

First Business Financial Services, Inc.

Form 10-Q

November 02, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

**For the quarterly period ended September 30, 2006**

**Commission file number 000-51028**

**FIRST BUSINESS FINANCIAL SERVICES, INC.**

(Exact name of registrant as specified in its charter)

**Wisconsin**

**39-1576570**

(State or jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

**401 Charmany Drive Madison, WI**

**53719**

(Address of Principal Executive Offices)

(Zip Code)

(608) 238-8008

Telephone number

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

The number of shares outstanding of the registrant's sole class of common stock, par value \$0.01 per share, on October 31, 2006 was 2,493,580 shares.

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**Table of Contents****PART I. Financial Information****Item 1. Financial Statements**  
**Consolidated Balance Sheets**

|   | (unaudited)<br><b>September<br/>30,<br/>2006</b> | <b>December<br/>31,<br/>2005</b> |
|---|--|----------------------------------|
|   | (In Thousands, Except Share Data)                |                                  |
| <b>Assets</b>   |  |                                  |
| Cash and due from banks   | \$ 13,292  | \$ 16,568                        |
| Short-term investments  | 5,536  | 139                              |
| Cash and cash equivalents   | 18,828   | 16,707                           |
| Securities available-for-sale, at fair value  | 95,260   | 92,055                           |
| Loans and leases receivable, net:   |  |                                  |
| Held for sale   | 100  |                                  |
| Held for investment   | 576,884  | 532,716                          |
| Leasehold improvements and equipment, net   | 1,084  | 1,155                            |
| Cash surrender value of bank-owned life insurance   | 13,308   | 12,856                           |
| Investment in Federal Home Loan Bank stock, at cost   | 2,127  | 2,898                            |
| Goodwill and other intangibles  | 2,825  | 2,852                            |
| Accrued interest receivable and other assets  | 9,389  | 8,010                            |
| Total assets  | \$ 719,805                                       | \$ 669,249                       |
| <b>Liabilities and Stockholders Equity</b>  |  |                                  |
| Deposits  | \$ 604,794                                       | \$ 567,464                       |
| Securities sold under agreement to repurchase   | 832  | 713                              |
| Federal Home Loan Bank and other borrowings   | 51,423   | 39,045                           |
| Junior subordinated debentures  | 10,310   | 10,310                           |
| Accrued interest payable and other liabilities  | 7,936  | 9,874                            |
| Total liabilities   | 675,295  | 627,406                          |
| Commitments and contingencies   |  |                                  |
| Stockholders Equity:  |  |                                  |
| Preferred stock, \$10 par value, 10,000 Series A shares and 10,000 Series B shares authorized, none issued and outstanding  |  |                                  |
| Common stock, \$.01 par value, 8,000,000 shares authorized, 2,511,695 and 2,456,754 shares issued, 2,489,080 and 2,435,008 outstanding in 2006 and 2005, respectively | 25   | 24                               |
| Additional paid-in capital  | 22,965   | 22,712                           |
| Retained earnings   | 23,441   | 21,085                           |
| Accumulated other comprehensive loss  | (1,391)  | (1,469)                          |
|   | (530)  | (509)                            |

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Treasury stock (22,615 and 21,746 shares in 2006 and 2005, respectively), at cost

|  |            |            |
|--|------------|------------|
| Total stockholders' equity                 | 44,510     | 41,843     |
| Total liabilities and stockholders' equity | \$ 719,805 | \$ 669,249 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

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**Table of Contents****Unaudited Consolidated Statements of Income**

|  | <b>Three Months</b>               |              | <b>Nine Months Ended,</b> |               |
|--|-----------------------------------|--------------|---------------------------|---------------|
|  | <b>Ended,</b>                     |              | <b>September 30,</b>      |               |
|  | <b>2006</b>                       | <b>2005</b>  | <b>2006</b>               | <b>2005</b>   |
|  | (In Thousands, Except Share Data) |              |                           |               |
| <b>Interest income:</b>  |                                   |              |                           |               |
| Loans and leases   | \$ 11,097                         | \$ 8,514     | \$ 31,415                 | \$ 23,768     |
| Securities income:   |                                   |              |                           |               |
| Taxable  | 1,026                             | 818          | 2,974                     | 2,281         |
| Short-term investments   | 42                                | 44           | 123                       | 146           |
| <b>Total interest income</b>   | <b>12,165</b>                     | <b>9,376</b> | <b>34,512</b>             | <b>26,195</b> |
| <b>Interest expense:</b>   |                                   |              |                           |               |
| Deposits   | 6,571                             | 4,444        | 18,087                    | 11,559        |
| Notes payable and other borrowings                                   | 617                               | 334          | 1,616                     | 768           |
| Junior subordinated debentures                                       | 260                               | 238          | 762                       | 700           |
| <b>Total interest expense</b>  | <b>7,448</b>                      | <b>5,016</b> | <b>20,465</b>             | <b>13,027</b> |
| <b>Net interest income</b>   | <b>4,717</b>                      | <b>4,360</b> | <b>14,047</b>             | <b>13,168</b> |
| Provision for loan and lease losses                                  | 413                               | 53           | 484                       | 118           |
| <b>Net interest income after provision for loan and lease losses</b> | <b>4,304</b>                      | <b>4,307</b> | <b>13,563</b>             | <b>13,050</b> |
| <b>Non-interest income:</b>  |                                   |              |                           |               |
| Service charges on deposits  | 186                               | 202          | 563                       | 630           |
| Credit, merchant and debit card fees                                 | 51                                | 36           | 129                       | 117           |
| Loan fees  | 181                               | 166          | 472                       | 444           |
| Gain on sale of 50% owned joint venture                              |                                   |              |                           | 973           |
| Increase in cash surrender value of bank-owned life insurance        | 154                               | 101          | 452                       | 282           |
| Trust and investment services fee income                             | 361                               | 258          | 1,022                     | 784           |
| Change in fair value of interest rate swaps                          | (68)                              | (198)        | (239)                     | 75            |
| Net cash settlement of interest rate swaps                           | 74                                | (26)         | 92                        | (78)          |
| Other  | 65                                | 52           | 183                       | 148           |
| <b>Total non-interest income</b>                                     | <b>1,004</b>                      | <b>591</b>   | <b>2,674</b>              | <b>3,375</b>  |
| <b>Non-interest expense:</b>   |                                   |              |                           |               |
| Compensation   | 2,508                             | 2,170        | 7,524                     | 6,525         |
| Occupancy  | 247                               | 226          | 743                       | 715           |
| Equipment  | 117                               | 109          | 364                       | 347           |
| Data processing  | 228                               | 208          | 673                       | 603           |
| Marketing  | 237                               | 233          | 657                       | 627           |
| Professional fees  | 331                               | 249          | 913                       | 875           |



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|  |         |         |          |          |
|--|---------|---------|----------|----------|
| Other  | 465     | 355     | 1,309    | 1,179    |
| Total non-interest expense   | 4,133   | 3,550   | 12,183   | 10,871   |
| Income before income tax expense                                       | 1,175   | 1,348   | 4,054    | 5,554    |
| Income tax expense   | 309     | 432     | 1,252    | 1,889    |
| Net income   | \$ 866  | \$ 916  | \$ 2,802 | \$ 3,665 |
| Earnings per share:  |         |         |          |          |
| Basic  | \$ 0.35 | \$ 0.38 | \$ 1.13  | \$ 1.52  |
| Diluted  | 0.35    | 0.37    | 1.13     | 1.49     |
| Dividends declared per share   | 0.06    |         | 0.18     | 0.115    |
| See accompanying Notes to Unaudited Consolidated Financial Statements. |         |         |          |          |

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**Table of Contents****Unaudited Consolidated Statements of Changes in Stockholders Equity and Comprehensive Income**

|  | <b>Common<br/>stock</b> | <b>Additional<br/>paid-in<br/>capital</b> | <b>Retained<br/>earnings</b> | <b>Accumulated<br/>other<br/>comprehensive<br/>loss</b> | <b>Treasury<br/>stock</b> | <b>Total</b> |
|--|-------------------------|---|------------------------------|---|---------------------------|--------------|
| (Dollars in thousands, except share data)                          |                         |   |                              |   |                           |              |
| Balance at December 31,<br>2004                                    | \$ 24                   | \$ 22,426                                 | \$ 16,752                    | \$ (677)  | \$ (384)                  | \$ 38,141    |
| Comprehensive income:  |                         |   |                              |   |                           |              |
| Net income   |                         |   | 3,665                        |   |                           | 3,665        |
| Unrealized securities losses<br>arising during the period          |                         |   |                              | (689)   |                           | (689)        |
| Unrealized derivatives<br>gains arising during the<br>period       |                         |   |                              | 27  |                           | 27           |
| Reclassification adjustment<br>for realized loss on<br>derivatives |                         |   |                              | 180   |                           | 180          |
| Income tax effect  |                         |   |                              | 229   |                           | 229          |
| Comprehensive income   |                         |   |                              |   |                           | 3,412        |
| Cash dividends (\$0.115 per<br>share)                              |                         |   | (278)                        |   |                           | (278)        |
| Treasury stock purchased<br>(150 shares)                           |                         |   |                              |   | (5)                       | (5)          |
| Stock options exercised<br>(6,280 shares)                          |                         | 166                                       |                              |   |                           | 166          |
| Balance at September 30,<br>2005                                   | \$ 24                   | \$ 22,592                                 | \$ 20,139                    | \$ (930)  | \$ (389)                  | \$ 41,436    |

|  | <b>Common<br/>stock</b> | <b>Additional<br/>paid-in<br/>capital</b> | <b>Retained<br/>earnings</b> | <b>Accumulated<br/>other<br/>comprehensive<br/>loss</b> | <b>Treasury<br/>stock</b> | <b>Total</b> |
|--|-------------------------|---|------------------------------|---|---------------------------|--------------|
| (Dollars in thousands, except share data)                    |                         |   |                              |   |                           |              |
| Balance at December 31,<br>2005                              | \$ 24                   | \$ 22,712                                 | \$ 21,085                    | \$ (1,469)  | \$ (509)                  | \$ 41,843    |
| Comprehensive income:  |                         |   |                              |   |                           |              |
| Net income   |                         |   | 2,802                        |   |                           | 2,802        |
| Unrealized securities losses<br>arising during the period    |                         |   |                              | (14)  |                           | (14)         |
| Unrealized derivatives<br>gains arising during the<br>period |                         |   |                              | 4   |                           | 4            |
| Reclassification adjustment<br>for realized loss on          |                         |   |                              | 86  |                           | 86           |

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|   |       |           |           |            |          |      |           |
|---|-------|-----------|-----------|------------|----------|------|-----------|
| derivatives                             |       |           |           |            |          |      |           |
| Income tax effect                       |       |           |           | 2          |          |      | 2         |
| Comprehensive income                    |       |           |           |            |          |      | 2,880     |
| Share based compensation                |       |           |           |            |          |      |           |
| restricted shares                       | 1     | 117       |           |            |          |      | 118       |
| Cash dividends (\$0.18 per share)       |       |           |           | (446)      |          |      | (446)     |
| Treasury stock purchased (869 shares)   |       |           |           |            |          | (21) | (21)      |
| Stock options exercised (14,314 shares) |       | 136       |           |            |          |      | 136       |
| Balance at September 30, 2006           | \$ 25 | \$ 22,965 | \$ 23,441 | \$ (1,391) | \$ (530) |      | \$ 44,510 |

