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SLADES FERRY BANCORP  
Form 10-K  
March 30, 2007

FORM 10-K

X ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
----- ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

Commission file number 000-23904  
-----

SLADE'S FERRY BANCORP.  
-----

(Exact name of registrant as specified in its charter)

MASSACHUSETTS  
-----

04-3061936  
-----

(State or other jurisdiction of  
in Company or organization)

(I.R.S. Employer  
Identification Number)

100 Slade's Ferry Avenue  
Somerset, Massachusetts  
-----

02726  
-----

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: (508) 675-2121

Securities registered pursuant to Section 12(b) of the Act: Common Stock,  
\$.01 par value

Name of each exchange on which registered: Nasdaq Capital Market

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as  
defined in Rule 405 of the Securities Act.

Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports  
pursuant to Section 13 or Section 15(d) of the Act.

Yes [ ] No [X]

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

Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405  
of Regulation S-K is not contained herein, and will not be contained, to the  
best of registrant's knowledge, in definitive proxy or information statements  
incorporated by reference in Part III of this Form 10-K or any amendment to  
this form 10-K. [ ]

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 [X]

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

Yes [ ] No [X]

The aggregate market value of the common equity of Slade's Ferry Bancorp., held by nonaffiliates of the registrant as of June 30, 2006 was approximately \$61,137,000.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of Registrant's Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A within 120 days after the Registrant's fiscal year end of December 31, 2006 are incorporated by reference into Part III of this Form 10-K.

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### PART I

#### FORWARD-LOOKING STATEMENTS

This Form 10-K contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements regarding the strength of the company's capital and asset quality. Such statements may be identified by words such as "believes," "will," "expects," "project," "may," "could," "developments," "strategic," "launching," "opportunities," "anticipates," "estimates," "intends," "plans," "targets" and similar expressions. These statements are based upon the current beliefs and expectations of Slade's Ferry Bancorp.'s management and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements as a result of numerous factors.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in our forward-looking statements:

- (1) enactment of adverse government regulation;
- (2) competitive pressures among depository and other financial institutions may increase significantly and have an effect on pricing, spending, third-party relationships and revenues;
- (3) the strength of the United States economy in general and specifically the strength of the New England economies may be different than expected, resulting in, among other things, a deterioration in overall credit quality and borrowers' ability to service and repay loans, or a reduced demand for credit, including the resultant effect on our loan portfolio, levels of charge-offs and non-performing loans and allowance for loan losses;
- (4) changes in the interest rate environment may reduce interest margins and adversely impact net interest income; and
- (5) changes in assumptions used in making such forward-looking statements.

Should one or more of these risks materialize or should underlying beliefs or assumptions prove incorrect, Slade's Ferry Bancorp.'s actual results could differ materially from those discussed.

All subsequent written and oral forward-looking statements attributable to

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Slade's Ferry Bancorp. or any person acting on its behalf are expressly qualified in their entirety by the cautionary statements set forth above. Slade's Ferry Bancorp. does not intend or undertake any obligation to update any forward-looking statement to reflect circumstances or events that occur after the date the forward-looking statements are made.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to Slade's Ferry Bancorp. and its consolidated subsidiaries, unless context otherwise requires.

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### ITEM 1

#### BUSINESS

##### GENERAL

Slade's Ferry Bancorp., a Massachusetts corporation, is a bank holding company headquartered in Somerset, Massachusetts with assets of \$607.8 million, net loans of \$422.4 million, deposits of \$424.0 million and stockholders' equity of \$51.2 million as of December 31, 2006. We conduct our business principally through our wholly-owned subsidiary, Slade's Ferry Trust Company (referred to herein as the "Bank"), a Massachusetts-chartered trust company. As a bank holding company, we are subject to the Bank Holding Company Act of 1956, as amended (the "BHCA"), and the rules and regulations of the Federal Reserve Board (the "FRB") under the BHCA. We are additionally subject to the provisions of the Massachusetts General Laws applicable to commercial bank and trust companies and other depository institutions and their holding companies and applicable regulations of the Massachusetts Division of Banks (the "Division"). We are also subject to the rules and regulations of the Securities and Exchange Commission (the "SEC") as our common stock is registered with the SEC and is quoted on the Nasdaq Capital Market. The Bank's deposit accounts are insured up to applicable limits by the Deposit Insurance Fund of the Federal Deposit Insurance Company (the "FDIC"). The Bank is subject to extensive regulation, examination and supervision by the Division as its primary corporate regulator, and by the FDIC as its deposit insurer and primary federal regulator. Any change in laws and regulations, whether by the Division, the FDIC, the FRB or the SEC or through legislation, could have a material adverse impact on our operation.

Our main office is located at 100 Slade's Ferry Avenue, Somerset, Massachusetts, 02726, and our telephone number is (508) 675-2121. Slade's Ferry Bancorp. was organized for the purpose of becoming the holding company of the Bank. Slade's Ferry Bancorp.'s acquisition of the Bank was completed on April 1, 1990.

We had asset growth of \$21.8 million or 3.7% and our level of deposits increased by \$8.2 million, or by 2.0%, during 2006. Aside from deposits, we increased borrowings from the Federal Home Loan Bank of Boston (the "FHLB") by \$11.2 million, or by 10.4% during 2006. This activity funded an increase in loans totaling \$12.8 million or 3.1%, and an increase in investments totaling \$7.2 million or 5.5%.

While we evaluate opportunities to acquire other banks or bank facilities as they arise and may in the future acquire other banks, financial institutions, or bank facilities, we do not currently have plans for in any such acquisition.

We are committed to the philosophy of serving the needs of customers within our market area. We believe that our comprehensive retail, small business, commercial and industrial, and commercial real estate products enable us to

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compete effectively. We do not have any major target accounts, nor do we derive a material portion of our deposits from any single depositor. We concentrate our operations in the area of retail banking and we service the needs of the local communities. Our loans are not concentrated within any single industry or group of related industries.

We currently have nine full service banking facilities, plus a drive up complex, which extend east from Seekonk, Massachusetts to Fairhaven, Massachusetts. These facilities service numerous communities in Southeastern Massachusetts and contiguous areas of Rhode Island. We also provide limited banking services at the Somerset High School in Somerset, Massachusetts. We opened our newest facility, located in Assonet, Massachusetts in early 2005. This branch is a state-of-the-art, full-service banking office, designed to provide superior customer convenience and service. We own and operate eight full service automated teller machines ("ATM") and one ATM dispenser.

The Bank maintains three wholly-owned subsidiaries. Two of these, Slade's Ferry Securities Corporation ("SFSC"), and Slade's Ferry Securities Corporation II ("SFSCII") are Massachusetts securities corporations on which, under current Massachusetts law, income is taxed at 1.32%, as compared to the Massachusetts bank taxation rate of 10.5%. In exchange for this lower tax rate, the assets of any Massachusetts security corporation are limited to certain securities, including United States Treasury and agency securities, obligations of government-sponsored enterprises, mortgage-backed securities, corporate debt securities and marketable equity securities. Investment securities with book values totaling \$18.9 million and \$27.2 million were held at SFSC and SFSC II, respectively, at December 31, 2006.

Slade's Ferry Realty Trust ("SFRT") owns and manages our land and buildings.

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Slade's Ferry Loan Company ("SFLC") was a Rhode Island Company founded for the purpose of generating loans in the State of Rhode Island. Because the Bank has received authorization to generate loans in Rhode Island directly, SFLC was dissolved in early 2005.

Slade's Ferry Statutory Trust I, a Connecticut statutory trust was formed on March 17, 2004 by the Company, and completed the sale of \$10,000,000 of floating rate trust preferred securities in a private placement as part of a pooled trust preferred securities transaction.

Our major customer accounts as of December 31, 2006 consisted of approximately 32,000 personal savings, checking and money market accounts, and approximately 6,930 personal and commercial certificates of deposit and individual retirement accounts. Our commercial base consists of approximately 3,340 checking, money market, and corporate accounts.

As we continued to grow in 2006, we maintained our commitment to customer service. We continued our systems upgrades during 2006 with the introduction of check imaging, document imaging, inquiry and report-writer enhancements, and bio-identity security measures. All of the upgrades allow customers to more easily access their own personal information, while simultaneously allowing our employees the ability to serve our customers more effectively and efficiently.

### SERVICES

We engage in a broad range of banking activities, including demand, savings and time deposits, related personal and commercial checking account services, real estate mortgages, commercial and installment lending, payroll services, money orders, travelers checks, Visa, MasterCard, ATM card, safe deposit rentals and

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automatic teller machines. We also offer certain non-traditional banking services including investments, life insurance, annuities, and cash management services, and we also provide a range of internet-based services for both consumer and commercial customers.

### LENDING ACTIVITIES

Our loan portfolio consists primarily of residential, multi-family and commercial real estate, construction and land development, and commercial loans, home equity lines of credit and consumer loans originated primarily in our market area. There are no foreign loans outstanding. The interest rates we charge on loans are affected principally by the demand for such loans, the supply of money available for lending purposes and the rates offered by our competitors. These factors are affected by general and economic conditions, monetary policies of the federal government, including the FRB, legislative tax policies and governmental budgetary matters. We originate residential mortgage loans, home equity lines of credit, fixed-rate equity loans, commercial business loans, consumer loans and commercial real estate loans. Total net loans were 69.5% of total assets at December 31, 2006, as compared to 69.9% of total assets at December 31, 2005. See Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operation", for detailed portfolio information.

#### Multi-Family and Commercial Real Estate Lending

We originate multi-family and commercial real estate loans that are generally secured by five or more unit apartment buildings and properties used for business purposes such as small office buildings, restaurants or retail facilities. Our multi-family and commercial real estate underwriting policies provide that such real estate loans may be made in amounts of up to 80% of the appraised value of the property, subject to our current loans-to-one-borrower limit, which was \$11.5 million at December 31, 2006. Our multi-family and commercial real estate loans are generally made with terms of up to 20 years and are offered with interest rates that adjust periodically. In reaching a decision on whether to make a multi-family or commercial real estate loan, we consider the net operating income of the property, the borrower's expertise, credit history and profitability and the value of the underlying property. We have generally required that the properties securing these real estate loans have debt service coverage ratios (earnings before debt service to debt service requirements) of at least 1.20 times. Environmental impact surveys are generally required for all commercial real estate loans. Generally, all multi-family and commercial real estate loans made to companies, partnerships and other business entities require personal guarantees by the principals. We may choose not to require a personal guarantee on such loans depending on the creditworthiness of the borrower and the amount of the down payment and other mitigating circumstances.

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Loans secured by multi-family and commercial real estate properties generally involve larger principal amounts and a greater degree of risk than one-to-four family residential mortgage loans. Because payments on loans secured by multi-family and commercial real estate properties are often dependent on successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. We seek to minimize these risks through our underwriting standards.

Multi-family and commercial real estate loans totaled \$209.2 million and comprised 49.0% of our total gross loan portfolio at December 31, 2006. At December 31, 2005, multi-family and commercial real estate loans totaled \$213.8 million, or 51.6% of our total gross loan portfolio.

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### Residential Lending

We currently offer fixed-rate, one-to-four family mortgage loans with terms from 10 to 30 years and a number of adjustable-rate mortgage ("ARM") loans with terms of up to 30 years and interest rates which adjust every one or three years from the outset of the loan. The interest rates for the ARM loans are generally indexed to the applicable Constant Maturity Treasury ("CMT") Index, or other comparable indices. Our ARM loans generally provide for periodic (not more than 2%) and overall (not more than 6%) caps on the increase or decrease in the interest rate at any adjustment date and over the life of the loan.

The origination of adjustable-rate residential mortgage loans and short-term fixed-rate mortgage loans, as opposed to 30-year, fixed-rate residential mortgage loans, generally helps reduce our exposure to increases in interest rates. However, adjustable-rate loans generally pose credit risks not inherent in fixed-rate loans, primarily because as interest rates rise, the underlying payments of the borrower rise, thereby increasing the potential for default. Periodic and lifetime caps on interest rate increases help to reduce the risks associated with adjustable-rate loans but also limit the interest rate sensitivity of such loans. Prior to 2006, there was a continued period of low market interest rates that was the impetus for our customers to continue to finance home purchases with fixed-rate loans or to refinance ARM loans into fixed-rate loans. Interest rates began to rise in 2006 but were accompanied by declines in property values resulting in a dearth of residential lending and refinancing activity slowed considerably during 2006.

Generally, we originate one-to-four family residential mortgage loans in amounts of up to 95% of the appraised value or selling price of the property securing the loan, whichever is lower. Certain loans in our "First-Time Home Buyer" program allow for a 97% loan-to-value ("LTV") ratio. Private mortgage insurance ("PMI") is required for loans with a LTV ratio of greater than 80%. Mortgage loans we originate generally include due-on-sale clauses, which provide us with the contractual right to deem the loan immediately due and payable in the event the borrower transfers ownership of the property without our consent. Due-on-sale clauses are an important means of adjusting the yields on our fixed-rate mortgage loan portfolio and we have generally exercised our rights under these clauses. We require fire, casualty, title, and, in certain cases, flood insurance on all properties securing real estate loans we make.

In an effort to provide financing for moderate income and first-time homebuyers, we offer Federal Housing Authority ("FHA") and Veterans Administration ("VA") loans and we have our own First-Time Home Buyer loan program. These programs offer residential mortgage loans to qualified individuals. These loans are offered with adjustable and fixed rates of interest and terms of up to 30 years. Such loans may be secured by a one-to-four family residential property, in the case of FHA and VA loans, and must be secured by a single-family, owner-occupied unit in the case of First-Time Home Buyer loans. These loans are originated using modified underwriting guidelines, in the case of FHA and VA loans, and the same underwriting guidelines as our other one-to-four family mortgage loans in the case of First-Time Home Buyer loans. Such loans may be originated in amounts of up to 97% of the lower of the property's appraised value or the sale price. Private mortgage insurance is required on all such loans with loan to values in excess of 80%.

We generally underwrite our residential real estate loans to comply with secondary market standards established by the Federal National Mortgage Association. Although loans are underwritten to standards that make them readily salable, we have not chosen to sell these loans, rather to maintain them in portfolio, consistent with our income and interest rate risk management targets.

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Residential real estate loans totaled \$132.4 million and comprised 31.0% of our total gross loan portfolio at December 31, 2006. At December 31, 2005, residential real estate loans totaled \$120.3 million, or 29.1% of our total gross loan portfolio.

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### Commercial Loans

Our commercial business loan portfolio consists of loans and lines of credit predominantly collateralized by inventory, furniture and fixtures, and accounts receivable. In assessing the collateral for these loans, management applies a 50% liquidation value to inventories; 25% to furniture, fixtures and equipment; and 70% to accounts receivable less than 90 days of invoice date. Like commercial real estate loans, the successful repayment of these loans is dependent on the operations of the business to which the loan is made. Accordingly, these loans carry a higher level of credit risk than loans secured by real estate. To alleviate some of this risk, credit enhancements, such as personal guarantees or additional collateral are often taken.

Commercial loans totaled \$47.7 million and comprised 11.2% of our total gross loan portfolio at December 31, 2006. At December 31, 2005, commercial loans totaled \$38.1 million, or 9.2% of our total gross loan portfolio.

### Construction Lending

We originate fixed-rate construction loans for the development of one-to-four family residential properties. In certain situations, construction loans are underwritten to allow borrowers to prefund reserves which are the source of interest repayments during the construction phase of the project. Although we do not generally make loans secured by raw land, our policies permit the origination of such loans. Construction loans are generally offered to experienced local developers operating in our primary market area and to individuals for the construction of their primary residences. Construction loans are generally offered with terms of up to 24 months and may be made in amounts of up to 70% of the appraised value of the property, as improved. In the case of construction loans to individuals for the construction of their primary residences, loans up to 90% of the appraisal value may be made. Loans made to individuals are generally written on a construction-to-permanent basis. Land loans of up to 80% of the appraised value may be made. Construction loan proceeds are disbursed periodically in increments as construction progresses and as inspections by an independent construction specialist warrant. Generally, if the borrower is a company, partnership or other business entity, personal guarantees by the principals are required for all construction loans.

Construction financing is generally considered to involve a higher degree of credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property's value at completion of construction compared to the estimated cost (including interest) of construction and other assumptions, including the estimated time to sell residential properties. If the estimate of value proves to be inaccurate, we may be confronted with a project, when completed, having a value which is insufficient to assure full repayment.

Construction and land development loans totaled \$21.0 million and comprised 4.9% of our total gross loan portfolio at December 31, 2006. At December 31, 2005, construction and land development loans totaled \$21.5 million, or 5.2% of our total gross loan portfolio.



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### Home Equity Lines of Credit

Substantially all of our home equity lines of credit are secured by second mortgages on owner-occupied, one-to-four family residences located in our primary market area. Our home equity lines of credit generally have interest rates, indexed to the Wall Street Journal Prime Rate, that adjust on a monthly basis. Home equity lines of credit generally have an 18% lifetime limit on interest rates. Generally, the maximum combined loan-to-value ratio on home equity lines of credit is 80%. The underwriting standards we employ for home equity lines of credit include a determination of the applicant's credit history and an assessment of the applicant's ability to meet existing obligations and payments on the proposed loan and the value of the collateral securing the loan. The stability of the applicant's monthly income may be determined by verification of gross monthly income from primary employment and, additionally, from any verifiable secondary income. Creditworthiness of the applicant is a primary consideration.

Home equity lines of credit totaled \$13.9 million and comprised 3.3% of our total gross loan portfolio at December 31, 2006. At December 31, 2005, home equity lines of credit totaled \$17.9 million, or 4.3% of our total gross loan portfolio.

### Consumer Lending

Loans secured by rapidly depreciable assets such as recreational vehicles and automobiles entail greater risks than one-to-four family, residential mortgage loans. In such cases, repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance, since there is a greater likelihood of damage, loss or

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depreciation of the underlying collateral. Further, collections on these loans are dependent on the borrower's continuing financial stability and, therefore, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Finally, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans in the event of a default. Accordingly, we originate consumer loans typically based on the borrower's ability to repay the loan through continued financial stability. We endeavor to minimize risk by reviewing the borrower's repayment history on past debts, and assessing the borrower's ability to meet existing obligations on the proposed loans. Because of the proliferation of manufacturers' discount financing and automobile leasing, origination of automobile loans has diminished significantly in the last five years, accounting for the continued decrease in consumer loans as a percentage of our loan portfolio.

Consumer loans totaled \$2.8 million and comprised 0.6% of our total gross loan portfolio at December 31, 2006. At December 31, 2005, consumer loans totaled \$2.6 million, or 0.6% of our total gross loan portfolio.

### Loan Approval Procedures and Authority

The Bank's Board of Directors establishes the Bank's lending policies and loan approval limits. The Board has authorized certain officers to consider and approve loans within their designated authority as established by the Board, typically at ranges up to \$500,000 for commercial loans, and up to \$417,000 for residential loans. The President and Chief Executive Officer and the Senior Vice President of Lending have authority to approve loans to \$500,000 individually, or up to \$1 million upon their joint concurrence. In addition, the Bank's Board of Directors has established an Executive Committee that

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approves or denies all loan requests in excess of individual lending authorities up to a maximum of \$5,000,000. All loan relationships in excess of \$5,000,000 require the approval of the Board.

