must either establish specified allowances for loan losses in the amount of 100% of the portion of the asset classified loss, or charge off such amount. At December 31, 2007, on the basis of management's review of the loan portfolio, the Company had loans totaling \$79.3 million on the classified loan list versus \$69.7 million on December 31, 2006. As of December 31, 2007, the Company had \$39.4 million of assets classified special mention, \$39.7 million classified as substandard, \$244,000 classified as doubtful and \$0 classified as loss as compared to \$26.9 million, \$42.6 million, \$100,000 and \$0 at December 31, 2006.

Allowance estimates are developed by management taking into account actual loss experience, adjusted for current economic conditions. The Company discusses this methodology with regulatory authorities to ensure compliance. Allowance estimates are considered a prudent measurement of the risk in the Company's loan portfolio and are applied to individual loans based on loan type. In accordance with FASB Statements 5 and 114, the allowance is provided for losses that have been incurred as of the balance sheet date and is based on past events and current economic conditions, and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. For a more thorough discussion of the allowance for loan losses methodology see the Critical Accounting Policies section of this Item.

The allowance for loan losses increased \$1.3 million from \$14.5 million December 31, 2006 to \$15.8 million at December 31, 2007. Pooled loan allocations increased \$728,000 from \$4.2 million at December 31, 2006 to \$4.9 million at December 31, 2007, which was primarily a result of an increase in pooled loan balances of \$159.9 million year over year. Specific loan allocations increased \$926,000 from \$9.7 million at December 31, 2006 to \$10.6 million at December 31, 2007. This increase was primarily due to additions to the classified loan list as well as increases in the specific allocations on two commercial credits. The unallocated component of the allowance for loan losses decreased \$316,000 from \$638,000 at December 31, 2006 to \$322,000 at December 31, 2007.

The Company has experienced growth in total loans over the last three years of \$520.5 million, or 51.9%. The concentration of this loan growth was in the commercial loan portfolio. Commercial loans comprised 82%, 80% and 81% of the total loan portfolio at December 31, 2007, 2006 and 2005. Traditionally, this type of lending may have more credit risk than other types of lending because of the size and diversity of the credits. The Company manages this risk by adjusting its pricing to the perceived risk of each individual credit and by diversifying the portfolio by customer, product, industry and geography. Management has historically considered growth and portfolio composition when determining loan loss allocations. Management believes that it is prudent to continue to provide for loan losses in a manner consistent with its historical approach due to the loan growth described above and current economic conditions.

As a result of the methodology in determining the adequacy of the allowance for loan losses, the provision for loan losses was \$4.3 million in 2007 versus \$2.6 million in 2006. At December 31, 2007, total nonperforming loans decreased by \$6.7 million to \$7.4 million from \$14.1 million at December 31, 2006. Loans delinquent 90 days or more that were included in the accompanying financial statements as accruing totaled \$409,000 versus \$299,000 at December 31, 2006. Total impaired loans decreased by \$6.6 million to \$6.7 million at December 31, 2007 from \$13.3 million at December 31, 2006. The decrease in impaired and nonperforming loans primarily resulted from the transfer to other real estate of a single borrowing relationship, a residential and commercial real estate developer. The majority of the balance of nonperforming and



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impaired loans is a single commercial credit of \$4.2 million and \$5.0 million at December 31, 2007 and 2006. The borrower filed chapter 11 bankruptcy late in the third quarter of 2004 and the plan for reorganization was approved late in the third quarter of 2005. Borrower collateral and the personal guarantees of its principals support this credit. The \$6.7 million in impaired loans are all in nonaccrual status. The Company allocated \$2.3 million and \$3.4 million of the allowance for loan losses to the impaired loans in 2007 and 2006. A loan is impaired when full payment under the original loan terms is not expected. Impairment is

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evaluated in total for smaller-balance loans of similar nature such as residential mortgage, consumer, and credit card loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral.

Management has observed a regional softening in economic conditions in the Company's markets, as well as slow downs in certain industries, including residential and commercial real estate development, recreational vehicle and mobile home manufacturing and other regional industries. The Company believes that the impact of these industry-specific issues will be mitigated by its overall expansion strategy, which promotes diversification among industries as well as a continued focus on enforcement of a strong credit environment and an aggressive position on loan work-out situations. The allowance for loan loss to total loans percentage was 1.04% in 2007, and 1.07% in 2006. The Company's total nonperforming loans were 0.49% of total loans at year end 2007 versus 1.04% of total loans at the end of 2006. However, the Company's overall asset quality position can be influenced by a small number of credits due to the focus on commercial lending activity.

Total deposits increased by \$3.2 million, or 0.2%, to \$1.479 billion at December 31, 2007 from \$1.476 billion at December 31, 2006. The increase resulted from increases of \$42.9 million in other certificates of deposit, \$9.5 million in money market deposit accounts and \$5.2 million in certificates of deposit of \$100,000 and over. These increases were offset by decreases of \$25.1 million in brokered deposits, \$18.7 million in interest bearing transaction accounts, \$7.5 million in public fund certificates of deposit of \$100,000 and over and \$3.1 million in demand deposits.

Total short-term borrowings increased by \$128.7 million, or 68.6%, to \$316.2 million at December 31, 2007 from \$187.5 million at December 31, 2006. The increase resulted from increases of \$70.0 million in federal funds purchased, \$48.2 million in securities sold under agreements to repurchase, \$10.0 million in other short-term borrowings, primarily short-term advances from the Federal Home Loan Bank of Indianapolis and \$428,000 in U.S. Treasury demand notes.

The Company believes that a strong, appropriately managed capital position is critical to long-term earnings and expansion. Bank regulatory agencies exclude the market value adjustment created by SFAS No. 115 (AFS adjustment) from capital adequacy calculations. Excluding this adjustment from the calculation, the Company had a total risk-based capital ratio of 11.5% and a Tier I risk-based capital ratio of 10.5% as of December 31, 2007. These ratios met or exceeded the Federal Reserve's "well-capitalized" minimums of 10.0% and 6.0%, respectively.

The ability to maintain these ratios is a function of the balance between net income and a prudent dividend policy. Total stockholders' equity increased by 12.4% to \$146.3 million as of December 31, 2007 from \$130.2 million as of December 31, 2006. The increase in 2007 resulted from net income of \$19.2 million, as well as the following factors:

- cash dividends of \$6.6 million,
- a favorable change in the AFS adjustment for the market valuation on securities held for sale of \$1.9 million, net of tax,
- positive pension liability adjustment of \$232,000, net of tax,
- \$243,000 for the acquisition of treasury stock and
- \$1.2 million related to stock option exercises.

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Total stockholders' equity increased by 14.9% to \$130.2 million as of December 31, 2006 from \$113.3 million as of December 31, 2005. The increase in 2006 resulted from net income of \$18.7 million, as well as the following factors:

- cash dividends of \$4.5 million,
- a favorable change in the AFS adjustment for the market valuation on securities held for sale of \$989,000, net of tax,
- positive minimum pension liability adjustment of \$95,000, net of tax,
- an adjustment to initially apply SFAS NO. 158 of \$448,000, net of tax,
- \$210,000 for the acquisition of treasury stock and
- \$2.0 million related to stock option exercises.

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The 2007 AFS adjustment was primarily related to a 339 basis point decrease in the two to five year U.S. Treasury rates during 2007. Management has factored this into the determination of the size of the AFS portfolio to assure that stockholders' equity is adequate under various scenarios.

**Critical Accounting Policies**

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Some of the facts and circumstances which could affect these judgments include changes in interest rates, in the performance of the economy or in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses and the valuation of mortgage servicing rights.

**Allowance for Loan Losses**

The Company maintains an allowance for loan losses to provide for probable incurred credit losses. Loan losses are charged against the allowance when management believes that a loan will not be repaid. Subsequent recoveries, if any, are credited to the allowance. Allocations of the allowance are made for specific loans and for pools of similar types of loans, although the entire allowance is available for any loan that, in management's judgment, should be charged against the allowance. A provision for loan losses is taken based on management's ongoing evaluation of the appropriate allowance balance. A formal evaluation of the adequacy of the loan loss allowance is conducted at least monthly and more often if deemed necessary. The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control.

The level of loan loss provision is influenced by growth in the overall loan portfolio, emerging market risk, commercial loan focus and large credit concentration, new industry lending activity, general economic conditions and historical loss analysis. In addition, management gives consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Furthermore, management's overall view on credit quality is a factor in the determination of the provision.

The determination of the appropriate allowance is inherently subjective, as it requires significant estimates. The Company has an established process to determine the adequacy of the allowance for loan losses that generally includes consideration of the following factors: changes in the nature and volume of the loan portfolio, overall portfolio quality and current economic conditions that may affect the borrowers' ability to repay. Consideration is not limited to these factors, although they represent the most commonly cited factors. With respect to specific allocation levels for individual credits, management generally considers the amounts and timing of expected future cash flows and the valuation of collateral as the primary measures. Management also considers trends in adversely classified loans based upon an ongoing review of those credits. With respect to pools of similar loans, we generally use percentage allocations based upon historical analysis. We may also adjust these allocations for other factors cited above. An appropriate level of general allowance for pooled loans is determined after considering the following: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentration, new industry lending activity and general economic conditions. It is also possible that the following could affect the overall process: social, political, economic and terrorist events or activities. All of these factors are susceptible to significant change. As a result of this detailed process, the allowance results in two forms of allocations, specific and general. These two components represent the total allowance for loan losses deemed adequate to cover probable losses inherent in the loan portfolio.

Commercial loans are subject to a dual standardized grading process administered by the credit administration and internal loan review functions. A credit grade is assigned to each commercial loan by both the commercial loan officer and the loan review department. These grade assignments are performed independent of each other and a loan may or may not be graded the same. The grade given by the loan review department is the assigned in the Company's loan system for individual credits. The need for specific allocation of the loan loss reserve is considered for individual credits when graded special mention, substandard, doubtful or loss. Other considerations with respect to specific allocations for individual credits include, but are not limited to, the following: (a) does the customer's cash flow or net worth appear insufficient to repay the loan; (b) is there adequate collateral to repay the loan; (c) has the loan been criticized in a regulatory examination; (d) is the loan on non-accrual; (e) are there other reasons where the ultimate collectibility of the loan is in question; or (f) are there unique loan characteristics require special monitoring. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that we believe indicates the loan is impaired.

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Allocations are also applied to categories of loans not considered individually impaired but for which the rate of loss is expected to be consistent with or greater than historical averages. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values. In addition, general allocations are made for other pools of loans, including non-classified loans. These general pooled loan allocations are performed for similar portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on a five-year historical average for loan losses for these portfolios, judgmentally adjusted for economic factors and portfolio trends.

Due to the imprecise nature of estimating the allowance for loan losses, the Company's allowance for loan losses includes an unallocated component. The unallocated component of the allowance for loan losses incorporates the Company's judgmental determination of inherent losses that may not be fully reflected in other allocations, including factors such as the level of classified credits, economic uncertainties, industry trends impacting specific portfolio segments, broad portfolio quality trends and trends in the composition of the Company's large commercial loan portfolio and related large dollar exposures to individual borrowers.

**Mortgage Servicing Rights Valuation**

The Company adopted SFAS No. 156 on January 1, 2007, and for sales of mortgage loans beginning in 2007, mortgage servicing rights (MSRs) are initially recognized as assets for the full fair value of retained servicing rights on loans sold. For sales of mortgage loans prior to January 1, 2007, a portion of the cost of the loan was allocated to the servicing right based on relative fair values. Subsequent measurement uses the amortization method where all servicing rights are expensed in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on the fair value of the rights, using groupings of the underlying loans as to type and interest rate. Fair value is determined based upon discounted cash flows using market-based assumptions.

To determine the fair value of MSRs, the Company uses a valuation model that calculates the present value of estimated future net servicing income. In using this valuation method, the Company incorporates assumptions that market participants would use in estimating future net servicing income, which include estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, late fees, and float income. The Company compares the valuation model inputs and results to published industry data in order to validate the model results and assumptions.

The most significant assumption used to value MSRs is prepayment rate. In general, during periods of declining interest rates, the value of MSRs decline due to increasing prepayment speeds attributable to increased mortgage refinancing activity. Prepayment rates are estimated based on published industry consensus prepayment rates. Prepayments will increase or decrease in correlation with market interest rates and actual prepayments generally differ from initial estimates. If actual prepayment rates are different than originally estimated, the Company may receive less mortgage servicing income, which could reduce the value of the MSRs. Other assumptions used in estimating the fair value of MSRs do not generally fluctuate to the same degree as prepayment rates, and therefore the fair value of MSRs is less sensitive to changes in these other assumptions.

The servicing assets had a fair value of \$2.5 million and \$2.4 million at December 31, 2007 and 2006, respectively. At December 31, 2007, key economic assumptions and the sensitivity of the current fair value of mortgage servicing rights to an immediate 10% and 20% adverse changes in those assumptions are as follows:

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Fair value of mortgage servicing assets	\$ 2,483
Constant prepayment speed (PSA)	219
Impact on fair value of 10% adverse change	\$ (109 )
Impact on fair value of 20% adverse change	(210 )
Discount rate	9.4 %
Impact on fair value of 10% adverse change	\$ (71 )
Impact on fair value of 20% adverse change	(139 )

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in value based on a 10% and 20% variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the value of the servicing asset is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments), which might magnify or counteract the sensitivities.

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On a monthly basis, the Company evaluates the possible impairment of MSRs based on the difference between the carrying amount and the current fair value of MSRs. For purposes of evaluating and measuring impairment, the Company stratifies its portfolios on the basis of certain risk characteristics, including loan type and interest rate. If impairment exists, a valuation allowance is established for any excess of amortized cost over the current fair value, by risk stratification, through a charge to income. If the Company later determines that all or a portion of the impairment no longer exists for a particular strata, a reduction of the valuation allowance may be recorded as an increase to income.