**Table of Contents****Unaudited Consolidated Statements of Cash Flows**

|   | <b>Nine Months Ended September<br/>30,</b> |             |
|---|--|-------------|
|   | <b>2006</b>                                | <b>2005</b> |
|   | (In Thousands)                             |             |
| <b>Operating Activities</b>   |  |             |
| Net income  | \$ 2,802                                   | \$ 3,665    |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |             |
| Deferred income taxes, net  | 276  | (1,820)     |
| Provision for loan and lease losses   | 484  | 118         |
| Depreciation, amortization and accretion, net                                     | 459  | 751         |
| Share based compensation  | 118  |             |
| Change in fair value of interest rate swaps                                       | 239  | (75)        |
| Increase in cash surrender value of bank-owned life insurance                     | (452)                                      | (282)       |
| Origination of loans originated for sale  | (897)                                      | (500)       |
| Sale of loans originated for sale   | 797  | 637         |
| Gain on sale of loans originated for sale   | (6)  | (3)         |
| Gain on sale of 50% owned joint venture   |  | (973)       |
| (Increase) decrease in accrued interest receivable and other assets               | (1,606)                                    | 183         |
| (Decrease) increase in accrued expenses and other liabilities                     | (792)                                      | 1,783       |
| Net cash provided by operating activities   | 1,422                                      | 3,484       |
| <b>Investing activities</b>   |  |             |
| Proceeds from maturities of available-for-sale securities                         | 16,630                                     | 21,540      |
| Proceeds from sale of 50% owned joint venture                                     |  | 2,082       |
| Purchases of available-for-sale securities  | (19,971)                                   | (50,072)    |
| Proceeds from sale of FHLB stock  | 771  |             |
| (Increase) in investment in FHLB stock  |  | (111)       |
| Net increase in loans and leases  | (44,647)                                   | (31,809)    |
| Purchases of leasehold improvements and equipment, net                            | (195)                                      | (145)       |
| Net cash used in investing activities   | (47,412)                                   | (58,515)    |
| <b>Financing activities</b>   |  |             |
| Net increase in deposits  | 37,330                                     | 54,063      |
| Net increase (decrease) in FHLB line of credit                                    | 6,993                                      | (11,256)    |
| Repayment of long-term borrowed funds   | (5,000)                                    |             |
| Proceeds from long-term borrowed funds  | 11,000                                     |             |
| Net (decrease) increase in short-term borrowed funds                              | (497)                                      | 20,195      |
| Termination of interest rate swaps  | (1,384)                                    |             |
| Exercise of stock options   | 136  | 166         |
| Cash dividends  | (446)                                      | (278)       |
| Purchase of treasury stock  | (21)                                       | (5)         |

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|  |           |           |
|--|-----------|-----------|
| Net cash provided by financing activities        | 48,111    | 62,885    |
| Net increase in cash and cash equivalents        | 2,121     | 7,854     |
| Cash and cash equivalents at beginning of period | 16,707    | 8,721     |
| Cash and cash equivalents at end of period       | \$ 18,828 | \$ 16,575 |

**Supplementary cash flow information**

Cash paid or credited to accounts:

|                                     |           |           |
|-------------------------------------|-----------|-----------|
| Interest on deposits and borrowings | \$ 19,407 | \$ 12,079 |
| Income taxes                        | 2,851     | 3,142     |

Non-cash transactions:

Loans transferred to foreclosed properties

See accompanying Notes to Unaudited Consolidated Financial Statements.

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**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Principles of Consolidation.**

The unaudited consolidated financial statements include the accounts and results of First Business Financial Services, Inc. ( FBFS or the Corporation ), and its wholly-owned subsidiaries, First Business Bank ( FBB ), and First Business Bank Milwaukee (the Banks ). All significant intercompany balances and transactions have been eliminated in consolidation.

**Note 2 Basis of Presentation.**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of the unaudited consolidated financial statements have been included.

In conformity with GAAP, management of the Corporation is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that could experience significant changes in the near-term include the allowance for loan and lease losses, the value of foreclosed property, lease residuals, derivative financial instruments, hedging activities and accrued and deferred income taxes. The results of operations for the three and nine-month periods ended September 30, 2006 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2006.

**Recent Accounting Changes.**

**Accounting for Uncertainty in Income Taxes.** In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48 ( FIN No. 48 ), *Accounting for Uncertainty in Income Taxes* which is an interpretation of FASB No. 109, *Accounting for Income Taxes*. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in the Corporation's financial statements. The interpretation applies to situations where there is uncertainty about the timing of the deduction, the amount of deduction, or the validity of the deduction. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Corporation is in the process of determining if the adoption of FIN No. 48 will have a material effect on the Corporation's consolidated financial statements.

**Fair Value Measurements.** In September 2006, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value under GAAP and requires enhanced disclosures about fair value measurements. It does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Corporation is in the process of assessing whether it will early adopt SFAS No. 157 as of the first quarter of fiscal 2007 as permitted, and is in the process of determining if the adoption of SFAS No. 157 will have a material effect on the consolidated financial statements of the Corporation.

**Accounting for Defined Benefit Pension and Other Postretirement Plans.** In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* ( SFAS No. 158 ). SFAS No. 158 amends SFAS No. 87, *Employers' Accounting for Pensions*, SFAS No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* and SFAS No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other*

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*Postretirement Benefits*, and other related accounting literature. SFAS No. 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through comprehensive income. SFAS No. 158 also requires employers to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. Employers with publicly traded equity securities are required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. The Corporation is in the process of evaluating the impact the adoption of SFAS No. 158 may have on its consolidated financial statements.

**Consideration of the Effects of Prior Year Misstatements on Current Year Financial Statements.** In September 2006, the SEC issued Staff Accounting Bulletin ( SAB ) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ). SAB 108 provides guidance on how to evaluate prior period financial statement misstatements for purposes of assessing their materiality in the current period. If the prior period effect is material to the current period, then the prior period is required to be corrected. Correcting prior year financial statements would not require an amendment of prior year financial statements, but such corrections would be made the next time the company files the prior year financial statements. Upon adoption, SAB 108 allows a one-time transitional cumulative effect adjustment to retained earnings for corrections of prior period misstatements required under this statement. SAB 108 is effective for fiscal years beginning after November 15, 2006. The adoption of SAB 108 is not expected to be material to the Corporation's consolidated financial statements.

**Note 3 Share Based Compensation.**

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment* ( SFAS No. 123R ) SFAS No. 123R is a revision of SFAS No. 123, *Accounting for Stock-based Compensation* ( SFAS No. 123 ) and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB No. 25 ), and its related implementation guidance and amends SFAS No. 95, *Statement of Cash Flows* ( SFAS No. 95 ). On January 1, 2006, the Corporation adopted the provisions of SFAS No. 123R using the prospective method. SFAS No. 123R focuses primarily on accounting for transactions in which an entity obtains employee services in exchange for equity instruments. SFAS No. 123R requires entities to recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of those awards (with limited exceptions). SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow as prescribed under SFAS No. 95.

Prior to its adoption of SFAS No. 123R, the Corporation followed the intrinsic value method in accordance with APB No. 25 to account for its employee stock options. Accordingly, no compensation expense was recognized under the Corporation's equity incentive plans, the 1993 plan as amended in 1995 and the 2001 Equity Incentive Plan ( the Plans ). The adoption of SFAS No. 123R resulted in no change in the Corporation's method of recognizing compensation expense related to previous grants under the Plans.

**Equity Incentive Plans.**

The Plans are administered by the Compensation Committee of the Board of Directors of FBFS and provide for the grant of equity ownership opportunities through incentive stock options, nonqualified stock options ( stock options ) and restricted stock ( unvested shares ). A maximum of 224,232 common shares are currently authorized for awards under the Plans. As of September 30, 2006, 9,666 shares were available for future grants under the Plans. Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the Plans. The Corporation may issue new shares and shares from treasury for shares delivered under the Plans.

In May 2006 the shareholders approved the 2006 Equity Incentive Plan ( the 2006 Plan ). The 2006 Plan is administered by the Compensation Committee of the Board of Directors of FBFS and provides for the

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grant of equity ownership opportunities through incentive stock options, unvested shares, restricted stock units and performance shares. A maximum of 200,000 common shares are currently authorized and available for awards under the 2006 Plan.

For the three and nine months ended September 30, 2006, share-based compensation expense included in net income totaled approximately \$45,000 and \$117,000, respectively. The income tax benefit related to share-based compensation included in net income totaled approximately \$17,000 and \$44,000 for the three and nine months ended September 30, 2006.

**Stock Options**

Stock options are granted to senior executives and other employees under the Plans. Options generally have an exercise price that is equal to the fair value of the common shares on the date the option is granted. Options granted under the Plans are subject to graded vesting, generally ranging from four to eight years, and have a contractual term of 10 years. For any new awards issued after adoption of SFAS No. 123R provisions, compensation expense is recognized over the requisite service period for the entire award on a straight-line basis. There were no stock options granted during the three and nine months ended September 30, 2006. The Corporation expects that a majority of the outstanding stock options will fully vest.

Stock option activity for the nine months ended September 30, 2006 was as follows:

|   | <b>For the nine months ended<br/>September 30,<br/>2006</b> |                                       |  |
|---|---|---------------------------------------|--|
|   | <b>Options</b>  | <b>Weighted<br/>Average<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life<br/>(Years)</b> |
| Outstanding at January 1, 2006            | 201,532   | \$21.06                               |  |
| Granted                                   |   |                                       |  |
| Exercised                                 | (14,314)  | 9.50                                  |  |
| Forfeited                                 | (19,152)  | 21.82                                 |  |
| Outstanding at end of period              | 168,066   | \$21.95                               | 6.8  |
| Options exercisable at September 30, 2006 | 99,086  | \$19.79                               | 6.3  |

The Corporation accounts for stock options FBFS issued prior to October 6, 2005 as a non-public company that are still outstanding under the intrinsic value method of APB No. 25, and related interpretations, under which no compensation cost has been recognized for any periods presented. SFAS No. 123R will be applied prospectively to these equity share options upon modification, repurchase or cancellation of the stock options.

**Restricted Shares**

Under the 2001 and 2006 Equity Incentive Plans, participants may be granted restricted shares, each of which represents an unfunded, unsecured right, which is nontransferable except in the event of death of the participant, to receive a common share on the date specified in the participant's award agreement. While the restricted shares are subject to forfeiture, the participant may exercise full voting



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rights and will receive all dividends and other distributions paid with respect to the restricted shares. The restricted shares granted under this plan are subject to graded vesting. For awards with graded vesting, compensation expense is recognized over the requisite service period of four years for the entire award on a straight-line basis. Restricted share activity for the nine months ended September 30, 2006 was as follows:

|  | <b>Number of<br/>Restricted<br/>Shares</b> | <b>Weighted<br/>Average<br/>Grant-Date<br/>Fair Value</b> |
|--|--|---|
| Nonvested balance as of January 1, 2006    |  | \$  |
| Granted                                    | 43,475                                     | 23.17   |
| Vested                                     |  |   |
| Forfeited                                  | (2,850)                                    | 23.03   |
| Nonvested balance as of September 30, 2006 | 40,625                                     | \$ 23.18  |

As of September 30, 2006, there was approximately \$824,000 of deferred compensation expense related to unvested restricted share awards which is expected to be recognized over four years. As of September 30, 2006 there were no restricted shares vested and not delivered.