### INVESTING ACTIVITIES

We utilize our investment portfolio as a temporary means of warehousing liquidity until the funds can be lent. The investment portfolio also serves to secure certain deposits and borrowings. We manage the investment portfolio to optimize earnings, while using the portfolio as a tool in managing interest rate risk. We use an independent investment advisor to assist us in our portfolio management function.

We utilize both a "held-to-maturity" category and an "available-for-sale" category, as defined in Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities", to manage the investment portfolio. Our investment policy requires Board approval before a trading account can be established. The held-to-maturity category was originally established for holding high-yielding municipal securities. Beginning in the third quarter of 2004, certain mortgage-backed securities designated as collateral for FHLB advances were also designated as held-to-maturity. Management has the ability and intent to hold these securities to their contractual maturity. Held-to-maturity securities totaled \$24.6 million at December 31, 2006, while available-for-sale securities totaled \$105.6 million as compared to \$29.3 million and \$94.3 million, respectively, at December 31, 2005.

We primarily utilize obligations of U.S. Government-sponsored enterprises and mortgage-backed securities as investment vehicles. High-quality corporate bonds and municipal securities are purchased when an exceptional opportunity to enhance investment yields arises. Purchases of these investments are limited to securities that carry a rating of "Baa1" (Moody's) or "BBB+" (Standard and Poor's), in order to control credit risk within the investment portfolio. Among other investment criteria, it is management's goal to maintain a total portfolio duration of less than 5 years. At December 31, 2006, the portfolio duration was estimated at 3.14 years.

Excess cash is sold on an overnight basis into federal funds or overnight deposits at the FHLB. At December 31, 2006 federal funds sold totaled \$1.9 million or 0.3% of total assets, as compared to \$2.2 million, or 0.4% of total assets at December 31, 2005.

Under Massachusetts Law, the Bank is permitted to invest in marketable equity securities. Management views equity securities as a source of current income as well as a source of capital gain income, given appreciation in the portfolio. Limits on asset quality, holding size, overall portfolio size and composition are in place to protect us from undue market risk. All equity securities are classified as available-for-sale.

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### DEPOSIT ACTIVITIES

We seek to develop relationships with our customers in order to become the customer's primary bank. We have developed programs that stress multiple account relationships in order to increase the level of "core deposits" in our portfolio. Management views a customer's checking account as the primary relationship account and, accordingly, emphasizes the growth of checking accounts in its strategic plans. Aside from checking accounts being a consistent, low-cost source of funds, they provide a source of non-interest income in the form of service charges and insufficient funds fees.

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Deposits are obtained from individuals and from small and medium-sized businesses in the local market area. Our customer base is diverse, and accordingly different product suites are offered to different groups of customers. The suites range from accounts that serve the basic service needs of any customer, such as free checking and statement savings accounts, to our "Coastal" product suite, which addresses the particular needs of high-balance customers. Additionally, small and medium-sized businesses have suites of products that address their particular needs. We also attract deposits from municipalities and other government agencies. We do not solicit or accept brokered deposits. We offer a full line of deposit products including checking and NOW accounts, savings accounts, money market accounts, and certificates of deposit. We offer debit cards for our checking and savings accounts.

Customers have access to deposit funds at any of our ten office locations, all of which are equipped with Automated Teller Machines. Additionally, the Bank is a member of the NYCE Network, enabling customers to have access to their funds worldwide. We also provide balance inquiry and funds transfer telephonically. Our website, [www.sladesferry.com](http://www.sladesferry.com), provides customers with the ability to manage their accounts and pay bills online. Business customers who utilize our cash management program have the ability to transfer funds and originate wire transfers or Automatic Clearing House transactions through the website as well.

As a general rule, management systematically reviews the deposit accounts it offers to determine if the products meet both the customers' needs and our asset/liability management goals. This review is the responsibility of the Pricing Committee, which meets weekly to determine products and pricing practices consistent with overall earnings and growth goals. The Pricing Committee establishes deposit interest rates based on a variety of factors, including local economy, market interest rates, competitors' interest rates, and the need to fund loan demand. We set rates to be competitive, but not necessarily the highest rates in our market area. As competition for deposits has intensified with the larger financial institutions in our market area, we introduced the use of off-maturity "special" certificate accounts. We actively market our other products to new depositors garnered through the use of promotions, in order to cross-sell additional products and services, and thereby establish a continued banking relationship.

In order to offset the potentially adverse effects of early withdrawal, we generally charge an early withdrawal penalty on certificates of deposit in an amount equal to three months' interest on accounts with original maturities of one year or less, and six months' interest on accounts with an original maturity of greater than one year. Interest credited to a certificate account during any term may be withdrawn without penalty at any time during the term. Upon renewal of a certificate account, only interest credited during the renewal term may be withdrawn without penalty.

### NON-DEPOSIT INVESTMENT PRODUCTS

We offer a variety of stock, bonds and other registered securities, mutual funds, annuities, and insurance products offered through third-party sales arrangements with Linsco Private Ledger, Inc. and the Savings Bank Life Insurance Company of Massachusetts ("SBLI").

### BORROWING ACTIVITIES

In order to fund additional asset growth, we have the ability to borrow at the FHLB of Boston. The FHLB limits borrowings to 30% of assets, and requires an investment in FHLB stock in an amount equal to 4.5% of total borrowings. These borrowings are collateralized by our residential loan portfolio, certain commercial real estate loans, and certain obligations and mortgage-backed securities of government-sponsored enterprises. Management views borrowing as

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not only a funding mechanism, but as a tool to manage the levels of interest rate risk inherent in the balance sheet. In addition, we maintain borrowing lines of credit with correspondent banks to meet short-term liquidity needs.

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During 2006 we utilized FHLB advances to enhance our interest rate risk position. In prior years, we had used amortizing advances to "match-fund" certain commercial loans. As management has taken a whole-balance sheet approach to interest rate risk management, the use of matched funding strategies has decreased, in favor of the use of bullet and community development advances, deployed in a ladder approach. Because the FHLB attaches significant prepayment penalties to long-term advances, management does not anticipate prepayment of the amortizing advances.

### COMPETITION

The banking business in our market area is highly competitive. We actively compete for both loans and deposits with local branches of nationwide and regional banks, as well as local banks and credit unions. We also compete with consumer mortgage and finance companies, financing subsidiaries of durable goods manufacturers, and insurance companies. Many of the major commercial banks or other affiliates in our service areas offer services such as international banking and trust services that we do not currently offer directly.

In order to expand our market area, we opened our newest facility located in Assonet, Massachusetts in early 2005. This branch is a state-of-the-art, full-service banking office, designed to provide superior customer convenience and service. We believe that the addition of this branch has added to the diversity in our loan portfolio and add a new pool of potential depositors.

### EMPLOYEES

At December 31, 2006, we had 111 full-time and 27 part-time employees. We believe that employee relations are good, and there are no known disputes between management and employees.

All employees are eligible to participate in our Retirement Savings 401(k) Plan and Profit Sharing Plan. Additionally, certain officers may participate in the Slade's Ferry Bancorp. Stock Option Plan, and certain executive officers may participate in a supplemental executive retirement program.

Our performance-based incentive programs for officers and employees have supported, and we believe they will continue to support our growth, by giving employees a stake in our overall performance and for balancing profit, growth and productivity.

### HOLDING COMPANY REGULATION

#### FEDERAL REGULATION

##### Capital Requirements

The FRB has adopted capital adequacy guidelines pursuant to which it assesses the adequacy of capital in examining and supervising a bank holding company and in analyzing applications to it under the BHCA. The FRB capital adequacy guidelines generally require bank holding companies to maintain total capital equal to 8% of total risk-adjusted assets, with at least one-half of that amount consisting of Tier I, or core capital, and up to one-half of that amount consisting of Tier II, or supplementary capital. Tier I capital for bank

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holding companies generally consists of the sum of common shareholders' equity and perpetual preferred stock (subject in the case of the latter to limitations on the kind and amount of such stocks which may be included as Tier I capital), less goodwill and, with certain exceptions, intangibles. Tier II capital generally consists of hybrid capital instruments; perpetual preferred stock which is not eligible to be included as Tier I capital; term subordinated debt and intermediate-term preferred stock; and, subject to limitations, general allowances for loan losses. Assets are adjusted under the risk-based guidelines to take into account different risk characteristics, with the categories ranging from 0% (requiring no additional capital) for assets such as cash to 100% for the bulk of assets which are typically held by a bank holding company, including multi-family residential and commercial real estate loans, commercial business loans and consumer loans. Single-family residential first mortgage loans which are not past-due (90 days or more) or non-performing and which have been made in accordance with prudent underwriting standards are assigned a 50% level in the risk-weighting system, as are certain privately-issued mortgage-backed securities representing indirect ownership of such loans. Off-balance sheet items also are adjusted to take into account certain risk characteristics.

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In addition to the risk-based capital requirements, the FRB requires bank holding companies to maintain a minimum leverage capital ratio of Tier I capital to total assets of 3.0%. Total assets for this purpose does not include goodwill and any other intangible assets and investments that the FRB determines should be deducted from Tier I capital. The FRB has announced that the 3.0% Tier I leverage capital ratio requirement is the minimum for the top-rated bank holding companies without any supervisory, financial or operational weaknesses or deficiencies or those that are not experiencing or anticipating significant growth. Other bank holding companies are expected to maintain Tier I leverage capital ratios of at least 4.0% to 5.0% or more, depending on their overall condition.

The Company is in compliance with the above-described FRB regulatory capital requirements.

### Activities

The BHCA prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any bank, or increasing such ownership or control of any bank, without prior approval of the FRB. No approval under the BHCA is required, however, for a bank holding company already owning or controlling 50% of the voting shares of a bank to acquire additional shares of such bank.

The BHCA also prohibits a bank holding company, with certain exceptions, from acquiring more than 5% of the voting shares of any company that is not a bank and from engaging in any business other than banking or managing or controlling banks. Under the BHCA, the FRB is authorized to approve the ownership of shares by a bank holding company in any company, the activities of which the FRB has determined to be so closely related to banking or to managing or controlling banks as to be a proper incident thereto. In making such determinations, the FRB is required to weigh the expected benefit to the public, such as greater convenience, increased competition or gains in efficiency, against the possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices.

In addition, a bank holding company that does not qualify and elect to be treated as a financial holding company under the Gramm-Leach-Bliley Financial Services Modernization Act is generally prohibited from engaging in, or

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acquiring, direct or indirect control of any company engaged in non-banking activities. One of the principal exceptions to this prohibition is for activities found by the FRB to be so closely related to banking or managing or controlling banks as to be permissible. Bank holding companies that do qualify as a financial holding company may engage in activities that are financial in nature or incident to activities which are financial in nature. Bank holding companies may qualify to become a financial holding company if they meet certain criteria set forth by the FRB. The Company has not elected to become a financial holding company.

Beginning June 1, 1997, the Interstate Banking Act permitted federal banking agencies to approve merger transactions between banks located in different states, regardless of whether the merger would be prohibited under the law of the two states. The Interstate Banking Act also permitted a state to "opt in" to the provisions of the Interstate Banking Act before June 1, 1997, and permitted a state to "opt out" of the provisions of the Interstate Banking Act by adopting appropriate legislation before that date. Accordingly, beginning June 1, 1997, the Interstate Banking Act permitted a bank, such as the Bank, to acquire an institution by merger in a state other than Massachusetts unless the other state had opted out of the Interstate Banking Act. The Interstate Banking Act also authorizes de novo branching into another state if the host state enacts a law expressly permitting out of state banks to establish such branches within its borders.

### MASSACHUSETTS REGULATION

The Company as a Massachusetts-chartered corporation is governed by the Massachusetts Business Company Law and the Company's Articles of Organization and Bylaws. Under the Massachusetts banking laws, a company owning or controlling two or more banking institutions, including a savings bank, is regulated as a bank holding company. The Company or the Bank would become a Massachusetts bank holding company if the Company acquired a second banking institution and operated it separately from the Bank or the Bank acquired a banking institution.

### ACQUISITION OF THE COMPANY OR THE BANK

#### Federal Restrictions

Under the federal Change in Bank Control Act, any person (including a company), or group acting in concert, seeking to acquire control of the Company or the Bank will be required to submit prior notice to the FRB. Under the Change in Bank Control Act, the FRB has 60 days within which to act on such notices, taking into consideration factors, including the financial and managerial resources of the acquirer, the convenience and needs of the communities served by the

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Company and the Bank, and the anti-trust effects of the acquisition. The term "control" is defined generally under the BHCA to mean the ownership or power to vote 25% or more of any class of voting securities of an institution or the ability to control in any manner the election of a majority of the institution's directors. Additionally under the Bank Merger Act sections of the Federal Deposit Insurance Act, the prior approval of an insured institution's primary federal regulator is required for an insured institution to merge with or transfer assets to another insured institution or an uninsured institution. Similarly, Massachusetts law requires 60-days notice to, and a nonobjection from, the Commissioner of the Division in advance of any acquisition of control of the Company or the Bank.

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### BANK REGULATION

#### MASSACHUSETTS BANKING REGULATION

##### General

The Bank is subject to Massachusetts statute and the rules and regulations of the Division establishing the powers of the Bank, investment limitations and minimum standards relative to the security and protection of the Bank for the benefit of Bank employees and the general public.

##### Loans-to-One-Borrower Limitations

With specified exceptions, the total obligations of a single borrower to a Massachusetts-chartered commercial bank and trust company may not exceed 20% of the Bank's capital. A commercial bank and trust company may lend additional amounts up to 100% of its retained earnings account if secured by collateral meeting the requirements of the Massachusetts banking laws. The Bank currently complies with applicable loans-to-one-borrower limitations.

##### Dividends

Under the Massachusetts banking laws, a commercial bank and trust company may, subject to several limitations, declare and pay a dividend on its capital stock out of the Bank's net profits. A dividend may not be declared, credited or paid by a stock trust company so long as there is any impairment of capital stock. No dividend may be declared on the Bank's common stock for any period other than for which dividends are declared upon preferred stock, except as authorized by the Commissioner of the Division. The approval of the Commissioner is also required for a commercial bank and trust company to declare a dividend, if the total of all dividends declared by the commercial bank and trust company in any calendar year shall exceed the total of its net profits for that year combined with its retained net profits of the preceding two years, less any required transfer to surplus or a fund for the retirement of any preferred stock.

In addition, federal law may also limit the amount of dividends that may be paid by the Bank. See "- Federal Banking Regulation - Prompt Corrective Action."

##### Examination and Enforcement

The Division is required to periodically examine commercial bank and trust companies at least once every calendar year or at least once each 18-month period if the commercial bank and trust company qualifies as well capitalized under the prompt corrective action provisions of the Federal Deposit Insurance Act. See "- Federal Banking Regulation - Prompt Corrective Action."

##### Community Reinvestment Act

The Bank is subject to provisions of the Massachusetts Community Reinvestment Act, which are similar to those imposed by the federal Community Reinvestment Act with the exception of the assigned exam ratings. Massachusetts banking law provides for an additional exam rating of "high satisfactory" in addition to the federal Community Reinvestment Act ratings of "outstanding," "satisfactory," "needs to improve" and "substantial noncompliance." The Division is required to consider a bank's Massachusetts Community Reinvestment Act rating when reviewing the Bank's application to engage in certain transactions, including mergers, asset purchases and the establishment of branch offices or automated teller machines, and provides that such assessment may serve as a basis for the denial of any such application. The Massachusetts Community Reinvestment Act requires the Division to assess a bank's compliance

and to make such

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assessment available to the public. The Bank's latest Massachusetts Community Reinvestment Act rating, from an exam dated July 18, 2005, was a rating of "Satisfactory."

#### FEDERAL BANKING REGULATION

##### Capital Requirements

FDIC regulations require insured banks, such as the Bank, to maintain minimum levels of capital. The FDIC regulations define two classes of capital known as Tier 1 and Tier 2 capital.

The FDIC regulations establish a minimum leverage capital requirement for banks in the strongest financial and managerial condition, with a rating of 1 (the highest examination rating of the FDIC for banks) under the Uniform Financial Institutions Rating System, of not less than a ratio of 3.0% of Tier 1 capital to total assets. For all other banks, the minimum leverage capital requirement is 4.0%, unless a higher leverage capital ratio is warranted by the particular circumstances or risk profile of the depository institution.

The FDIC regulations also require that banks meet a risk-based capital standard. The risk-based capital standard requires the maintenance of a ratio of total capital (which is defined as the sum of Tier 1 capital and Tier 2 capital) to risk-weighted assets of at least 8% and a ratio of Tier 1 capital to risk-weighted assets of at least 4%. In determining the amount of risk-weighted assets, all assets, plus certain off balance sheet items, are multiplied by a risk-weight of 0% to 100%, based on the risks the FDIC believes are inherent in the type of asset or item.

The federal banking agencies, including the FDIC, have also adopted regulations to require an assessment of an institution's exposure to declines in the economic value of a bank's capital due to changes in interest rates when assessing the Bank's capital adequacy. Under such a risk assessment, examiners will evaluate a bank's capital for interest rate risk on a case-by-case basis, with consideration of both quantitative and qualitative factors.

Institutions with significant interest rate risk may be required to hold additional capital. The agencies also issued a joint policy statement providing guidance on interest rate risk management, including a discussion of the critical factors affecting the agencies' evaluation of interest rate risk in connection with capital adequacy. The Bank was considered "well-capitalized" under FDIC guidelines at December 31, 2006.

##### Activity Restrictions on State-Chartered Banks

Section 24 of the Federal Deposit Insurance Act ("FDIA"), as amended, which was added by the Federal Deposit Insurance Company Improvement Act of 1991 ("FDICIA"), generally limits the activities and investments of state-chartered FDIC insured banks and their subsidiaries to those permissible for national banks and their subsidiaries, unless such activities and investments are specifically exempted by Section 24 or consented to by the FDIC.

Section 24 provides an exception for investments by a bank in common and preferred stocks listed on a national securities exchange or the shares of registered investment companies if:

- (1) The Bank held such types of investments during the 14-month period



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from September 30, 1990 through November 26, 1991;

- (2) The state in which the Bank is chartered permitted such investments as of September 30, 1991; and
- (3) The Bank notifies the FDIC and obtains approval from the FDIC to make or retain such investments. Upon receiving such FDIC approval, an institution's investment in such equity securities will be subject to an aggregate limit up to the amount of its Tier 1 capital.

The Bank received approval from the FDIC to retain and acquire such equity investments subject to a maximum permissible investment equal to the lesser of 100% of the Bank's Tier 1 capital or the maximum permissible amount specified by the FDIA. Section 24 also provides an exception for majority owned subsidiaries of a bank, but Section 24 limits the activities of such subsidiaries to those permissible for a national bank, permissible under Section 24 of the FDIA and the FDIC regulations issued pursuant thereto, or as approved by the FDIC.

Before making a new investment or engaging in a new activity not permissible for a national bank or not otherwise permissible under Section 24 or the FDIC regulations thereunder, an insured bank must seek approval from the FDIC to

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make such investment or engage in such activity. The FDIC will not approve the activity unless the Bank meets its minimum capital requirements and the FDIC determines that the activity does not present a significant risk to the FDIC insurance funds.

### Enforcement

The FDIC has extensive enforcement authority over insured state-chartered commercial bank and trust companies, including the Bank. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease and desist orders and to remove directors and officers. In general, these enforcement actions may be initiated in response to violations of laws and regulations and to unsafe or unsound practices.