**Newly Issued But Not Yet Effective Accounting Standards:**

FASB Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations* is effective for fiscal years beginning after December 15, 2008. SFAS No. 141(R) establishes principles and requirements for how the acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The Company does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.

FASB Statement of Financial Accounting Standards No. 157 (SFAS No. 157), *Fair Value Measurements* is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about

fair value measurements. This Statement emphasizes that fair value is a market-based measurement and should be determined based on assumptions that a market participant would use when pricing an asset or liability. This

Statement clarifies that market participant assumptions should include assumptions about risk as well as the effect of a restriction on the sale or use of an asset. Additionally, this Statement establishes a fair value hierarchy that provides the highest priority to quoted prices in active markets and the lowest priority to unobservable data. The

Company plans to adopt this standard as of January 1, 2008. The Company does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.

FASB Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* Including an amendment of FASB Statement No. 115 is effective for fiscal years beginning after November 15, 2007. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. This statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The Company plans to adopt this standard as of January 1, 2008. The Company did not elect the fair value option for any financial assets or liabilities as of January 1, 2008.

FASB Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51* is effective for fiscal years beginning after December 15, 2008. SFAS No. 160 improves the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing certain accounting and reporting standards requirements. The Company does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.



Emerging Issues Task Force (EITF) Issue 06-04, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements* is effective for fiscal years beginning after December 15, 2007, with earlier adoption permitted. EITF Issue 06-04 requires that for an endorsement split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a

liability for future benefits in accordance with Statement 106 (if, in substance, a postretirement benefit plan exists) or Opinion 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee and all available evidence should be considered in determining the substance of the arrangement, such as the explicit written terms of the arrangement, communications made by the

employer to the employee, and the determination of whether the employer or the insurer is the primary obligor for

the postretirement benefit. The Company does not have any postretirement benefit on endorsement split-dollar life insurance and therefore does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.

Staff Accounting Bulletin No. 109 (SAB No. 109), *Written Loan Commitments Recorded at Fair Value through Earnings* supersedes SAB 105, *Application of Accounting Principles to Loan Commitments* which stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 states that the expected net future cash

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flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also states that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 is effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Company does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.

No other new accounting standards have been issued that are not yet effective that are expected to have a significant impact on the Company's financial condition or results of operations.

**Liquidity**

Management maintains a liquidity position that it believes will adequately provide funding for loan demand and deposit run-off that may occur in the normal course of business. The Company relies on a number of different sources in order to meet these potential liquidity demands. The primary sources are increases in deposit accounts and cash flows from loan payments and the securities portfolio. Given current prepayment assumptions, the cash flow from the securities portfolio is expected to provide approximately \$82.2 million of funding in 2008.

In addition to these primary sources of funds, management has several secondary sources available to meet potential funding requirements. As of December 31, 2007, the Company had \$235.0 million in Federal Funds lines with correspondent banks and may borrow up to \$150.0 million at the Federal Home Loan Bank of Indianapolis. The Company had all of its securities in the available for sale (AFS) portfolio at December 31, 2007. Therefore, the Company may sell securities to meet funding demands. Management believes that the securities in the AFS portfolio are of high quality and would therefore be marketable. Approximately 69% of this portfolio is comprised of Federal agency securities or mortgage-backed securities directly or indirectly backed by the Federal government. In addition, the Company has historically sold the majority of its originated mortgage loans on the secondary market to reduce interest rate risk and to create an additional source of funding.

During 2007, cash and cash equivalents decreased \$52.0 million from \$119.7 million as of December 31, 2006 to \$67.7 million as of December 31, 2007. The primary driver of this decrease was an increase in loan balances of \$178.5 million, which is net of approximately \$37.5 million of loans originated and sold in 2007. Another use of funds was purchases of securities of \$104.0 million. Sources of funds were proceeds from short-term borrowings of \$128.7 million, proceeds from maturities, calls and principal paydowns of securities of \$43.6 million, proceeds from loan sales of \$39.5 million and proceeds from the sale of securities of \$31.6 million.

During 2006, cash and cash equivalents increased \$37.0 million from \$82.7 million as of December 31, 2005 to \$119.7 million as of December 31, 2006. The primary driver of this increase was an increase in deposit balances of \$209.5 million. Other sources of funds were proceeds from maturities, calls and principal paydowns of securities of \$46.8 million and proceeds from loan sales of \$37.7 million. The primary use of funds was a \$156.1 million increase in net loans, which is net of approximately \$38.6 million in loans originated and sold during 2006. Other uses of funds were purchases of securities of \$74.2 million and payments on short-term borrowings of \$24.1 million.

During 2005, cash and cash equivalents decreased \$21.2 million from \$103.9 million as of December 31, 2004 to \$82.7 million as of December 31, 2005. The primary driver of this decrease was an increase in net loans of \$199.1 million, which is net of approximately \$43.9 million of loans originated and sold during 2005. Other uses of funds were purchases of securities of \$68.4 million and payments on long-term borrowings

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of \$10.0 million. Sources of funds were a net increase in deposits of \$150.8 million, proceeds from maturities, calls and principal paydowns of securities of \$51.0 million and proceeds from loan sales of \$46.4 million. Other sources of funds were proceeds from short-term borrowings of \$25.9 million and proceeds from the sale of securities of \$6.3 million.

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The following tables disclose information on the maturity of the Company's contractual long-term obligations and commitments. Certificates of deposit listed are those with original maturities of 1 year or more.

	Payments Due by Period				
	Total	One year or less	1-3 years	4-5 years	After 5 years
	(in thousands)				
Certificates of deposit	\$ 279,934	\$ 231,414	\$ 46,364	\$ 2,118	\$ 38
Long—term debt	44	0	0	0	44
Operating leases	53	32	20	1	0
Subordinated debentures	30,928	0	0	0	30,928
Total contractual long—term cash obligations	\$ 310,959	\$ 231,446	\$ 46,384	\$ 2,119	\$ 31,010

	Amount of Commitment Expiration Per Period		
	Total Amount Committed	One year or less	Over one year
	(in thousands)		
Unused loan commitments	\$ 609,022	\$ 420,627	\$ 188,395
Commercial letters of credit	861	861	0
Standby letters of credit	14,800	12,314	2,486
Total commitments and letters of credit	\$ 624,683	\$ 433,802	\$ 190,881

**Off-Balance Sheet Transactions**

During the normal course of business, the Company becomes a party to financial instruments with off-balance sheet risk in order to meet the financing needs of its customers. These financial instruments include commitments to make loans and open-ended revolving lines of credit. The Company follows the same credit policy (including requiring collateral, if deemed appropriate) to make such commitments as is followed for those loans that are recorded in its financial statements.

The Company's exposure to credit losses in the event of nonperformance is represented by the contractual amount of the commitments. Management does not expect any significant losses as a result of these commitments. Off-Balance Sheet transactions are more fully discussed in Note 19.

**Inflation**

The effects of price changes and inflation can vary substantially for most financial institutions. While management believes that inflation affects the growth of total assets, it believes that it is difficult to assess the overall impact. Management believes this to be the case due to the fact that generally neither the timing nor the magnitude of the inflationary changes in the consumer price index ("CPI") coincides with changes in interest rates. The price of one or more of the components of the CPI may fluctuate considerably and thereby influence the overall CPI without having a corresponding affect on interest rates or upon the cost of those goods and services normally purchased by the Company. In years of high inflation and high interest rates, intermediate and long-term interest rates tend to increase, thereby adversely impacting the market values of investment securities, mortgage loans and other long-term fixed rate loans. In addition, higher short-term interest rates caused by inflation tend to increase the cost of funds. In other years, the reverse situation may occur.

Table of Contents**ITEM 7a. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Asset/Liability Management (ALCO) and Securities**

Interest rate risk represents the Company's primary market risk exposure. The Company does not have material exposure to foreign currency exchange risk, does not own any significant derivative financial instruments and does not maintain a trading portfolio. The Board of Directors annually reviews and approves the ALCO policy used to manage interest rate risk. This policy sets guidelines for balance sheet structure, which are designed to protect the Company from the impact that interest rate changes could have on net income, but does not necessarily indicate the effect on future net interest income. Given the Company's mix of interest bearing liabilities and interest bearing assets on December 31, 2007, the net interest margin could be expected to decline in a falling interest rate environment and conversely, to increase in a rising rate environment. Beginning with the September 18, 2007 meeting the Federal Open Market Committee (FOMC) started lowering the target federal funds rate. In the three meeting from September 2007 through December 2007 the FOMC lowered the rate from 5.25% to 4.25%. Despite these rate cuts, the yield on earning assets increased from 6.75% for 2006 to 6.89% for 2007. The increase in the yield on earning assets was offset by an increase in the rates paid on deposit accounts. The rate paid on deposit accounts and purchased funds increased from 3.96% for 2006 to 4.35% for 2007. The combined result of the increase in the yield on earning assets and the increase in the rates paid on deposits and purchased funds was a decrease in the net margin from 3.38% for 2006 to 3.22% for 2007. Future changes in the net interest margin will be dependent upon multiple factors including further actions by the FOMC during 2008 in response to economic conditions, competitive pressures in the various markets served, and changes in the structure of the balance sheet in as a result of changes in customer demands for products and services.

The Company utilizes a computer program to stress test the balance sheet under a wide variety of interest rate scenarios. The model quantifies the income impact of changes in customer preference for products, basis risk between the assets and the liabilities that support them and the risk inherent in different yield curves, as well as other factors. The ALCO committee reviews these possible outcomes and makes loan, investment and deposit decisions that maintain reasonable balance sheet structure in light of potential interest rate movements. Although management does not consider GAP ratios in this planning, the information can be used in a general fashion to look at asset and liability mismatches. The Company's cumulative repricing GAP ratio as of December 31, 2007 for the next 12 months using a rates unchanged scenario was a negative 18.22% of earning assets.

The Company's investment portfolio consists of U.S. Treasury securities, agencies, mortgage-backed securities and municipal bonds. During 2007, purchases in the securities portfolio consisted primarily of agency securities, whole-loan securities and municipal bonds. As of December 31, 2007, the Company's investment in mortgage-backed securities represented approximately 76% of total securities and consisted primarily of CMOs and mortgage pools issued by Ginnie Mae, Fannie Mae and Freddie Mac. Ginnie Mae, Fannie Mae and Freddie Mac securities are each guaranteed by their respective agencies as to principal and interest. The whole-loan securities purchased were all super senior securities that met specific criteria established by the Asset Liability Management Committee of the Company. All mortgage securities purchased by the Company are within risk tolerances for price, prepayment, extension and original life risk characteristics contained in the Company's investment policy. The Company uses Bloomberg analytics to evaluate and monitor all purchases. As of December 31, 2007, the securities in the AFS portfolio had approximately a two and three-quarter year average life with approximately 10% price depreciation in the event of a 300 basis points upward movement. The portfolio had approximately 5% price appreciation in the event of a 300 basis point downward movement in rates. As of December 31, 2007, all mortgage securities were performing in a manner consistent with management's original expectations.

The following table provides information regarding the Company's financial instruments used for purposes other than trading that are sensitive to changes in interest rates. For loans, securities and liabilities with contractual maturities, the table present principal cash flows and related weighted-average interest rates by contractual maturities, as well as the Company's historical experience of the impact of interest-rate fluctuations on the prepayment of residential and home equity loans and mortgage-backed securities. Core deposits such as deposits, interest-bearing checking, savings and money market deposits that have no contractual maturity, are shown under Year 1, however historical

experience indicates that some portion of the balances are retained over time. Weighted-average variable rates are based upon rates existing at the reporting date.

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2007

Principal/Notional Amount Maturing in:  
(in thousands)

	Year 1	Year 2	Year 3	Year 4	Year 5	Thereafter	Total	Fair Value 12/31/2007
Rate sensitive assets:								
Fixed interest rate loans	\$ 187,313	\$ 152,624	\$ 130,420	\$ 120,818	\$ 92,819	\$ 36,653	\$ 720,647	\$ 733,974
Average interest rate	6.84 %	6.69 %	6.91 %	7.11 %	6.91 %	6.92 %	6.88 %	
Variable interest rate loans	\$ 581,142	\$ 45,712	\$ 31,775	\$ 14,318	\$ 15,301	\$ 114,825	\$ 803,073	\$ 800,851
Average interest rate	7.13 %	7.32 %	7.20 %	7.13 %	7.99 %	6.52 %	7.07 %	
Fixed interest rate securities	\$ 71,476	\$ 73,024	\$ 56,864	\$ 28,108	\$ 20,735	\$ 77,087	\$ 327,294	\$ 327,538
Average interest rate	4.50 %	4.39 %	3.01 %	4.15 %	4.76 %	5.31 %	4.41 %	
Variable interest rate securities	\$ 218	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 218	\$ 219
Average interest rate	7.35 %	0.00 %	0.00 %	0.00 %	0.00 %	0.00 %	7.35 %	
Other interest—bearing assets	\$ 11,413	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 11,413	\$ 11,413
Average interest rate	4.32 %	0.00 %	0.00 %	0.00 %	0.00 %	0.00 %	4.32 %	
Rate sensitive liabilities:								
Non—interest bearing checking	\$ 255,348	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 255,348	\$ 255,348
Average interest rate								
Savings & interest bearing checking	\$ 523,857	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 523,857	\$ 523,857
Average interest rate	3.00 %	0.00 %	0.00 %	0.00 %	0.00 %	0.00 %	3.00 %	
Time deposits	\$ 563,360	\$ 106,482	\$ 14,465	\$ 8,790	\$ 6,031	\$ 585	\$ 699,713	\$ 703,766
Average interest rate	5.00 %	4.93 %	4.65 %	4.85 %	4.57 %	4.57 %	4.98 %	
Fixed interest rate borrowings	\$ 101,688	\$ 0	\$ 0	\$ 0	\$ 0	\$ 44	\$ 101,732	\$ 101,752
Average interest rate	4.51 %	0.00 %	0.00 %	0.00 %	0.00 %	6.15 %	4.51 %	
Variable interest rate borrowings	\$ 214,477	\$ 0	\$ 0	\$ 0	\$ 0	\$ 30,928	\$ 245,405	\$ 247,486
Average interest rate	6.05 %	0.00 %	0.00 %	0.00 %	0.00 %	8.47 %	6.84 %	