**Note 4 Goodwill and Other Intangible Assets.**

Goodwill is not amortized but is subject to impairment tests on at least an annual basis. No impairment loss was necessary in 2005 or through September 30, 2006. At September 30, 2006, goodwill was \$2,689,000. There was no change in the carrying amount of goodwill for the nine months ended September 30, 2006 and 2005, as shown below:

|                                | <b>Nine Months Ended<br/>September 30,<br/>2006      2005</b> |          |
|--------------------------------|---|----------|
|                                | (In Thousands)  |          |
| Balance at beginning of period | \$ 2,689  | \$ 2,689 |
| Goodwill acquired              |   |          |
| Balance at end of period       | \$ 2,689  | \$ 2,689 |

The Corporation has other intangible assets that are amortized, including core deposit intangibles and other intangibles, consisting of a purchased client list from a purchased brokerage/investment business.

Changes in the gross carrying amount, accumulated amortization and net book value of core deposit intangibles and other intangibles were as follows:

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|                                | <b>Nine Months Ended<br/>September 30,<br/>2006                  2005</b> |        |
|--------------------------------|---|--------|
|                                | (In Thousands)  |        |
| Core deposit intangibles:      |   |        |
| Gross carrying amount          | \$ 145  | \$ 145 |
| Accumulated amortization       | (72)  | (47)   |
| Net book value                 | \$ 73   | \$ 98  |
| Additions during the year      | \$  | \$     |
| Amortization during the period | (18)  | (25)   |
| Other intangibles:             |   |        |
| Gross carrying amount          | \$ 120  | \$ 120 |
| Accumulated amortization       | (57)  | (45)   |
| Net book value                 | \$ 63   | \$ 75  |
| Additions during the year      | \$  | \$     |
| Amortization during the period | (9)   | (9)    |

The following table shows the current period and estimated future amortization expense for amortized intangible assets:

|   | <b>Core<br/>Deposit<br/>Intangibles</b> | <b>Other<br/>Intangibles</b> | <b>Total</b> |
|---|---|------------------------------|--------------|
|   | (In Thousands)                          |                              |              |
| Nine months ended September 30, 2006                  | \$ 18                                   | \$ 9                         | \$ 27        |
| Estimate for the three months ended December 31, 2006 | 5                                       | 3                            | 8            |
| Estimate for the year ended December 31,              |   |                              |              |
| 2007  | 18                                      | 12                           | 30           |
| 2008  | 13                                      | 12                           | 25           |
| 2009  | 10                                      | 12                           | 22           |
| 2010  | 7                                       | 12                           | 19           |
|   | \$ 48                                   | \$ 48                        | \$ 96        |

**Table of Contents****Note 5 Securities.**

The amortized cost and estimated fair values of securities available-for-sale were as follows (in thousands):

| <b>Securities available-for-sale</b>      | <b>Amortized<br/>cost</b> | <b>As of September 30, 2006</b>                   |  | <b>Estimated<br/>fair value</b> |
|---|---------------------------|---|--|---------------------------------|
|   |                           | <b>Gross<br/>unrealized<br/>holding<br/>gains</b> | <b>Gross<br/>unrealized<br/>holding<br/>losses</b> |                                 |
|   |                           | (In Thousands)                                    |  |                                 |
| U.S. Government corporations and agencies | \$ 3,255                  | \$  | \$ (53)  | \$ 3,202                        |
| Municipals                                | 185                       |   | (3)  | 182                             |
| Collateralized mortgage obligations       | 93,919                    | 37  | (2,080)  | 91,876                          |
|   | \$97,359                  | \$ 37   | \$(2,136)  | \$95,260                        |

| <b>Securities available-for-sale</b>      | <b>Amortized<br/>cost</b> | <b>As of December 31, 2005</b>                    |  | <b>Estimated<br/>fair value</b> |
|---|---------------------------|---|--|---------------------------------|
|   |                           | <b>Gross<br/>unrealized<br/>holding<br/>gains</b> | <b>Gross<br/>unrealized<br/>holding<br/>losses</b> |                                 |
|   |                           | (In Thousands)                                    |  |                                 |
| U.S. Government corporations and agencies | \$ 3,264                  | \$  | \$ (80)  | \$ 3,184                        |
| Municipals                                | 275                       |   | (3)  | 272                             |
| Collateralized mortgage obligations       | 90,601                    | 2   | (2,004)  | 88,599                          |
|   | \$94,140                  | \$ 2  | \$(2,087)  | \$92,055                        |

The table below shows the Corporation's gross unrealized losses and fair value of investments, aggregated by investment category and length of time that individual investments have been in a continuous unrealized loss position at September 30, 2006. Such securities have declined in value due to current interest rate environments and not credit quality and do not presently represent realized losses. The Corporation has the ability to and anticipates that these securities, which have been in a continuous loss position but are not other-than-temporarily impaired, will be kept in the portfolio until the unrealized loss is recovered. If held until maturity, it is anticipated that the investments will be realized with no loss. If the Corporation determines that any of the above securities are deemed other-than-temporarily impaired, the impairment loss will be recognized in the income statement.

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A summary of unrealized loss information for investment securities, categorized by security type follows (in thousands):

|   | Less than 12 months |                 | As of September 30, 2006 |                 | Total      |                 |
|---|---------------------|-----------------|--------------------------|-----------------|------------|-----------------|
|   | Fair Value          | Unrealized loss | Fair Value               | Unrealized loss | Fair Value | Unrealized loss |
|   |                     |                 | (In Thousands)           |                 |            |                 |
| U.S. Government corporations and agencies | \$                  | \$              | \$ 3,202                 | \$ 53           | \$ 3,202   | \$ 53           |
| Municipals                                |                     |                 | 182                      | 3               | 182        | 3               |
| Collateralized mortgage obligations       | 18,629              | 221             | 66,860                   | 1,859           | 85,489     | 2,080           |
|   | \$ 18,629           | \$ 221          | \$ 70,244                | \$ 1,915        | \$ 88,873  | \$ 2,136        |

The Corporation has not sold any available-for-sale securities for any of the periods shown and has therefore not realized any gains or losses on such transactions.

At September 30, 2006 and December 31, 2005, securities with a fair value of approximately \$23,429,000 and \$29,700,000, respectively, were pledged to secure public deposits, securities sold under arrangements to repurchase, and borrowings.

**Note 6 Loans and Allowance for Loan and Lease Losses.**

Loan and lease receivables consisted of the following (in thousands):

|                                     | As of              |                         | 2004       |
|-------------------------------------|--------------------|-------------------------|------------|
|                                     | September 30, 2006 | As of December 31, 2005 |            |
|                                     | (In thousands)     |                         |            |
| First mortgage loans:               |                    |                         |            |
| Commercial real estate              | \$ 250,293         | \$ 249,133              | \$ 215,605 |
| Construction                        | 69,823             | 50,619                  | 41,910     |
| Multi-family                        | 25,960             | 22,115                  | 17,786     |
| 1-4 family                          | 32,649             | 26,513                  | 22,814     |
|                                     | 378,725            | 348,380                 | 298,115    |
| Commercial business loans           | 163,226            | 151,688                 | 136,482    |
| Direct financing leases, net        | 18,899             | 17,852                  | 25,583     |
| Second mortgage loans               | 7,981              | 8,231                   | 5,563      |
| Credit card and other               | 15,573             | 13,579                  | 10,743     |
|                                     | 584,404            | 539,730                 | 476,486    |
| Less:                               |                    |                         |            |
| Allowance for loan and lease losses | 7,260              | 6,773                   | 6,375      |
| Deferred loan fees                  | 160                | 241                     | 310        |

\$ 576,984      \$            532,716      \$ 469,801

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An analysis of the allowance for loan and lease losses is presented below (in thousands):

|                                     | <b>Nine<br/>Months<br/>Ended<br/>September<br/>30,<br/>2006</b> | <b>Year Ended<br/>December<br/>31,<br/>2005</b> |
|-------------------------------------|---|---|
|                                     | (In Thousands)  |   |
| Allowance at beginning of period    | \$ 6,773  | \$ 6,375  |
| Charge-offs:                        |   |   |
| Mortgage                            |   |   |
| Commercial                          |   |   |
| Lease                               |   |   |
| Consumer                            |   | (10)  |
| Total charge-offs                   |   | (10)  |
| Recoveries:                         |   |   |
| Mortgage                            |   | 4   |
| Commercial                          | 3   | 4   |
| Lease                               |   |   |
| Consumer                            |   |   |
| Total recoveries                    | 3   | 8   |
| Net recoveries (charge-offs)        | 3   | (2)   |
| Provision                           | 484   | 400   |
| Allowance at end of period          | \$ 7,260  | \$ 6,773  |
| Allowance to gross loans and leases | 1.24%   | 1.25%   |

**Note 7 Deposits.**

Deposits consisted of the following (in thousands):

|  | <b>September 30,<br/>2006</b> |                                      | <b>December 31,<br/>2005</b> |                                      |
|--|-------------------------------|--------------------------------------|------------------------------|--------------------------------------|
|  | <b>Balance</b>                | <b>Weighted<br/>Average<br/>Rate</b> | <b>Balance</b>               | <b>Weighted<br/>Average<br/>Rate</b> |
|  | (Dollars in Thousands)        |                                      |                              |                                      |
| Transaction accounts:                              |                               |                                      |                              |                                      |
| Demand deposits                                    | \$ 43,056                     | 0.00%                                | \$ 46,766                    | 0.00%                                |
| Negotiable order of withdrawal ( NOW )<br>accounts | 49,524                        | 4.19                                 | 46,962                       | 2.85                                 |
|  | 92,580                        |                                      | 93,728                       |                                      |
| Money market accounts                              | 155,640                       | 4.49                                 | 138,442                      | 3.10                                 |
| Certificates of deposit                            | 356,574                       | 4.53                                 | 335,294                      | 3.95                                 |

\$ 604,794

\$ 567,464

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Borrowings consisted of the following (in thousands):

|   | <b>As of September 30,<br/>2006</b> |   |                                      |
|---|-------------------------------------|---|--------------------------------------|
|   | <b>Balance</b>                      | <b>Weighted<br/>Average<br/>Balance</b> | <b>Weighted<br/>Average<br/>Rate</b> |
|   | (Dollars in Thousands)              |   |                                      |
| Fed funds purchased and securities sold under agreement to repurchase | \$ 21,707                           | \$ 12,825                               | 4.97%                                |
| FHLB advances   | 19,538                              | 17,981                                  | 4.78                                 |
| Junior subordinated debentures  | 10,310                              | 10,310                                  | 9.85                                 |
| Line of credit  | 10                                  | 4,126                                   | 6.88                                 |
| Subordinated note payable   | 11,000                              | 5,044                                   | 7.40                                 |
|   | <b>\$ 62,565</b>                    | <b>\$ 50,286</b>                        | <b>6.31%</b>                         |
| Short-term borrowings   | \$ 21,726                           |   |                                      |
| Long-term borrowings (due beyond one year)                            | 40,839                              |   |                                      |
|   | <b>\$ 62,565</b>                    |   |                                      |
|   |                                     | <b>As of December 31,<br/>2005</b>      |                                      |
|   | <b>Balance</b>                      | <b>Weighted<br/>Average<br/>Balance</b> | <b>Weighted<br/>Average<br/>Rate</b> |
|   | (Dollars in Thousands)              |   |                                      |
| Fed funds purchased and securities sold under agreement to repurchase | \$ 19,463                           | \$ 9,021                                | 3.45%                                |
| FHLB advances   | 12,545                              | 11,427                                  | 3.67                                 |
| Junior subordinated debentures  | 10,310                              | 10,310                                  | 9.18                                 |
| Line of credit  | 2,750                               | 2,338                                   | 5.39                                 |
| Subordinated note payable   | 5,000                               | 5,000                                   | 5.75                                 |
|   | <b>\$ 50,068</b>                    | <b>\$ 38,096</b>                        | <b>5.49%</b>                         |
| Short-term borrowings   | \$ 22,222                           |   |                                      |
| Long-term borrowings (due beyond one year)                            | 27,846                              |   |                                      |
|   | <b>\$ 50,068</b>                    |   |                                      |



**Table of Contents****Note 9 Derivative and Hedging Activities.**

Derivative gains and losses reclassified from accumulated other comprehensive income to current period earnings are included in the line item in which the hedged cash flows are recorded. At September 30, 2006 and December 31, 2005 accumulated other comprehensive income included unrealized after tax losses of \$4,000 and \$8,000, respectively, related to derivatives used to hedge funding cash flows. At September 30, 2006 and December 31, 2005, the fair value of the interest rate swaps designated as cash flow hedges represented unrealized losses of \$7,000 and \$14,000, respectively. There were no unrealized gains on interest rate swaps which qualify as cash flow hedges as of September 30, 2006 and December 31, 2005. The estimated amount of pre-tax loss expected to be reclassified into earnings from accumulated other comprehensive income due to net expenses on cash flow hedges within the next twelve months is \$1,000.