The FDIC is required, with certain exceptions, to appoint a receiver or conservator for an insured state bank if that bank is "critically undercapitalized." For this purpose, "critically undercapitalized" means having a ratio of tangible capital to total assets of less than 2%. The FDIC may also appoint a conservator or receiver for a state bank on the basis of the institution's financial condition or upon the occurrence of certain events.

### Deposit Insurance

The FDIC merged the Bank Insurance Fund and the Savings Association Insurance Fund to form the Deposit Insurance Fund on March 31, 2006. The Bank is a member of the Deposit Insurance Fund and pays its deposit insurance assessments to the Deposit Insurance Fund.

Pursuant to the FDICIA, the Federal Deposit Insurance Corporation established a system for setting deposit insurance premiums based upon the risks a particular bank or savings association posed to its deposit insurance fund. Effective January 1, 2007, the FDIC established a risk-based assessment system for determining the deposit insurance assessments to be paid by insured depository institutions. Under the assessment system, the FDIC assigns an institution to one of four risk categories, with the first category having two sub-categories

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based on the institution's most recent supervisory and capital evaluations, designed to measure risk. Assessment rates currently range from 0.05% of deposits for an institution in the highest sub-category of the highest category to 0.43% of deposits for an institution in the lowest category. The FDIC is authorized to raise the assessment rates as necessary to maintain the required reserve ratio of 1.25%. The FDIC allows the use of credits for assessments previously paid, and the Bank has been notified that it has credits that will offset certain assessments.

In addition, all FDIC-insured institutions are required to pay assessments to the FDIC to fund interest payments on bonds issued by the Financing Corporation, an agency of the federal government established to recapitalize the predecessor to the Savings Association Insurance Fund. These assessments, set by the FDIC quarterly, will continue until the Financing Corporation bonds mature in 2017 through 2019.

Under the FDIA, the FDIC may terminate the insurance of an institution's deposits upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. The Bank's management does not know of any practice, condition or violation that might lead to termination of deposit insurance.

### Transactions with Affiliates of the Bank

Transactions between an insured bank, such as the Bank, and any of its affiliates are governed by Sections 23A and 23B of the Federal Reserve Act (the "FRA"), as interpreted by the FRB's Regulation W. An affiliate of a bank is any company or entity that controls, is controlled by or is under common control with the Bank. A subsidiary of a bank that is not also a depository institution is not treated as an affiliate of the Bank for purposes of Sections 23A and 23B.

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### Section 23A:

- \* limits the extent to which the Bank or its subsidiaries may engage in "covered transactions" with any one affiliate to an amount equal to 10% of such bank's capital stock and retained earnings, and limit on all such transactions with all affiliates to an amount equal to 20% of such capital stock and retained earnings; and
- \* requires that all such transactions be on terms that are consistent with safe and sound banking practices.

The term "covered transaction" includes the making of loans, purchase of assets, issuance of guarantees and other similar types of transactions. Further, most loans by a bank to any of its affiliates must be secured by collateral in amounts ranging from 100 to 130 percent of the loan amounts. In addition, any covered transaction by a bank with an affiliate and any purchase of assets or services by a bank from an affiliate must be on terms that are substantially the same, or at least as favorable to the Bank, as those that would be provided to a non-affiliate.

Under Section 23B, affiliated transactions, including covered transactions under Section 23A and other transactions between the Bank and its affiliates, must be on terms which are as favorable to the Bank as comparable transactions with non-affiliates. The Bank is also prohibited, in most cases, from acquiring low-quality assets from an affiliate.

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### Loans to Insiders

The Bank's authority to extend credit to its directors, executive officers and 10% shareholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the FRA and Regulation O of the FRB. Among other things, these provisions require that extensions of credit to insiders (a) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features and (b) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of the Bank's capital. The regulations allow small discounts on fees on residential mortgages for directors, officers and employees. In addition, extensions for credit in excess of certain limits must be approved by the Bank's Board of Directors.

Section 402 of the Sarbanes-Oxley Act of 2002 prohibits the extension of personal loans to directors and executive officers of issuers (as defined in Sarbanes-Oxley). The prohibition, however, does not apply to mortgages advanced by an insured depository institution, such as the Bank, that are subject to the insider lending restrictions of Section 22(h) of the Federal Reserve Act.

### Community Reinvestment Act

Under the Community Reinvestment Act ("CRA"), any insured depository institution, including the Bank, has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community. The CRA requires the FDIC, in connection with its examination of a commercial bank and trust company, to assess the depository institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by such institution, including applications for additional branches and acquisitions.

The CRA requires the FDIC to provide a written evaluation of an institution's CRA performance utilizing a four-tiered descriptive rating system and requires public disclosure of an institution's CRA rating. The Bank received a "Satisfactory" rating on its last CRA exam July 18, 2005. The Bank's obligation under the CRA are generally consistent with its obligations under the Massachusetts Community Reinvestment Act. See "- Massachusetts Banking Regulation - Community Reinvestment Act."

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### Nontraditional Mortgage Product Risk

In September of 2006, the federal banking agencies, including the FDIC, published final guidance for institutions that originate or service nontraditional or alternative mortgage products, defined to include all residential mortgage loan products that allow borrowers to defer repayment on principal or interest, such as interest-only mortgages and payment option adjustable-rate mortgages. At this time the Bank does not originate or service nontraditional or alternative mortgage products.

### Concentrations in Commercial Real Estate Loans

In December of 2006, the FDIC along with other federal banking regulators

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adopted guidance entitled "Concentrations in Commercial Real Estate (CRE) Lending, Sound Risk Management Practices," or the CRE Guidance, to address concentrations of commercial real estate loans in institutions. The CRE Guidance reinforces and enhances the FDIC's existing regulations and guidelines for real estate lending and loan portfolio management, and establishes specific commercial real estate lending thresholds at which a concentration of commercial real estate loan is deemed to exist. The CRE Guidance applies to institutions with an accumulation of credit concentration exposures and asks that the banks quantify the additional risk such exposures may pose, including stratification of the commercial real estate portfolio by, among other things, property type, geographic market, tenant concentrations, tenant industries, developer concentrations and risk rating. In addition, an institution should perform periodic market analyses for the various property types and geographic markets represented in its portfolio. Further, an institution with commercial real estate concentration risk should also perform portfolio level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings and capital. The Bank believes that the CRE Guidance will not have a material impact on the conduct of its business, and the Bank will be able to effectively implement requirements and suggestions set forth in the CRE Guidance during 2007.

### Safety and Soundness Standards

Pursuant to the requirements of the FDICIA, as amended by the Riegle Community Development and Regulatory Improvement Act of 1994, each federal banking agency, including the FDIC, has adopted guidelines establishing general standards relating to internal controls, information and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, asset quality, earnings and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal stockholder.

In addition, the FDIC adopted regulations to require a bank that is given notice by the FDIC that it is not satisfying any of such safety and soundness standards to submit a compliance plan to the FDIC. If, after being so notified, a bank fails to submit an acceptable compliance plan or fails in any material respect to implement an accepted compliance plan, the FDIC may issue an order directing corrective and other actions of the types to which a significantly undercapitalized institution is subject under the "prompt corrective action" provisions of the FDICIA. If a bank fails to comply with such an order, the FDIC may seek to enforce such an order in judicial proceedings and to impose civil monetary penalties.

### Prompt Corrective Action

The FDICIA also established a system of prompt corrective action to resolve the problems of undercapitalized institutions. The FDIC, as well as the other federal banking regulators, adopted regulations governing the supervisory actions that may be taken against undercapitalized institutions. The regulations establish five categories, consisting of "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." The severity of the action authorized or required to be taken under the prompt corrective action regulations increases as a bank's capital decreases within the three undercapitalized categories. All banks are prohibited from paying dividends or other capital distributions or paying management fees to any controlling person if, following such distribution, the Bank would be undercapitalized.

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### FEDERAL RESERVE SYSTEM

Under Federal Reserve Board regulations, the Bank is required to maintain noninterest-earning reserves against its transaction accounts. Current FRB regulations generally require that reserves of 3% must be maintained against aggregate transaction accounts of \$45.8 million or less, subject to adjustment by the Federal Reserve Board. Total transaction accounts in excess of \$45.8 million are required to have a reserve of 10% held against them, which are also subject to adjustment by the FRB. The first \$8.0 million of otherwise reservable balances, subject to adjustments by the FRB, are exempted from the reserve requirements. The Bank is in compliance with these requirements. Because required reserves must be maintained in the form of vault cash, a noninterest-bearing account at a Federal Reserve Bank or a pass-through account as defined by the FRB, the effect of this reserve requirement is to reduce the Bank's interest-earning assets.

### FEDERAL HOME LOAN BANK SYSTEM

The Bank is a member of the Federal Home Loan Bank system, which consists of 12 regional Federal Home Loan Banks. The Federal Home Loan Bank provides a central credit facility primarily for member institutions. The Bank, as a member of the Federal Home Loan Bank of Boston (the "FHLB"), is required to acquire and hold shares of capital stock in the FHLB in an amount equal to at least 1% of the aggregate principal amount of its unpaid residential mortgage loans and similar obligations at the beginning of each year, or 1/20 of its advances (borrowings) from the FHLB, whichever is greater. The Bank was in compliance with this requirement with an investment in FHLB stock at December 31, 2006 of \$6.9 million. The Federal Home Loan Banks are required to provide funds for certain purposes including contributing funds for affordable housing programs. These requirements could reduce the amount of dividends that the Federal Home Loan Banks pay to their members and result in the Federal Home Loan Banks imposing a higher rate of interest on advances to their members.

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### THE U.S.A. PATRIOT ACT

The Bank is subject to the USA PATRIOT Act, which gives the federal government new powers to address money laundering and terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing, and amendments to the Bank Secrecy Act. Title III of the USA PATRIOT Act takes measures intended to encourage information sharing among financial institutions, bank regulatory agencies and law enforcement bodies. Further, certain provisions of Title III impose affirmative obligations on a broad range of financial institutions, including banks, thrifts, brokers, dealers, credit unions, money transfer agents, and parties registered under the Commodity Exchange Act.

Among other requirements, Title III of the USA PATRIOT Act imposes the following obligations on financial institutions:

- \* Pursuant to Section 352, all financial institutions must establish anti-money laundering programs that include, at minimum: (i) internal policies, procedures, and controls; (ii) specific designation of an anti-money laundering compliance officer; (iii) ongoing employee training programs; and (iv) an independent audit function to test the anti-money laundering program.
- \* Pursuant to Section 326, rules establishing minimum standards for customer due diligence, identification and verification became effective on October 1, 2003.

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- \* Section 312 requires financial institutions that establish, maintain, administer, or manage private banking accounts or correspondent accounts in the United States for non-United States persons or their representatives (including foreign individuals visiting the United States) to establish appropriate, specific, and, where necessary, enhanced due diligence policies, procedures, and controls designed to detect and report instances of money laundering through those accounts.
- \* Section 318, which became effective December 25, 2001, prohibits financial institutions from establishing, maintaining, administering, or managing correspondent accounts for foreign shell banks (foreign banks that do not have a physical presence in any country), and requires financial institutions to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to indirectly provide banking services to foreign shell banks.
- \* Bank regulators are directed to consider a holding company's effectiveness in combating money laundering when ruling on Bank Holding Company Act and Bank Merger Act applications.

### THE SARBANES-OXLEY ACT

The Sarbanes-Oxley Act of 2002 implements a broad range of corporate governance and accounting measures for public companies designed to promote honesty and transparency in corporate America and protect investors from corporate wrongdoing. The Sarbanes-Oxley Act's principal legislation and derivative regulation and rulemaking promulgated by the SEC includes:

- \* The creation of an independent accounting oversight board;
- \* Auditor independence provisions which restrict non-audit services that accountants may provide to their audit clients;
- \* Additional corporate governance and responsibility measures, including the requirement that the chief executive officer and chief financial officer certify financial statements;
- \* A requirement that companies establish and maintain a system of internal control over financial reporting and that management provide an annual report regarding its assessment of the effectiveness of such internal control over financial reporting which, for the Company, is effective as of December 31, 2007.

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The Company's independent registered public accounting firm will be required to provide an attestation report with respect to management's assessment of the effectiveness of the Company's internal control over financial reporting effective as of December 31, 2008.

- \* The forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement;
- \* An increase in the oversight of, and enhancement of, certain

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requirements relating to audit committees of public companies and how they interact with the Company's independent auditors;

- \* Requirement that audit committee members must be independent and are absolutely barred from accepting consulting, advisory or other compensatory fees from the issuer;
- \* Requirement that companies disclose whether at least one member of the committee is an "audit committee financial expert" (as such term is defined by the Securities and Exchange Commission) and if not, why not;
- \* Expanded disclosure requirements for corporate insiders, including accelerated reporting of stock transactions by insiders and a prohibition on insider trading during pension blackout periods;
- \* A prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions;
- \* Disclosure of a code of ethics and filing a Form 8-K for a change or waiver of such code;
- \* Mandatory disclosure by analysts of potential conflicts of interest; and
- \* A range of enhanced penalties for fraud and other violations.

Although the Company has and will continue to incur additional expense in complying with the provisions of the Sarbanes-Oxley Act and the resulting regulations, such compliance is not expected to have a material impact on its results of operations or financial condition.

### FEDERAL SECURITIES LAWS

The Company's common stock is registered with the SEC under Section 12(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Thus, the Company is subject to information, proxy solicitation, insider trading restrictions, and other requirements under the Exchange Act.

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### ITEM 1A

#### RISK FACTORS

Our loan portfolio includes loans with a higher risk of loss. We originate multi-family and commercial real estate loans, construction and land development loans, commercial loans, consumer loans, residential mortgage loans and home equity lines of credit primarily within our market area. Commercial mortgage, construction and land development loans, commercial, and consumer loans may expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans may not be sold as easily as residential real estate. In addition, commercial real estate and commercial loans may also involve relatively large loan balances to individual borrowers or groups of borrowers. These loans also have greater credit risk than residential real estate for the following reasons:

- \* Commercial Real Estate Loans. Repayment is dependent upon income being generated in amounts sufficient to cover operating expenses and debt service. Commercial mortgage loans represented 49.0% of total gross loans as of December 31, 2006.

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- \* Commercial Loans. Repayment is generally dependent upon the successful operation of the borrower's business. Commercial loans represented 11.2% of total gross loans as of December 31, 2006.
- \* Construction and Land Development Loans. Construction financing is generally considered to involve a higher degree of credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property's value at completion of construction compared to the estimated cost (including interest) of construction and other assumptions, including the estimated time to sell residential properties. Construction and land development loans represented 4.9% of total gross loans as of December 31, 2006.
- \* Consumer Loans. Consumer loans (such as personal lines of credit) may or may not be collateralized with assets that provide an adequate source of payment of the loan due to depreciation, damage, or loss. Consumer loans represented 0.6% of total gross loans as of December 31, 2006.

Any downturn in the real estate market or local economy could adversely affect the value of the properties securing the loans or revenues from the borrower's business thereby increasing the risk of non-performing loans.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could decrease. Our loan customers may not repay their loans according to their terms and the collateral securing the payment of these loans may be insufficient to pay any remaining loan balance. We therefore may experience significant loan losses, which could have a material adverse effect on our operating results.

Material additions to our allowance for loan losses also would materially decrease our net income, and the charge-off of loans may cause us to increase the allowance. We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. We rely on our loan quality reviews, our historical loss experience and our evaluation of economic conditions, among other factors, in determining the amount of the allowance for loan losses. If our assumptions prove to be incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in additions to our allowance. As of December 31, 2006, the allowance for loan losses as a percent of year-end loans was 1.03%.

Changes in interest rates could adversely affect our results of operations and financial condition. Our profitability, like that of most financial institutions, depends substantially on our net interest income, which is the difference between the interest income earned on our interest-earning assets and the interest expense paid on our interest-bearing liabilities. Increases in interest rates may decrease loan demand and make it more difficult for borrowers to repay adjustable rate loans. In addition, as market interest rates rise, we will have competitive pressures to increase the rates we pay on deposits, which will result in a decrease of our net interest income.

We also are subject to reinvestment risk associated with changes in interest rates. Changes in interest rates may affect the average life of loans and mortgage-related securities. Decreases in interest rates can result in



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increased prepayments of loans and mortgage-related securities as borrowers refinance to reduce borrowing costs. Under these circumstances, we are subject to reinvestment risk to the extent that we are unable to reinvest the cash received from such prepayments at rates that are comparable to the rates on existing loans and securities.

Our earnings may be adversely impacted by an increase in interest rates because a significant portion of our interest-earning assets are long-term, fixed rate mortgage-related assets that will not reprice as long-term interest rates increase, while a majority of our interest-bearing liabilities are expected to reprice as interest rates increase. Therefore, in an increasing interest rate environment, our cost of funds is expected to increase more rapidly than the yields earned on our loan portfolio and securities portfolio. An increasing rate environment is expected to cause a narrowing of our net interest rate spread and a decrease in our net interest income. The rising interest rate environment has compressed our net interest margin from 3.39% for the year ended December 31, 2005 to 3.26% for the year ended December 31, 2006.

Our local economy may affect our future growth possibilities. Our market area is principally located in southeastern Massachusetts and contiguous areas of Rhode Island. Our future growth opportunities depend on the growth and stability of our regional economy and our ability to expand our market area. A downturn in our local economy may limit funds available for deposit and may negatively affect our borrowers' ability to repay their loans on a timely basis, both of which could have an impact on our profitability.

Competition in our primary market area may reduce our ability to attract and retain deposits and originate loans. We operate in a competitive market for both attracting deposits, which is our primary source of funds, and originating loans. Historically, our most direct competition for savings deposits has come from credit unions, community banks, large commercial banks and thrift institutions in our primary market area. Particularly in times of extremely low or extremely high interest rates, we have faced additional significant competition for investors' funds from brokerage firms and other firms' short-term money market securities and corporate and government securities. Our competition for loans comes principally from mortgage brokers, commercial banks, other thrift institutions, and insurance companies. Competition for loan originations and deposits may limit our future growth and earnings prospects.

We operate in a highly regulated environment, and changes in laws and regulations to which we are subject may adversely affect our results of operations. We are subject to extensive regulation, supervision and examination by the state of Massachusetts, as the Bank's chartering authority, and by the FDIC as the insurer of our deposits up to certain limits. We also belong to the FHLB System and, as a member, we are subject to certain limited regulations promulgated by the FHLB of Boston. This regulation and supervision limits the activities in which we may engage. The purpose of regulation and supervision is primarily to protect our depositors and borrowers and, in the case of FDIC regulation, the FDIC's insurance fund. Regulatory authorities have extensive discretion in the exercise of their supervisory and enforcement powers. They may, among other things, impose restrictions on the operation of a banking institution, the classification of assets by such institution and such institution's allowance for loan losses. Regulatory and law enforcement authorities also have wide discretion and extensive enforcement powers under various consumer protection and civil rights laws, including the Truth-in-Lending Act, the Equal Credit Opportunity Act, the Fair Housing Act, and the Real Estate Settlement Procedures Act. Any change in the laws or regulations applicable to us, or in banking regulators' supervisory policies or examination procedures, whether by the Massachusetts Commissioner of Banks, the FDIC, other state or federal regulators, the United States Congress or the Massachusetts legislature could have a material adverse effect on our business, financial condition, results of operations and cash flows.