Table of Contents**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA****CONSOLIDATED BALANCE SHEETS (in thousands except share data)**

<b>December 31</b>	<b>2007</b>	<b>2006</b>
<b>ASSETS</b>		
Cash and due from banks	\$ 56,278	\$ 65,252
Short-term investments	11,413	54,447
Total cash and cash equivalents	67,691	119,699
Securities available for sale (carried at fair value)	327,757	296,191
Real estate mortgage loans held for sale	537	2,175
Loans, net of allowance for loan losses of \$15,801 and \$14,463	1,507,919	1,339,374
Land, premises and equipment, net	27,525	25,177
Bank owned life insurance	21,543	20,570
Accrued income receivable	9,126	8,720
Goodwill	4,970	4,970
Other intangible assets	619	825
Other assets	21,446	19,005
Total assets	\$ 1,989,133	\$ 1,836,706

**LIABILITIES AND STOCKHOLDERS' EQUITY****LIABILITIES**

Noninterest bearing deposits	\$ 255,348	\$ 258,472
Interest bearing deposits	1,223,570	1,217,293
Total deposits	1,478,918	1,475,765
Short-term borrowings		
Federal funds purchased	70,010	0
Securities sold under agreements to repurchase	154,913	106,670
U.S. Treasury demand notes	1,242	814
Other short-term borrowings	90,000	80,000
Total short-term borrowings	316,165	187,484
Accrued expenses payable	15,497	11,959
Other liabilities	1,311	338
Long-term borrowings	44	45
Subordinated debentures	30,928	30,928
Total liabilities	1,842,863	1,706,519

Commitments, off-balance sheet risks and contingencies (Notes 1 and 19)

**STOCKHOLDERS' EQUITY**

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Common stock: 180,000,000 shares authorized, no par value		
12,207,723 shares issued and 12,111,703 outstanding as of December 31, 2007		
12,117,808 shares issued and 12,031,023 outstanding as of December 31, 2006	<b>1,453</b>	1,453
Additional paid-in capital	<b>18,078</b>	16,525
Retained earnings	<b>129,090</b>	116,516
Accumulated other comprehensive loss	<b>(1,010)</b>	(3,178)
Treasury stock, at cost (2007 - 96,020 shares, 2006 - 86,785 shares)	<b>(1,341)</b>	(1,129)
Total stockholders' equity	<b>146,270</b>	130,187
Total liabilities and stockholders' equity	<b>\$ 1,989,133</b>	\$ 1,836,706

*The accompanying notes are an integral part of these consolidated financial statements.*

Table of Contents**CONSOLIDATED STATEMENTS OF INCOME (in thousands except share and per share data)**

<b>Years Ended December 31</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>NET INTEREST INCOME</b>			
Interest and fees on loans			
Taxable	\$ 102,840	\$ 91,946	\$ 68,417
Tax exempt	137	279	182
Interest and dividends on securities			
Taxable	11,591	10,123	9,343
Tax exempt	2,474	2,405	2,341
Interest on short-term investments	931	798	333
Total interest income	117,973	105,551	80,616
Interest on deposits	53,614	45,101	24,331
Interest on borrowings			
Short-term	7,239	5,594	3,790
Long-term	2,564	2,529	2,232
Total interest expense	63,417	53,224	30,353
<b>NET INTEREST INCOME</b>	<b>54,556</b>	<b>52,327</b>	<b>50,263</b>
Provision for loan losses	4,298	2,644	2,480
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>50,258</b>	<b>49,683</b>	<b>47,783</b>
<b>NONINTEREST INCOME</b>			
Wealth advisory fees	3,142	2,550	2,368
Investment brokerage fees	1,491	1,290	745
Service charges on deposit accounts	7,238	7,260	6,742
Loan, insurance and service fees	2,483	2,292	1,984
Merchant card fee income	2,624	2,413	2,435
Other income	1,837	1,946	1,709
Gain on sale of credit card portfolio	0	0	863
Net gains on sales of real estate mortgage loans held for sale	676	581	934
Net securities gains/(losses)	89	(68	) (69
Total noninterest income	19,580	18,264	17,711
<b>NONINTEREST EXPENSE</b>			
Salaries and employee benefits	23,817	22,378	20,543
Net occupancy expense	2,734	2,510	2,774
Equipment costs	1,906	1,799	1,942
Data processing fees and supplies	2,906	2,457	2,396
Credit card interchange	1,732	1,627	1,527
Other expense	9,166	8,941	8,875
Total noninterest expense	42,261	39,712	38,057
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	<b>27,577</b>	<b>28,235</b>	<b>27,437</b>
Income tax expense	8,366	9,514	9,479

<b>NET INCOME</b>	<b>\$ 19,211</b>	\$ 18,721	\$ 17,958
<b>BASIC WEIGHTED AVERAGE COMMON SHARES</b>	<b>12,188,594</b>	12,069,300	11,927,756
<b>BASIC EARNINGS PER COMMON SHARE</b>	<b>\$ 1.58</b>	\$ 1.55	\$ 1.51
<b>DILUTED WEIGHTED AVERAGE COMMON SHARES</b>	<b>12,424,137</b>	12,375,467	12,289,466
<b>DILUTED EARNINGS PER COMMON SHARE</b>	<b>\$ 1.55</b>	\$ 1.51	\$ 1.46

*The accompanying notes are an integral part of these consolidated financial statements.*

Table of Contents**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (in thousands except share and per share data)**

	<b>Common Stock</b>	<b>Additional Paid-in Capital</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Treasury Stock</b>	<b>Total Stockholders' Equity</b>
Balance at January 1, 2005	\$ 1,453	\$ 12,463	\$ 89,864	\$ (1,267 )	\$ (748 )	\$ 101,765
Comprehensive income:						
Net income			17,958			17,958
Other comprehensive income, net of tax				(2,547 )		(2,547 )
Comprehensive income						15,411
Cash dividends declared, \$.46 per share			(5,495 )			(5,495 )
Treasury shares purchased under deferred directors' plan (8,282 shares)		171			(171 )	0
Stock issued for stock option exercises (140,400 shares)		1,168				1,168
Tax benefit of stock option exercises		485				485
Balance at December 31, 2005	1,453	14,287	102,327	(3,814 )	(919 )	113,334
Comprehensive income:						
Net income			18,721			18,721
Other comprehensive income, net of tax				1,084		1,084
Comprehensive income						19,805
Adjustment to initially apply SFAS NO. 158, net of tax of \$305				(448 )		(448 )
Cash dividends declared, \$.375 per share			(4,532 )			(4,532 )
Treasury shares purchased under deferred directors' plan (9,361 shares)		210			(210 )	0
Stock issued for stock option exercises (145,700 shares)		1,148				1,148
Tax benefit of stock option exercises		692				692
Stock option expense		188				188
Balance at December 31, 2006	1,453	16,525	116,516	(3,178 )	(1,129 )	130,187
Comprehensive income:						
Net income			<b>19,211</b>			<b>19,211</b>
Other comprehensive income, net of tax				<b>2,168</b>		<b>2,168</b>
Comprehensive income						<b>21,379</b>
Cash dividends declared, \$.545 per share			(6,637 )			(6,637 )
Treasury shares purchased under deferred directors' plan (10,557 shares)		<b>243</b>			(243 )	<b>0</b>
Treasury stock sold and distributed under deferred directors' plan (1,322 shares)		(31 )			<b>31</b>	<b>0</b>
Stock issued for stock option exercises (98,117 shares, net of 8,202 shares redeemed)		<b>771</b>				<b>771</b>



Table of Contents**CONSOLIDATED STATEMENTS OF CASH FLOWS (in thousands)**

<b>Years Ended December 31</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Cash flows from operating activities:			
Net income	\$ 19,211	\$ 18,721	\$ 17,958
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation	1,721	1,650	1,829
Provision for loan losses	4,298	2,644	2,480
Write down of other real estate owned	127	0	0
Amortization of intangible assets	206	209	211
Amortization of loan servicing rights	416	454	572
Net change in loan servicing rights valuation allowance	(49)	(67)	(159)
Loans originated for sale	(37,539)	(38,614)	(43,909)
Net gain on sales of loans	(676)	(581)	(934)
Proceeds from sale of loans	39,526	37,683	46,431
Net gain on sale of credit card portfolio	0	0	(863)
Net (gain) loss on sale of premises and equipment	1	(14)	(79)
Net (gain) loss on sales of securities available for sale	(89)	68	69
Net securities amortization	473	1,743	2,612
Stock compensation expense	174	188	0
Earnings on life insurance	(810)	(755)	(656)
Tax benefit of stock option exercises	(396)	(692)	0
Net change:			
Accrued income receivable	(406)	(1,304)	(1,651)
Accrued expenses payable	3,770	1,183	2,995
Other assets	1,869	(2,152)	(1,152)
Other liabilities	1,216	(171)	244
Total adjustments	13,832	1,472	8,040
Net cash from operating activities	33,043	20,193	25,998
Cash flows from investing activities:			
Proceeds from sale of securities available for sale	31,612	21,634	6,259
Proceeds from maturities, calls and principal paydowns of securities available for sale	43,628	46,794	51,047
Purchases of securities available for sale	(104,007)	(74,240)	(68,391)
Purchase of life insurance	(163)	(161)	(2,102)
Proceeds from credit card sale	0	0	4,008
Net increase in total loans	(178,171)	(156,133)	(199,116)
Proceeds from sales of land, premises and equipment	85	210	459
Purchases of land, premises and equipment	(4,155)	(2,460)	(1,715)
Net cash from investing activities	(211,171)	(164,356)	(209,551)
Cash flows from financing activities:			
Net increase in total deposits	3,153	209,520	150,846
Net increase (decrease) in short-term borrowings	128,681	(24,058)	25,892
Payments on long-term borrowings	(1)	(1)	(10,000)
Dividends paid	(6,637)	(5,908)	(5,361)
Proceeds from stock option exercise	1,167	1,840	1,168
Purchase of treasury stock	(243)	(210)	(171)



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Net cash from financing activities	<b>126,120</b>	181,183	162,374
Net change in cash and cash equivalents	<b>(52,008 )</b>	37,020	(21,179 )
Cash and cash equivalents at beginning of the year	<b>119,699</b>	82,679	103,858
Cash and cash equivalents at end of the year	<b>\$ 67,691</b>	\$ 119,699	\$ 82,679
Cash paid during the year for:			
Interest	<b>\$ 59,822</b>	\$ 51,937	\$ 27,682
Income taxes	<b>8,427</b>	11,205	9,420
Supplemental non-cash disclosures:			
Loans transferred to other real estate	<b>5,328</b>	71	0

*The accompanying notes are an integral part of these consolidated financial statements.*

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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Nature of Operations and Principles of Consolidation:

The consolidated financial statements include Lakeland Financial Corporation and its wholly-owned subsidiary, Lake City Bank (the “Bank”), together referred to as (the “Company”). Also included in the consolidated financial statements prior to December 27, 2006 is LCB Investments, Limited, a wholly-owned subsidiary of Lake City Bank, which is a Bermuda corporation that managed a portion of the Bank’s investment portfolio. On December 27, 2006, all securities were transferred to Lake City Bank from LCB Investments, Limited. On December 18, 2006, LCB Investments II, Inc. was formed as a wholly owned subsidiary of Lake City Bank incorporated in Nevada manages a portion of the Bank’s investment portfolio beginning in 2007. On December 21, 2006 LCB Funding, Inc., a real estate investment trust incorporated in Maryland, was formed as a wholly-owned subsidiary of LCB Investments II, Inc. All intercompany transactions and balances are eliminated in consolidation.

The Company provides financial services through its subsidiary, Lake City Bank, a full-service commercial bank with 43 branch offices in twelve counties in northern Indiana. The Company also operates a loan production office in Indianapolis, which is staffed by a commercial loan officer and was opened in 2006. The Company provides commercial, retail, trust and investment services to its customers. Commercial products include commercial loans and technology-driven solutions to meet commercial customers’ cash management needs such as internet business banking and on-line cash management services. Retail banking clients are provided a wide array of traditional retail banking services, including lending, deposit and investment services. Retail lending programs are focused on mortgage loans, home equity lines of credit and traditional retail installment loans. The Company provides credit card services to retail and commercial customers through its retail card program and merchant processing activity. The Company also has an Honors Private Banking program that is positioned to serve the more financially sophisticated customer with a menu including brokerage and trust services, executive mortgage programs and access to financial planning seminars and programs. The Company’s Prospero Program is dedicated to serving the expanding financial needs of the Latino community. The Company provides trust clients with traditional personal and corporate trust services. The Company also provides retail brokerage services, including an array of financial and investment products such as annuities and life insurance. Other financial instruments, which represent potential concentrations of credit risk, include deposit accounts in other financial institutions.

Use of Estimates:

To prepare financial statements in conformity with U.S. generally accepted accounting principles, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided and future results could differ. The allowance for loan losses, the fair values of financial instruments and the fair value of loan servicing rights are particularly subject to change.

Cash Flows:

Cash and cash equivalents include cash, demand deposits in other financial institutions and short-term investments with maturities of 90 days or less. Cash flows are reported net for customer loan and deposit transactions.

Securities:

Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income (loss), net of tax. Trading securities are bought for sale in the near term and are carried at fair value, with changes in unrealized holding gains and losses included in income. Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity.

Purchase premiums or discounts are recognized in interest income using the interest method over the terms of the securities or over estimated lives for mortgage-backed securities. Gains and losses on sales are based on the amortized cost of the security sold and recorded on the trade date. Securities are written down to fair value when a decline in fair value is deemed to be other than temporary, as more fully disclosed in Note 2.