The unrealized holding gains and losses, net of tax effect, included in accumulated other comprehensive income at September 30, 2006 and December 31, 2005, were (\$17,000) and (\$105,000), respectively. At September 30, 2006 and December 31, 2005, the fair value of other derivatives included in other assets totaled \$43,000 and \$40,000, respectively. At September 30, 2006 and December 31, 2005, the fair value of other derivatives included in other liabilities totaled \$0 and \$1,141,000.

The interest rate swap agreements consist of the following:

|  | As of September 30,<br>2006 |                  |               |                  | As of December 31,<br>2005 |                  |               |                  |
|--|-----------------------------|------------------|---------------|------------------|----------------------------|------------------|---------------|------------------|
|  | Notional<br>Amount          | Maturity<br>Date | Fixed<br>Rate | Variable<br>Rate | Notional<br>Amount         | Maturity<br>Date | Fixed<br>Rate | Variable<br>Rate |
| (In thousands)                                     |                             |                  |               |                  |                            |                  |               |                  |
| <b>Cash Flow<br/>Hedge:</b>                        |                             |                  |               |                  |                            |                  |               |                  |
| Pay-fixed<br>interest rate<br>swap                 | \$ 660                      | April, 2009      | 5.24%         | 5.04%            | \$ 789                     | April, 2009      | 5.24%         | 3.97%            |
| <b>Other<br/>Derivatives:</b>                      |                             |                  |               |                  |                            |                  |               |                  |
| Pay-fixed<br>interest rate<br>swap                 | 10,000                      | October, 2006    | 3.94          | 5.03             | 10,000                     | October, 2006    | 3.94          | 4.08             |
| Pay-fixed<br>interest rate<br>swap                 | 10,000                      | November, 2006   | 3.75          | 5.03             | 10,000                     | November, 2006   | 3.75          | 4.12             |
| Pay-fixed<br>interest rate<br>swap                 | 10,000                      | December, 2006   | 4.94          | 5.39             | 10,000                     | December, 2006   | 4.94          | 4.50             |
| Callable<br>receive-fixed<br>interest rate<br>swap |                             |                  |               |                  | 10,000                     | January, 2010    | 4.25          | 4.44             |
| Callable<br>receive-fixed<br>interest rate<br>swap |                             |                  |               |                  | 10,000                     | February, 2010   | 4.35          | 4.39             |
|  |                             |                  |               |                  | 10,000                     | February, 2010   | 4.10          | 4.42             |

|  |           |                |      |           |
|--|-----------|----------------|------|-----------|
| Callable<br>receive-fixed<br>interest rate<br>swap |           |                |      |           |
| Callable<br>receive-fixed<br>interest rate<br>swap | 10,000    | November, 2010 | 4.00 | 4.41      |
| Pay-fixed<br>interest rate<br>swap                 | 4,742     | June, 2011     | 5.49 | 4.20      |
|  | \$ 30,660 |                |      | \$ 75,531 |

As required by SFAS No. 133, the Corporation is amortizing, over the remaining term of the pay-fixed interest rate swap maturing in October 2006, to interest expense the market loss at the date that interest rate swap no longer qualified for cash flow hedge accounting. This swap no longer qualified for hedge accounting treatment because the Corporation did not redesignate a new hedging relationship upon adoption of FIN46R. At September 30, 2006 and December 31, 2005, the balance of the unamortized loss, net of tax effect, on this interest rate swap included in accumulated other comprehensive income is approximately \$13,000 and \$96,000, respectively.

**Table of Contents****Note 10 Earnings Per Share.**

Basic earnings per share for the three and nine months ended September 30, 2006 and 2005 have been determined by dividing net income for the respective periods by the weighted average number of shares of common stock outstanding. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding plus the effect of dilutive securities. The effect of dilutive securities is computed using the treasury stock method. For the three month periods ended September 30, 2006 and 2005, average anti-dilutive employee stock options totaled 65,323 and 15,750, respectively. For the nine month periods ended September 30, 2006 and 2005, average anti-dilutive employee stock options totaled 65,762 and 12,384, respectively.

|  | <b>Three Months Ended September<br/>30,</b> |             |
|--|---|-------------|
|  | <b>2006</b>                                 | <b>2005</b> |
| Numerator:   |   |             |
| Net income   | \$ 866,302                                  | \$ 916,404  |
| <br>   |   |             |
| Numerator for basic and diluted earnings per share income available to common stockholders                 | 866,302                                     | 916,404     |
| <br>   |   |             |
| Denominator:   |   |             |
| Denominator for basic earnings per share weighted-average common shares outstanding                        | 2,480,023                                   | 2,423,847   |
| <br>   |   |             |
| Effect of dilutive securities:   |   |             |
| Employee stock options   | 13,232                                      | 41,357      |
| <br>   |   |             |
| Denominator for diluted earnings per share adjusted weighted-average common shares and assumed conversions | 2,493,255                                   | 2,465,204   |
| <br>   |   |             |
| Basic earnings per share   | \$ 0.35                                     | \$ 0.38     |
| Diluted earnings per share   | 0.35  | 0.37        |

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|  | <b>Nine Months Ended September<br/>30,</b> |              |
|--|--|--------------|
|  | <b>2006</b>                                | <b>2005</b>  |
| Numerator:   |  |              |
| Net income   | \$ 2,801,980                               | \$ 3,664,539 |
| Numerator for basic and diluted earnings per share income available to common stockholders                 | \$ 2,801,980                               | \$ 3,664,539 |
| Denominator:   |  |              |
| Denominator for basic earnings per share weighted-average common shares outstanding                        | 2,471,825                                  | 2,418,679    |
| Effect of dilutive securities:   |  |              |
| Employee stock options   | 16,765                                     | 45,190       |
| Denominator for diluted earnings per share adjusted weighted-average common shares and assumed conversions | 2,488,590                                  | 2,463,869    |
| Basic earnings per share   | \$ 1.13                                    | \$ 1.52      |
| Diluted earnings per share   | 1.13                                       | 1.49         |

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

This quarterly report on Form 10-Q ( Form 10-Q ) contains or incorporates by reference various forward-looking statements concerning the Corporation's prospects that are based on the current expectations or beliefs of management. Forward-looking statements may also be made by the Corporation from time to time in other reports and documents as well as oral presentations. When used in written documents or oral statements, the words anticipate, believe, estimate, expect, objective and similar expressions and verbs in the future tense, are intended to identify forward-looking statements. The statements contained herein and such future statements involve or may involve certain assumptions, risks, and uncertainties, many of which are beyond the Corporation's control that could cause the Corporation's actual results and performance to differ materially from what is expected. In addition to the assumptions and other factors referenced specifically in connection with such statements, the following factors could impact the business and financial prospects of the Corporation: general economic conditions; legislative and regulatory initiatives; increased competition and other effects of deregulation and consolidation of the financial services industry; monetary and fiscal policies of the federal government; deposit flows; disintermediation; the cost of funds; general market rates of interest; interest rates or investment returns on competing investments; demand for loan products; demand for financial services; changes in accounting policies or guidelines; general economic developments; acts of terrorism and developments in the war on terrorism; and changes in the quality or composition of loan and investment portfolios. See also **Item 1a. Risk Factors** discussed in our annual Report on Form 10-K and factors regarding future operations discussed below.

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The following discussion and analysis is presented to assist in the understanding and evaluation of the Corporation's financial condition and results of operations. It is intended to complement the unaudited consolidated financial statements, footnotes, and supplemental financial data appearing elsewhere in this Form 10-Q and should be read in conjunction with such statements, footnotes and data. The presentation focuses on the three and nine months ended September 30, 2006 and the comparable periods in 2005.

**Overview**

First Business Financial Services, Inc. ( "FBFS" or the Corporation ) is a registered bank holding company incorporated under the laws of the State of Wisconsin and is engaged in the commercial banking business through its wholly-owned banking subsidiaries First Business Bank and First Business Bank - Milwaukee (referred to as the Banks ). All of the operations of FBFS are conducted through its Banks and certain subsidiaries of First Business Bank. The Corporation operates as a business bank focusing on delivering products and services to small and medium size businesses. The Corporation does not utilize its locations to attract retail customers. FBFS seeks to provide lending and deposit products to local businesses and business executives. To supplement its business banking deposit base, the Corporation utilizes wholesale funding alternatives to fund a portion of the Corporation's loan and lease portfolio.

Net interest income is dependent on the amounts of and yields on interest-earning assets as compared to the amounts of and rates on interest-bearing liabilities. Net interest income is sensitive to changes in market rates of interest and the asset/liability management procedures used by FBFS in responding to such changes. The provision for loan and lease losses is dependent upon the credit quality of loans and leases and management's assessment of the collectibility of loans and leases under current economic conditions. Non-interest expenses are influenced by the growth of operations, with additional employees necessary to staff such growth. Growth in the number of relationships directly affects such expenses as data processing costs, supplies, postage, and other miscellaneous expenses.

**Recent Developments/Financial Highlights**

Net income for the three and nine months ended September 30, 2006 decreased \$50,000 and \$863,000 over the comparable prior year periods due to higher compensation expense as the Corporation continues to hire additional business development staff in order to increase loan and lease receivables, greater provision for loan and lease losses primarily due to the growth in the loan and lease portfolio accompanied by no significant changes in the risk profile of the loan and lease portfolio and the nine month period ended September 30, 2005 included a \$973,000 pre-tax gain on the sale of the 50% owned joint venture

Net loans and leases receivable increased 8.3% from December 31, 2005 to \$577 million at September 31, 2006

Deposits increased 6.6% to \$605 million

**Results of Operations**

*Comparison of Three and Nine Months Ended September 30, 2006 and 2005*

**General.** Net income for the three and nine months ended September 30, 2006 decreased \$50,000 and \$863,000 to \$866,000 and \$2.8 million from \$916,000 and \$3.7 million for the same periods in 2005. The increase in net interest income of \$879,000 for the nine months ended September 30, 2006 was more than offset by an increase of \$366,000 in the provision for loan and lease losses, a decrease of \$314,000 in the change in fair value of interest rate swaps and an increase in compensation costs of \$1.0 million. Additionally, the nine months ended September 30, 2005 included a gain on the sale of the 50% equity investment in a leasing joint venture, m2 Lease Funds, LLC ( "m2" ), of \$973,000. The three months ended September 30, 2006 reflected an increase of \$357,000 in net interest income and an increase of \$130,000 in the change in fair value of interest rate swaps which were offset by increases in the provision for loan and lease losses of \$360,000 and an increase in compensation costs of \$338,000. Diluted earnings per share for the three months ended September 30, 2006 decreased to \$0.35 from \$0.37 for the same period in 2005 largely attributable to the decrease in net income. The annualized returns on average assets and average

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stockholders' equity for the three months ended September 30, 2006 were 0.50% and 7.97%, respectively, as compared to 0.59% and 9.00%, respectively, for the same period in 2005. Diluted earnings per share for the nine months ended September 30, 2006 decreased to \$1.13 from \$1.49 for the same period in 2005 due to the decrease in net income. The annualized returns on average assets and average stockholders' equity for the nine months ended September 30, 2006 were 0.55% and 8.74%, respectively, as compared to 0.81% and 12.46%, respectively, for the same periods in 2005.