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We depend on our executive officers and key personnel to continue the implementation of our long-term business strategy and could be harmed by the loss of their services. We believe that our continued growth and future success will depend in large part upon the skills of our management team. The competition for qualified personnel in the financial services industry is intense, and the loss of our key personnel or an inability to continue to attract, retain and motivate key personnel could adversely affect our business. We cannot assure you that we will be able to retain our existing key personnel or attract additional qualified personnel. Although we have employment agreements with our president and chief executive officer, our executive vice president and chief financial officer/chief operations officer, and one senior vice president that contain non-compete provisions, the loss of the services of one or more of our executive officers and key personnel could impair our ability to continue to develop our business strategy.

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If we fail to maintain an effective system of internal control over financial reporting, we may not be able to accurately report our financial results or prevent fraud, and, as a result, investors and depositors could lose confidence in our financial reporting, which could adversely affect our business, the trading price of our stock and our ability to attract additional deposits. We will be required to include in our annual reports filed with the SEC a report of our management regarding internal control over financial reporting beginning with our annual report for the fiscal year ending December 31, 2007. In anticipation of this new obligation, we have continued to document and evaluate our internal control over financial reporting in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 and SEC rules and regulations, which require an annual management report on our internal control over financial reporting, including, among other matters, management's assessment of the effectiveness of internal control over financial reporting. In addition, for the fiscal year ended December 31, 2008, our independent auditors will be required to render an opinion on both management's assessment and on the Company's internal control over financial reporting. Accordingly, management has retained outside consultants to assist us in (i) assessing and documenting the adequacy of our internal control over financial reporting, (ii) improving control processes, where appropriate, and (iii) verifying through testing that controls are functioning as documented. If we fail to identify and correct (remediate) any significant deficiencies in the design or operating effectiveness of our internal control over financial reporting or fail to prevent fraud, current and potential stockholders and depositors could lose confidence in our financial reporting, which could adversely affect our business, financial condition and results of operations, the trading price of our stock and our ability to attract additional deposits.

### ITEM 1B

#### UNRESOLVED STAFF COMMENTS

There were no unresolved staff comments as of December 31, 2006.

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### ITEM 2

#### PROPERTIES

Our main office is located at 100 Slade's Ferry Avenue, Somerset, Massachusetts at the junctions of U.S. Routes 6, 138, and 103. We operate our business from

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nine office locations and one drive up complex in Assonet, Fairhaven, Fall River, New Bedford, Seekonk, Somerset and Swansea, Massachusetts. As of December 31, 2006, the following properties were owned through the Bank's wholly-owned subsidiary, Slade's Ferry Realty Trust:

|                  | Location<br>-----        |                 | Sq. Footage<br>----- |
|------------------|--------------------------|-----------------|----------------------|
| Main Office      | 100 Slade's Ferry Avenue | Somerset, MA    | 42,000               |
| North Somerset   | 2722 County Street       | Somerset, MA    | 3,025                |
| Linden Street    | 244-253 Linden Street    | Fall River, MA  | 1,750                |
| Brayton Avenue   | 855 Brayton Avenue       | Fall River, MA  | 3,325                |
| North Swansea    | 2388 G.A.R. Highway      | Swansea, MA     | 2,960                |
| Seekonk          | 1400 Fall River Avenue   | Seekonk, MA     | 2,300                |
| Fairhaven        | 75 Huttleston Avenue     | Fairhaven, MA   | 13,000               |
| Ashley Boulevard | 833 Ashley Boulevard     | New Bedford, MA | 2,655                |

The office listed below is leased by the Bank with a lease that expires in February 2010 with two options to extend the term for five year periods.

|         |                       |             |       |
|---------|-----------------------|-------------|-------|
| Assonet | 58B South Main Street | Assonet, MA | 2,000 |
|---------|-----------------------|-------------|-------|

The facility listed below is owned by the Bank, however, the land is leased with a lease that expires in November 2015.

|                                    |                   |                |     |
|------------------------------------|-------------------|----------------|-----|
| Brayton Avenue<br>Drive-Up Complex | 16 Stevens Street | Fall River, MA | 549 |
|------------------------------------|-------------------|----------------|-----|

The main office building contains approximately 42,000 square feet of usable space which we occupy for retail, administrative office, and banking operations space. The Seekonk office is an 8,800 square foot building of which we lease out 6,500 square feet to unrelated third party tenants.

We own an ATM dispenser, located at 58A South Main Street, Assonet, Massachusetts. We sublease the space on which the ATM dispenser is located. The original term of lease expires October 2010.

We have embarked on a multi-year project to upgrade, modernize and present a common design theme at all of our retail locations. As part of this project, the Company has signed agreements to remodel three of its facilities - Somerset, New Bedford, and North Somerset, Massachusetts. At December 31, 2006, commitments related to these agreements aggregated \$1,649,000.

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### ITEM 3

#### LEGAL PROCEEDINGS

We are not involved in any pending legal proceedings that would have a material impact on our consolidated financial condition and results of operations.

### ITEM 4

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### SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

During the fourth quarter of 2006, no matters were submitted to a vote of our stockholders.

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### PART II

#### ITEM 5

### MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

#### Market Information

Our common stock is listed in the Nasdaq Capital Market under the symbol SFBC. The following table sets forth the range of high and low bid price for our common stock as reported for the Nasdaq Capital Market by quarter for the two-year period ended:

|                | December 31, |           |            |           |
|----------------|--------------|-----------|------------|-----------|
|                | 2006         |           | 2005       |           |
|                | High Price   | Low Price | High Price | Low Price |
| First Quarter  | \$20.09      | \$17.30   | \$20.80    | \$18.01   |
| Second Quarter | \$18.40      | \$16.10   | \$19.00    | \$18.01   |
| Third Quarter  | \$19.49      | \$16.25   | \$20.25    | \$17.75   |
| Fouth Quarter  | \$19.30      | \$16.88   | \$21.68    | \$18.18   |

During 2006, there were 42,443 shares of the Company's stock repurchased pursuant to a repurchase program announced in July, 2006. Additionally, there were 48,277 shares acquired pursuant to a deferred compensation arrangement whereby these shares may be awarded to directors and/or executives. No shares were awarded during the fiscal year ended December 31, 2006.

This table provides certain information with respect to our purchase of our common stock during the three months ended December 2006.

| Period  | Total Number of<br>Shares Purchased(2) | Average Price<br>Paid per Share | Total Number of Shares<br>Purchased as Part of<br>Publicly Announced Plans<br>or Programs |
|---|--|---------------------------------|---|
| October 1, 2006 through<br>October 31, 2006   | 11,425                                 | \$18.82                         | 5,615   |
| November 1, 2006 through<br>November 30, 2006 | 15,131                                 | \$18.26                         | 4,441   |
| December 1, 2006 through<br>December 31, 2006 | 9,178                                  | \$17.29                         | 1,282   |
| Total   | 35,734                                 | \$18.19                         | 11,338  |

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- (1) On July 18, 2006, the Company announced that its Board of Directors approved a repurchase program under which the Company may repurchase up to 208,036 shares of its common stock.
- (2) During the fourth quarter of 2006, 24,396 shares were repurchased in open market transactions and restricted stock grants. These shares were purchased by an independent trustee and held in trust for the Company.

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### Holder

As of March 16, 2007, the record date for the annual meeting of shareholders, there were 1,220 holders of an aggregate of 4,050,291 shares of common stock issued and outstanding.

### Dividends - History and Policy

Since the Company's inception in 1990, and prior thereto the Bank, has consistently paid dividends to shareholders since 1961. We paid four quarterly cash dividends of \$.09 per share for a total of \$.36 per share during each of 2005 and 2006.

The declaration of cash dividends is dependent on a number of factors, including regulatory limitations, and our operating results and financial condition. Our shareholders will be entitled to dividends only when, and if, declared by the Board of Directors out of funds legally available. Under the Massachusetts Business Corporation Law, a dividend may not be declared if the Company is insolvent or if the declaration of the dividend would render the Company insolvent.

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### Performance Graph

The following graph compares the performance of the Company for the periods indicated with the performance of the NASDAQ Stock Market and the performance of a group of banks in the \$250 million to \$500 million, \$500 million to \$1 billion and New England Bank indices assuming reinvestment of dividends.

[GRAPHIC OMITTED]

| Index                        | Period Ending |          |          |          |          |          |
|------------------------------|---------------|----------|----------|----------|----------|----------|
|                              | 12/31/01      | 12/31/02 | 12/31/03 | 12/31/04 | 12/31/05 | 12/31/06 |
| Slade's Ferry Bancorp.       | 100.00        | 91.38    | 157.18   | 143.03   | 142.79   | 129.1    |
| NASDAQ Composite             | 100.00        | 68.76    | 103.67   | 113.16   | 115.57   | 127.5    |
| SNL \$250M-\$500M Bank Index | 100.00        | 128.95   | 186.31   | 211.46   | 224.51   | 234.5    |
| SNL \$500M-\$1B Bank Index   | 100.00        | 127.67   | 184.09   | 208.62   | 217.57   | 247.4    |
| SNL New England Bank Index   | 100.00        | 75.43    | 124.46   | 131.63   | 131.49   | 155.2    |

Source: SNL Financial LC, Charlottesville, VA

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## ITEM 6

### SELECTED CONSOLIDATED FINANCIAL DATA

The following table sets forth selected financial data of Slade's Ferry Bancorp. The following information is only a summary and should be read in conjunction with our consolidated financial statements and notes.

|  | At of for the Years Ended Decem |            |            |      |
|--|---------------------------------|------------|------------|------|
|  | 2006                            | 2005       | 2004       |      |
|  | (In thousands except per share  |            |            |      |
| <b>EARNINGS DATA</b>                             |                                 |            |            |      |
| Interest and dividend income                     | \$ 33,401                       | \$ 28,919  | \$ 24,106  | \$   |
| Interest expense                                 | 15,338                          | 10,995     | 7,946      |      |
| Net interest income                              | 18,063                          | 17,924     | 16,160     |      |
| Provision (credit) for loan losses               | 39                              | 167        | 376        |      |
| Noninterest income                               | 2,747                           | 2,320      | 2,505      |      |
| Noninterest expense                              | 14,903                          | 13,896     | 12,785     |      |
| Income before income taxes                       | 5,868                           | 6,181      | 5,504      |      |
| Provision for income taxes                       | 2,249                           | 2,161      | 1,887      |      |
| Net income                                       | 3,619                           | 4,020      | 3,617      |      |
| <br>   |                                 |            |            |      |
| Return on average assets                         | 0.61%                           | 0.70%      | 0.70%      |      |
| Return on average equity                         | 8.59%                           | 8.36%      | 8.28%      |      |
| Net interest margin                              | 3.26%                           | 3.39%      | 3.44%      |      |
| Net interest spread                              | 2.70%                           | 2.96%      | 3.07%      |      |
| <br>   |                                 |            |            |      |
| Basic earnings per share                         | \$ 0.87                         | \$ 0.98    | \$ 0.89    | \$   |
| Diluted earnings per share                       | \$ 0.87                         | \$ 0.97    | \$ 0.88    | \$   |
| Cash dividends declared per share                | \$ 0.36                         | \$ 0.36    | \$ 0.36    | \$   |
| Dividend payout ratio                            | 41.61%                          | 36.84%     | 40.31%     |      |
| <br><b>BALANCE SHEET DATA</b>                    |                                 |            |            |      |
| Assets   | \$ 607,760                      | \$ 585,914 | \$ 549,398 | \$ 4 |
| Loans, net of deferred loan fees                 | 426,755                         | 413,943    | 366,366    | 3    |
| Allowance for loan losses                        | 4,385                           | 4,333      | 4,101      |      |
| Loans, net                                       | 422,370                         | 409,610    | 362,265    | 3    |
| Goodwill   | 2,173                           | 2,173      | 2,173      |      |
| Securities and FHLB Stock                        | 137,082                         | 129,908    | 126,305    |      |
| Deposits   | 424,006                         | 415,846    | 399,905    | 3    |
| Borrowings                                       | 129,368                         | 118,175    | 100,596    |      |
| Stockholders' equity                             | 51,245                          | 48,855     | 46,601     |      |
| <br>   |                                 |            |            |      |
| Average equity as a percentage of average assets | 7.12%                           | 8.40%      | 8.49%      |      |
| Shares outstanding at end of period              | 4,102,242                       | 4,132,200  | 4,068,423  | 3,9  |
| Book value (at end of period)                    | \$ 12.49                        | \$ 11.82   | \$ 11.45   | \$   |

## ITEM 7

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

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The purpose of Management's Discussion and Analysis is to focus on certain significant factors which have affected our operating results and financial condition, and to provide shareholders a more comprehensive review of the financial data contained in this report. The following discussion should be read in conjunction with our audited financial statements and notes thereto, included as pages F-1 through F-42 of this report.

### 2006 ITEMS OF SIGNIFICANCE

- \* In 2006, we recorded net income of \$3.6 million or \$0.87 per share on a diluted basis compared to \$4.0 million or \$0.97 per share on a diluted basis in 2005. This represents a decrease of \$401,000 or 10.0% in net income and \$0.10 or 10.3% per share on a diluted basis between 2006 and 2005. The decrease was primarily due to a 39.5% increase in interest expense that was only partially offset by an increase in interest income of 15.5%. This resulted from a substantial migration of deposit monies to higher cost products combined with the higher costs of borrowed funds. Our return on average equity for the year ended December 31, 2006 was 8.59% compared to 8.36% for the year ended December 31, 2005.
- \* 2006 experienced an inverted yield curve throughout the year. As a result, our net interest margin has compressed from 3.39% for the year ended December 31, 2005 to 3.26% for the year ended December 31, 2006.
- \* The book value of our common stock increased from \$11.82 per share at December 31, 2005 to \$12.49 at December 31, 2006.
- \* Total assets increased by \$21.8 million, or 3.7% from the fiscal year ended December 31, 2005.
- \* Total gross loans increased by \$12.7 million, or 3.1% from the fiscal year ended December 31, 2005.
- \* Capital adequacy ratios continue to meet the criteria of "well capitalized" under regulatory guidelines.
- \* We continued our commitment to customer service by implementing check imaging, document imaging, inquiry and report-writer enhancements, and bio-identity security measures for employees in our efforts to serve customers more effectively and efficiently.

### FINANCIAL CONDITION

Total assets increased by \$21.8 million, or 3.7%, from \$585.9 million at December 31, 2005 to \$607.8 million at December 31, 2006. The increase in total assets during 2006 is the result of planned growth across the balance sheet. Total net loans increased from \$409.6 million at December 31, 2005 to \$422.4 million, an increase of \$12.8 million or 3.1%, while the investment portfolio increased from \$129.9 million at December 31, 2005 to \$137.1 million at December 31, 2006, an increase of 5.5%. The combination of growth in deposits and FHLB advances funded the increase in loans and investments. Total deposits increased from \$415.8 million at December 31, 2005 to \$424.0 million at December 31, 2006, an increase of \$8.2 million or 2.0%. Total FHLB advances increased by \$11.2 million or 10.4%, to \$119.1 million at December 31, 2006 from \$107.9 million at December 31, 2005.

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### INVESTMENT PORTFOLIO

The main objectives of our investment portfolio are to achieve a competitive rate of return over a reasonable time period and to provide liquidity.

Our total investment portfolio increased from \$129.9 million at December 31, 2005 to \$137.1 million at December 31, 2006, an increase of 5.5%. The increase is the result of the investment of excess funds from both deposits and borrowings into obligations of government-sponsored entities and mortgage-backed securities, which were raised in accordance with our strategic plans. On June 20, 2006, the Board of Directors approved a strategy to restructure the available-for-sale investment portfolio through the sale of approximately \$14.5 million of low-yielding obligations of government-sponsored enterprises. Realized losses amounted to \$176,000 or 1.2% of the underlying cost basis of these securities.

Our current investment strategy has concentrated on the purchase of state and municipal obligations generally maturing or callable within five to seven years. Our investment policy also permits investments in mortgage-backed securities, usually having a longer weighted average life. Our investment policy, however, limits the duration of the aggregate investment portfolio to 5 years. At December 31, 2006, the portfolio duration was 3.1 years. We do not purchase investments with imbedded derivative characteristics, or free-standing derivative instruments such as swaps, options, or futures.

#### Securities Held to Maturity

The held-to-maturity portfolio consists of mortgage-backed securities and securities issued by states and municipalities. Held-to-maturity securities decreased from \$29.3 million at December 31, 2005 to \$24.6 million at December 31, 2006. The decrease resulted from the maturity, calls and paydowns of certain state and municipal obligations and mortgage-backed securities. Those funds were used to increase the available-for-sale portfolio to provide liquidity for future loan growth. Management has designated these mortgage-backed securities to secure advances from the FHLB. We have the positive intent and ability to hold these securities to maturity.

The following table shows the amortized cost basis and fair value of the major categories of investment securities held to maturity for the years indicated:

|                                   | December 31,            |               |                         |               |          |
|-----------------------------------|-------------------------|---------------|-------------------------|---------------|----------|
|                                   | 2006                    |               | 2005                    |               |          |
|                                   | Amortized<br>Cost Basis | Fair<br>Value | Amortized<br>Cost Basis | Fair<br>Value |          |
|                                   | (In thousands)          |               |                         |               |          |
| State and municipal obligations   | \$ 5,001                | \$ 5,069      | \$ 6,766                | \$ 6,892      | \$ 8,588 |
| Mortgage-backed securities        | 19,622                  | 19,150        | 22,540                  | 21,966        | 29,185   |
| Total securities held to maturity | \$24,623                | \$24,219      | \$29,306                | \$28,858      | \$37,773 |

The following table shows the amortized cost basis of securities held to



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maturity with the weighted average interest yield for each maturity range.

| December 31, 2006             |   |                                   |          |
|-------------------------------|---|-----------------------------------|----------|
|                               | State and<br>Municipal<br>Obligations (2) | Mortgage-Backed<br>Securities (1) | Total    |
| (Dollars in thousands)        |   |                                   |          |
| Maturity                      |   |                                   |          |
| -----                         |   |                                   |          |
| Within 1 year                 | \$1,611                                   | \$ -                              | \$ 1,611 |
| Yield                         | 5.87%                                     | 0.00%                             | 5.87%    |
| After 1 year through 5 years  | 1,446                                     | -                                 | 1,446    |
| Yield                         | 6.34%                                     | 0.00%                             | 6.34%    |
| After 5 year through 10 years | 1,223                                     | -                                 | 1,223    |
| Yield                         | 6.52%                                     | 0.00%                             | 6.52%    |
| Over 10 years                 | 721                                       | 19,622                            | 20,343   |
| Yield                         | 6.95%                                     | 4.88%                             | 4.95%    |
|                               | -----                                     | -----                             | -----    |
| Amount                        | \$5,001                                   | \$19,622                          | \$24,623 |
|                               | =====                                     | =====                             | =====    |
| Yield                         | 6.32%                                     | 4.88%                             | 5.17%    |
|                               | =====                                     | =====                             | =====    |

- 1) Mortgage-backed securities stated using contractual maturity.
- 2) On fully taxable equivalent basis based on tax rate of 35.0%.