The Company does not have any material derivative instruments, nor does the Company participate in any significant hedging activities.

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

Real Estate Mortgage Loans Held for Sale:

Loans held for sale are reported at the lower of cost or market on an aggregate basis. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Loan sales occur on the delivery date agreed to in the commitment agreement. The Company retains servicing on the majority of loans sold. The carrying value of loans sold is reduced by the amount allocated to the servicing right. The gain or loss on the sale of loans is the difference between the carrying value of the loans sold and the funds received from the sale.

Loans:

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses.

Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. All mortgage and commercial loans for which collateral is insufficient to cover all principal and accrued interest are reclassified as nonaccrual loans, on or before the date when the loan becomes 90 days delinquent. When a loan is classified as a nonaccrual loan, interest on the loan is no longer accrued, all unpaid accrued interest is reversed and interest income is subsequently recorded only to the extent cash payments are received. Accrual status is resumed when all contractually due payments are brought current and future payments are reasonably assured. Consumer installment loans, except those loans that are secured by real estate, are not placed on a nonaccrual status since these loans are charged-off when they have been delinquent from 90 to 180 days, and when the related collateral, if any, is not sufficient to offset the indebtedness. Advances under consumer line of credit programs, are charged-off when collection appears doubtful.

Allowance for Loan Losses:

The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any are credited to the allowance. Management estimates the allowance balance required using past loan loss experience, known and inherent risks in the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, internal loan grade classifications, economic conditions and other factors. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available or as future events change. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as special mention, substandard, doubtful or loss on the Company's watch list. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors.

A loan is impaired when full payment under the original loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature such as residential mortgage and consumer loans, and on an individual loan basis for other loans. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Mortgage and commercial loans, when they have been delinquent from 90 to 180 days, are reviewed to determine if a charge-off is necessary, if the related collateral, if any, is not sufficient to offset the indebtedness.

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

Investments in Limited Partnerships:

Investments in limited partnerships represent the Company's investments in affordable housing projects for the primary purpose of available tax benefits. The Company is a limited partner in these investments and as such, the Company is not involved in the management or operation of such investments. These investments are accounted for using the equity method of accounting. Under the equity method of accounting, the Company records its share of the partnership's earnings or losses in its income statement and adjusts the carrying amount of the investments on the balance sheet. These investments are evaluated for impairment when events indicate the carrying amount may not be recoverable. The investment recorded at December 31, 2007 and 2006 was \$334,000 and \$373,000 and is included with other assets in the balance sheet.

Foreclosed Assets:

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed. At December 31, 2007 and 2006, the balance of repossessed assets and real estate owned was \$2.4 million and \$106,000 and are included with other assets on the balance sheet.

Land, Premises and Equipment:

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the useful lives of the assets. Premises assets have useful lives between 7 and 40 years. Equipment assets have useful lives between 3 and 10 years.

Loan Servicing Rights:

The Company adopted SFAS No. 156 on January 1, 2007, and for sales of mortgage loans beginning in 2007, loan servicing rights are initially recognized as assets for the full fair value of retained servicing rights on loans sold with the income statement effect recorded in gains on sales of real estate mortgage loans held for sale. For sales of mortgage loans prior to January 1, 2007, a portion of the cost of the loan was allocated to the servicing right based on relative fair values. Subsequent measurement uses the amortization method where all loan servicing rights are expensed in proportion to, and over the period of, estimated net servicing revenues.

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Impairment is evaluated based on the fair value of the rights, using groupings of the underlying loans as to loan type, term and interest rates. Any impairment of a grouping is reported as a valuation allowance. Fair value is calculated on a loan by loan basis and is determined based upon discounted cash flows using market-based assumptions, specifically prepayment speeds, discount rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, late fees, and float income.

Servicing fee income/(loss), amortization and changes in the valuation allowance are included in loan, insurance and service fees. Fees earned for servicing loans are based on a contractual percentage of the outstanding principal. Late fees and ancillary fees related to loan servicing are not material.

### Bank Owned Life Insurance:

At December 31, 2007 and 2006, the Company owned \$20.8 million and \$20.1 million of life insurance policies on certain officers to provide life insurance for these officers. At December 31, 2007 and 2006 the Company also owned \$719,000 and \$500,000 of variable life insurance on certain officers related to a deferred compensation plan. Bank owned life insurance is recorded at the amount that can be realized, which is the cash surrender value adjusted, beginning January 1, 2007, for other changes or other amounts due that are probable at settlement.

### Goodwill and Other Intangible Assets:

Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment will be recognized in the period identified.

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

Other intangible assets consist of core deposit intangibles arising from branch acquisitions and trust deposit relationships arising from a trust acquisition. Core deposit intangibles are initially measured at fair value and then are amortized on an accelerated method over their estimated useful lives, which is 12 years. Trust deposit relationships are initially measured at fair value and then amortized on an accelerated method over their estimated useful lives, which is 10 years.

Federal Home Loan Bank and Federal Reserve Bank Stock:

Federal Home Loan Bank and Federal Reserve Bank stock is carried at cost in other assets and is periodically evaluated for impairment based on ultimate recoverability of par value. Both cash and stock dividends are reported as income.

Repurchase Agreements:

Substantially all repurchase agreement liabilities represent amounts advanced by various customers. Securities are pledged to cover these liabilities, which are not covered by federal deposit insurance.

Long-term Assets:

Premises and equipment, core deposit and other intangible assets and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

Benefit Plans:

The Company maintains a 401(k) profit sharing plan for all employees meeting age and service requirements. The Company contributions are based upon the percentage of budgeted net income earned during the year. The Company has a noncontributory defined benefit pension plan which covered substantially all employees until the plan was frozen effective April 1, 2000. Funding of the plan equals or exceeds the minimum funding requirement determined by the actuary. Pension expense is the net of interest cost, return on plan assets and amortization of gains and losses not immediately recognized. Benefits are based on years of service and compensation levels. An employee deferred compensation plan is available to certain employees with returns based on investments in mutual funds. The Company maintains a directors' deferred compensation plan. Effective January 1, 2003, the directors' deferred compensation plan was amended to restrict the deferral to be in stock only and deferred directors' fees are included in equity. The Company acquires shares on the open market and records such shares as treasury stock.



## Stock Compensation:

Effective January 1, 2006, employee compensation expense under stock options is reported using Statement 123 (revised 2004), *Share-Based Payment*. Previously all awards were recorded under the intrinsic value method of APB Opinion No. 25 *Accounting for Stock Issued to Employees*. Statement 123(R) was adopted using the modified prospective method and no restatements were made to prior periods. The following table provides comparative information on the effects of stock-based compensation expense on net income and earnings per share, as if Statement 123 had been applied for 2005.

	2005
Net income (in thousands) as reported	\$ 17,958
Deduct: stock-based compensation expense determined under fair value based method (in thousands)	311
Pro forma net income (in thousands)	\$ 17,647
Basic earnings per common share as reported	\$ 1.51
Pro forma basic earnings per common share	\$ 1.48
Diluted earnings per common share as reported	\$ 1.46
Pro forma diluted earnings per common share	\$ 1.44

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

There is no pro forma effect for the years ended December 31, 2007 and 2006 since stock based compensation was recorded under Statement 123(R) in 2007 and 2006. Included in net income for the years ended

December 31, 2007 and 2006 was employee compensation expense of \$174,000 and \$188,000, and a related tax benefit of \$70,000 and \$76,000 respectively.

Income Taxes:

Annual consolidated federal and state income tax returns are filed by the Company. Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Income tax expense is recorded based on the amount of taxes due on its tax return plus net deferred taxes computed based upon the expected

future tax consequences of temporary differences between carrying amounts and tax basis of assets and liabilities,

using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

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

The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

Off-Balance Sheet Financial Instruments:

Financial instruments include credit instruments, such as commitments to make loans and standby letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded. The fair value of standby letters of credit is recorded as a liability during the commitment period in accordance with FASB Interpretation No. 45.

Earnings Per Common Share:

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Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options. Earnings and dividends per share are restated for all stock splits and dividends through the date of issue of the financial statements. The common shares included in Treasury Stock for 2007 and 2006 reflect the acquisition of 96,020 and 86,785 shares, respectively of Lakeland Financial Corporation common stock that have been purchased under the directors' deferred compensation plan described

above. Because these shares are held in trust for the participants, they are treated as outstanding when computing the weighted-average common shares outstanding for the calculation of both basic and diluted earnings per share.

### Comprehensive Income:

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available for sale during the year and changes in defined benefit pension plans, which are also recognized as a separate component of equity.

Table of Contents**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

The components of other comprehensive income and related tax effects are as follows:

	Years Ended December 31,		
	2007	2006	2005
	(in thousands)		
Unrealized holding gain/(loss) on securities available for sale arising during the period	\$ 3,272	\$ 1,188	\$ (4,120 )
Reclassification adjustment for (gains)/losses included in net income	(89 )	68	69
Net securities gain /(loss) activity during the period	3,183	1,256	(4,051 )
Tax effect	(1,247 )	(267 )	1,486
Net of tax amount	1,936	989	(2,565 )
Net gain on defined benefit pension plans	277	160	30
Amortization of net actuarial loss	114	0	0
Net gain/(loss) activity during the period	391	160	30
Tax effect	(159 )	(65 )	(12 )
Net of tax amount	232	95	18
Other comprehensive income/(loss), net of tax	\$ 2,168	\$ 1,084	\$ (2,547 )

## Loss Contingencies:

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

## Restrictions on Cash:

The Company was required to have \$5.7 million and \$6.8 million of cash on hand or on deposit with the Federal Reserve Bank to meet regulatory reserve and clearing requirements at year-end 2007 and 2006. These balances do not earn interest.

## Dividend Restriction:

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the Company or by the Company to its shareholders. These restrictions pose no practical limit on the ability of the Bank or Company to pay dividends at historical levels.

Fair Value of Financial Instruments:

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 18. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

Industry Segments:

The Company's chief decision-makers monitor and evaluate financial performance on a Company-wide basis. All of the Company's financial service operations are similar and considered by management to be aggregated into one reportable operating segment. While the Company has assigned certain management responsibilities by region, the Company's chief decision-makers monitor and evaluate financial performance on a Company-wide basis. The majority of the Company's revenue is from the business of banking and the Company's assigned regions have similar economic characteristics, products, services and customers. Accordingly, all of the Company's operations are considered by management to be aggregated in one reportable operating segment.

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

Adoption of New Accounting Standards:

On January 1, 2007, the Company adopted FASB Statement of Financial Accounting Standards No. 156 (SFAS No. 156), *Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140*. SFAS No. 156 requires the recognition of a servicing asset or servicing liability when entering into a servicing contract to service a financial asset and requires all separately recognized servicing assets and liabilities to be initially measured at fair value. Further SFAS No. 156 permits a choice of subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities between the current amortization method and the fair value measurement method. At initial adoption, SFAS No. 156 permits a one time reclassification of available for sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available for sale securities under Statement 115, provided the securities are identified in some manner as offsetting the exposure to changes in fair value of servicing assets or servicing liabilities that are subsequently measured at fair value. Finally, SFAS No. 156 requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the balance sheet and additional disclosures for all separately recognized servicing assets and servicing liabilities. The Company elected the amortization method for subsequent measurement of its servicing assets. The adoption of this standard did not have any material effect on the Company's operating results or financial condition.

During 2007 the Company adopted FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*. FIN 48 requires that realization of an uncertain income tax position be "more likely than not" before it can be recognized in the financial statements. Further, FIN 48 prescribes the benefit to be recorded in the financial statements as the largest amount more likely than not to be realized assuming a review by tax authorities having all relevant information and applying current conventions. FIN 48 also clarifies the financial statement classification of tax-related penalties and interest and sets forth new disclosures regarding unrecognized tax benefits. The adoption of this standard did not have any material effect on the Company's operating results or financial condition.

During 2007 the Company adopted Emerging Issues Task Force (EITF) Issue 06-05, *Accounting for Purchase of Life Insurance - Determining the Amount that Could be Realized in Accordance with FASB Technical Bulletin No. 85-4*. EITF Issue No. 06-05 requires a policyholder to consider any additional amounts included in

the contractual terms of the policy in determining the amount that could be realized under the insurance contract; to determine the amount that could be realized under the insurance contract assuming the surrender of an

individual-life policy (or certificate by certificate in a group policy); not to discount the cash surrender value

component of the amount that could be realized under the insurance contract when contractual restrictions on the ability to surrender a policy exist, as long as the holder of the policy continues to participate in the changes in the cash surrender value as it had done prior to the surrender request; and if a group of individual-life policies or a group policy only allows for the surrender of all of the individual-life policies or certificates as a group, then the policyholder should determine the amount that could be realized under the insurance contract on a group basis. The adoption of this standard did not have any material effect on the Company's operating results or financial condition.

Newly Issued But Not Yet Effective Accounting Standards:

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FASB Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations* is effective for fiscal years beginning after December 15, 2008. SFAS No. 141(R) establishes principles and requirements for how the acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The Company does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.

FASB Statement of Financial Accounting Standards No. 157 (SFAS No. 157), *Fair Value Measurements* is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about

fair value measurements. This Statement emphasizes that fair value is a market-based measurement and should be determined based on assumptions that a market participant would use when pricing an asset or liability. This

Statement clarifies that market participant assumptions should include assumptions about risk as well as the effect of a restriction on the sale or use of an asset. Additionally, this Statement establishes a fair value hierarchy that provides the highest priority to quoted prices in active markets and the lowest priority to unobservable data. The

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

Company plans to adopt this standard as of January 1, 2008. The Company does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.

FASB Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* Including an amendment of FASB Statement No. 115 is effective for fiscal years beginning after November 15, 2007. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. This statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The Company plans to adopt this standard as of January 1, 2008. The Company did not elect the fair value option for any financial assets or liabilities as of January 1, 2008.