**Net Interest Income.** Net interest income increased \$357,000, or 8.2%, to \$4.7 million for the three months ended September 30, 2006 from \$4.4 million for the same period in 2005. For the nine months ended September 30, 2006, net interest income increased \$879,000, or 6.7%, to \$14.0 million from \$13.2 million for the same period in 2005. The improvement in net interest income for the three and nine months ended September 30, 2006 was due to an increase in average earning assets partially offset by a decrease in net interest margin as compared to the same period in 2005. The net interest margin decreased to 2.84% for the three months ended September 30, 2006 from 2.93% for the same period in 2005. The net interest margin decreased to 2.89% for the nine months ended September 30, 2006 from 3.03% for the same period in 2005. Similarly, there were decreases in the interest rate spread to 2.39% and 2.47% for the three and nine months ended September 30, 2006 from 2.50% and 2.64% for the same three and nine month periods in 2005. The decreases in the net interest margin were the result of the increases in yields paid on interest-bearing liabilities outpacing the increases in yields earned on interest-earning assets and a decrease in net interest earning assets. The increase in rates is reflective of the change in market rates.

Interest income on interest-earning assets increased \$2.8 million to \$12.2 million for the three months ended September 30, 2006 as compared to the same period in 2005 driven principally by an increase in average loans and leases outstanding of \$61.5 million, an increase of 12.2%, accompanied by an increase in the average yield earned on loans and leases to 7.86% from 6.77% for the three months ended September 30, 2006 in comparison to the same period during 2005.

For the nine months ended September 30, 2006, interest income on interest-earning assets increased \$8.3 million to \$34.5 million as compared to the same period in 2005. Interest income on loans and leases increased \$7.6 million to \$31.4 million from \$23.8 million for the same period in 2005. Average loans and leases outstanding increased \$57.7 million, or 11.8%, accompanied by an increase in average yield to 7.65% for the nine months ended September 30, 2006, from 6.47% for the same period in 2005.

The increase in average yields earned on loans and leases for both the three and nine months ended September 30, 2006 was primarily caused by a change in market rates. The average balance of loans and leases increased to \$564.5 million for the three months ended September 30, 2006 from \$503.0 million for the three months ended September 30, 2005. The increase was driven by growth in mortgage loans which includes commercial real estate, construction, multi-family and 1-4 family loans and commercial loans. For the three months ended September 30, 2006, the average balance of mortgage loans grew \$40.5 million, or 12.1%, from \$335.7 million to \$376.2 million. Average commercial loans increased \$23.3 million, or 16.1% to \$167.7 million for the three months ended September 30, 2006 from \$144.4 million for the same period in 2005. Average leases decreased \$2.4 million, or 11.7%, for the three months ended September 30, 2006 in comparison to September 30, 2005. The average balance of loans and leases increased to \$547.6 million for the nine months ended September 30, 2006 from \$489.9 million as of September 30, 2005. For the nine months ended September 30, 2006, average mortgage loans grew \$39.8 million, or 12.3%, from \$324.4 million for the nine months ended September 30, 2005 to \$364.3 million. Average commercial loans grew \$22.2 million, or 15.8%, from \$140.2 million for the nine months ended September 30, 2005 to \$162.4 million for the nine months ended September 30, 2006. Average leases decreased \$4.4 million, or 19.4% for the nine months ended September 30, 2006 in comparison to the nine months ended September 30, 2005. The growth in mortgage and commercial loans has largely been the result of expanding relationships with existing clients and attracting new clients in both of the Banks' two principal markets.

Also contributing to the increase in income on interest earning assets was an increase in income on mortgage related securities of \$206,000 and \$687,000 to \$997,000 and \$2.9 million for the respective three and nine months ended September 30, 2006 from \$791,000 and \$2.2 million for the same periods in 2005.

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Purchases of such securities were made as interest rates have become more attractive in those securities as a result of rising mortgage rates. Average balances of mortgage related securities increased \$7.6 million to \$92.5 million for the three months ended September 30, 2006 from \$84.8 million for the same periods in 2005. For the nine months ended September 30, 2006 average balances of mortgage related securities increased \$11.2 million to \$91.7 million from \$80.6 million for the nine months ended September 30, 2005. These increases were accompanied by an increase in average yields on such securities from 3.73% and 3.64% for the respective three and nine months ended September 30, 2005 to 4.31% and 4.20% in 2006. It is the Corporation's policy to diversify assets and part of that diversification includes an investment portfolio that is no less than 10.0% of total assets.

Interest expense increased \$2.4 million to \$7.4 million for the three months ended September 30, 2006 from \$5.0 million, for the same period in 2005. For the nine months ended September 30, 2006 interest expense increased \$7.4 million from \$13.2 million to \$20.5 million. These increases were primarily due to respective \$2.1 million and \$6.5 million increases in interest expense on deposits for the three and nine months ended September 30, 2006 with the weighted average rate increasing to 4.78% and 4.49% from 3.64% and 3.25% for the same periods in 2005. The increases in interest expense were largely due to rising rates on deposits accompanied by increases in average interest-bearing deposits. Average interest-bearing deposits increased \$61.9 million, or 12.7%, to \$549.9 million for the three month period ended September 30, 2006 from \$488.0 million for the three months ended September 30, 2005. For the nine month period ended September 30, 2006 average interest-bearing deposits increased \$62.6 million, or 13.2%, to \$537.4 million from \$474.8 million for the same period in 2005. These increases were largely a result of growth in money market accounts acquired primarily within the local market and growth in average certificates of deposit primarily acquired through deposit brokers. Average money market deposits increased \$38.4 million, or 32.7%, from \$117.4 million for the three months ended September 30, 2005 to \$155.8 million for the same period in 2006. Average money market deposits increased \$41.0 million, or 38.3%, from \$107.0 million for the nine months ended September 30, 2005 to \$148.0 million for the same period in 2006. Average certificates of deposit increased \$22.5 million and \$21.4 million, respectively, from \$322.9 million and \$317.5 million for the three and nine months ended September 30, 2005 to \$345.4 million and \$338.9 million for the same periods in 2006. The average balance of Federal Home Loan Bank (FHLB) advances, used as another source of funding, increased \$9.8 million to \$19.6 million for the three months ended September 30, 2006 from \$9.8 million for the three months ended September 30, 2005. For the nine months ended Sept 30, 2006 average FHLB advances increased \$6.9 million to \$18.0 million from \$11.0 million for the same period in 2005. The weighted average cost of FHLB advances increased from 4.40% and 3.27% for the three and nine months ended September 30, 2005 to 4.86% and 4.78% for the same periods in 2006. Average other borrowings increased \$6.3 million from \$15.7 million to \$22.0 million for the nine months ended September 30, 2006. The overall weighted average cost of borrowings increased from 5.28% for the nine months ended September 30, 2005 to 6.31% for the same period in 2006. Specifically average federal funds purchased and securities sold under agreement to repurchase increased \$3.9 million to \$12.8 million for the nine months ended September 30, 2006 from \$8.9 million for the same period in 2005. The average cost of federal funds purchased and securities sold under agreement to repurchase was 4.97% for the nine months ended September 30, 2006 as compared to 3.26% for the same period in 2005. The average borrowings under the Corporation's line of credit increased \$2.2 million to \$4.1 million for the nine months ended September 30, 2006 from \$1.9 million for the same period in 2005. The average cost of the line of credit was 6.88% for the nine months ended September 30, 2006 as compared to 5.08% for the nine months ended September 30, 2005.

The Banks' strategies continue to focus on developing deeper relationships with clients through the sale of products and services that meet clients' needs accompanied by employee incentive programs that encourage the growth of loans and deposits. Specific deposit initiatives include service and retention calling programs, increased advertising and identification of high growth potential individuals and businesses. Additionally, the Banks' use of wholesale funding, in the form of deposits generated through distribution channels other than the Corporation's own bank locations, allows the Banks to gather funds across a wider geographic base at pricing levels considered attractive.

**Provision for Loan and Lease Losses.** The provision for loan and lease losses totaled \$413,000 and \$484,000 for the three and nine months ended September 30, 2006 compared to a provision of \$53,000





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and \$118,000 for the same periods in 2005. Growth in the loan and lease portfolio is the primary reason for the provision in loan and lease losses during the nine month period in 2006 accompanied by no significant changes in the risk profile associated with the loan and lease portfolio. The improvement in the Corporation's historical charge-off migration was offset by an increase in the specific reserves established for impaired loans due to declining values of collateral. In order to establish the levels of the allowance for loan and lease losses, management regularly reviews its historical charge-off migration analysis and an analysis of the current level and trend of several factors that management believes provide an indication of losses in the loan and lease portfolio. These factors include delinquencies, volume, average size, average risk rating, technical defaults, geographic concentrations, industry concentrations, loans and leases on the management attention list, experience in the credit granting functions and changes in underwriting standards. There was no charge-off activity for the three and nine month periods ended September 30, 2006.

**Non-Interest Income.** Non-interest income, consisting primarily of deposit and loan related fees as well as fees earned for trust and investment services, changes in fair value of derivatives and income from bank-owned life insurance, increased \$413,000 to \$1.0 million for the three months ended September 30, 2006 from \$591,000 for the same period in 2005 and decreased \$701,000 to \$2.7 million for the nine months ended September 30, 2006 as compared to \$3.4 million for the same period in 2005. A gain on sale of \$973,000 from the Corporation's 50% owned joint venture, m2, occurred during the nine months ended September 30, 2005. Other primary contributors to the changes for the three and nine months ended September 30, 2006 were an increase in the fair value of derivatives of \$130,000 in the three month period and a decline in fair value of derivatives totaling \$314,000 for the nine month period ending September 30, 2006. The decrease in service charges on demand deposit accounts for the three and nine months ended September 30, 2006 of \$16,000 and \$67,000 in comparison to the same periods for 2005 is mainly attributable to the increase in the earnings credit rate on demand deposit accounts which results in lower service charges paid by the client. These decreases were partially offset by increases of \$54,000 and \$171,000 in income from bank-owned life insurance for the three and nine months ended September 30, 2006 as compared to the same periods during 2005 due to the purchase of additional bank-owned life insurance. In addition to this, for the three and nine months ended September 30, 2006, there were increases of \$103,000 and \$238,000 in trust and investment services fee income from FBB's trust and investment services area due to successful efforts to increase trust assets under management. Trust assets under management have increased \$11.0 million from June 30, 2006 and \$39.3 million from December 31, 2005 to \$180.4 million. Money transferred in from new and existing clients contributed to the increase in trust assets managed.