### Securities Available for Sale

Securities not designated as held-to-maturity are designated as available for sale. Although we do not anticipate the sale of these securities, the designation as available for sale allows us the flexibility to alter our investment strategies and sell these securities when conditions warrant. Additionally, marketable equity securities that have no maturity date must be designated as available-for-sale. These securities are carried at fair value. The available for sale securities portfolio includes obligations and mortgage-backed securities of government-sponsored enterprises, corporate debt and equity securities.

The following table shows the amortized cost basis and fair value of the major categories of securities available for sale at the dates indicated:

|                                  | December 31,            |               |                         |               |                      |
|----------------------------------|-------------------------|---------------|-------------------------|---------------|----------------------|
|                                  | 2006                    |               | 2005                    |               | Amortize<br>Cost Bas |
|                                  | Amortized<br>Cost Basis | Fair<br>Value | Amortized<br>Cost Basis | Fair<br>Value |                      |
| (In thousands)                   |                         |               |                         |               |                      |
| Debt Securities:                 |                         |               |                         |               |                      |
| Government-sponsored enterprises | \$ 34,462               | \$ 33,957     | \$50,443                | \$49,581      | \$41,41              |
| Corporate                        | 9,221                   | 9,080         | 9,564                   | 9,014         | 9,36                 |
| Mortgage-backed securities       | 57,946                  | 57,980        | 31,574                  | 31,232        | 27,80                |
| Marketable equity securities     | 3,139                   | 3,389         | 3,426                   | 3,271         | 3,85                 |
| Mutual funds                     | 1,215                   | 1,197         | 1,205                   | 1,200         | 1,21                 |
|                                  | -----                   | -----         | -----                   | -----         | -----                |

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\$105,983      \$105,603      \$96,212      \$94,298      \$83,666  
 =====  
 =====  
 =====

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The following table shows the amortized cost basis of debt securities available for sale with the weighted average interest yield for each maturity range.

| December 31, 2006             |   |                                   |           |           |
|-------------------------------|---|-----------------------------------|-----------|-----------|
|                               | Government-<br>Sponsored<br>Enterprises | Mortgage-Backed<br>Securities (1) | Corporate | Total     |
| Maturity                      |   |                                   |           |           |
| Within 1 year                 | \$12,000                                | \$ 65                             | \$ -      | \$ 12,065 |
| Yield                         | 3.74%                                   | 4.04%                             | 0.00%     | 3.74%     |
| After 1 year through 5 years  | 22,462                                  | 986                               | 9,221     | 32,669    |
| Yield                         | 6.34%                                   | 5.00%                             | 5.06%     | 4.38%     |
| After 5 year through 10 years | -                                       | 4,397                             | -         | 4,397     |
| Yield                         | 0.00%                                   | 4.59%                             | 0.00%     | 4.59%     |
| Over 10 years                 | -                                       | 52,498                            | -         | 52,498    |
| Yield                         | 0.00%                                   | 5.59%                             | 0.00%     | 5.59%     |
| Amount                        | \$34,462                                | \$57,946                          | \$9,221   | \$101,629 |
| Yield                         | 3.96%                                   | 5.50%                             | 5.06%     | 4.94%     |

1) Mortgage-backed securities stated using contractual maturity.

LOANS

Our total loan portfolio increased from \$409.6 million at December 31, 2005 to \$422.4 million at December 31, 2006, an increase of \$12.8 million or 3.1%. The increase is the result of continued loan growth initiatives designed to invest the deposits and borrowings that were raised in accordance with our strategic plans.

Although multi-family and commercial real estate loans and business loans have traditionally been our leading loan products, management has made considerable effort to diversify the loan portfolio by adding significant levels of residential real estate and commercial and industrial loan products to the balance sheet. Management believes these loans both produce higher yielding products and for residential real estate loans enhance our overall credit risk profile. At December 31, 2006, our one-to-four family mortgage loans totaled \$132.4 million or 31.0% of total gross loans, compared with \$120.3 million, or 29.1% of total gross loans outstanding at December 31, 2005, while home equity lines of credit totaled \$13.9 million, or 3.3% of our total gross loans, compared to \$17.9 million or 4.3% of total gross loans at December 31, 2005. Originations of residential real estate loans for the year ended December 31, 2006 totaled \$24.7 million as compared to \$27.0 million for the year ended December 31, 2005. Gross home equity lines of credit totaled \$13.9 million and unadvanced funds committed under home equity lines of credit totaled \$16.9 million at December 31, 2006.

The multi-family and commercial real estate loan portfolio was \$209.2 million or 49.0% of total loans at December 31, 2006. At December 31, 2005, commercial real estate loans totaled \$213.8 million or 51.6% of total gross loans.

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Multi-family and commercial real estate loan originations totaled \$36.1 million for the year ended December 31, 2006. At December 31, 2006, we had \$21.0 million of advanced construction loans that amounted to 4.9% of our total gross loans, compared to \$21.5 million or 5.2% of total gross loans at December 31, 2005. Construction loan originations totaled \$19.1 million for the year ended December 31, 2006. Unfunded portions of construction loans totaled \$12.2 million at December 31, 2006. Other commercial loans totaled \$47.7 million or 11.2% of the total gross loan portfolio at December 31, 2006, compared to \$38.1 million or 9.2% at December 31, 2005.

Consumer loans at December 31, 2006 amounted to \$2.8 million, or 0.6% of total gross loans, as compared to \$2.6 million or 0.6% of total gross loans at December 31, 2005.

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The following table summarizes loans by category at the end of each of the last five years.

|                                 | December 31,   |           |           |           |
|---------------------------------|----------------|-----------|-----------|-----------|
|                                 | 2006           | 2005      | 2004      | 2003      |
|                                 | (In thousands) |           |           |           |
| Real estate mortgage loans:     |                |           |           |           |
| Multi-family and commercial     | \$209,172      | \$213,815 | \$192,822 | \$181,888 |
| Residential                     | 132,381        | 120,345   | 97,496    | 88,100    |
| Construction                    | 20,988         | 21,490    | 24,240    | 10,180    |
| Home equity lines of credit     | 13,917         | 17,915    | 23,131    | 18,330    |
| Commercial                      | 47,736         | 38,111    | 26,606    | 33,100    |
| Consumer                        | 2,766          | 2,623     | 2,510     | 4,100     |
|                                 | 426,960        | 414,299   | 366,805   | 336,598   |
| Less: Allowance for loan losses | (4,385)        | (4,333)   | (4,101)   | (4,100)   |
| Net deferred loan fees          | (205)          | (356)     | (439)     | (439)     |
|                                 | \$422,370      | \$409,610 | \$362,265 | \$331,959 |

We have no foreign loans nor do we have any reportable concentrations of loans.

### Loan portfolio rate sensitivity

Because of the relatively low residential mortgage interest rate environment for the last few years, we have originated a minimal number of adjustable-rate loans. Additionally, our customer base tends to prefer fixed-rate mortgage loans to adjustable-rate loans. Accordingly, the portfolio of adjustable-rate loans has declined significantly during the past three years. Adjustable-rate mortgage loans totaled \$5.8 million, or 4.9% of residential real estate loans at December 31, 2006. Substantially all of our home equity lines of credit have interest rates that adjust monthly with the Wall Street Journal prime rate.

Additionally, the market for commercial and multi-family and commercial real estate loans in our market area is intense. In response to the competition, we offer commercial real estate loans that adjust every five years, based on either the Wall Street Journal prime rate or the Treasury rate matching the adjustment period. Of the total multi-family and commercial real estate loan

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portfolio, \$184.2 million, or 88.1% have adjustable interest rates at December 31, 2006.

The following table shows the contractual maturity distributions of all loan categories at December 31, 2006:

|                             | Within Year<br>----- | One to<br>Five<br>Years<br>----- | After<br>Five<br>Years<br>----- | Total<br>----- |
|-----------------------------|----------------------|----------------------------------|---------------------------------|----------------|
| (In thousands)              |                      |                                  |                                 |                |
| Real estate mortgage loans: |                      |                                  |                                 |                |
| Multi-family and commercial | \$ 2,762             | \$ 9,222                         | \$197,188                       | \$209,172      |
| Residential                 | 731                  | 2,997                            | 128,653                         | 132,381        |
| Construction                | 73                   | -                                | 20,915                          | 20,988         |
| Home equity lines of credit | 516                  | 2,574                            | 10,827                          | 13,917         |
| Commercial                  | 20,623               | 6,928                            | 20,185                          | 47,736         |
| Consumer                    | 1,365                | 1,401                            | -                               | 2,766          |
|                             | -----                | -----                            | -----                           | -----          |
|                             | \$26,070             | \$23,122                         | \$377,768                       | \$426,960      |
|                             | =====                | =====                            | =====                           | =====          |

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The following table shows the amounts, included in the preceding table, which are due after one year and which have fixed interest rates and adjustable interest rates:

|                             | Total Due After One Year<br>----- |                          |                |
|-----------------------------|-----------------------------------|--------------------------|----------------|
|                             | Fixed Rate<br>-----               | Adjustable Rate<br>----- | Total<br>----- |
| (In thousands)              |                                   |                          |                |
| Real estate mortgage loans: |                                   |                          |                |
| Multi-family and commercial | \$ 22,224                         | \$184,186                | \$206,410      |
| Residential                 | 128,502                           | 3,148                    | 131,650        |
| Construction                | 3,719                             | 17,196                   | 20,915         |
| Home equity lines of credit | -                                 | 13,401                   | 13,401         |
| Commercial                  | 8,861                             | 18,252                   | 27,113         |
| Consumer                    | 1,175                             | 226                      | 1,401          |
|                             | -----                             | -----                    | -----          |
|                             | \$164,481                         | \$236,409                | \$400,890      |
|                             | =====                             | =====                    | =====          |

### Loan Delinquencies

It is our policy to manage our loan portfolio in order to recognize problem loans at an early stage and thereby minimize loan losses. Loans are considered delinquent when any payment of principal or interest is one month or more past due. We generally commence collection procedures when accounts are 15 days past due. Generally, when a loan becomes past due 90 days or more, management discontinues the accrual of interest and reverses previously accrued interest, unless the credit is well-secured and in process of collection. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. When a loan is determined to be uncollectible, it is charged to the allowance for loan losses or, if applicable, any real estate that is securing the loan is acquired through foreclosure, and recorded as other real estate owned.

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Management defines non-performing loans to include non-accrual loans, loans past due 90 days or more and still accruing, and restructured loans not performing in accordance with amended terms.

The following table presents information regarding non-performing loans in the portfolio:

|   | December 31,           |        |        |
|---|------------------------|--------|--------|
|   | 2006                   | 2005   | 2004   |
|   | (Dollars in thousands) |        |        |
| Non-accrual loans   | \$ 600                 | \$ 906 | \$ 506 |
| Loans 90 days or more past due and still accruing                                 | -                      | -      | -      |
| Total non-performing assets   | \$ 600                 | \$ 906 | \$ 506 |
| Restructured debt performing in accordance with amended terms, not included above | \$ -                   | \$ -   | \$ -   |
| Percentage of non-accrual loans to total loans                                    | 0.14%                  | 0.22%  | 0.14%  |
| Percentage of allowance for loan losses to non-accrual loans                      | 730.8%                 | 478.3% | 810.5% |

For the year ended December 31, 2006, interest income that would have been recorded if non-accrual loans at December 31, 2006 had been current in accordance with their original terms amounted to \$77,000. The actual interest recorded on these loans amounted to \$67,000 for the year ended December 31, 2006.

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### Allowance for Loan Losses

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that generally have been identified as impaired. For such loans, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses.

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As the composition of the loan portfolio gradually changes and diversifies from higher credit risk weighted loans, such as commercial real estate and commercial, to residential and home equity loans, a lower overall reserve allowance rate will be required. During 2006 and 2005, stronger underwriting guidelines and overall improvement in credit quality of existing loans resulted in a decrease in the degree of credit risk embedded in the loan portfolio. Consequently, the allowance for loan losses as a percentage of total loans outstanding declined from 1.05% at December 31, 2005 to 1.03% at December 31, 2006. After thorough review and analysis of the adequacy of the loan loss allowance during 2006, we recorded a provision for loan losses of \$39,000, compared to \$167,000 recorded for the year ended December 31, 2005. There were \$16,000 of loan charge-offs in 2006 with no loans charged off in 2005. We realized recoveries of previously charged-off loans totaling \$29,000 for the year ended December 31, 2006 compared with recoveries totaling \$65,000 for the year ended December 31, 2005. Management believes that the allowance for loan losses of \$4.4 million as of December 31, 2006 is adequate to cover potential losses in the loan portfolio, based on current information available to management.

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The table below illustrates the changes in the allowance for loan losses for the periods indicated.

|  | December 31,           |         |         |
|--|------------------------|---------|---------|
|  | 2006                   | 2005    | 2004    |
|  | -----                  | -----   | -----   |
|  | (Dollars in thousands) |         |         |
| Balance at beginning of year                             | \$4,333                | \$4,101 | \$4,154 |
| Charge-offs:   |                        |         |         |
| Real estate mortgage loans:                              |                        |         |         |
| Multi-family and commercial                              | -                      | -       | (446)   |
| Residential  | -                      | -       | -       |
| Home equity lines of credit                              | -                      | -       | -       |
| Commercial   | -                      | -       | (62)    |
| Consumer   | (16)                   | -       | (17)    |
|  | -----                  | -----   | -----   |
|  | (16)                   | -       | (525)   |
|  | -----                  | -----   | -----   |
| Recoveries:  |                        |         |         |
| Real estate mortgage loans:                              |                        |         |         |
| Multi-family and commercial                              | -                      | 39      | 8       |
| Residential  | 5                      | -       | -       |
| Home equity lines of credit                              | -                      | 16      | 17      |
| Commercial   | 11                     | -       | 60      |
| Consumer   | 13                     | 10      | 11      |
|  | -----                  | -----   | -----   |
|  | 29                     | 65      | 96      |
|  | -----                  | -----   | -----   |
| Net loan recoveries (charge-offs)                        | 13                     | 65      | (429)   |
| Provision (credit) for loan losses                       | 39                     | 167     | 376     |
|  | -----                  | -----   | -----   |
| Balance at end of year                                   | \$4,385                | \$4,333 | \$4,101 |
|  | =====                  | =====   | =====   |
| Allowance for loan losses as a percent of year-end loans | 1.03%                  | 1.05%   | 1.12%   |
|  | =====                  | =====   | =====   |

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|   |       |       |        |
|---|-------|-------|--------|
| Ratio of net charge-offs to average loans outstanding | 0.00% | 0.00% | -0.12% |
|   | ===== | ===== | =====  |

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The table below shows an allocation of the allowance for loan losses at the dates indicated:

|                          | December 31, 2006      |  | December 31, 2005 |  | December 31, 2004 |  | December |
|--------------------------|------------------------|--|-------------------|--|-------------------|--|----------|
|                          | Amount                 | Percent of Loans in Each Category to Total Loans | Amount            | Percent of Loans in Each Category to Total Loans | Amount            | Percent of Loans in Each Category to Total Loans | Amount   |
|                          | (Dollars in thousands) |  |                   |  |                   |  |          |
| Commercial               | \$ 718                 | 11.2%  | \$ 905            | 9.2%   | \$ 743            | 7.3%   | \$ 943   |
| Real estate construction | 260                    | 4.9%   | 248               | 5.2%   | 236               | 6.6%   | 52       |
| Real estate mortgage     | 3,181                  | 83.3%  | 3,056             | 85.0%  | 2,989             | 85.4%  | 3,071    |
| Consumer                 | 226                    | 0.6%   | 124               | 0.6%   | 133               | 0.7%   | 88       |
|                          | -----                  | -----  | -----             | -----  | -----             | -----  | -----    |
|                          | \$4,385                | 100.0%   | \$4,333           | 100.0%   | \$4,101           | 100.0%   | \$4,154  |
|                          | =====                  | =====  | =====             | =====  | =====             | =====  | =====    |

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DEPOSITS AND BORROWED FUNDS

We solicit deposits from our primary market area using rates and services designed to appeal to customers across a broad spectrum of ages and income levels. We compete for deposit customers with community banks and credit unions, as well as local branches of regional and national banks. Despite this level of competition, our total deposits increased from \$415.8 million at December 31, 2005 to \$424.0 million at December 31, 2006, an increase of \$8.2 million or 2.0%. Implementation of our "Coastal" product line in 2005 was designed to attract high-balance customers with whom we have multiple-product relationships. During the year ended December 31, 2006, there were significant migrations from lower cost deposit products to higher cost products.

The following table sets forth the average amount and the average rate paid on deposits for the periods indicated:

| December 31,    |              |                 |              |                 |              |
|-----------------|--------------|-----------------|--------------|-----------------|--------------|
| 2006            |              | 2005            |              | 2004            |              |
| Average Balance | Average Rate | Average Balance | Average Rate | Average Balance | Average Rate |
| -----           | -----        | -----           | -----        | -----           | -----        |

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(Dollars in thousands)

|                              |           |       |           |       |           |
|------------------------------|-----------|-------|-----------|-------|-----------|
| Noninterest-bearing deposits | \$ 74,042 | 0.00% | \$ 78,960 | 0.00% | \$ 76,815 |
| NOW deposits                 | 55,124    | 1.26  | 49,787    | 1.06  | 42,533    |
| Savings deposits             | 80,875    | 1.39  | 92,578    | 1.14  | 87,983    |
| Money market deposits        | 26,897    | 2.31  | 33,543    | 1.28  | 36,929    |
| Time deposits                | 180,152   | 3.93  | 147,360   | 2.77  | 150,839   |
|                              | -----     |       | -----     |       | -----     |
|                              | \$417,090 | 2.28% | \$402,228 | 1.51% | \$395,099 |
|                              | =====     |       | =====     |       | =====     |

As of December 31, 2006, the aggregate amount of time deposits in denominations of \$100,000 or more had the following maturities:

|  |                |
|--|----------------|
|  | Amount         |
|  | -----          |
|  | (In thousands) |
| Within three months                    | \$ 9,382       |
| After three months through six months  | 45,050         |
| After six months through twelve months | 11,024         |
| Over twelve months                     | 1,438          |
|  | -----          |
|  | \$ 66,894      |
|  | =====          |

As of December 31, 2006, the aggregate amount of time deposits in denominations of less than \$100,000 had the following maturities:

|  |                |
|--|----------------|
|  | Amount         |
|  | -----          |
|  | (In thousands) |
| Within three months                    | \$ 22,055      |
| After three months through six months  | 63,779         |
| After six months through twelve months | 28,993         |
| Over twelve months                     | 6,903          |
|  | -----          |
|  | \$121,730      |
|  | =====          |

As a member of the FHLB, the Bank is entitled to participate in the FHLB's advance programs. The advance programs allow the Bank to borrow up to 30% of total assets, but limited, based on the amount of qualified collateral (as defined by the FHLB) pledged, and the amount of FHLB preferred stock held. FHLB advances are utilized as an additional funding source for loans and investments as well as a tool for controlling the levels of interest rate risk on the balance sheet. FHLB advances are secured by a blanket lien on qualified collateral, consisting primarily of loans with first mortgages secured by one-to-four family properties and certain unencumbered investment securities. In addition qualified commercial real estate loans are used as collateral to obtain additional FHLB advances.