FASB Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51* is effective for fiscal years beginning after December 15, 2008. SFAS No. 160 improves the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing certain accounting and reporting standards requirements. The Company does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.

Emerging Issues Task Force (EITF) Issue 06-04, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements* is effective for fiscal years beginning after December 15, 2007, with earlier adoption permitted. EITF Issue 06-04 requires that for an endorsement split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a

liability for future benefits in accordance with Statement 106 (if, in substance, a postretirement benefit plan exists) or Opinion 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee and all available evidence should be considered in determining the substance of the arrangement, such as the explicit written terms of the arrangement, communications made by the

employer to the employee, and the determination of whether the employer or the insurer is the primary obligor for

the postretirement benefit. The Company does not have any postretirement benefit on endorsement split-dollar life insurance and therefore does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.

Staff Accounting Bulletin No. 109 (SAB No. 109), *Written Loan Commitments Recorded at Fair Value through Earnings* supersedes SAB 105, *Application of Accounting Principles to Loan Commitments* which stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 states that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also states that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 is effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Company does not anticipate the adoption of this standard will have any material effect on the Company's operating results or financial condition.



No other new accounting standards have been issued that are not yet effective that are expected to have a significant impact on the Company's financial condition or results of operations.

Reclassifications:

Certain amounts appearing in the financial statements and notes thereto for prior periods have been reclassified to conform with the current presentation. The reclassifications had no effect on net income or stockholders' equity as previously reported.

Table of Contents**NOTE 2 - SECURITIES**

Information related to the fair value of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) at December 31 is provided in the tables below.

	<b>Fair Value</b>	<b>Gross Unrealized Gain</b>	<b>Gross Unrealized Losses</b>
		(in thousands)	
<b>2007</b>			
U.S. Treasury securities	\$ 1,206	\$ 5	\$ 0
U.S. Government agencies	18,555	48	(32 )
Mortgage-backed securities	250,495	1,210	(1,873 )
State and municipal securities	57,501	1,037	(149 )
Total	\$ 327,757	\$ 2,300	\$ (2,054 )
<b>2006</b>			
U.S. Treasury securities	\$ 965	\$ 0	\$ (37 )
U.S. Government agencies	30,525	0	(724 )
Mortgage-backed securities	210,000	652	(3,704 )
State and municipal securities	54,701	1,116	(240 )
Total	\$ 296,191	\$ 1,768	\$ (4,705 )

Information regarding the fair value of available for sale debt securities by maturity as of December 31, 2007 is presented below. Maturity information is based on contractual maturity for all securities other than mortgage-backed securities. Actual maturities of securities may differ from contractual maturities because borrowers may have the right to prepay the obligation without prepayment penalty.

	<b>Fair Value</b>
	(in thousands)
Due in one year or less	\$ 4,006
Due after one year through five years	17,890
Due after five years through ten years	28,526
Due after ten years	26,840
	77,262
Mortgage-backed securities	250,495
Total debt securities	\$ 327,757

Security proceeds, gross gains and gross losses for 2007, 2006 and 2005 were as follows:

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	2007	2006	2005
		(in thousands)	
Sales of securities available for sale			
Proceeds	<b>\$ 31,612</b>	\$ 21,634	\$ 6,259
Gross gains	<b>219</b>	78	2
Gross losses	<b>130</b>	146	71

Securities with carrying values of \$239.5 million and \$188.4 million were pledged as of December 31, 2007 and 2006, as collateral for deposits of public funds, securities sold under agreements to repurchase, borrowings from the FHLB and for other purposes as permitted or required by law.

Table of Contents**NOTE 2 – SECURITIES (continued)**

Information regarding securities with unrealized losses as of December 31, 2007 and 2006 is presented below. The tables distribute the securities between those with unrealized losses for less than twelve months and those with unrealized losses for twelve months or more.

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(in thousands)			
<b>2007</b>						
U.S. Treasury securities	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
U.S. Government agencies	0	0	12,890	32	12,890	32
Mortgage-backed securities	45,424	740	98,068	1,133	143,492	1,873
State and municipal securities	9,595	132	1,734	17	11,329	149
Total temporarily impaired	\$ 55,019	\$ 872	\$ 112,692	\$ 1,182	\$ 167,711	\$ 2,054
<b>2006</b>						
U.S. Treasury securities	\$ 0	\$ 0	\$ 965	\$ 37	\$ 965	\$ 37
U.S. Government agencies	983	19	29,542	705	30,525	724
Mortgage-backed securities	14,807	101	140,245	3,603	155,052	3,704
State and municipal securities	5,091	43	7,739	197	12,830	240
Total temporarily impaired	\$ 20,881	\$ 163	\$ 178,491	\$ 4,542	\$ 199,372	\$ 4,705

All of the following are considered to determine whether or not the impairment of these securities is other-than-temporary. All of the securities are backed by the U.S. Government, government agencies, government sponsored agencies or are A rated or better, except for certain non-local municipal securities. None of the securities have call provisions (with the exception of the municipal securities) and payments as originally agreed are being received. There are no concerns of credit losses and there is nothing to indicate that full principal will not be received. Management considers the unrealized losses to be from interest rate movement rather than credit quality concerns and no loss is expected to be realized unless the securities are sold. The Company does not have a history of actively trading securities, but keeps the securities available for sale should liquidity or other needs develop that would warrant the sale of securities. While these securities are held in the available for sale portfolio, the current intent and ability is to hold them until a recovery in fair value or maturity.

**NOTE 3 - LOANS**

Total loans outstanding as of year-end consisted of the following:

2007

2006

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	(in thousands)	
Commercial and industrial loans	<b>\$ 968,336</b>	\$ 847,233
Commercial real estate - multifamily loans	<b>16,839</b>	17,351
Commercial real estate construction loans	<b>84,498</b>	82,183
Agri-business and agricultural loans	<b>170,921</b>	139,644
Residential real estate mortgage loans	<b>124,107</b>	109,176
Home equity loans	<b>108,429</b>	104,506
Installment loans and other consumer loans	<b>50,516</b>	53,804
Subtotal	<b>1,523,646</b>	1,353,897
Less: Allowance for loan losses	<b>(15,801</b>	) (14,463 )
Net deferred loan (fees)/costs	<b>74</b>	(60 )
Loans, net	<b>\$ 1,507,919</b>	\$ 1,339,374

Table of Contents**NOTE 4 - ALLOWANCE FOR LOAN LOSSES**

The following is an analysis of the allowance for loan losses for 2007, 2006 and 2005:

	<b>2007</b>		2006		2005
			(in thousands)		
Balance, January 1,	<b>\$ 14,463</b>		\$ 12,774		\$ 10,754
Provision for loan losses	<b>4,298</b>		2,644		2,480
Loans charged-off	<b>(3,392)</b>	)	(1,072)	)	(601)
Recoveries	<b>432</b>		117		141
Net loans charged-off	<b>(2,960)</b>	)	(955)	)	(460)
Balance December 31	<b>\$ 15,801</b>		\$ 14,463		\$ 12,774
Nonaccrual loans	<b>\$ 7,039</b>		\$ 13,820		\$ 7,321
Interest not recorded on nonaccrual loans	<b>1,033</b>		776		460
Loans past due 90 days and still accruing	<b>409</b>		299		174

As of December 31, 2007, 2006 and 2005 there were no loans renegotiated as troubled debt restructurings.

Impaired loans were as follows:

	<b>2007</b>		2006
			(in thousands)
Year-end loans with no allocated allowance for loan losses	<b>\$ 0</b>		\$ 0
Year-end loans with allocated allowance for loan losses	<b>6,748</b>		13,333
	<b>\$ 6,748</b>		\$ 13,333
Amount of the allowance for loan losses allocated	<b>\$ 2,343</b>		\$ 3,448

	<b>2007</b>		2006		2005
			(in thousands)		
Average of impaired loans during the year	<b>\$ 11,773</b>		\$ 8,915		\$ 7,853
Interest income recognized during impairment	<b>14</b>		0		69
Cash-basis interest income recognized	<b>8</b>		0		70

The Company is not committed to lend additional funds to debtors whose loans have been modified in a troubled debt restructuring. For December 31, 2007 and 2006 the total for impaired loans were also included in the total for nonaccrual loans. Total impaired loans decreased by

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\$6.6 million to \$6.7 million at December 31, 2007 from \$13.3 million at December 31, 2006. The decrease in impaired and nonperforming loans resulted primarily from the transfer to other real estate of a single borrowing relationship, a residential and commercial real estate developer. The majority of the balance of nonperforming and impaired loans is a single commercial credit of \$4.2 million and \$5.0 million at December 31, 2007 and 2006. The borrower filed chapter 11 bankruptcy late in the third quarter of 2004 and the plan for reorganization was approved late in the third quarter of 2005. Borrower collateral and the personal guarantees of its principals support this credit.

Table of Contents**NOTE 5 - SECONDARY MORTGAGE MARKET ACTIVITIES**

Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of these loans were \$245.3 million and \$244.7 million at December 31, 2007 and 2006. Net loan servicing income/(loss) excluding adjustments to the valuation allowance included in loan, insurance and service fees was \$206,000, \$165,000 and \$41,000 for 2007, 2006 and 2005. Late fees and ancillary fees are not material. Information on loan servicing rights, which are included in other assets, follows:

Loan servicing rights:	2007	2006	2005
	(in thousands)		
Carrying amount at beginning of year	\$ 1,766	\$ 1,923	\$ 2,052
Originations	327	297	443
Amortization	(416)	(454)	(572)
Carrying amount before valuation allowance	\$ 1,677	\$ 1,766	\$ 1,923
Valuation allowance:	2007	2006	2005
	(in thousands)		
Beginning of year	\$ 118	\$ 185	\$ 344
Provisions/(recoveries)	(49)	(67)	(159)
End of year	69	118	185
Carrying amount at end of year	\$ 1,608	\$ 1,648	\$ 1,738
Fair value at beginning of the year	\$ 2,397	\$ 2,604	\$ 2,010
Fair value at the end of the year	\$ 2,483	\$ 2,397	\$ 2,604

Fair value at year end 2007 was determined using discount rates ranging from 5.0% to 9.5%, prepayment speeds ranging from 94 to 917, depending on the stratification of the specific right, and a weighted average default rate of .33%. Fair value at year end 2006 was determined using discount rates ranging from 5.0% to 9.5%, prepayment speeds ranging from 106 to 1233, depending on the stratification of the specific right, and a weighted average default rate of .34%.

**NOTE 6 - LAND, PREMISES AND EQUIPMENT, NET**

Land, premises and equipment and related accumulated depreciation were as follows at December 31:

	2007	2006
	(in thousands)	
Land	\$ 9,866	\$ 8,308



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Premises	<b>24,209</b>	23,109
Equipment	<b>13,879</b>	14,138
Total cost	<b>47,954</b>	45,555
Less accumulated depreciation	<b>20,429</b>	20,378
Land, premises and equipment, net	<b>\$ 27,525</b>	\$ 25,177

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Table of Contents**NOTE 7 – GOODWILL AND OTHER INTANGIBLE ASSETS****Goodwill**

There have been no changes in the \$5.0 million carrying amount of goodwill since 2002.

**Acquired Intangible Assets**

	As of December 31, 2007		As of December 31, 2006	
	(in thousands)		(in thousands)	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets				
Core deposit	\$ 2,032	\$ 1,735	\$ 2,032	\$ 1,586
Trust deposit relationships	572	250	572	193
Total	\$ 2,604	\$ 1,985	\$ 2,604	\$ 1,779

Aggregate amortization expense was \$206,000, \$209,000 and \$211,000 for 2007, 2006 and 2005.

Estimated amortization expense for each of the next five years:

	Amount (in thousands)
2008	\$ 206
2009	206
2010	54
2011	54
2012	52

**NOTE 8 – DEPOSITS**

The aggregate amount of time deposits, each with a minimum denomination of \$100,000, was approximately \$384.3 million and \$411.7 million at December 31, 2007 and 2006.

At December 31, 2007, the scheduled maturities of time deposits were as follows:

	<b>Amount</b> <b>(in thousands)</b>
Maturing in 2008	<b>\$ 563,360</b>
Maturing in 2009	<b>106,482</b>
Maturing in 2010	<b>14,465</b>
Maturing in 2011	<b>8,790</b>
Maturing in 2012	<b>6,031</b>
Thereafter	<b>585</b>
Total time deposits	<b>\$ 699,713</b>

Table of Contents**NOTE 9 - SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE**

Securities sold under agreements to repurchase (“repo accounts”) represent collateralized borrowings with customers located primarily within the Company’s service area. Repo accounts are not covered by federal deposit insurance and are secured by securities owned. Information on these liabilities and the related collateral for 2007 and 2006 is as follows:

	2007 (in thousands)		2006	
Average daily balance during the year	<b>\$ 121,372</b>		\$ 92,870	
Average interest rate during the year	<b>3.52</b>	%	3.20	%
Maximum month-end balance during the year	<b>\$ 154,913</b>		\$ 106,670	
Securities underlying the agreements at year-end				
Fair value	<b>\$ 160,272</b>		\$ 123,072	

Term	Repurchase Liability (in thousands)	Weighted Average Interest Rate	Collateral at Fair Values (in thousands)
Mortgage-backed securities:			
On demand	<b>\$ 154,477</b>	<b>3.20</b>	% <b>\$ 159,057</b>
31- to 90 days	<b>135</b>	<b>4.40</b>	% <b>375</b>
Over 90 days	<b>301</b>	<b>3.25</b>	% <b>840</b>
Total	<b>\$ 154,913</b>	<b>3.20</b>	% <b>\$ 160,272</b>

The Company retains the right to substitute similar type securities, and has the right to withdraw all collateral applicable to repo accounts whenever the collateral values are in excess of the related repurchase liabilities. At December 31, 2007, there were no material amounts of securities at risk with any one customer. The Company maintains control of these securities through the use of third-party safekeeping arrangements.