**Non-Interest Expense.** Non-interest expense increased \$583,000, or 16.4%, and \$1.3 million, or 12.1%, to \$4.1 million and \$12.2 million for the three and nine months ended September 30, 2006 from \$3.6 million and \$10.9 million in the same periods for 2005. A significant portion of the increase for the three and nine month periods ended September 30, 2006 as compared to the same periods in 2005 was due to increases of \$338,000 and \$1.0 million in employee salaries and benefits reflecting additions to staff, increases in benefit costs and expense associated with awards of restricted shares of the Corporation's common stock. Marketing expense increased \$30,000 for the nine month period as a result of efforts to develop new and existing relationships. Data processing expense increased \$70,000 for the nine month period largely to keep pace with internal growth as well as overall technology in the industry. Professional fees increased \$38,000 and other expenses increased \$130,000 for the nine month period as compared to the same period in the prior year.

**Income Taxes.** Income tax expense was \$309,000 and \$1.3 million for the three and nine months ended September 30, 2006, with effective rates of 26.3% and 30.9% compared to \$432,000 and \$1.9 million for the same periods in 2005, with effective rates of 32.0% and 34.0% for the respective periods in 2005. Contributing to the reduction in the effective tax rate during the three and nine months ended September 30, 2006 was an increase in the amount of non-taxable income from bank-owned life insurance in comparison to the same periods for 2005.

**Average Interest-Earning Assets, Average Interest-Bearing Liabilities and Interest Rate Spread.** The tables on the following pages show the Corporation's average balances, interest, average

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rates, net interest margin and the spread between the combined average rates earned on interest-earning assets and average cost of interest-bearing liabilities for the periods indicated. The average balances are derived from average daily balances.

|   | <b>Three Months Ended September 30,</b> |                 |   |                            |                 |                                    |
|---|---|-----------------|---|----------------------------|-----------------|------------------------------------|
|   | <b>2006</b>                             |                 |   | <b>2005</b>                |                 |                                    |
|   | <b>Average<br/>Balance</b>              | <b>Interest</b> | <b>Average<br/>Yield/<br/>Cost<br/>(Dollars in Thousands)</b> | <b>Average<br/>Balance</b> | <b>Interest</b> | <b>Average<br/>Yield/<br/>Cost</b> |
| <b>Interest-Earning Assets</b>                      |   |                 |   |                            |                 |                                    |
| Mortgage loans <sup>(1)</sup>                       | \$ 376,230                              | \$ 6,891        | 7.33%   | \$ 335,733                 | \$ 5,406        | 6.44%                              |
| Commercial loans                                    | 167,696                                 | 3,847           | 9.18  | 144,439                    | 2,797           | 7.75                               |
| Leases  | 17,818                                  | 314             | 7.05  | 20,172                     | 270             | 5.35                               |
| Consumer loans                                      | 2,740                                   | 45              | 6.57  | 2,683                      | 41              | 6.11                               |
| Total loans and leases<br>receivable <sup>(1)</sup> | 564,484                                 | 11,097          | 7.86  | 503,027                    | 8,514           | 6.77                               |
| Mortgage-related securities<br><sup>(2)</sup>       | 92,487                                  | 997             | 4.31  | 84,847                     | 791             | 3.73                               |
| Investment securities <sup>(2)</sup>                | 3,409                                   | 28              | 3.29  | 3,436                      | 28              | 3.26                               |
| Federal Home Loan Bank<br>stock                     | 2,127                                   | 22              | 4.14  | 2,848                      | 35              | 4.92                               |
| Fed funds sold and other                            |   |                 | 0.00  | 107                        | 1               | 3.74                               |
| Short-term investments                              | 1,755                                   | 21              | 4.79  | 944                        | 7               | 2.97                               |
| Total interest-earning assets                       | 664,262                                 | 12,165          | 7.33  | 595,209                    | 9,376           | 6.30                               |
| Non-interest-earning assets                         | 30,807                                  |                 |   | 22,357                     |                 |                                    |
| Total assets  | \$ 695,069                              |                 |   | \$ 617,566                 |                 |                                    |
| <b>Interest-Bearing Liabilities</b>                 |   |                 |   |                            |                 |                                    |
| NOW accounts  | \$ 48,755                               | \$ 543          | 4.45%   | \$ 47,647                  | \$ 368          | 3.09%                              |
| Money market  | 155,794                                 | 1,871           | 4.80  | 117,444                    | 959             | 3.27                               |
| Certificates regular                                | 303,267                                 | 3,635           | 4.79  | 278,691                    | 2,737           | 3.93                               |
| Certificates large                                  | 42,095                                  | 522             | 4.96  | 44,198                     | 380             | 3.44                               |
| Total deposits                                      | 549,911                                 | 6,571           | 4.78  | 487,980                    | 4,444           | 3.64                               |
| Junior subordinated<br>debentures                   | 10,310                                  | 260             | 10.09   | 10,310                     | 238             | 9.23                               |
| FHLB advances                                       | 19,605                                  | 238             | 4.86  | 9,811                      | 108             | 4.40                               |
| Other borrowings                                    | 23,816                                  | 379             | 6.37  | 20,328                     | 226             | 4.45                               |
| Total interest-bearing<br>liabilities               | 603,642                                 | 7,448           | 4.94  | 528,429                    | 5,016           | 3.80                               |
| Non-interest-bearing<br>liabilities                 | 47,944                                  |                 |   | 48,429                     |                 |                                    |

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|  |            |          |            |          |       |
|--|------------|----------|------------|----------|-------|
| Total liabilities  | 651,586    |          | 576,858    |          |       |
| Stockholders' equity   | 43,483     |          | 40,708     |          |       |
| Total liabilities and Stockholders' equity                                       | \$ 695,069 |          | \$ 617,566 |          |       |
| Net interest income/interest rate spread   |            | \$ 4,717 | 2.39%      | \$ 4,360 | 2.50% |
| Net interest-earning assets  | \$ 60,620  |          | \$ 66,780  |          |       |
| Net interest margin  |            |          | 2.84%      |          | 2.93% |
| Ratio of average interest-earning assets to average interest-earning liabilities | 1.10       |          | 1.13       |          |       |
| Return on average assets   | 0.50%      |          | 0.59%      |          |       |
| Return on average equity   | 7.97%      |          | 9.00%      |          |       |
| Average equity to average assets   | 6.26%      |          | 6.59%      |          |       |
| Non-interest expense to average assets   | 2.38%      |          | 2.36%      |          |       |

(1) The average balances of loans and leases include non-performing loans and leases, interest of which is generally recognized on a cash basis.

(2) Includes amortized cost basis of assets held and available for sale.

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|   | <b>Nine Months Ended September 30,</b> |                 |                                    |                            |                 |                                    |
|---|--|-----------------|------------------------------------|----------------------------|-----------------|------------------------------------|
|   | <b>2006</b>                            |                 |                                    | <b>2005</b>                |                 |                                    |
|   | <b>Average<br/>Balance</b>             | <b>Interest</b> | <b>Average<br/>Yield/<br/>Cost</b> | <b>Average<br/>Balance</b> | <b>Interest</b> | <b>Average<br/>Yield/<br/>Cost</b> |
|   | (Dollars in Thousands)                 |                 |                                    |                            |                 |                                    |
| <b>Interest-Earning Assets</b>                      |  |                 |                                    |                            |                 |                                    |
| Mortgage loans <sup>(1)</sup>                       | \$ 364,253                             | \$ 19,353       | 7.08%                              | \$ 324,443                 | \$ 14,891       | 6.12%                              |
| Commercial loans                                    | 162,372                                | 10,944          | 8.99                               | 140,197                    | 7,861           | 7.48                               |
| Leases  | 18,230                                 | 979             | 7.16                               | 22,605                     | 900             | 5.31                               |
| Consumer loans                                      | 2,793                                  | 139             | 6.64                               | 2,692                      | 116             | 5.75                               |
| <br>  |  |                 |                                    |                            |                 |                                    |
| Total loans and leases<br>receivable <sup>(1)</sup> | 547,648                                | 31,415          | 7.65                               | 489,937                    | 23,768          | 6.47                               |
| Mortgage-related securities<br><sup>(2)</sup>       | 91,749                                 | 2,888           | 4.20                               | 80,590                     | 2,201           | 3.64                               |
| Investment securities <sup>(2)</sup>                | 3,439                                  | 85              | 3.30                               | 3,443                      | 80              | 3.10                               |
| Federal Home Loan Bank<br>stock                     | 2,607                                  | 66              | 3.38                               | 2,813                      | 111             | 5.26                               |
| Fed funds sold and other                            | 44                                     | 2               | 6.06                               | 1,084                      | 17              | 2.09                               |
| Short-term investments                              | 1,696                                  | 56              | 4.40                               | 974                        | 18              | 2.46                               |
| <br>  |  |                 |                                    |                            |                 |                                    |
| Total interest-earning assets                       | 647,183                                | 34,512          | 7.11                               | 578,841                    | 26,195          | 6.03                               |
| Non-interest-earning assets                         | 31,043                                 |                 |                                    | 22,029                     |                 |                                    |
| <br>  |  |                 |                                    |                            |                 |                                    |
| Total assets  | \$ 678,226                             |                 |                                    | \$ 600,870                 |                 |                                    |
| <br>  |  |                 |                                    |                            |                 |                                    |
| <b>Interest-Bearing Liabilities</b>                 |  |                 |                                    |                            |                 |                                    |
| NOW accounts  | \$ 50,442                              | \$ 1,586        | 4.19%                              | \$ 50,275                  | \$ 1,000        | 2.65%                              |
| Money market  | 147,989                                | 4,982           | 4.49                               | 107,017                    | 2,272           | 2.83                               |
| Certificates regular                                | 295,057                                | 10,020          | 4.53                               | 275,007                    | 7,339           | 3.56                               |
| Certificates large                                  | 43,863                                 | 1,499           | 4.56                               | 42,488                     | 948             | 2.97                               |
| <br>  |  |                 |                                    |                            |                 |                                    |
| Total deposits                                      | 537,351                                | 18,087          | 4.49                               | 474,787                    | 11,559          | 3.25                               |
| Junior subordinated<br>debentures                   | 10,310                                 | 762             | 9.85                               | 10,310                     | 700             | 9.05                               |
| FHLB advances                                       | 17,981                                 | 645             | 4.78                               | 11,044                     | 271             | 3.27                               |
| Other borrowings                                    | 21,994                                 | 971             | 5.89                               | 15,739                     | 497             | 4.21                               |
| <br>  |  |                 |                                    |                            |                 |                                    |
| Total interest-bearing<br>liabilities               | 587,636                                | 20,465          | 4.64                               | 511,880                    | 13,027          | 3.39                               |
| Non-interest-bearing<br>liabilities                 | 47,841                                 |                 |                                    | 49,771                     |                 |                                    |
| <br>  |  |                 |                                    |                            |                 |                                    |
| Total liabilities                                   | 635,477                                |                 |                                    | 561,651                    |                 |                                    |
| Stockholders equity                                 | 42,749                                 |                 |                                    | 39,219                     |                 |                                    |

|  |            |           |       |            |       |
|--|------------|-----------|-------|------------|-------|
| Total liabilities and Stockholders equity  | \$ 678,226 |           |       | \$ 600,870 |       |
| Net interest income/interest rate spread   |            | \$ 14,047 | 2.47% | \$ 13,168  | 2.64% |
| Net interest-earning assets  | \$ 59,547  |           |       | \$ 66,961  |       |
| Net interest margin  |            |           | 2.89% |            | 3.03% |
| Ratio of average interest-earning assets to average interest-earning liabilities | 1.10       |           |       | 1.13       |       |
| Return on average assets   | 0.55%      |           |       | 0.81%      |       |
| Return on average equity   | 8.74%      |           |       | 12.46%     |       |
| Average equity to average assets   | 6.30%      |           |       | 6.53%      |       |
| Non-interest expense to average assets   | 2.40%      |           |       | 2.49%      |       |

(1) The average balances of loans and leases include non-performing loans and leases, interest of which is generally recognized on a cash basis.