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Short-term borrowings include funds drawn under lines of credit with the FHLB and FHLB advances with an original maturity of less than one year. Total short-term borrowings decreased from \$7.0 million at December 31, 2005 to zero at December 31, 2006. The average balance of short-term borrowings did not exceed 30% of stockholders' equity at any time during the year ended December 31, 2006.

Long-term FHLB advances increased from \$100.9 million at December 31, 2005 to \$119.1 million at December 31, 2006, an increase of \$18.2 million or 18.0%. The proceeds were utilized to fund loan and investment growth in excess of deposit growth, as well as to hedge the effects of rising short-term interest rates on net interest income. At December 31, 2006, outstanding long-term FHLB advances had the following scheduled maturities and weighted average interest rates:

| Final Maturity<br>----- | Amount<br>----- | Weighted<br>Average Rate<br>----- |
|-------------------------|-----------------|-----------------------------------|
| (In thousands)          |                 |                                   |
| 2007                    | \$ 27,000       | 3.4%                              |
| 2008                    | 25,139          | 4.4%                              |
| 2009                    | 40,000          | 5.0%                              |
| 2010                    | 7,000           | 4.5%                              |
| Thereafter              | 19,919          | 6.2%                              |
|                         | -----           |                                   |
|                         | \$119,058       | 4.7%                              |
|                         | =====           |                                   |

Although most advances are payable at maturity, advances totaling \$14.1 million are payable on an amortizing basis, in terms ranging from 120 to 240 months. Amortizing advances are being repaid in equal monthly payments and are being amortized from the date of the advance to the maturity date on a direct reduction basis. Also, certain advances are redeemable at the option of the FHLB, at par value on the call date and quarterly thereafter.

In March 2004, we issued \$10.3 million in subordinated debentures. The debentures mature in 2034, and carry an adjustable interest rate equivalent to the three-month LIBOR plus 279 basis points. The rate adjusts every three months based on the change in the LIBOR. At December 31, 2006, the interest rate on the subordinated debentures was 8.18%. Current bank and bank holding company regulations view these debentures as "tier 1 capital." As such, we may leverage this regulatory capital in order to expand our franchise or otherwise enhance our earnings.

### STOCKHOLDERS' EQUITY

Total stockholders' equity increased from \$48.9 million at December 31, 2005 to \$51.2 million at December 31, 2006, primarily the result of net income of \$3.6 million. Net income was reduced by cash dividends declared totaling \$1.5 million. Other factors increasing stockholders' equity were the issuance of common stock through option exercises and our dividend reinvestment plans, totaling \$891,000, and an increase in other comprehensive income of \$734,000 pertaining to a reduction in net unrealized losses on securities available for sale offset by an adjustment to initially apply FASB Statement No. 158 for unrecognized pension plan losses. Other factors decreasing stockholders' equity were the repurchase of stock totaling \$778,000 under our stock repurchase program, and the purchase of shares of common stock in the open market totaling \$887,000 to fund restricted stock awards.

### RESULTS OF OPERATIONS

Our operating performance is dependent on net interest income, which is the

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difference between interest income earned on loans and investments and interest expense paid on deposits and borrowed funds. The level of net interest income achieved is impacted by several factors such as economic conditions, interest rates, asset/liability management, and corporate tax and strategic planning.

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The following table sets forth our average assets, liabilities, and stockholders' equity, interest earned and interest paid, average rates earned and paid, net interest spread and the net interest margin. Average balances reported are daily averages.

|                                      | Years Ended December 31, |                            |                 |                    |                            |                 |
|--------------------------------------|--------------------------|----------------------------|-----------------|--------------------|----------------------------|-----------------|
|                                      | 2006                     |                            |                 | 2005               |                            |                 |
|                                      | Average<br>Balance       | Interest<br>Income/Expense | Average<br>Rate | Average<br>Balance | Interest<br>Income/Expense | Average<br>Rate |
|                                      | (Dollars in thousands)   |                            |                 |                    |                            |                 |
| <b>Assets:</b>                       |                          |                            |                 |                    |                            |                 |
| -----                                |                          |                            |                 |                    |                            |                 |
| Interest earning assets (1)          |                          |                            |                 |                    |                            |                 |
| Loans:                               |                          |                            |                 |                    |                            |                 |
| Commercial                           | \$ 47,256                | \$ 3,668                   | 7.76%           | \$ 32,560          | \$ 2,160                   | 6.63%           |
| Commercial real estate               | 228,535                  | 15,042                     | 6.58%           | 223,355            | 13,613                     | 6.09%           |
| Residential real estate              | 146,729                  | 8,346                      | 5.69%           | 135,714            | 7,267                      | 5.35%           |
| Consumer                             | 2,645                    | 207                        | 7.83%           | 2,405              | 144                        | 5.99%           |
|                                      | -----                    |                            |                 |                    |                            |                 |
| Total loans                          | 425,165                  | 27,263                     | 6.41%           | 394,034            | 23,184                     | 5.88%           |
| Federal funds sold                   | 3,708                    | 196                        | 5.29%           | 8,754              | 247                        | 2.82%           |
| Taxable debt securities              | 112,511                  | 5,156                      | 4.58%           | 112,637            | 4,708                      | 4.18%           |
| Tax-exempt debt securities (2)       | 5,791                    | 386                        | 6.67%           | 7,837              | 520                        | 6.64%           |
| Marketable equity securities         | 4,396                    | 149                        | 3.39%           | 4,612              | 160                        | 3.47%           |
| FHLB stock                           | 6,471                    | 348                        | 5.38%           | 5,868              | 257                        | 4.38%           |
| Other investments                    | 650                      | 38                         | 5.85%           | 650                | 25                         | 3.85%           |
|                                      | -----                    |                            |                 |                    |                            |                 |
| Total interest earning<br>assets     | 558,692                  | 33,536                     | 6.00%           | 534,392            | 29,101                     | 5.45%           |
|                                      | -----                    |                            |                 |                    |                            |                 |
| Allowance for loan losses            | (4,366)                  |                            |                 | (4,212)            |                            |                 |
| Deferred loan fees                   | (321)                    |                            |                 | (415)              |                            |                 |
| Cash and due from banks              | 13,192                   |                            |                 | 16,249             |                            |                 |
| Other assets                         | 24,806                   |                            |                 | 26,311             |                            |                 |
|                                      | -----                    |                            |                 |                    |                            |                 |
|                                      | \$592,003                |                            |                 | \$572,325          |                            |                 |
|                                      | =====                    |                            |                 |                    |                            |                 |
| <b>Liabilities and Stockholders'</b> |                          |                            |                 |                    |                            |                 |
| -----                                |                          |                            |                 |                    |                            |                 |
| <b>Equity:</b>                       |                          |                            |                 |                    |                            |                 |
| -----                                |                          |                            |                 |                    |                            |                 |
| Interest bearing liabilities         |                          |                            |                 |                    |                            |                 |
| Savings accounts                     | \$ 80,875                | \$ 1,123                   | 1.39%           | \$ 92,578          | \$ 1,051                   | 1.14%           |
| NOW accounts                         | 55,124                   | 694                        | 1.26%           | 49,787             | 529                        | 1.06%           |
| Money market accounts                | 26,897                   | 621                        | 2.31%           | 33,543             | 428                        | 1.28%           |
| Time deposits                        | 180,152                  | 7,086                      | 3.93%           | 147,360            | 4,076                      | 2.77%           |
| FHLB advances                        | 112,048                  | 4,986                      | 4.45%           | 108,450            | 4,274                      | 3.94%           |

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|                                    |           |          |       |           |          |       |
|------------------------------------|-----------|----------|-------|-----------|----------|-------|
| Subordinated debt                  | 10,310    | 828      | 8.03% | 10,282    | 637      | 6.20% |
|                                    | -----     |          |       | -----     |          |       |
| Total interest bearing liabilities | 465,406   | 15,338   | 3.30% | 442,000   | 10,995   | 2.49% |
|                                    |           | -----    |       |           | -----    |       |
| Demand deposits                    | 74,042    |          |       | 78,960    |          |       |
| Other liabilities                  | 10,404    |          |       | 3,304     |          |       |
|                                    | -----     |          |       | -----     |          |       |
| Total liabilities                  | 549,852   |          |       | 524,264   |          |       |
| Total stockholders' equity         | 42,151    |          |       | 48,061    |          |       |
|                                    | -----     |          |       | -----     |          |       |
|                                    | \$592,003 |          |       | \$572,325 |          |       |
|                                    | =====     |          |       | =====     |          |       |
| Net interest income                |           | \$18,198 |       |           | \$18,106 |       |
|                                    |           | =====    |       |           | =====    |       |
| Net interest spread                |           |          | 2.70% |           |          | 2.96% |
|                                    |           |          | ===== |           |          | ===== |
| Net interest margin                |           |          | 3.26% |           |          | 3.39% |
|                                    |           |          | ===== |           |          | ===== |

- (1) Average balance includes non-accruing loans. The effect of including such loans, although not reflected in the average rate earned on the Company's loans.
- (2) On a fully taxable equivalent basis based on tax rate of 35.0% for 2006 and 2005, and 34.3% for 2004, investments and net interest income includes a fully taxable equivalent adjustment of \$135,000 in 2005, and \$217,000 in 2004.

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RATE - VOLUME ANALYSIS

The following table presents the changes in components of net interest income for the years ended December 31, which are the result of changes in interest rates and the changes that are the result of changes in volume of the underlying asset or liability. Changes that are attributable to changes in both rate and volume have been allocated equally to rate and volume.

NET INTEREST INCOME - CHANGES DUE TO VOLUME AND RATE

|                         | 2006 vs. 2005 Increase (Decrease) |               |             | 2005 vs. 2004 Increase (Decrease) |               |
|-------------------------|-----------------------------------|---------------|-------------|-----------------------------------|---------------|
|                         | Total Change                      | Due to Volume | Due to Rate | Total Change                      | Due to Volume |
|                         | -----                             |               |             |                                   |               |
|                         | (In thousands)                    |               |             |                                   |               |
| Commercial loans        | \$1,508                           | \$1,095       | \$ 413      | \$ 443                            | \$ 62         |
| Commercial real estate  | 1,429                             | 321           | 1,108       | 1,114                             | 933           |
| Residential real estate | 1,079                             | 611           | 468         | 1,400                             | 1,093         |
| Consumer loans          | 63                                | 15            | 48          | (36)                              | (48)          |
| Federal funds sold      | (51)                              | (205)         | 154         | 62                                | (200)         |
| Taxable debt securities | 448                               | (6)           | 454         | 1,746                             | 1,703         |

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|                                |       |        |          |         |         |
|--------------------------------|-------|--------|----------|---------|---------|
| Tax-exempt debt securities (1) | (134) | (136)  | 2        | (113)   | (121)   |
| Marketable equity securities   | (11)  | (7)    | (4)      | 67      | 26      |
| FHLB Stock                     | 91    | 28     | 63       | 159     | 89      |
| Other investments              | 13    | -      | 13       | (64)    | (229)   |
|                                | ----- |        |          | -----   |         |
| Total interest income          | 4,435 | 1,716  | 2,719    | 4,778   | 3,308   |
|                                | ----- |        |          | -----   |         |
| Savings accounts               | 72    | (148)  | 220      | 169     | 49      |
| NOW accounts                   | 165   | 61     | 104      | 215     | 65      |
| Money market accounts          | 193   | (119)  | 312      | (69)    | (45)    |
| Time deposits                  | 3,010 | 1,039  | 1,971    | 787     | (86)    |
| FHLB advances                  | 712   | 146    | 566      | 1,680   | 1,810   |
| Subordinated debt              | 191   | 2      | 189      | 267     | 109     |
|                                | ----- |        |          | -----   |         |
| Total interest expense         | 4,343 | 981    | 3,362    | 3,049   | 1,902   |
|                                | ----- |        |          | -----   |         |
| Net interest income            | \$ 92 | \$ 735 | \$ (643) | \$1,729 | \$1,406 |
|                                | ===== |        |          | =====   |         |

- (1) The change in interest income on investments and net interest income includes interest on a tax equivalent basis based on a tax rate of 35.0% for 2006 and 2005, and 34.3% for 2004.

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COMPARISON OF OPERATING RESULTS FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

We realized net income totaling \$3.6 million for the year ended December 31, 2006, equivalent to basic and diluted earnings per share of \$0.87. This represents a 10.0% decrease in net income from the year ended December 31, 2005, where net income totaled \$4.0 million, or \$0.98 per share (basic) and \$0.97 per share (diluted). Net interest income increased marginally from \$17.9 million for the year ended December 31, 2005 to \$18.1 million for the year ended December 31, 2006, primarily the result of the migration to higher cost funding sources that was present throughout most of the year. We recognized a provision for loan losses of \$39,000 and \$167,000 for the years ended December 31, 2006 and 2005, respectively. We continue concerted efforts to enhance the credit quality of our loan portfolio. The dedication to loan quality that management has undertaken has resulted in a loan loss provision that management believes is in line with the risks inherent in its loan portfolio. Non-interest income increased from \$2.3 million for the year ended December 31, 2005 to \$2.7 million for the year ended December 31, 2006. During the same period, non-interest expense increased from \$13.9 million for the year ended December 31, 2005 to \$14.9 million for the year ended December 31, 2006. Income before taxes was \$5.9 million and \$6.2 million, for the years ended December 31, 2006 and 2005, respectively. Income taxes remained flat at \$2.2 million for the years ended December 31, 2005 and 2006.

Interest income increased from \$28.9 million for the year ended December 31, 2005, to \$33.4 million for the year ended December 31, 2006, an increase of 15.5%. This increase can be attributed to the growth in the loan portfolio, as

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the average balance of loans increased by \$31.1 million or 7.90%. The yield on the loan portfolio increased from 5.88% for the year ended December 31, 2005, to 6.41% for the year ended December 31, 2006. Interest and dividends on investments increased by \$0.4 million, on a fully taxable equivalent basis, from \$5.7 million for the year ended December 31, 2005 to \$6.1 million for the year ended December 31, 2006, the result of the higher yielding securities. The portfolio decreased from an average balance of \$131.6 million to \$129.8 million. Income from federal funds sold decreased from \$247,000 to \$196,000, the result of increased rates on lower volumes of overnight money.

Interest expense increased from \$11.0 million for the year ended December 31, 2005 to \$15.3 million for the year ended December 31, 2006, resulting primarily from the migration of deposits to higher cost certificates of deposits during 2006. The average balance of FHLB advances increased from \$108.5 million for the year ended December 31, 2005 to \$112.0 million for the year ended December 31, 2006. Management used borrowings to fund a substantial portion of our loan growth in 2006. As a result of the timing of borrowings, the average rate paid on FHLB advances increased from 3.94% for the year ended December 31, 2005 to 4.45% for the year ended December 31, 2006. Interest expense on deposits increased from \$6.1 million for the year ended December 31, 2005 to \$9.5 million for the year ended December 31, 2006. We also continued to increase certain interest rates in response to increases in market interest rates and corresponding increases in deposit interest rates offered by our competitors, in order to continue to fund loan growth. This increase was the result of the deposit campaigns, both for certificates of deposit and core accounts. A marketing strategy, begun in 2005 and continued in 2006, was employed whereby certificates of deposit were offered at premium rates, and the customer was cross-sold basic banking products to establish a long-term relationship with the customer. At the same time, a suite of products was offered to high-balance customers. These campaigns served to increase the levels of all deposit types, including non-interest bearing demand deposits. The \$10.3 million of subordinated debentures carry an interest rate equal to the three-month LIBOR plus 279 basis points which equated to 8.18% and 7.29% at December 31, 2006 and 2005, respectively. The cost of interest-bearing liabilities increased from 2.49% in 2005 to 3.30% in 2006.

Net interest income increased from \$17.9 million for the year ended December 31, 2005 to \$18.1 million for the year ended December 31, 2006, an increase of 0.8%. This increase was the result of a substantial growth in interest income (15.5%), offset by an even greater increase in the cost of funds (39.5%), compressing our net interest margin from 3.39% for the year ended December 31, 2005 to 3.26% for the year ended December 31, 2006.

The provision for loan losses is a charge against earnings and funds the allowance for loan losses. We maintain the allowance for loan losses at a level that we believe is adequate to absorb inherent losses within the loan portfolio. In determining the appropriate level of the allowance for loan losses, management takes into consideration past and anticipated loss experience, prevailing economic conditions, evaluations of underlying collateral, the nature of the portfolio mix and the balance of non-performing and classified loans. We assess the allowance for loan losses on a quarterly basis. After thorough review and analysis of the adequacy of the allowance and the continued improvement in asset quality in the loan portfolio, management deemed it prudent to provide \$39,000 and \$167,000 for possible loan losses for the years ended December 31, 2006 and 2005, respectively.

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Non-interest income increased from \$2.3 million for the year ended December 31, 2005 to \$2.7 million for the year ended December 31, 2006, an increase of 18.4%. The increase was primarily attributable to the introduction of a check

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"bounce" protection program, and the increase in deposit fees attributable to this program. The increase in fees were partially offset by an approximate \$176,000 loss on the sale of some low yielding investment securities for higher yielding investment securities. The loss was completely earned out with increased interest income attributable to the higher yielding investment securities.

Non-interest expense increased from \$13.9 million for the year ended December 31, 2005 to \$14.9 million for the year ended December 31, 2006, an increase of 7.2%. Salaries and employee benefits increased by \$24,000, or 0.3%, from \$8.06 million for the year ended December 31, 2005, to \$8.09 million for the year ended December 31, 2006. Salary and benefits increases in 2006 related normal increases, and the adoption of FAS 123R were offset by staff layoffs and retirements associated with outsourcing initiatives and increased deferrals of loan origination costs. Occupancy and equipment expense increased from \$1.7 million for the year ended December 31, 2005 to \$1.9 million for the year ended December 31, 2006. The increase in occupancy expense is primarily the result of a full year of operations during 2006 at the new Assonet branch opened in April 2005 and outsourced property management services. Professional fees increased by approximately \$50,000 primarily due to outsourcing our internal audit function when comparing the years ended December 31, 2006 and 2005. Marketing costs decreased \$185,000 for the year ended December 31, 2006 from \$549,000 for the year ended December 31, 2005. This was the result of reduced promotional programs during 2006 and a delayed promotional program that will be rolled out early in the second quarter of 2007. Other expenses increased approximately \$600,000 due to the outsourcing of the Bank's item processing and statement rendering functions that were formerly completed in the Bank's internal backroom operations. Other expense in 2006 versus 2005 were increased by approximately \$100,000 attributable to fraud losses and other losses combined with and increased Board of Director committee fees of an additional \$100,000.

Income before income taxes was \$5.9 million for the year ended December 31, 2006, compared to \$6.2 million for the year ended December 31, 2005. Provision for income taxes totaled \$2.2 million for the years ended December 31, 2006 and 2005, representing overall effective tax rates of 38.3% and 35.0%, respectively.