**NOTE 10 – BORROWINGS**

Long-term borrowings at December 31 consisted of:

	2007 (in thousands)	2006
Federal Home Loan Bank of Indianapolis Notes, 6.15%, Due January 15, 2018	<b>\$ 44</b>	\$ 45
Total	<b>\$ 44</b>	\$ 45

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There are no long-term borrowings maturing during the next five years.

Short-term borrowings at December 31 consisted of:

	<b>2007</b>	2006
	(in thousands)	
Federal Home Loan Bank of Indianapolis Notes, 5.31%, Due February 26, 2007	<b>\$ 0</b>	\$ 80,000
Federal Home Loan Bank of Indianapolis Notes, 4.58%, Due January 14, 2008	<b>30,000</b>	0
Federal Home Loan Bank of Indianapolis Notes, 3.75%, Due February 26, 2008	<b>60,000</b>	0
Total	<b>\$ 90,000</b>	\$ 80,000

All notes require monthly interest payments and were secured by residential real estate loans and securities with a carrying value of \$247.9 million at December 31, 2007. At December 31, 2007, the Company owned \$4.6 million of Federal Home Loan Bank (FHLB) stock, which also secures debts to the FHLB. The Company is authorized to borrow up to \$150 million at the FHLB.

Table of Contents**NOTE 11 – SUBORDINATED DEBENTURES**

Lakeland Statutory Trust II, a trust formed by the Company, issued \$30.0 million of floating rate trust preferred securities on October 1, 2003 as part of a privately placed offering of such securities. The Company issued subordinated debentures to the trust in exchange for the proceeds of the trust. Subject to the Company having received prior approval of the Federal Reserve if then required, the Company may redeem the subordinated debentures, in whole or in part, but in all cases in a principal amount with integral multiples of \$1,000, on any interest payment date on or after October 1, 2008 at 100% of the principal amount, plus accrued and unpaid interest. The subordinated debentures must be redeemed no later than 2033. These securities are considered as Tier I capital (with certain limitations applicable) under current regulatory guidelines. The floating rate of the trust preferred securities and subordinated debentures was 7.880%, 8.410% and 7.580% at December 31, 2007, 2006 and 2005. The holding company's investment in the common stock of the trust was \$928,000 and is included in other assets.

**NOTE 12 - EMPLOYEE BENEFIT PLANS**

In April, 2000, the Lakeland Financial Corporation Pension Plan was frozen. The Company also maintains a Supplemental Executive Retirement Plan (SERP) for select officers that was established as a funded, non-qualified deferred compensation plan. Only one current officer of the Company is a participant in the SERP plan and there are 7 total participants. The measurement date for both the pension and SERP plans is September 30 for 2007 and 2006, but will be December 31 for 2008.

Information as to the Company's plans at December 31 is as follows:

	<b>Pension Benefits</b>		<b>SERP Benefits</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	(in thousands)		(in thousands)	
Change in benefit obligation:				
Beginning benefit obligation	<b>\$ 2,514</b>	\$ 2,693	<b>\$ 1,362</b>	\$ 1,429
Interest cost	<b>142</b>	144	<b>75</b>	75
Actuarial (gain)/loss	<b>(76)</b> )	(114) )	<b>(4)</b> )	(8) )
Benefits paid	<b>(182)</b> )	(209) )	<b>(134)</b> )	(134) )
Ending benefit obligation	<b>2,398</b>	2,514	<b>1,299</b>	1,362
Change in plan assets (primarily equity and fixed income investments and money market funds), at fair value:				
Beginning plan assets	<b>2,182</b>	2,050	<b>1,192</b>	1,160
Actual return	<b>303</b>	168	<b>165</b>	98
Employer contribution	<b>104</b>	173	<b>59</b>	68
Benefits paid	<b>(182)</b> )	(209) )	<b>(134)</b> )	(134) )
Ending plan assets	<b>2,407</b>	2,182	<b>1,282</b>	1,192
Funded status at end of year	<b>\$ 9</b>	\$ (332) )	<b>\$ (17)</b> )	\$ (170) )

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Amounts recognized in the consolidated balance sheets consist of:

	<b>Pension Benefits</b>		<b>SERP Benefits</b>	
	<b>2007</b>	2006	<b>2007</b>	2006
	(in thousands)		(in thousands)	
Funded status included in other liabilities	\$ 9	\$ (332 )	\$ (17 )	\$ (170 )

Amounts recognized in accumulated other comprehensive income consist of:

	<b>Pension Benefits</b>		<b>SERP Benefits</b>	
	<b>2007</b>	2006	<b>2007</b>	2006
	(in thousands)		(in thousands)	
Net actuarial loss	\$ 1,372	\$ 1,630	\$ 620	\$ 753

Table of Contents**NOTE 12 - EMPLOYEE BENEFIT PLANS (continued)**

The accumulated benefit obligation for the pension plan was \$2.4 million and \$2.5 million for December 31, 2007 and 2006 respectively. The accumulated benefit obligation for the SERP plan was \$1.3 million and \$1.4 million for December 31, 2007 and 2006 respectively.

Net pension expense includes the following:

	<b>Pension Benefits</b>			<b>SERP Benefits</b>		
	<b>2007</b>	2006	2005	<b>2007</b>	2006	2005
Net pension expense						
	(in thousands)			(in thousands)		
Service cost	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Interest cost	142	144	149	75	75	79
Expected return on plan assets	(178 )	(167 )	(145 )	(93 )	(93 )	(102 )
Recognized net actuarial (gain) loss	57	44	38	57	53	44
Net pension expense	\$ 21	\$ 21	\$ 42	\$ 39	\$ 35	\$ 21

Other changes in plan assets and benefit obligations recognized in other comprehensive income

Net gain	\$ (201 )	\$ 0	\$ 0	\$ (76 )	\$ 0	\$ 0
Amortization of net loss	(57 )	0	0	(57 )	0	0
Change in minimum pension liability	0	(160 )	(30 )	0	0	0
Total recognized in other comprehensive income	\$ (258 )	\$ (160 )	\$ (30 )	\$ (133 )	\$ 0	\$ 0
Total recognized in net pension expense and other comprehensive income	\$ (237 )	\$ (139 )	\$ 12	\$ (94 )	\$ 35	\$ 21

The estimated net loss (gain) for the defined benefit pension plan and SERP plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is \$57,000 for both plans.

2007                      2006                      2005                      2007                      2006                      2005



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The following assumptions were used in calculating the net benefit obligation:

	(in thousands)			(in thousands)				
Weighted average discount rate	<b>6.00</b>	% 5.75	% 5.50	%	<b>6.00</b>	% 5.75	% 5.50	%
Rate of increase in future compensation	<b>N/A</b>	N/A	N/A		<b>N/A</b>	N/A	N/A	

The following assumptions were used in calculating the net pension expense:

Weighted average discount rate	<b>5.75</b>	% 5.50	% 5.75	%	<b>5.75</b>	% 5.50	% 5.75	%
Rate of increase in future compensation	<b>N/A</b>	N/A	N/A		<b>N/A</b>	N/A	N/A	
Expected long-term rate of return	<b>8.25</b>	% 8.25	% 8.25	%	<b>8.25</b>	% 8.25	% 8.25	%

The expected long-term rate of return on plan assets is developed in consultation with the plan actuary. It is primarily based upon industry trends and consensus rates of return which are then adjusted to reflect the specific asset allocations and historical rates of return of the Company's plan assets.

Table of Contents**NOTE 12 - EMPLOYEE BENEFIT PLANS (continued)**

The asset allocations at the measurement dates of September 30, 2007 and 2006, by asset category are as follows:

Asset Category	Pension Plan Assets at September 30,				SERP Plan Assets at September 30,			
	2007		2006		2007		2006	
Equity securities	<b>62</b>	%	59	%	<b>62</b>	%	67	%
Debt Securities	<b>24</b>	%	28	%	<b>29</b>	%	27	%
Other	<b>14</b>	%	13	%	<b>9</b>	%	6	%
Total	<b>100</b>	%	100	%	<b>100</b>	%	100	%

The Company's investment strategies are to invest in a prudent manner for the purpose of providing benefits to participants. The investment strategies are targeted to maximize the total return of the portfolio net of inflation, spending and expenses. Risk is controlled through diversification of asset types and investments in domestic and international equities and fixed income securities. Certain asset types and investment strategies are

prohibited including: commodities, options, futures, short sales, margin transactions and non-marketable securities. The target allocation is 60% equities and 40% debt securities although acceptable ranges are: 55-65% equities and 35-45% debt securities.

Contributions

The Company expects to contribute \$0 to its pension plan and \$13,000 to its SERP plan in 2008.

Estimated Future Benefit Payments

The following benefit payments are expected to be paid:

<u>Plan Year</u>	<b>Pension Benefits (in thousands)</b>	<b>SERP Benefits</b>
2008	\$ 112	\$ 136
2009	119	134
2010	129	131
2011	130	129
2012	140	125

**Other Employee Benefit Plans**

The Company maintains a 401(k) profit sharing plan for all employees meeting age and service requirements. The Company contributions are based upon the percentage of budgeted net income earned during the year. The expense recognized was \$858,000, \$836,000 and \$844,000 in 2007, 2006 and 2005.

Effective January 1, 2004, the Company adopted the Lake City Bank Deferred Compensation Plan. The purpose of the deferred compensation plan is to extend full 401(k) type retirement benefits to certain individuals without regard to statutory limitations under tax qualified plans. The expense recognized was \$83,000, \$49,000 and \$38,000 in 2007, 2006 and 2005. The plan is funded solely by participant contributions and does not receive a company match.

Under employment agreements with certain executives, certain events leading to separation from the Company could result in cash payments totaling \$2.4 million as of December 31, 2007. On December 31, 2007, no amounts were accrued on these contingent obligations.

Table of Contents**NOTE 13 - OTHER EXPENSE**

Other expense for the years ended December 31, was as follows:

	<b>2007</b>	2006 (in thousands)	2005
Corporate and business development	<b>\$ 1,508</b>	\$ 1,458	\$ 1,235
Advertising	<b>304</b>	603	671
Office supplies	<b>496</b>	562	644
Telephone and postage	<b>1,219</b>	1,151	1,139
Regulatory fees and FDIC insurance	<b>336</b>	302	275
Professional fees	<b>1,548</b>	1,453	1,386
Amortization of other intangible assets	<b>206</b>	209	211
Courier and delivery	<b>299</b>	395	590
Miscellaneous	<b>3,250</b>	2,808	2,724
Total other expense	<b>\$ 9,166</b>	\$ 8,941	\$ 8,875

**NOTE 14 - INCOME TAXES**

Income tax expense for the years ended December 31, consisted of the following:

	<b>2007</b>	2006 (in thousands)	2005
Current federal	<b>\$ 8,456</b>	\$ 8,391	\$ 8,070
Deferred federal	<b>(69)</b>	(852)	(546)
Current state	<b>0</b>	1,496	1,737
Deferred state	<b>(417)</b>	(213)	(267)
Tax benefit of stock options	<b>396</b>	692	485
Total income tax expense	<b>\$ 8,366</b>	\$ 9,514	\$ 9,479

Income tax expense included (\$36,000), (\$25,000) and (\$28,000) applicable to security transactions for 2007, 2006 and 2005. The differences between financial statement tax expense and amounts computed by applying the statutory federal income tax rate of 35% for 2007, 2006 and 2005 to income before income taxes were as follows:

	<b>2007</b>	2006 (in thousands)	2005
Income taxes at statutory federal rate	<b>\$ 9,652</b>	\$ 9,882	\$ 9,603
Increase (decrease) in taxes resulting from:			

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Tax exempt income	(898	)	(918	)	(875	)
Nondeductible expense	273		343		214	
State income tax, net of federal tax effect	(224	)	897		999	
Net operating loss	(30	)	(30	)	(30	)
Tax credits	(82	)	(82	)	(83	)
Bank owned life insurance	(340	)	(317	)	(280	)
Other	15		(261	)	(69	)
Total income tax expense	\$ 8,366		\$ 9,514		\$ 9,479	

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Table of Contents**NOTE 14 - INCOME TAXES (continued)**

The net deferred tax asset recorded in the consolidated balance sheets at December 31, consisted of the following:

	<b>2007</b>		<b>2006</b>	
	<b>Federal</b>	<b>State</b>	<b>Federal</b>	<b>State</b>
	<b>(in thousands)</b>			
Deferred tax assets:				
Bad debts	\$ 5,268	\$ 1,187	\$ 5,062	\$ 1,135
Pension and deferred compensation liability	391	88	293	66
Net operating loss carryforward	89	349	119	0
Nonaccrual loan interest	533	120	468	105
Other	198	24	130	10
	<b>6,479</b>	<b>1,768</b>	<b>6,072</b>	<b>1,316</b>
Deferred tax liabilities:				
Accretion	138	20	100	15
Depreciation	886	89	890	97
Loan servicing rights	563	127	577	129
State taxes	445	0	299	0
Leases	56	13	42	9
Deferred loan fees	38	9	40	9
Intangible assets	766	173	618	139
FHLB stock dividends	118	26	118	26
Prepaid expenses	177	39	165	37
	<b>3,187</b>	<b>496</b>	<b>2,849</b>	<b>461</b>
Valuation allowance	0	0	0	0
Net deferred tax asset	\$ 3,292	\$ 1,272	\$ 3,223	\$ 855

In addition to the net deferred tax assets included above, the deferred income tax asset/liability allocated to the unrealized net gain/loss on securities available for sale included in equity was (\$71,000) and \$1.2 million for 2007 and 2006. The deferred income tax asset allocated to the pension liability included in equity was \$807,000 and \$966,000 for 2007 and 2006.