(2) Includes amortized cost basis of assets held and available for sale.

**Table of Contents****Financial Condition**

**General.** The total assets of FBFS increased \$50.6 million to \$719.8 million at September 30, 2006 from \$669.2 million at December 31, 2005. This increase was funded primarily by net increases in deposits and other borrowings of \$49.8 million. This growth is generally invested in securities and loans and leases receivable.

**Securities.** Securities available-for-sale increased \$3.2 million at September 30, 2006 from December 31, 2005 as a result of purchases of \$20.0 million net of maturities of \$16.6 million and \$200,000 of net premium amortization and discount accretion. Mortgage-related securities consist largely of agency-backed mortgage-derivative securities in the form of REMICs.

**Loans and Leases Receivable.** Net loans and leases held for investment increased \$44.2 million to \$577.0 million at September 30, 2006 from \$532.7 million at December 31, 2005. The activity in the loan and lease portfolio consisted of originations and loans purchased for investment of \$205.4 million offset by principal repayments and participations sold of \$161.2 million. Deferred loan fees declined \$81,000 to \$160,000 at September 30, 2006 from \$241,000 at December 31, 2005. The primary reason for this decrease was fewer loans originated by the Banks during the nine months ended September 30, 2006 where origination fees were collected as well as amortization of fees related to loans that paid off prior to their contractual maturity date.

**Investment in FHLB stock.** As allowed by the FHLB of Chicago, the Corporation voluntarily redeemed excess FHLB stock totaling approximately \$771,000 in the second quarter of 2006.

**Deposits.** As of September 30, 2006, deposits increased \$37.3 million to \$604.8 million from \$567.5 million at December 31, 2005. The increase during the nine months ended September 30, 2006 was largely attributable to an increase of \$17.2 million in money market accounts and an increase of \$27.4 million in brokered certificates of deposit partially offset by a decrease of \$6.1 million of in-market certificates of deposit and a decrease of \$1.2 million in transaction accounts. The weighted average cost of interest bearing deposits increased to 4.49% at September 30, 2006 from 3.44% at December 31, 2005.

**Borrowings.** The Corporation had borrowings of \$62.6 million as of September 30, 2006 compared to \$50.1 million as of December 31, 2005, an increase of \$12.5 million. Federal funds purchased and securities sold under agreement to repurchase increases of \$2.2 million, purchases of FHLB advances totaling \$7.0 million and an increase of \$6.0 million in the Corporation's subordinated note was partially offset by a decrease in the Corporation's line of credit of \$2.7 million. As of September 30, 2006 borrowings included FHLB advances of \$19.5 million which had a weighted average rate of 4.78%, junior subordinated debentures of \$10.3 million with a weighted average rate of 9.85% as well as Fed funds purchased and securities sold under agreement to repurchase which totaled \$21.7 million and had a weighted average rate of 4.97%. In addition, the Corporation has a \$7.0 million line of credit with an outstanding balance of \$10,000 and a weighted average rate of 6.88% and an \$11.0 million subordinated note payable which carried a weighted average rate of 7.40%. At December 31, 2005, FHLB advances were \$12.5 million with a weighted average rate of 3.67%. Federal funds purchased and securities sold under agreement to repurchase totaled \$19.5 million and had a weighted average rate of 3.45%. The Corporation's line of credit of \$2.8 million had a weighted average rate of 5.39%, the subordinated note payable of \$5 million carried a weighted average rate of 5.75% and junior subordinated debentures of \$10.3 million had a weighted average rate of 9.18%.

**Stockholders' Equity.** As of September 30, 2006, stockholders' equity was \$44.5 million, or 6.2% of total assets. Stockholders' equity increased \$2.7 million during the nine months ended September 30, 2006 primarily as a result of comprehensive income of \$2.9 million, which includes net income of \$2.8 million. Stock options exercised totaled \$136,000. Net restricted share activity caused stockholders' equity to increase \$118,000. See **Note 3** to the unaudited consolidated financial statements. These increases were partially offset by dividends paid of \$446,000 and treasury stock purchases of \$21,000. As of December 31, 2005, stockholders' equity totaled \$41.8 million, or 6.3% of total assets. During the nine

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months ended September 30, 2006, options for 14,314 shares of common stock were exercised at a weighted-average price of \$9.50 per share.

**Asset Quality**

**Non-performing Assets.** Non-performing assets consists of non-accrual loans and leases of \$1.3 million, or 0.19% of total assets, as of September 30, 2006, as compared to \$1.5 million, or 0.23% of total assets, as of December 31, 2005. A loan to a plumbing, heating and air conditioning company with a net carrying value totaling \$200,000 was renewed and taken off of non-accrual status upon collection of interest due to the Bank during the first quarter of 2006. Offsetting this decrease is an increase in non-accrual loans due to one loan to a pharmaceutical sales company with a net carrying value totaling \$200,000. As of September 30, 2006 the Corporation does not anticipate any loss from this borrower.

The Corporation's non-accrual loans and leases consisted of the following at September 30, 2006 and December 31, 2005, respectively.

|   | <b>At<br/>September<br/>30,<br/>2006</b> | <b>At December<br/>31,<br/>2005</b> |
|---|--|-------------------------------------|
|   | (Dollars in Thousands)                   |                                     |
| Non-accrual loans   | \$ 1,332                                 | \$ 1,454                            |
| Non-accrual leases  |  | 90                                  |
| Total non-accrual loans and leases                                  | 1,332                                    | 1,544                               |
| Foreclosed properties and repossessed assets, net                   |  |                                     |
| Total non-performing assets   | \$ 1,332                                 | \$ 1,544                            |
| Performing troubled debt restructurings                             | \$                                       | \$                                  |
| Total non-accrual loans and leases to total loans and leases        | 0.23%                                    | 0.29%                               |
| Total non-performing assets to total assets                         | 0.19                                     | 0.23                                |
| Allowance for loan and lease losses to total loans and leases       | 1.24                                     | 1.25                                |
| Allowance for loan and lease losses to non-accrual loans and leases | 544.87                                   | 438.64                              |

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The following represents information regarding the Corporation's impaired loans:

|  | <b>September<br/>30,<br/>2006</b> | <b>December<br/>31,<br/>2005</b> |
|--|-----------------------------------|----------------------------------|
|  | (In Thousands)                    |                                  |
| Impaired loans and leases  | \$ 655                            | \$ 811                           |
| Impaired loans and leases with impairment reserves required          | 677                               | 733                              |
| Less:  |                                   |                                  |
| Impairment reserve (included in allowance for loan and lease losses) | 428                               | 399                              |
| Net impaired loans and leases  | \$ 904                            | \$ 1,145                         |
| Average impaired loans and leases                                    | \$ 1,440                          | \$ 1,790                         |
| Interest income attributable to impaired loans and leases            | 104                               | 177                              |
| Interest income recognized on impaired loans and leases              | 72                                | 65                               |

The amount of foregone interest for the nine months ended September 30, 2006 and the year ended December 31, 2005 was \$32,000 and \$112,000, respectively.

A summary of the activity in the allowance for loan and lease losses follows:

|                                  | <b>Three Months<br/>Ended September<br/>30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|----------------------------------|---|-------------|--|-------------|
|                                  | <b>2006</b>                                     | <b>2005</b> | <b>2006</b>                                | <b>2005</b> |
|                                  | (Dollars in Thousands)                          |             |  |             |
| Allowance at beginning of period | \$ 6,846  | \$ 6,437    | \$ 6,773                                   | \$ 6,375    |
| Charge-offs:                     |   |             |  |             |
| Mortgage                         |   |             |  |             |
| Commercial                       |   |             |  |             |
| Lease                            |   |             |  |             |
| Consumer                         |   |             |  | (9)         |
| Total charge-offs                |   |             |  | (9)         |
| Recoveries:                      |   |             |  |             |
| Mortgage                         |   |             |  | 1           |
| Commercial                       | 1   | 1           | 3  | 6           |
| Lease                            |   |             |  |             |
| Consumer                         |   |             |  |             |
| Total recoveries                 | 1   | 1           | 3  | 7           |
| Net recoveries (charge-offs)     | 1   | 1           | 3  | (2)         |
| Provision                        | 413   | 53          | 484  | 118         |
| Allowance at end of period       | \$ 7,260  | \$ 6,491    | \$ 7,260                                   | \$ 6,491    |



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|                                     |       |       |       |       |
|-------------------------------------|-------|-------|-------|-------|
| Allowance to gross loans and leases | 1.24% | 1.28% | 1.24% | 1.28% |
|                                     | 27    |       |       |       |

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**Liquidity and Capital Resources**

During the nine months ended September 30, 2006 and 2005 and the year ended December 31, 2005, the Banks did not make dividend payments to the Corporation. The Banks are subject to certain regulatory limitations regarding their ability to pay dividends to the Corporation. Management believes that the Corporation will not be adversely affected by these dividend limitations. The Corporation's principal liquidity requirements at September 30, 2006 are the repayment of interest payments due on subordinated debentures and the junior subordinated debentures during 2006. The Corporation expects to meet its liquidity needs through existing cash flow sources, its bank line of credit in the amount of \$7.5 million of which \$10 thousand is outstanding on September 30, 2006 and through any future projected dividends received from the Banks. The Corporation and its subsidiaries continue to have a strong capital base and the Corporation's regulatory capital ratios continue to be significantly above the defined minimum regulatory ratios. In addition to the capital instruments on the September 30, 2006 balance sheet the Corporation has the option through January of 2007 to draw up to an additional \$10.0 million of subordinated debt in order to manage its capital position.

FBFS manages its liquidity to ensure that funds are available to each of its Banks to satisfy the cash flow requirements of depositors and borrowers and to ensure the Corporation's own cash requirements are met. The Banks maintain liquidity by obtaining funds from several sources.

The Banks' primary sources of funds are principal and interest repayments on loans receivable and mortgage-related securities, deposits and other borrowings such as federal funds and Federal Home Loan Bank advances. The scheduled repayments of loans and the repayments of mortgage-related securities are a predictable source of funds. Deposit flows and loan repayments, however, are greatly influenced by general interest rates, economic conditions and competition.

Brokered deposits are used by the Banks, which allows them to gather funds across a larger geographic base at price levels considered attractive. Access to such deposits allows the flexibility to not pursue single service deposit relationships in markets that have experienced some unprofitable pricing levels. Brokered deposits account for \$306.9 million and \$279.6 million of deposits as of September 30, 2006 and December 31, 2005, respectively. Brokered deposits are utilized to support asset growth and are generally a lower cost source of funds when compared to the interest rates on deposits with similar terms that would need to be offered in the local markets to generate a sufficient level of funds. In addition, the administrative costs associated with brokered deposits are considerably less than the administrative costs that would be incurred to administer a similar level of local deposits. Although local market deposits are expected to increase as new client relationships are established and as marketing efforts are made to increase the balances in existing clients' deposit accounts, the usage of brokered deposits will likely remain. In order to provide for ongoing liquidity and funding, all of the brokered deposits are certificates of deposit that do not allow for withdrawal, at the option of the depositor, before the stated maturity. In the event that there is a disruption in the availability of brokered deposits at maturity, the Banks have managed the maturity structure so that at least 90 days of maturities would be funded through other means, including but not limited to advances from the Federal Home Loan Bank, replacement with higher cost local market deposits or cash flow from borrower repayments and security maturities.