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### COMPARISON OF OPERATING RESULTS FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

We realized net income totaling \$4.0 million for the year ended December 31, 2005, equivalent to basic earnings per share of \$0.98 and diluted earnings per share of \$0.97. This represents a 11.1% increase in net income from the year ended December 31, 2004, where net income totaled \$3.6 million, or \$0.89 per share (basic) and \$0.88 per share (diluted). Net interest income increased from \$16.2 million for the year ended December 31, 2004 to \$17.9 million for the year ended December 31, 2005, the direct result of our growth over the year. We recognized a provision for loan losses of \$167,000 and \$376,000 for the years ended December 31, 2005 and 2004, respectively. During the past three years, we have made concerted efforts to enhance the credit quality of our loan portfolio. Continuing the dedication to loan quality that management has taken has resulted in a loan loss provision that management believes is in line with its growing loan portfolio. Non-interest income decreased from \$2.5 million for the year ended December 31, 2004 to \$2.3 million for the year ended December 31, 2005. During the same period, non-interest expense increased from \$12.8 million for the year ended December 31, 2004 to \$13.9 million for the year ended December 31, 2005. Income before taxes was \$6.2 million and \$5.5 million, for the years ended December 31, 2005 and 2004, respectively. Income taxes increased from \$1.9 million for the year ended December 31, 2004, to \$2.2 million for the year ended December 31, 2005.

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Interest income increased from \$24.1 million for the year ended December 31, 2004, to \$28.9 million for the year ended December 31, 2005, an increase of 20.0%. This increase can be attributed to the growth in the loan portfolio, as the average balance of loans increased by \$36.5 million or 10.21%. The yield on the loan portfolio increased from 5.67% for the year ended December 31, 2004, to 5.88% for the year ended December 31, 2005. Interest and dividends on investments increased by \$1.8 million, on a fully taxable equivalent basis, from \$3.9 million for the year ended December 31, 2004 to \$5.7 million for the year ended December 31, 2005, the result of the growth in the investment portfolio. The portfolio grew from an average balance of \$98.9 million to \$131.6 million. Income from federal funds sold increased from \$185,000 to \$247,000, the result of increased volume of overnight money.

Interest expense increased from \$7.9 million for the year ended December 31, 2004 to \$11.0 million for the year ended December 31, 2005, resulting primarily from the increased use of borrowings in 2005. The average balance of FHLB advances increased from \$63.4 million for the year ended December 31, 2004 to \$108.5 million for the year ended December 31, 2005. Management used borrowings to fund a substantial portion of our loan growth in 2005. During the period of low interest rates, we utilized longer-term advances to fund loan originations in order to control interest rate risk. As a result of the timing of borrowings, the average rate paid on FHLB advances decreased from 4.09% for the year ended December 31, 2004 to 3.94% for the year ended December 31, 2005. Interest on deposits increased from \$5.0 million for the year ended December 31, 2004 to \$6.1 million for the year ended December 31, 2005. We have increased certain interest rates in response to increases in market interest rates and corresponding increases in deposit interest rates offered by our competitors, in order to continue to fund loan growth. This increase was the result of the deposit campaigns, both for certificates of deposit and core accounts. A marketing strategy was employed whereby certificates of deposit were offered at premium rates, and the customer was cross-sold basic banking products to establish a long-term relationship with the customer. At the same time, a suite of products was offered to high-balance customers. These campaigns served to increase the levels of all deposit types, including non-interest bearing demand deposits. We also issued \$10.3 million of subordinated debentures in March 2004. The debentures carry an interest rate equal to the three-month LIBOR plus 279 basis points. The effect of the issue was to increase interest expense by \$267,000. The cost of interest-bearing liabilities increased from 2.04% to 2.49%.

Net interest income increased from \$16.2 million for the year ended December 31, 2004 to \$17.9 million for the year ended December 31, 2005, an increase of 10.9%. This increase was the result of our growth, offset by a compression of our net interest margin from 3.44% for the year ended December 31, 2004 to 3.39% for the year ended December 31, 2005, and the continued period of low market interest rates, combined with intense competition for deposits in our market area.

The provision for loan losses is a charge against earnings and funds the allowance for loan losses. We maintain the allowance for loan losses at a level that we believe is adequate to absorb inherent losses within the loan portfolio. In determining the appropriate level of the allowance for loan losses, management takes into consideration past and anticipated loss experience, prevailing economic conditions, evaluations of underlying collateral, the nature of the portfolio mix and the balance of non-performing and classified loans. We assess the allowance for loan losses on a monthly basis. After thorough review and analysis of the adequacy of the allowance and the continued improvement in

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asset quality in the loan portfolio, management deemed it prudent to provide \$167,000 and \$376,000 for possible loan losses for the year ended December 31, 2005 and 2004, respectively.

Non-interest income decreased from \$2.5 million for the year ended December 31, 2004 to \$2.3 million for the year ended December 31, 2005, a decrease of 7.4%. The decrease can be attributed to a one-time sale of impaired loans, which resulted in a gain of \$196,000 for the year ended December 31, 2004, as compared to \$49,000 for the year ended December 31, 2005, a decrease of 75%. Also, contributing to the decrease is the result of the introduction of free checking account products. In response to competitive pressure, we offered and promoted free checking accounts and realized a significant shift of accounts into this product, resulting in decreased fee income. Service charges on deposit accounts declined \$124,000 from \$1.0 million for the year ended December 31, 2004 to \$914,000 for the year ended December 31, 2005. Other income increased from \$844,000 for the year ended December 31, 2004 to \$860,000 for the year ended December 31, 2005, an increase of 1.9%. This increase was the result of official check fees, ATM and debit card income offset by the decrease of commissions on sales of non-deposit investment products.

Non-interest expense increased from \$12.8 million for the year ended December 31, 2004 to \$13.9 million for the year ended December 31, 2005, an increase of 8.7%. Salaries and employee benefits increased by \$423,000, or 5.5%, from \$7.6 million for the year ended December 31, 2004, to \$8.0 million for the year ended December 31, 2005. Salary increases in 2005 were offset by increased levels of deferred loan origination costs. Occupancy and equipment expense increased from \$1.3 million for the year ended December 31, 2004 to \$1.7 million for the year ended December 31, 2005. The increase is a result of cost savings realized from closing branches in 2004 that have been offset by costs associated with opening the new Assonet branch in April 2005. Equipment expense increased due to modernization of and investments in teller and platform systems initiatives that we believe will ultimately result in a more efficient customer service. Professional fees increased by \$320,000 when comparing the years ended December 31, 2005 and 2004. The increase is the result of accounting and consulting costs associated with our restatement of certain financial statements and related information totaling \$211,000. Also professional fees increased by \$25,000 in 2005 due to costs associated with the anticipated implementation of Section 404 of the Sarbanes-Oxley Act of 2002 and implementing section 305 for the FDIC Improvement Act of 1991. Marketing costs increased from \$510,000 for the year ended December 31, 2004 to \$549,000 for the year ended December 31, 2005. This is the result of increased advertising and promotional costs associated with our "Coastal" product line and other deposit gathering initiatives. As we continue to launch new deposit products and services, such as the Coastal Savings account and the Bank at Work Program, we expect marketing costs to rise. Other expenses decreased from \$2.3 million for the year ended December 31, 2004 to \$2.2 million for the year ended December 31, 2005, a decrease of \$6,000.

Income before income taxes was \$6.2 million for the year ended December 31, 2005, compared to \$5.5 million for the year ended December 31, 2004. Provision for income taxes totaled \$2.2 million and \$1.9 million for the years ended December 31, 2005 and 2004, respectively, representing overall effective tax rates of 35.0% and 34.3%, respectively.

### IMPACT OF INFLATION

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in terms of historical dollars without considering changes in the relative purchasing power of money over time due to inflation.



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The primary effect of inflation on our operations is reflected in increased operating costs. Unlike most industrial companies, virtually all assets of a financial institution are monetary in nature. As a result, interest rates have a more significant effect on a financial institution's performance than the effect of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services.

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### LIQUIDITY AND CAPITAL RESOURCES

#### LIQUIDITY

Our principal sources of funds are customer deposits, amortization and payoff of existing loan principal, and sales, maturities or paydowns of various investment securities. The Bank is a voluntary member of the Federal Home Loan Bank of Boston (the "FHLB") and as such, may take advantage of the FHLB's borrowing programs to enhance liquidity and leverage its favorable capital position. The Bank also may draw on lines of credit at the FHLB or the Federal Reserve Board (the "FRB"), and enter into repurchase or reverse repurchase agreements with authorized brokers. These various sources of liquidity are used to fund withdrawals, new loans, and investments.

Management seeks to promote deposit growth while controlling cost of funds. Sales-oriented programs to attract new depositors and the cross-selling of various products to its existing customer base are currently in place. Management reviews, on an ongoing basis, possible new products, with particular attention to products and services, which will aid in retaining our base of lower-costing deposits.

Maturities, paydowns and sales of investment securities provide us with significant liquidity. Our policy of purchasing shorter-term debt securities reduces market risk in the bond portfolio while providing significant cash flow. For the year ended December 31, 2006, cash flow from maturities of securities was \$14.3 million, proceeds from sales of securities totaled \$17.0 million, compared to maturities of securities of \$21.1 million, and proceeds from sales of securities of \$2.6 million for the year ended December 31, 2005. Purchases of securities during 2006 and 2005 totaled \$36.7 million and \$28.0 million, respectively.

Amortization and pay-offs of the loan portfolio also provide us with significant liquidity. Traditionally, amortization and pay-offs are reinvested into loans. Excess liquidity is invested in federal funds sold and overnight investments at the FHLB.

We have also used borrowed funds as a source of liquidity. At December 31, 2006, the Bank's outstanding borrowings from the FHLB were \$119.1 million. The Bank has the capacity to borrow in excess of \$20.9 million additional at the FHLB.

Loan originations for the year ended December 31, 2006 totaled \$101.9 million. Commitments to originate loans at December 31, 2006 were \$8.4 million, excluding unadvanced construction funds totaling \$12.4 million, unadvanced commercial lines of credit totaling \$24.4 million and unadvanced home equity lines totaling \$16.9 million. Management believes that adequate liquidity is available to fund loan commitments utilizing deposits, loan amortization, maturities of securities, or borrowings.

#### CAPITAL RESOURCES

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At December 31, 2006, our total stockholders' equity was \$51.2 million, an increase of \$2.4 million from \$48.9 million reported on December 31, 2005. The increase in capital was a combination of several factors. Additions consisted primarily of net income of \$3.6 million for the year ended December 31, 2006. There were also 32,762 shares issued at a value of \$586,000, pursuant to our Dividend Reinvestment Program, in lieu of cash dividends or for optional cash contributions and exercised stock options resulted in the issuance of 28,000 shares common stock at a value of \$305,000, including a tax benefit. Additionally, there was an increase in accumulated other comprehensive income attributable to a net reduction in unrealized losses on available-for-sale securities of \$957,000, partially offset by an adjustment of \$223,000 to initially apply FASB Statement No. 158 regarding the Company's defined benefit pension plan. Other reductions related to dividends paid of \$1.5 million, the repurchase of 42,443 shares of common stock under our stock repurchase program at a cost of \$778,000 and the purchase of 48,277 shares of stock at a cost of \$887,000 to be used to grant potential stock awards.

Under the requirements for Risk Based and Leverage Capital of the federal banking agencies, a minimum level of capital will vary among banks based on safety and soundness of operations. Risk Based Capital ratios are calculated with reference to risk-weighted assets, which include both on and off balance sheet exposure.

In addition to meeting the required levels, Slade's Ferry Bancorp.'s and the Bank's capital ratios meet the criteria of the "well capitalized" category established by the federal banking agencies as of December 31, 2006 and 2005; refer to Note 13 to the consolidated Financial Statements included herein for additional information.

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### ITEM 7A

#### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We consider interest rate risk to be a significant market risk as it could potentially have an effect on our financial condition and results of operation. The definition of interest rate risk is the exposure of our earnings to adverse movements in interest rates, arising from the differences in the timing of the repricing of assets and liabilities; the differences in the various pricing indices inherent in our assets and liabilities; and the effects of overt and embedded options in our assets and liabilities. Our Asset/Liability Committee, comprised of executive management, is responsible for managing and monitoring interest rate risk, and reviewing with the Board of Directors, at least quarterly, the interest rate risk positions, the impact changes in interest rates would have on net interest income, and the maintenance of interest rate risk exposure within approved guidelines.

The potentially volatile nature of market interest rates requires us to manage interest rate risk on an active and dynamic basis. Our objective is to reduce and control the volatility of net interest income to within tolerance levels established by the Board of Directors, by managing the relationship of interest-earning assets and interest-bearing liabilities. In order to manage this relationship, the Asset/Liability Committee utilizes an income simulation model to measure the net interest income at risk under differing interest rate scenarios. Additionally, the Committee uses an Economic Value of Equity ("EVE") analysis to measure the effects of changing interest rates on the market values of rate-sensitive assets and liabilities, taken as a whole. The Board of Directors and management believe that static measures of timing differences, such as "gap analysis", do not accurately assess the levels of interest rate risk inherent in our balance sheet. Gap analysis does not reflect the effects

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of overt and embedded options on net interest income, given a shift in interest rates; nor does it take into account basis risk, the risk arising from using various different indices on which to base pricing decisions.

The income simulation model currently utilizes a 200 basis point increase in interest rates and a 200 basis point decrease in rates. The interest rate movements used assume an instant and parallel change in interest rates and no implementation of any strategic plans are made in response to the change in rates. Prepayment speeds for loans are based on median dealer forecasts for each interest rate scenario.

The Board of Directors has established a risk limit of a 5.00% change in net interest income for each 100 basis point shift in market interest rates. The limit established by the Board provides an internal tolerance level to control interest rate risk. We were slightly outside our policy-mandated risk limit for net interest income at risk due to a management decision, with the Board of Directors concurrence, not to extend long-term funding in light of what we believe to be temporarily overpriced short and long term funding costs.

The following table reflects our estimated exposure as a percentage of net interest income and the change in basis points for the next twelve months, assuming an immediate change in interest rates set forth below:

| Rate Change<br>(Basis Points) | Estimated Exposure as a Percentage<br>of Net Interest Income | Change<br>(Basis Points) |
|-------------------------------|--|--------------------------|
| +200                          | -14.19%  | (24)                     |
| -200                          | 6.68%  | 12                       |

Additionally we use the model to estimate the effects of changes in interest rates on our EVE. EVE represents our theoretical market value, given the rate shocks applied in the model. The Board of Directors has established a risk limit for EVE which provides that the EVE will not fall below 6.00%, the FDIC's minimum capital level to be classified as "well capitalized". We are within our risk limit for EVE.

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The following table presents the changes in EVE given rate shocks.

| Rate Change<br>(Basis Points) | Economic Value of Equity | Change from<br>Flat Rates |
|-------------------------------|--------------------------|---------------------------|
| Flat                          | 13.24%                   | N/A                       |
| +200                          | 11.69%                   | -1.55%                    |
| -200                          | 13.22%                   | -0.02%                    |

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### ITEM 8

#### FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our consolidated financial statements, together with the reports of independent registered public accounting firms, appear beginning on page F-1 of this Annual Report on Form 10-K.

### ITEM 9

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### CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Effective March 14, 2005, the Audit Committee of our Board of Directors dismissed Shatswell, MacLeod & Company, P.C. and engaged Wolf & Company, P.C. as our independent registered public accounting firm for the fiscal year ended December 31, 2005. We had no disagreements with Shatswell, MacLeod & Company on accounting and financial disclosure matters.

#### ITEM 9A

##### CONTROLS AND PROCEDURES

As required by Rule 13a-15 under the Securities Exchange Act of 1934, within the 90 days prior to the date of this report, the Company carried out an evaluation under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal accounting officer, as appropriate to allow timely decisions regarding disclosure. In connection with the rules regarding disclosure and control procedures, we intend to continue to review and document our disclosure controls and procedures, including our internal controls and procedures for financial reporting, and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our business.

There has been no change in the Company's internal controls over financial reporting identified in connection with the Company's evaluation of its disclosure controls and procedures that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.

#### ITEM 9B

##### OTHER INFORMATION

None.

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#### PART III

#### ITEM 10

##### DIRECTORS AND EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information required by this Item is incorporated herein by reference to our Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A within 120 days following our December 31, 2006 fiscal year end.

#### ITEM 11

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### EXECUTIVE COMPENSATION

Information required by this Item is incorporated herein by reference to our Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A within 120 days following our December 31, 2006 fiscal year end.

### ITEM 12

#### SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required by this Item is incorporated herein by reference to our Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A within 120 days following our December 31, 2006 fiscal year end.

#### Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth information pertaining to our equity compensation plans in effect as of December 31, 2006.

| Plan Category   | Number of securities<br>to be issued upon<br>exercise of outstanding<br>options, warrants<br>and rights | Weighted-average<br>exercise price of<br>outstanding options,<br>warrants and rights |
|---|---|--|
| -----   | -----   | -----  |
|   | (a)   | (b)  |
| Equity compensation plans approved by<br>security holders     | 230,945   | \$18.18  |
| Equity compensation plans not approved by<br>security holders | -   | -  |
|   | -----   | -----  |
|   | 230,945   | \$18.18  |
|   | =====   | =====  |

### ITEM 13

#### CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information required by this Item is incorporated herein by reference to our Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A within 120 days following our December 31, 2006 fiscal year end.

### ITEM 14

#### PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required by this Item is incorporated herein by reference to our Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A within 120 days following our December 31, 2006 fiscal year end.

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PART IV

ITEM 15

EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report:

- (1) Financial Statement Schedules  
All financial statement schedules required by Item 15(a) (2) have been omitted because they are inapplicable or because the required information has been included in the Consolidated Financial Statements or Notes thereto.
- (2) Exhibits: see attached Exhibit Index

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SIGNATURES

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Pursuant to the requirements of Section 13 or 15(d) 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.

Slade's Ferry Bancorp.