The Company and its subsidiaries file a consolidated U.S. federal tax return and a combined unitary return in the State of Indiana. These returns are subject to examinations by authorities for all years after 2003. The Company adopted the provisions of FASB Interpretation No.48, Accounting for Uncertainty in Income Taxes, on January 1, 2007, and the adoption had no material impact on the financial statements. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is the Company's policy to record such accruals in its income taxes accounts; no such accruals exist as of December 31, 2007 and 2006. As of December 31, 2007 and 2006 the Company had no accrued liability for unrecognized tax benefits.



Table of Contents**NOTE 15 - RELATED PARTY TRANSACTIONS**

Loans to principal officers, directors, and their affiliates as of December 31, 2007 and 2006 were as follows:

	<b>2007</b>	2006
	(in thousands)	
Beginning balance	<b>\$ 50,426</b>	\$ 54,488
New loans and advances	<b>97,917</b>	108,067
Effect of changes in related parties	<b>(4,284</b>	) 6,873
Repayments	<b>(95,265</b>	) (119,002 )
Ending balance	<b>\$ 48,794</b>	\$ 50,426

Deposits from principal officers, directors, and their affiliates at both year-end 2007 and 2006 were \$1.7 million. In addition, the amount owed directors for fees under the deferred directors' plan as of December 31, 2007 and 2006 was \$1.4 million and \$1.2 million. The related expense for the deferred directors' plan as of December 31, 2007, 2006 and 2005 was \$267,000, \$266,000 and \$212,000.

Thomas A. Hiatt was appointed to the Board of Directors by the incumbent directors, with such appointment effective January 9, 2007. Mr. Hiatt is the Managing Director and Co-founder of Centerfield Capital Partners, headquartered in Indianapolis, Indiana ("Centerfield Capital"). The Bank currently has approximately \$272,000 invested in investment funds managed by Centerfield Capital and has committed to fund an additional \$728,000, or less than 2.0% of the funds managed by Centerfield Capital.

**NOTE 16 - STOCK OPTIONS**

Effective December 9, 1997, the Company adopted the Lakeland Financial Corporation 1997 Share Incentive Plan, which is shareholder approved. At its inception there were 1,200,000 shares of common stock reserved for grants of stock options to employees of Lakeland Financial Corporation, its subsidiaries and Board of Directors. The plan expired on December 8, 2007 and therefore there were no options available for future grants as of December 31, 2007. The stock option plan requires that the exercise price for options be the market price on the date the options are granted. The maximum option term is ten years and the options vest over 5 years. Certain option awards provide for accelerated vesting if there is a change in control or retirement (as defined in the Plan). The Company has a policy of issuing new shares to satisfy option exercises.

The fair value of each option award is estimated with the Black Scholes option pricing model, using the following weighted-average assumptions as of the grant date for options granted during the years presented. Expected volatilities are based on historical volatility of the Company's stock over the immediately preceding expected life period, as well as other factors known on the grant date that would have a significant effect on the stock price during the expected life period. Prior to 2006, the expected option life for all awards was the vesting period of the option. For grants in 2006, the expected option life used was primarily the average of the vesting period of the option and the years to expiration of the option. For grants in 2007, the expected option life used was the historical option life of the similar employee base or Board of Directors. The turnover rate is based on historical data on the similar employee base as a group and the Board of Directors as a group. The risk-free interest rate is the U.S. Treasury rate on the date of grant corresponding to the expected life period of the option.



	<b>2007</b>		2006		2005	
Risk-free interest rate	<b>4.46</b>	%	4.56	%	5.08	%
Expected option life	<b>5.50</b>	<b>years</b>	6.11	years	5.00	years
Expected price volatility	<b>35.49</b>	%	31.51	%	67.52	%
Dividend yield	<b>3.40</b>	%	2.22	%	2.99	%

Table of Contents**NOTE 16 - STOCK OPTIONS (continued)**

A summary of the activity in the stock option plan as of December 31, 2007 and changes during the period then ended follows:

	Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at beginning of the year	602,230	\$ 10.83		
Granted	9,000	24.60		
Exercised	(98,117 )	9.92		
Forfeited	(6,600 )	17.99		
Outstanding at end of the year	506,513	\$ 11.16	3.8	\$ 4,976,014
Options exercisable at end of the year	341,033	\$ 7.58	2.5	\$ 4,529,070

The weighted-average grant-date fair value of options granted during the periods ended December 31, 2007, 2006 and 2005 was \$7.05, \$6.59 and \$5.76. The total intrinsic value of options exercised during the periods ended December 31, 2007, 2006 and 2005 was \$1.4 million, \$2.2 million and \$1.7 million, respectively.

There were no modifications of awards during the periods ended December 31, 2007, 2006 and 2005.

Cash received from option exercise for the periods ending December 31, 2007, 2006 and 2005 was \$771,000, \$1.1 million and \$1.2 million, respectively. The actual tax benefit realized for the tax deductions from option exercise totaled \$396,000, \$692,000 and \$485,000, respectively for the periods ended December 31, 2007, 2006 and 2005.

As of December 31, 2007, there was \$330,000 of total unrecognized compensation cost related to nonvested stock options granted under the plan. That cost is expected to be recognized over a weighted-average period of 2.52 years.

**NOTE 17 - CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS**

The Company and Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly discretionary, actions by regulators that, if undertaken, could have a

direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and Bank must meet specific capital guidelines that involve quantitative measures of the assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2007 and 2006, that the Company and Bank meet all capital adequacy requirements to which they are subject.

Table of Contents**NOTE 17 - CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS (continued)**

As of December 31, 2007, the most recent notification from the federal regulators categorized the Company and Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Company and Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Company's or Bank's category.

	Actual		Minimum Required For Capital Adequacy Purposes			Minimum Required to Be Well Capitalized Under Prompt Corrective Action Regulations			
	Amount	Ratio	Amount	Ratio		Amount	Ratio		
As of December 31, 2007:									
Total Capital (to Risk Weighted Assets)									
Consolidated	\$ 187,323	11.51 %	\$ 130,196	8.00 %		\$ 162,746	10.00	%	
Bank	\$ 185,580	11.41 %	\$ 130,156	8.00 %		\$ 162,694	10.00	%	
Tier I Capital (to Risk Weighted Assets)									
Consolidated	\$ 171,521	10.54 %	\$ 65,098	4.00 %		\$ 97,647	6.00	%	
Bank	\$ 169,779	10.44 %	\$ 65,078	4.00 %		\$ 97,617	6.00	%	
Tier I Capital (to Average Assets)									
Consolidated	\$ 171,521	8.93 %	\$ 76,857	4.00 %		\$ 96,071	5.00	%	
Bank	\$ 169,779	8.84 %	\$ 76,786	4.00 %		\$ 95,983	5.00	%	
As of December 31, 2006:									
Total Capital (to Risk Weighted Assets)									
Consolidated	\$ 170,435	11.76 %	\$ 115,981	8.00 %		\$ 144,976	10.00	%	
Bank	\$ 169,101	11.67 %	\$ 115,905	8.00 %		\$ 144,881	10.00	%	
Tier I Capital (to Risk Weighted Assets)									
Consolidated	\$ 155,972	10.76 %	\$ 57,991	4.00 %		\$ 86,986	6.00	%	
Bank	\$ 154,638	10.67 %	\$ 57,952	4.00 %		\$ 86,929	6.00	%	
Tier I Capital (to Average Assets)									
Consolidated	\$ 155,972	8.87 %	\$ 70,339	4.00 %		\$ 87,923	5.00	%	
Bank	\$ 154,638	8.80 %	\$ 70,314	4.00 %		\$ 87,893	5.00	%	

The Bank is required to obtain the approval of the Department of Financial Institutions for the payment of any dividend if the total amount of all dividends declared by the Bank during the calendar year, including the proposed dividend, would exceed the sum of the retained net income for the year to date combined with its retained net income for the previous two years. Indiana law defines "retained net income" to mean the net income of a specified period, calculated under the consolidated report of income instructions, less the total amount of all dividends declared for the specified period. As of December 31, 2007, approximately \$28.7 million was available to be paid as dividends to the Company by the Bank.

The payment of dividends by any financial institution or its holding company is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and a financial institution generally is prohibited from paying any dividends if, following payment thereof, the institution would be undercapitalized. As described above, the Bank exceeded its minimum capital requirements under applicable guidelines as of December 31, 2007. Notwithstanding the availability of funds for dividends, however, the FDIC may prohibit the payment of any dividends by the Bank if the FDIC determines such payment would constitute an unsafe or unsound practice.

Table of Contents**NOTE 18 – FAIR VALUES OF FINANCIAL INSTRUMENTS**

The following table contains the estimated fair values and the related carrying values of the Company's financial instruments at December 31, 2007 and 2006. Items which are not financial instruments are not included.

	<b>2007</b>	<b>Estimated</b>	2006	<b>Estimated</b>
	<b>Carrying</b>	<b>Fair Value</b>	<b>Carrying</b>	<b>Fair Value</b>
	<b>Value</b>	<b>Fair Value</b>	<b>Value</b>	<b>Fair Value</b>
	(in thousands)			
Financial Assets:				
Cash and cash equivalents	\$ 67,691	\$ 67,691	\$ 119,699	\$ 119,699
Securities available for sale	327,757	327,757	296,191	296,191
Real estate mortgage loans held for sale	537	543	2,175	2,203
Loans, net	1,507,919	1,519,024	1,339,374	1,335,210
Federal Home Loan Bank stock	4,551	4,551	4,193	4,193
Federal Reserve Bank stock	1,738	1,738	1,738	1,738
Accrued interest receivable	9,113	9,113	8,706	8,706
Financial Liabilities:				
Certificates of deposit	(699,713 )	(703,766 )	(684,246 )	(683,375 )
All other deposits	(779,205 )	(779,205 )	(791,519 )	(791,519 )
Securities sold under agreements to repurchase	(154,913 )	(154,913 )	(106,670 )	(106,670 )
Other short-term borrowings	(161,252 )	(161,273 )	(80,814 )	(80,814 )
Long-term borrowings	(44 )	(43 )	(45 )	(44 )
Subordinated debentures	(30,928 )	(33,009 )	(30,928 )	(32,197 )
Standby letters of credit	(145 )	(145 )	(112 )	(112 )
Accrued interest payable	(11,104 )	(11,104 )	(7,502 )	(7,502 )

For purposes of the above disclosures of estimated fair value, the following assumptions were used as of December 31, 2007 and 2006. The estimated fair value for cash and cash equivalents, accrued interest and Federal Home Loan Bank and Federal Reserve Bank stock is considered to approximate cost. Security fair values are based on market prices or dealer quotes, and if no such information is available, on the rate and term of the security and information about the issuer. Real estate mortgages held for sale are based upon the actual contracted price for those loans sold but not yet delivered, or the current Federal Home Loan Mortgage Corporation price for normal delivery of mortgages with similar coupons and maturities at year-end. The estimated fair value of loans is based on estimates of the rate the Company would charge for similar loans at December 31, 2007 and 2006, applied for the time period until estimated repayment. The estimated fair value for demand and savings deposits is based on their carrying value. The estimated fair value for certificates of deposit and borrowings is based on estimates of the rate the Company would pay on such deposits or borrowings at December 31, 2007 and 2006, applied for the time period until maturity. The estimated fair value of variable rate short-term borrowed funds is considered to approximate carrying value. The fair value of off-balance-sheet items is based on the current fees or cost that would be charged to enter into or terminate such arrangements. The estimated fair value of other financial instruments approximate cost and are not considered significant to this presentation.

While these estimates of fair value are based on management's judgment of the most appropriate factors, there is no assurance that, were the Company to have disposed of such items at December 31, 2007 and 2006, the estimated fair values would necessarily have been achieved at that date, since market values may differ depending on various circumstances. The estimated fair values at December 31, 2007 and 2006 should not

necessarily be considered to apply at subsequent dates.

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Table of Contents**NOTE 19 - COMMITMENTS, OFF-BALANCE SHEET RISKS AND CONTINGENCIES**

During the normal course of business, the Company becomes a party to financial instruments with off-balance sheet risk in order to meet the financing needs of its customers. These financial instruments include commitments to make loans and open-ended revolving lines of credit. Amounts as of December 31, 2007 and 2006, were as follows:

	<b>2007</b>	<b>Variable</b>	2006	Variable
	<b>Fixed</b>	<b>Rate</b>	Fixed	Rate
	<b>Rate</b>	<b>Rate</b>	Rate	Rate
		(in thousands)		
Commercial loan lines of credit	\$ 66,142	\$ 430,712	\$ 73,563	\$ 359,830
Commercial letters of credit	0	861	0	1,337
Standby letters of credit	3,311	11,489	35	11,479
Real estate mortgage loans	4,191	1,119	2,160	2,266
Real estate construction mortgage loans	1,143	833	1,622	1,476
Home equity mortgage open-ended revolving lines	0	100,402	0	93,484
Consumer loan open-ended revolving lines	0	4,480	0	4,070
Total	\$ 74,787	\$ 549,896	\$ 77,380	\$ 473,942

The index on variable rate commercial loan commitments is principally the Company's base rate, which is the national prime rate. Interest rate ranges on commitments and open-ended revolving lines of credit for December 31, 2007 and 2006, were as follows:

	<b>2007</b>	<b>Variable</b>	2006	Variable
	<b>Fixed</b>	<b>Rate</b>	Fixed	Rate
	<b>Rate</b>	<b>Rate</b>	Rate	Rate
Commercial loan	3.00-12.00%	3.00-11.45%	2.98-11.00%	3.00-12.75%
Real estate mortgage loan	5.75-8.25%	5.88-7.25%	5.75-7.125%	5.50-7.50%
Consumer loan open-ended revolving line	N/A	6.00-15.00%	N/A	7.50-15.00%

Commitments, excluding open-ended revolving lines, generally have fixed expiration dates of one year or less. Open-ended revolving lines are monitored for proper performance and compliance on a monthly basis. Since many commitments expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. The Company follows the same credit policy (including requiring collateral, if deemed appropriate) to make such commitments as is followed for those loans that are recorded in its financial statements.