The Banks are required by federal regulation to maintain sufficient liquidity to ensure safe and sound operations. Management believes that its Banks have an acceptable liquidity percentage to match the balance of net withdrawable deposits and short-term borrowings in light of present economic conditions and deposit flows.

Under Federal law and regulation, the Corporation and the Banks are required to meet certain tier 1 and risk-based capital requirements. Tier 1 capital generally consists of stockholders' equity plus certain qualifying debentures and other specified items less intangible assets such as goodwill. Risk-based capital

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requirements presently address credit risk related to both recorded and off-balance sheet commitments and obligations.

As of September 30, 2006, the most recent notification from the Federal Deposit Insurance Corporation and the State of Wisconsin Department of Financial Institutions (DFI) categorized the Banks as well capitalized under the regulatory framework for prompt corrective action. The qualification results in lower assessment of FDIC premiums, among other benefits.

In addition, the Banks exceeded minimum net worth requirement of 6.0% as required by the State of Wisconsin at December 31, 2005.

The following table summarizes the Corporation and Banks' capital ratios and the ratios required by their federal regulators at September 30, 2006 and December 31, 2005, respectively:

|   | Actual   |        | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be Well<br>Capitalized Under<br>FDIC Requirements |        |
|---|----------|--------|--|-------|--|--------|
|   | Amount   | Ratio  | Amount   | Ratio | Amount   | Ratio  |
| <b>As of September 30, 2006:</b>            |          |        |  |       |  |        |
| Total capital<br>(to risk-weighted assets)  |          |        |  |       |  |        |
| Consolidated                                | \$71,336 | 10.93% | \$52,219   | 8.00% | N/A  | N/A    |
| First Business Bank                         | 60,130   | 10.70  | 44,972   | 8.00  | \$56,215   | 10.00% |
| First Business Bank Milwaukee               | 10,158   | 11.40  | 7,127  | 8.00  | 8,909  | 10.00  |
| Tier 1 capital<br>(to risk-weighted assets) |          |        |  |       |  |        |
| Consolidated                                | \$53,076 | 8.13%  | \$26,109   | 4.00% | N/A  | N/A    |
| First Business Bank                         | 54,135   | 9.63   | 22,486   | 4.00  | \$33,729   | 6.00%  |
| First Business Bank Milwaukee               | 9,043    | 10.15  | 3,564  | 4.00  | 5,345  | 6.00   |
| Tier 1 capital<br>(to average assets)       |          |        |  |       |  |        |
| Consolidated                                | \$53,076 | 7.64%  | \$27,801   | 4.00% | N/A  | N/A    |
| First Business Bank                         | 54,135   | 9.13   | 23,708   | 4.00  | \$29,635   | 5.00%  |
| First Business Bank Milwaukee               | 9,043    | 8.59   | 4,212  | 4.00  | 5,265  | 5.00   |

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|   | Actual   |        | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be Well<br>Capitalized Under<br>FDIC Requirements |        |
|---|----------|--------|--|-------|--|--------|
|   | Amount   | Ratio  | Amount   | Ratio | Amount   | Ratio  |
| <b>As of December 31, 2005:</b>             |          |        |  |       |  |        |
| Total capital<br>(to risk-weighted assets)  |          |        |  |       |  |        |
| Consolidated                                | \$62,234 | 10.43% | \$47,748   | 8.00% | N/A  | N/A    |
| First Business Bank                         | 55,240   | 10.88  | 40,610   | 8.00  | \$50,763   | 10.00% |
| First Business Bank Milwaukee               | 9,009    | 10.32  | 6,981  | 8.00  | 8,727  | 10.00  |
| Tier 1 capital<br>(to risk-weighted assets) |          |        |  |       |  |        |
| Consolidated                                | \$50,461 | 8.45%  | \$23,874   | 4.00% | N/A  | N/A    |
| First Business Bank                         | 49,713   | 9.79   | 20,305   | 4.00  | \$30,458   | 6.00%  |
| First Business Bank Milwaukee               | 7,917    | 9.07   | 3,491  | 4.00  | 5,236  | 6.00   |
| Tier 1 capital<br>(to average assets)       |          |        |  |       |  |        |
| Consolidated                                | \$50,461 | 7.92%  | \$25,486   | 4.00% | N/A  | N/A    |
| First Business Bank                         | 49,713   | 9.14   | 21,746   | 4.00  | \$27,182   | 5.00%  |
| First Business Bank Milwaukee               | 7,917    | 8.21   | 3,858  | 4.00  | 4,823  | 5.00   |

**Contractual Obligations**

The following table summarizes the Corporation's contractual cash obligations and other commitments at September 30, 2006.

| Contractual Obligations  | Total      | Payment Due by Period |            |              | More than<br>5 Years |
|--|------------|-----------------------|------------|--------------|----------------------|
|  |            | Less than<br>1 Year   | 1-3 Years  | 4-5<br>Years |                      |
| (Dollars in Thousands)   |            |                       |            |              |                      |
| Operating lease obligations  | \$ 4,973   | \$ 577                | \$ 1,139   | \$ 1,066     | \$ 2,191             |
| Fed funds purchased and securities sold<br>under repurchase agreements | 21,706     | 21,706                |            |              |                      |
| Time deposits  | 356,574    | 129,681               | 138,805    | 80,206       | 7,882                |
| Line of Credit   | 10         | 10                    |            |              |                      |
| Subordinated debt  | 11,000     |                       |            |              | 11,000               |
| Junior subordinated debentures   | 10,310     |                       |            |              | 10,310               |
| FHLB advances  | 19,538     | 9                     | 6,021      | 13,023       | 485                  |
| Total contractual obligations  | \$ 424,111 | \$ 151,983            | \$ 145,965 | \$ 94,295    | \$ 31,868            |



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**Off-balance Sheet Arrangements**

As of September 30, 2006 the Corporation had outstanding commitments to originate \$207.6 million of loans. Commitments to extend funds to or on behalf of clients pursuant to standby letters of credit and other credit substitutes totaled \$15.3 million as of September 30, 2006. Commitments to extend funds typically have a term of less than one year; however the Banks have \$84.6 million of commitments which extend beyond one year. No losses are expected as a result of these funding commitments and other credit substitutes. Management believes adequate capital and liquidity are available from various sources to fund projected commitments.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The primary function of asset and liability management is to provide liquidity and maintain an appropriate balance between interest-earning assets and interest-bearing liabilities within specified maturities and/or repricing dates. Interest rate risk is the imbalance between interest-earning assets and interest-bearing liabilities at a given maturity or repricing date, and is commonly referred to as the interest rate gap (the "gap"). A positive gap exists when there are more assets than liabilities maturing or repricing within the same time frame. A negative gap occurs when there are more liabilities than assets maturing or repricing within the same time frame. During a period of rising interest rates, a negative gap over a particular period would tend to adversely affect net interest income over such a period, while a positive gap over a particular period would tend to result in an increase in net interest income.

The Corporation's strategy for asset and liability management is to maintain an interest rate gap that minimizes the impact of interest rate movements to the net interest margin by maintaining a favorable match between the maturities and repricing dates of interest-earning assets and interest-bearing liabilities. This strategy is monitored by the respective Banks' Asset/Liability Management Committees, in accordance with policies approved by the respective Banks' Boards. These committees meet regularly to review the sensitivity of the Corporation's assets and liabilities to changes in interest rates, liquidity needs and sources, and pricing and funding strategies.

The Corporation uses two techniques to measure interest rate risk. The first is simulation of earnings. The balance sheet is modeled as an ongoing entity whereby future growth, pricing, and funding assumptions are implemented. These assumptions are modeled under different rate scenarios that include a simultaneous, instant and sustained change in interest rates.

The second measurement technique used is static gap analysis. This technique measures the difference between the amount of interest-earning assets maturing and/or repricing and the amount of interest-bearing liabilities and interest rate swaps maturing and/or repricing in specified time periods. A significant repricing gap could result in a large impact on net interest margin during periods of changing interest rates.

The Corporation's asset and liability management requires management to make a number of assumptions as to when an asset or liability will reprice or mature. Management believes that its assumptions approximate actual experience and considers them reasonable, although the actual amortization and repayment of assets and liabilities may vary substantially. The Corporation's economic sensitivity to change in rates at September 30, 2006 has not changed materially since December 31, 2005.

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**Item 4. Controls and Procedures**

In accordance with Rule 13a-15b under the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this Form 10-Q, the Corporation's management evaluated, with the participation of the Corporation's Chairman of the Board and Chief Executive Officer along with its Senior Vice President and Chief Financial Officer, the effectiveness of the design and operation of the Corporation's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the Corporation's Chief Executive Officer and the Corporation's Senior Vice President and Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures were effective as of the date of such evaluation in timely alerting them to material information relating to the Corporation, including its consolidated subsidiaries, required to be included in the Corporation's periodic filings with the Securities and Exchange Commission, particularly during the period in which this Form 10-Q was being prepared.

There was no change in the Corporation's internal control over financial reporting that occurred during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting.

**Table of Contents****Part II. Other Information****Item 1. Legal Proceedings**

From time to time, the Corporation and its subsidiaries are engaged in legal proceedings in the ordinary course of their respective businesses. Management believes that any liability arising from any such proceedings currently existing or threatened will not have a material adverse effect on the Corporation's financial position, results of operations, and cash flows.

**Item 1A. Risk Factors**

There have been no material changes to risk factors as previously disclosed in Item 1A. to Part 1 of the Corporation's Form 10-K filed on March 17, 2006.

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

(a) The following transactions occurred during the quarter ended September 30, 2006 pursuant to the 1993 Equity Incentive Plan. On July 26, 2006, 4,620 shares of FBFS common stock were sold for \$41,995.80. On July 28, 2006, 416 shares of FBFS common stock were sold for \$3,781.44. Those transactions were entered into pursuant to the exemption provided in Rule 701.

(b) None.

**(c) Issuer Purchases of Equity Securities**

| Period                    | Total Number<br>Of Shares<br>Purchased | Average<br>Price Paid<br>Per Share | Total Number<br>Of Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or Programs | Maximum<br>Number that<br>May Yet Be<br>Purchased<br>Under the<br>Plans or Programs |
|---------------------------|--|------------------------------------|---|---|
| July 1 - 31,<br>2006      | 157                                    | \$24.00                            | None  | None  |
| August 1 -<br>31, 2006    |  |                                    |   |   |
| September 1 -<br>30, 2006 |  |                                    |   |   |

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

(31.1) Certification of the Chairman of the Board and Chief Executive Officer.

(31.2) Certification of the Senior Vice President and Chief Financial Officer.

(32) Certification of the Chairman of the Board and Chief Executive Officer and Senior Vice President and Chief Financial Officer pursuant to 18 U.S.C. paragraph 1350.



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**Signatures**

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**FIRST BUSINESS FINANCIAL SERVICES, INC.**

By: /s/ Jerome J. Smith

Jerome J. Smith  
Chairman of the Board and Chief Executive Officer

November 2, 2006

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