The Company's exposure to credit losses in the event of nonperformance is represented by the contractual amount of the commitments. Management does not expect any significant losses as a result of these commitments.





Table of Contents**NOTE 20 - PARENT COMPANY STATEMENTS**

The Company operates primarily in the banking industry, which accounts for substantially all of its revenues, operating income, and assets. Presented below are parent only financial statements:

**CONDENSED BALANCE SHEETS**

	<b>December 31,</b>	
	<b>2007</b>	2006
	(in thousands)	
<b>ASSETS</b>		
Deposits with Lake City Bank	\$ 1,370	\$ 529
Investments in banking subsidiary	174,526	158,852
Investments in Lakeland Statutory Trust II	928	928
Other assets	512	954
Total assets	\$ 177,336	\$ 161,263
<b>LIABILITIES</b>		
Dividends payable and other liabilities	\$ 138	\$ 148
Subordinated debt	30,928	30,928
<b>STOCKHOLDERS' EQUITY</b>		
Total liabilities and stockholders' equity	\$ 177,336	\$ 161,263

**CONDENSED STATEMENTS OF INCOME**

	<b>Years Ended December 31,</b>		
	<b>2007</b>	2006	2005
	(in thousands)		
Dividends from Lake City Bank, Lakeland Statutory Trust II	\$ 7,717	\$ 5,533	\$ 3,332
Equity in undistributed income of subsidiaries	13,506	15,178	16,053
Interest expense on subordinated debt	2,643	2,573	2,009
Miscellaneous expense	590	624	338
<b>INCOME BEFORE INCOME TAXES</b>	<b>17,990</b>	17,514	17,038
Income tax benefit	1,221	1,207	920
<b>NET INCOME</b>	<b>\$ 19,211</b>	\$ 18,721	\$ 17,958

**CONDENSED STATEMENTS OF CASH FLOWS**

	<b>Years ended December 31,</b>		
	<b>2007</b>	2006	2005

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(in thousands)

Cash flows from operating activities:			
Net income	\$ 19,211	\$ 18,721	\$ 17,958
Adjustments to net cash from operating activities:			
Equity in undistributed income of subsidiaries	(13,506 )	(15,178 )	(16,053 )
Other changes	849	(286 )	3,086
Net cash from operating activities	6,554	3,257	4,991
Cash flows from investing activities	0	0	0
Cash flows from financing activities	(5,713 )	(4,279 )	(4,364 )
Net increase in cash and cash equivalents	841	(1,022 )	627
Cash and cash equivalents at beginning of the year	529	1,551	924
Cash and cash equivalents at end of the year	\$ 1,370	\$ 529	\$ 1,551

Table of Contents**NOTE 21 - EARNINGS PER SHARE**

Following are the factors used in the earnings per share computations:

	<b>2007</b>	2006	2005
Basic earnings per common share:			
Net income	<b>\$ 19,211,000</b>	\$ 18,721,000	\$ 17,958,000
Weighted-average common shares outstanding	<b>12,188,594</b>	12,069,300	11,927,756
Basic earnings per common share	<b>\$ 1.58</b>	\$ 1.55	\$ 1.51
Diluted earnings per common share:			
Net income	<b>\$ 19,211,000</b>	\$ 18,721,000	\$ 17,958,000
Weighted-average common shares outstanding for basic earnings per common share	<b>12,188,594</b>	12,069,300	11,927,756
Add: Dilutive effect of assumed exercises of stock options	<b>235,543</b>	306,167	361,710
Average shares and dilutive potential common shares	<b>12,424,137</b>	12,375,467	12,289,466
Diluted earnings per common share	<b>\$ 1.55</b>	\$ 1.51	\$ 1.46

Stock options for 14,000 and 5,000 shares of common stock were not considered in computing diluted earnings per common share for 2007 and 2006 because they were antidilutive.

Table of Contents**NOTE 22 – SELECTED QUARTERLY DATA (UNAUDITED) (in thousands except per share data)**

<b>2007</b>	<b>4th</b>	<b>3rd</b>	<b>2nd</b>	<b>1st</b>
	<b>Quarter</b>	<b>Quarter</b>	<b>Quarter</b>	<b>Quarter</b>
Interest income	\$ 30,365	\$ 30,091	\$ 29,259	\$ 28,258
Interest expense	16,307	16,372	15,578	15,160
Net interest income	\$ 14,058	\$ 13,719	\$ 13,681	\$ 13,098
Provision for loan losses	1,054	1,697	906	641
Net interest income after provision	\$ 13,004	\$ 12,022	\$ 12,775	\$ 12,457
Noninterest income	5,028	4,953	5,138	4,461
Noninterest expense	11,196	10,711	10,226	10,128
Income tax expense	2,012	1,890	2,432	2,032
Net income	\$ 4,824	\$ 4,374	\$ 5,255	\$ 4,758
Basic earnings per common share	\$ 0.40	\$ 0.36	\$ 0.43	\$ 0.39
Diluted earnings per common share	\$ 0.40	\$ 0.35	\$ 0.42	\$ 0.38
<b>2006</b>	<b>4th</b>	<b>3rd</b>	<b>2nd</b>	<b>1st</b>
	<b>Quarter</b>	<b>Quarter</b>	<b>Quarter</b>	<b>Quarter</b>
Interest income	\$ 28,450	\$ 27,285	\$ 25,843	\$ 23,973
Interest expense	15,109	14,226	12,776	11,113
Net interest income	\$ 13,341	\$ 13,059	\$ 13,067	\$ 12,860
Provision for loan losses	1,042	510	639	453
Net interest income after provision	\$ 12,299	\$ 12,549	\$ 12,428	\$ 12,407
Noninterest income	4,451	4,679	4,736	4,398
Noninterest expense	10,171	9,937	9,854	9,750
Income tax expense	2,020	2,561	2,528	2,405
Net income	\$ 4,559	\$ 4,730	\$ 4,782	\$ 4,650
Basic earnings per common share*	\$ 0.38	\$ 0.39	\$ 0.40	\$ 0.38
Diluted earnings per common share*	\$ 0.37	\$ 0.38	\$ 0.39	\$ 0.37

\* Per share data has been adjusted for a 2-for-1 stock split on April 28, 2006.



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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON FINANCIAL STATEMENTS**

Stockholders and Board of Directors

Lakeland Financial Corporation

Warsaw, Indiana

We have audited the accompanying consolidated balance sheets of Lakeland Financial Corporation (“Company”) and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in stockholders’ equity and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lakeland Financial Corporation and subsidiaries as of December 31, 2007 and 2006 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007 in conformity with U.S. generally accepted accounting principles.

We also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Lakeland Financial Corporation’s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 7, 2008 expressed an unqualified opinion thereon.

Crowe Chizek and Company LLC

South Bend, Indiana

February 7, 2008





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**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Not applicable.

**ITEM 9a. CONTROLS AND PROCEDURES**

a) An evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of December 31, 2007. Based on that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective.

b) MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities and Exchange Act of 1934. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

The Company's internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on our assessment and those criteria, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2007.

The Company's independent registered public accounting firm has issued their report on the Company's internal control over financial reporting. That report follows under the heading, Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting.

c) There have been no changes in the Company's internal controls during the previous fiscal quarter, ended December 31, 2007, that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.



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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Stockholders and Board of Directors

Lakeland Financial Corporation

Warsaw, Indiana

We have audited Lakeland Financial Corporation's (the "Company") internal control over financial reporting as of December 31, 2007, based on *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Lakeland Financial Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Lakeland Financial Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Lakeland Financial Corporation as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2007 and our report dated February 7, 2008 expressed an unqualified opinion on those consolidated financial statements.

Crowe Chizek and Company LLC

South Bend, Indiana

February 7, 2008

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**ITEM 9b. OTHER INFORMATION**

Not applicable.

**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information appearing in the definitive Proxy Statement, dated as of March 3, 2008, is incorporated herein by reference in response to this item.

**ITEM 11. EXECUTIVE COMPENSATION**

The information appearing in the definitive Proxy Statement, dated as of March 3, 2008, is incorporated herein by reference in response to this item.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED SHAREHOLDER MATTERS**

The information appearing in the definitive Proxy Statement, dated as of March 3, 2008, is incorporated herein by reference in response to this item.

**Equity Compensation Plan Information**

The table below sets forth the following information as of December 31, 2007 for (i) all compensation plans previously approved by the Company's shareholders and (ii) all compensation plans not previously approved by the Company's shareholders:

- (a) the number of securities to be issued upon the exercise of outstanding options, warrants and rights;

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- (b) the weighted-average exercise price of such outstanding options, warrants and rights;
- (c) other than securities to be issued upon the exercise of such outstanding options, warrants and rights, the number of securities remaining available for future issuance under the plans.

**EQUITY COMPENSATION PLAN INFORMATION**

<u>Plan category</u>	<u>Number of securities to be issued upon exercise of outstanding options</u>	<u>Weighted-average exercise price of outstanding options</u>	<u>Number of securities remaining available for future issuance</u>
Equity compensation plans approved by security holders <sup>(1)</sup>	506,513	\$11.16	0
Equity compensation plans not approved by security holders	0	\$ 0.00	0
<b>Total</b>	506,513	\$11.16	0

(1) Lakeland Financial Corporation 1997 Share Incentive Plan adopted on April 14, 1998 by the Board of Directors.

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**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information appearing in the definitive Proxy Statement, dated as of March 3, 2008, is incorporated herein by reference in response to this item.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information appearing in the definitive proxy statement, dated as of March 3, 2008, is incorporated herein by reference in response to this item.

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The documents listed below are filed as a part of this report:

## (a) Exhibits

Exhibit No.	Document	Incorporated by reference to
3.1	Amended and Restated Articles of Incorporation of Lakeland Financial Corporation	Exhibit 4.1 to the Company's Form S-8 filed with the Commission on April 15, 1998
3.2	Bylaws of Lakeland Financial Corporation	Exhibit 3(ii) to the Company's Form 10-Q for the quarter ended June 30, 1996
4.1	Form of Common Stock Certificate	Exhibit 4.1 to the Company's Form 10-K for the fiscal year ended December 31, 2003
10.1	Lakeland Financial Corporation 1997 Share Incentive Plan	Exhibit 4.3 to the Company's Form S-8 filed with the Commission on April 15, 1998
10.2	Form of Indenture for Trust Preferred Issuance	Exhibit 4.1 to the Company's Form 10-K for the fiscal year ended December 31, 2003
10.3	Lakeland Financial Corporation 401(k) Plan	Exhibit 10.1 to the Company's Form S-8 filed with the Commission on October 23, 2000
10.4	Amended and Restated Lakeland Financial Corporation Director's Fee Deferral Plan	Exhibit 10.5 to the Company's Form 10-K for the fiscal year ended December 31, 2002
10.5	Form of Change of Control Agreement entered into with David M. Findlay and Kevin L. Deardorff	Exhibit 10.5 to the Company's Form 10-K for the fiscal year ended December 31, 2001
10.6	Form of Change in Control Agreement	Exhibit 10.3 to the Company's Form



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entered into with Michael L. Kubacki and  
Charles D. Smith

10-K for the fiscal year ended  
December 31, 2000

10.7

Employee Deferred Compensation Plan  
and Form of Agreement

Exhibit 10.8 to the Company's Form  
10-K for the fiscal year ended  
December 31, 2004

10.8

Schedule of Board Fees

Attached hereto

10.9

Form of Option Grant Agreement

Exhibit 10.10 to the Company's Form  
10-K for the fiscal year ended  
December 31, 2004

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10.10	Executive Incentive Bonus Plan	Exhibit 10.11 to the Company's Form 10-K for the fiscal year ended December 31, 2004
21.0	Subsidiaries	Attached hereto
23.1	Consent of Independent Registered Public Accounting Firm	Attached hereto
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-15(e)/15d-15(e) and 13(a)-15(f)/15d-15(f)	Attached hereto
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-15(e)/15d-15(e) and 13(a)-15(f)/15d-15(f)	Attached hereto
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Attached hereto
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Attached hereto

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**SIGNATURES**

Pursuant to the requirements of Section 15(d) of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**LAKELAND FINANCIAL CORPORATION**

Date: February 29, 2008

By /s/Michael L. Kubacki  
Michael L. Kubacki, Chairman

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/Michael L. Kubacki Michael L. Kubacki	Principal Executive Officer and Director	February 29, 2008
/s/David M. Findlay David M. Findlay	Principal Financial Officer	February 29, 2008
/s/Teresa A. Bartman Teresa A. Bartman	Principal Accounting Officer	February 29, 2008
/s/Robert E. Bartels, Jr. Robert E. Bartels, Jr.	Director	February 29, 2008
/s/L. Craig Fulmer L. Craig Fulmer	Director	February 29, 2008
_____ Thomas A. Hiatt	Director	February 29, 2008
_____ Allan J. Ludwig	Director	February 29, 2008

/s/Charles E. Niemier  
Charles E. Niemier

Director

February 29, 2008

/s/Emily E. Pichon  
Emily E. Pichon

Director

February 29, 2008

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/s/Richard L. Pletcher Richard L. Pletcher	Director	February 29, 2008
/s/Steven D. Ross Steven D. Ross	Director	February 29, 2008
/s/Donald B. Steininger Donald B. Steininger	Director	February 29, 2008
/s/Terry L. Tucker Terry L. Tucker	Director	February 29, 2008
/s/M. Scott Welch M. Scott Welch	Director	February 29, 2008

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Exhibit 21

Subsidiaries

1. Lake City Bank, Warsaw, Indiana, a banking corporation organized under the laws of the State of Indiana.
2. Lakeland Statutory Trust II, a statutory business trust formed under Connecticut law.
3. LCB Investments II, Inc., a subsidiary of Lake City Bank incorporated in Nevada to manage a portion of the Bank's investment portfolio.
4. LCB Funding, Inc., a subsidiary of LCB Investments II, Inc. incorporated under the laws of Maryland to operate as a real estate investment trust.