By /s/ Mary Lynn D. Lenz 3/30/07

-----  
Mary Lynn D. Lenz,  
President/Chief Executive Officer

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

|                              |          |                               |          |
|------------------------------|----------|-------------------------------|----------|
| /s/ Peter G. Collias         | 03/30/07 | /s/ Anthony F. Cordeiro       | 03/30/07 |
| -----                        |          | -----                         |          |
| Peter G. Collias             |          | Anthony F. Cordeiro           |          |
| Director                     |          | Director                      |          |
| /s/ Scott W. Costa, PE       | 03/30/07 | /s/ Paul C. Downey            | 03/30/07 |
| -----                        |          | -----                         |          |
| Scott W. Costa, PE           |          | Paul C. Downey                |          |
| Director                     |          | Lead Independent Director     |          |
| /s/ Melvyn A. Holland        | 03/30/07 | /s/ Mary Lynn D. Lenz         | 03/30/07 |
| -----                        |          | -----                         |          |
| Melvyn A. Holland            |          | Mary Lynn D. Lenz             |          |
| Director                     |          | President/CEO                 |          |
|                              |          | (Principal Executive Officer) |          |
| /s/ Jean F. MacCormack, Ed.D | 03/30/07 | /s/ Francis A. Macomber       | 03/30/07 |
| -----                        |          | -----                         |          |
| Jean F. MacCormack, Ed.D     |          | Francis A. Macomber           |          |

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|                                     |          |                               |          |
|-------------------------------------|----------|-------------------------------|----------|
| Director                            |          | Director                      |          |
| /s/ Joan Parkos Moran               | 03/30/07 | /s/ Majed Mouded, MD          | 03/30/07 |
| -----                               |          | -----                         |          |
| Joan Parkos Moran                   |          | Majed Mouded, MD              |          |
| Director                            |          | Director                      |          |
| /s/ Shaun O'Hearn Sr.               | 03/30/07 | /s/ Lawrence J. Oliveira, DDS | 03/30/07 |
| -----                               |          | -----                         |          |
| Shaun O'Hearn Sr.                   |          | Lawrence J. Oliveira, DDS     |          |
| Director                            |          | Director                      |          |
| /s/ William J. Piccerelli, CPA, CVA | 03/30/07 | /s/ Carl Ribeiro              | 03/30/07 |
| -----                               |          | -----                         |          |
| William J. Piccerelli, CPA, CVA     |          | Carl Ribeiro                  |          |
| Director                            |          | Director                      |          |
| /s/ William J. Sullivan             | 03/30/07 | /s/ David F. Westgate         | 03/30/07 |
| -----                               |          | -----                         |          |
| William J. Sullivan                 |          | David F. Westgate             |          |
| Director                            |          | Director                      |          |
| /s/ Deborah A. McLaughlin           | 03/30/07 |                               |          |
| -----                               |          |                               |          |
| Deborah A. McLaughlin               |          |                               |          |
| Executive Vice President            |          |                               |          |
| Chief Financial Officer/Chief       |          |                               |          |
| Operations Officer                  |          |                               |          |
| (Principal Financial and            |          |                               |          |
| Accounting Officer)                 |          |                               |          |

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EXHIBIT INDEX

| Exhibit No. | Description   | Item |
|-------------|---|------|
| -----       | -----   | ---- |
| 3.1         | Amended and Restated Articles of Incorporation of Slade's Ferry Bancorp.  | (1)  |
| 3.2         | Amended and Restated Bylaws of Slade's Ferry Bancorp.   | (2)  |
| 3.3         | Articles of Amendment to the Amended and Restated Articles of Incorporation of Slade's Ferry Bancorp.   | (3)  |
| 10.1        | Slade's Ferry Bancorp. 1996 Stock Option Plan, as amended   | (4)  |
| 10.2        | Supplemental Executive Retirement Agreement between Slade's Ferry Bancorp. and Manuel J. Tavares  | (5)  |
| 10.3        | Form of Director Supplemental Retirement Program Director Agreement, Exhibit 1 thereto (Slade's Ferry Trust Company Director Supplemental Retirement Program Plan) and Endorsement Method Split Dollar Plan Agreement thereunder. | (6)  |
| 10.4        | Form of Directors' Paid-up Insurance Policy (part of the Director Supplemental Retirement Program).   | (7)  |

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|       |   |      |
|-------|---|------|
| 10.5  | Supplemental Executive Retirement Agreement between Slade's Ferry Bancorp. and Mary Lynn D. Lenz              | (8)  |
| 10.6  | Employment Agreement between Slade's Ferry Bancorp. and Mary Lynn D. Lenz                                     | (9)  |
| 10.7  | Employment Agreement between Slade's Ferry Bancorp. and Deborah A. McLaughlin                                 | (10) |
| 10.8  | Employment Agreement between Slade's Ferry Bancorp. and Manuel J. Tavares                                     | (11) |
| 10.9  | Form Change of Control Agreement  | (12) |
| 10.10 | Severance Pay Plan  | (13) |
| 10.11 | Slade's Ferry Bancorp. 2004 Equity Incentive Plan   | (14) |
| 10.12 | Form of Amendment to Directors' Supplemental Retirement Program for Non-Employee Directors                    | (15) |
| 10.13 | Form of Amendment to Directors' Supplemental Retirement Program for Francis A. Macomber and Melvyn A. Holland | (15) |
| 14.1  | Code of Ethics  | (16) |
| 21.1  | List of Subsidiaries  | (17) |
| 23.1  | Consent of Wolf & Company, P.C.   |      |
| 23.2  | Consent of Shatswell, MacLeod & Company, P.C.   |      |
| 31.1  | Rule 13a-14(a)/15d-14(a) Certification of the CEO   |      |
| 31.2  | Rule 13a-14(a)/15d-14(a) Certification of the CFO   |      |
| 32.1  | Section 1350 Certification of the CEO   |      |
| 32.2  | Section 1350 Certification of the CFO   |      |

- 
- (1) Incorporated by reference to the Registrant's Registration Statement on Form SB-2 filed with the Commission on April 14, 1997.
  - (2) Incorporated by reference to the Registrant's Form 10-Q filed with the Commission on May 12, 2005.
  - (3) Incorporated by reference to the Registrant's Form 8-K filed with the Commission on December 21, 2004.
  - (4) Incorporated by reference to the Registrant's Form 10-Q for the quarter ended June 30, 1999.
  - (5) Incorporated by reference to the Registrant's Form 10-KSB for the fiscal year ended December 31, 1996.
  - (6) Incorporated by reference to Exhibit 10 to the Registrant's Form 10-Q for the quarter ended March 31, 1999.
  - (7) Incorporated by reference to Exhibit 10 to the Registrant's Form 10-QSB for the quarter ended June 30, 1998.
  - (8) Incorporated by reference to Exhibit 10.10 to the Registrant's Form 10-Q for the quarter ended March 31, 2003.
  - (9) Incorporated by reference to Exhibit 10.11 to the Registrant's Form 10-Q for the quarter ended June 30, 2004.



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- (10) Incorporated by reference to Exhibit 10.7 to the Registrant's Form 10-Q for the quarter ended September 30, 2004.
- (11) Incorporated by reference to Exhibit 10.8 to the Registrant's Form 10-Q for the quarter ended September 30, 2004.
- (12) Incorporated by reference to the Registrant's Form 8-K filed with the Commission on January 13, 2005.
- (13) Incorporated by reference to the Registrant's Form 8-K filed with the Commission on January 14, 2005.
- (14) Incorporated by reference to Appendix C to the Registrant's Proxy Statement filed on April 9, 2004.
- (15) Incorporated by reference to the Registrant's Form 8-K filed with the Commission on December 22, 2006.
- (16) Incorporated by reference to the Registrant's Form 10-K for the fiscal year ended December 31, 2003.
- (17) Incorporated by reference to Part I, Item 1 - "General."

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### INDEX TO FINANCIAL STATEMENTS

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| Consolidated Balance Sheets as of December 31, 2006 and<br>December 31, 2005                                       | F-4  |
| Consolidated Statements of Income for the years ended<br>December 31, 2006, 2005 and 2004                          | F-5  |
| Consolidated Statements of Changes in Stockholders' Equity for<br>the years ended December 31, 2006, 2005 and 2004 | F-6  |
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### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of  
Slade's Ferry Bancorp.

We have audited the accompanying consolidated balance sheets of Slade's Ferry Bancorp. and subsidiary (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we

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plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Slade's Ferry Bancorp. and subsidiary as of December 31, 2006 and 2005, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ Wolf & Company, P.C.

Boston, Massachusetts  
March 23, 2007

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### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of  
Slade's Ferry Bancorp.

We have audited the accompanying consolidated statements of income, changes in stockholders' equity and cash flows of Slade's Ferry Bancorp. and subsidiary for the year ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated results of operations and cash flows of Slade's Ferry Bancorp. and subsidiary for the year ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

/s/ Shatswell, MacLeod & Company, P.C.

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West Peabody, Massachusetts  
January 13, 2005

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Slade's Ferry Bancorp. and Subsidiary  
Consolidated Balance Sheets

|  | December 31,   |           |
|--|----------------|-----------|
|  | 2006           | 2005      |
|  | (In thousands) |           |
| <b>Assets</b>  |                |           |
| -----  |                |           |
| Cash and due from banks  | \$ 19,448      | \$ 17,233 |
| Interest-bearing deposits with other banks   | 1,007          | 58        |
| Federal funds sold   | 1,900          | 2,200     |
|  | -----          | -----     |
| Cash and cash equivalents  | 22,355         | 20,011    |
| Interest-bearing certificates of deposit with other banks  | 100            | 10        |
| Securities available for sale  | 105,603        | 94,299    |
| Securities held to maturity (fair value approximates \$24,219 at December 31, 2006 and \$28,858 at December 31, 2005)                                | 24,623         | 29,300    |
| Federal Home Loan Bank stock, at cost  | 6,856          | 6,300     |
| Loans, net of allowance for loan losses of \$4,385 at December 31, 2006 and \$4,333 at December 31, 2005   | 422,370        | 409,611   |
| Premises and equipment, net  | 5,587          | 5,911     |
| Goodwill   | 2,173          | 2,177     |
| Accrued interest receivable  | 2,311          | 2,299     |
| Bank-owned life insurance  | 12,317         | 11,888    |
| Deferred tax asset, net  | 2,039          | 2,088     |
| Other assets   | 1,426          | 1,911     |
|  | -----          | -----     |
|  | \$607,760      | \$585,911 |
|  | =====          | =====     |
| <b>Liabilities and Stockholders' Equity</b>  |                |           |
| -----  |                |           |
| <b>Deposits:</b>   |                |           |
| Noninterest-bearing  | \$ 79,101      | \$ 80,700 |
| Interest-bearing   | 344,905        | 335,141   |
|  | -----          | -----     |
| Total deposits   | 424,006        | 415,841   |
| Short-term borrowings  | -              | 7,000     |
| Long-term borrowings   | 119,058        | 100,866   |
| Subordinated debentures  | 10,310         | 10,310    |
| Accrued expenses and other liabilities   | 3,141          | 3,030     |
|  | -----          | -----     |
| Total liabilities  | 556,515        | 537,057   |
| Commitments and contingencies (Notes 5, 11 and 12)   |                |           |
| <b>Stockholders' equity:</b>   |                |           |
| Common stock, par value \$0.01 per share; authorized 10,000,000 shares; issued and outstanding 4,102,242 shares in 2006 and 4,132,200 shares in 2005 | 41             | 41        |
| Additional paid-in capital   | 31,444         | 31,011    |

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|                                      |           |          |
|--------------------------------------|-----------|----------|
| Retained earnings                    | 21,111    | 18,99    |
| Accumulated other comprehensive loss | (464)     | (1,19)   |
| Unearned compensation                | (887)     |          |
|                                      | -----     | -----    |
| Total stockholders' equity           | 51,245    | 48,85    |
|                                      | -----     | -----    |
|                                      | \$607,760 | \$585,91 |
|                                      | =====     | =====    |

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

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Slade's Ferry Bancorp. and Subsidiary  
Consolidated Statements of Income

|  | Years Ended December 31,         |          |
|--|----------------------------------|----------|
|  | 2006                             | 2005     |
|  | -----                            | -----    |
|  | (In thousands, except per share) |          |
| Interest and dividend income:  |                                  |          |
| Interest and fees on loans   | \$27,263                         | \$23,184 |
| Interest and dividends on securities:                                |                                  |          |
| Taxable  | 5,653                            | 5,125    |
| Tax-exempt   | 251                              | 338      |
| Interest on federal funds sold                                       | 196                              | 247      |
| Other interest   | 38                               | 25       |
|  | -----                            | -----    |
| Total interest and dividend income                                   | 33,401                           | 28,919   |
|  | -----                            | -----    |
| Interest expense:  |                                  |          |
| Interest on deposits   | 9,524                            | 6,084    |
| Interest on Federal Home Loan Bank advances                          | 4,986                            | 4,274    |
| Interest on subordinated debentures                                  | 828                              | 637      |
|  | -----                            | -----    |
| Total interest expense   | 15,338                           | 10,995   |
|  | -----                            | -----    |
| Net interest and dividend income                                     | 18,063                           | 17,924   |
| Provision for loan losses  | 39                               | 167      |
|  | -----                            | -----    |
| Net interest income, after provision for loan losses                 | 18,024                           | 17,757   |
|  | -----                            | -----    |
| Noninterest income:  |                                  |          |
| Service charges on deposit accounts                                  | 1,394                            | 914      |
| Gain (loss) on sales and calls of available-for-sale securities, net | (116)                            | 29       |
| Gain on sales of loans, net  | -                                | 49       |
| Increase in cash surrender value of life insurance policies          | 433                              | 468      |
| Other income   | 1,036                            | 860      |
|  | -----                            | -----    |
| Total noninterest income   | 2,747                            | 2,320    |
|  | -----                            | -----    |
| Noninterest expense:   |                                  |          |
| Salaries and employee benefits                                       | 8,087                            | 8,063    |
| Occupancy and equipment expense                                      | 1,950                            | 1,680    |
| Professional fees  | 1,414                            | 1,360    |

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|                            |          |          |
|----------------------------|----------|----------|
| Marketing expense          | 364      | 549      |
| Data processing            | 847      | 303      |
| Other expense              | 2,241    | 1,941    |
|                            | -----    | -----    |
| Total noninterest expense  | 14,903   | 13,896   |
|                            | -----    | -----    |
| Income before income taxes | 5,868    | 6,181    |
| Provision for income taxes | 2,249    | 2,161    |
|                            | -----    | -----    |
| Net income                 | \$ 3,619 | \$ 4,020 |
|                            | =====    | =====    |
| Earnings per share:        |          |          |
| Basic                      | \$ 0.87  | \$ 0.98  |
|                            | =====    | =====    |
| Diluted                    | \$ 0.87  | \$ 0.97  |
|                            | =====    | =====    |

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

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SLADE'S FERRY BANCORP. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
Years Ended December 31, 2006, 2005 and 2004

|  | Shares of<br>Common<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumula<br>Compre<br>Income |
|--|------------------------------|-----------------|----------------------------------|----------------------|------------------------------|
|  | -----                        | -----           | -----                            | -----                | -----                        |
|  | (In thousands, except per s  |                 |                                  |                      |                              |
| Balance, December 31, 2003             | 3,995,857                    | \$40            | \$28,609                         | \$14,300             | \$ (                         |
| Comprehensive income:                  |                              |                 |                                  |                      |                              |
| Net income                             |                              | -               | -                                | 3,617                |                              |
| Other comprehensive income             |                              | -               | -                                | -                    |                              |
| Total comprehensive income             |                              |                 |                                  |                      |                              |
| Issuance of common stock               | 33,588                       | -               | 710                              | -                    |                              |
| Stock options exercised                | 42,390                       | 1               | 532                              | -                    |                              |
| Tax benefit of stock options exercised |                              | -               | 157                              | -                    |                              |
| Common stock retired                   | (3,412)                      | -               | (32)                             | -                    |                              |
| Dividends declared (\$.36 per share)   |                              | -               | -                                | (1,458)              |                              |
|  | -----                        | -----           | -----                            | -----                | -----                        |
| Balance at December 31, 2004           | 4,068,423                    | 41              | 29,976                           | 16,459               |                              |
| Comprehensive income:                  |                              |                 |                                  |                      |                              |
| Net income                             |                              | -               | -                                | 4,020                |                              |
| Other comprehensive loss               |                              | -               | -                                | -                    | (1,                          |
| Total comprehensive income             |                              |                 |                                  |                      |                              |
| Issuance of common stock               | 33,777                       | -               | 627                              | -                    |                              |
| Stock options exercised                | 30,000                       | -               | 316                              | -                    |                              |
| Tax benefit of stock options exercised |                              | -               | 95                               | -                    |                              |
| Dividends declared (\$.36 per share)   |                              | -               | -                                | (1,481)              |                              |
|  | -----                        | -----           | -----                            | -----                | -----                        |
| Balance at December 31, 2005           | 4,132,200                    | 41              | 31,014                           | 18,998               | (1,                          |

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|   |           |      |          |          |      |
|---|-----------|------|----------|----------|------|
| Comprehensive income:   |           |      |          |          |      |
| Net income  | -         | -    | 3,619    |          |      |
| Other comprehensive income  | -         | -    | -        |          |      |
| Total comprehensive income  |           |      |          |          |      |
| Issuance of common stock  | 32,762    | -    | 586      | -        |      |
| Stock options exercised   | 28,000    | -    | 305      | -        |      |
| Tax benefit of stock options exercised                                  | -         | -    | 82       | -        |      |
| Stock-based compensation  | -         | -    | 235      | -        |      |
| Purchase of treasury stock  | (42,443)  | -    | (778)    | -        |      |
| Unearned compensation   | (48,277)  | -    | -        | -        |      |
| Dividends declared (\$.36 per share)                                    | -         | -    | -        | (1,506)  |      |
| Adjustment to initially apply FASB Statement No. 158, net of tax effect | -         | -    | -        | -        |      |
| Balance at December 31, 2006  | 4,102,242 | \$41 | \$31,444 | \$21,111 | \$ ( |

The accompanying notes are an integral part of these consolidated financial

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Slade's Ferry Bancorp. and Subsidiary  
Consolidated Statements of Cash Flows

|   | Years Ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2006                     | 2005     | 2004     |
|   | -----                    | -----    | -----    |
|   | (In thousands)           |          |          |
| Cash flows from operating activities:   |                          |          |          |
| Net income  | \$ 3,619                 | \$ 4,020 | \$ 3,617 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |          |          |
| Amortization, net of accretion of securities                                      | 129                      | 294      | 247      |
| (Gain) loss on sales and calls of available-for-sale securities, net              | 116                      | (29)     | 5        |
| Amortization of net deferred loan fees  | (151)                    | (83)     | (4)      |
| Provision for loan losses   | 39                       | 167      | 376      |
| Deferred tax provision (benefit)  | (373)                    | (195)    | 686      |
| Depreciation and amortization   | 894                      | 813      | 659      |
| Gain on sale of loans, net  | -                        | (49)     | (196)    |
| Increase in cash surrender value of life insurance                                | (433)                    | (468)    | (432)    |
| Stock-based compensation  | 235                      | -        | -        |
| Excess tax benefits from stock-based compensation                                 | 82                       | 95       | 157      |
| Net change in:  |                          |          |          |
| Other assets  | 114                      | 477      | (1,301)  |
| Accrued interest receivable   | (13)                     | (329)    | (472)    |
| Other liabilities   | 103                      | 933      | (105)    |
| Net cash provided by operating activities   | 4,361                    | 5,646    | 3,237    |
| Cash flows from investing activities:   |                          |          |          |
| Decrease in interest-bearing time deposits with other banks                       | -                        | -        | 100      |

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|  |          |          |          |
|--|----------|----------|----------|
| Activity in available-for-sale securities:   |          |          |          |
| Purchases                                    | (36,655) | (28,027) | (57,976) |
| Sales  | 17,021   | 2,590    | 1,646    |
| Maturities, calls and pay-downs              | 9,690    | 12,837   | 19,536   |
| Activity in held-to-maturity securities:     |          |          |          |
| Purchases                                    | -        | -        | (30,109) |
| Maturities, calls and pay-downs              | 4,611    | 8,253    | 3,586    |
| Purchases of Federal Home Loan Bank stock    | (552)    | (1,654)  | (1,626)  |
| Investment in unconsolidated subsidiary      | -        | -        | (310)    |
| Loan originations, net of principal payments | (12,677) | (47,494) | (39,528) |
| Recoveries of loans previously charged off   | 29       | 65       | 96       |
| Capital expenditures                         | (589)    | (1,221)  | (886)    |
| Proceeds from sale of property and equipment | -        | 13       | -        |
| Proceeds from sale of investment real estate | -        | 653      | -        |
| Proceeds from sales of loans                 | 25       | 49       | 8,487    |
| Investment in life insurance policies        | -        | -        | (135)    |
| Redemption of life insurance policy          | -        | 132      | -        |
| Investment in limited partnership            | -        | -        | (119)    |
|  | -----    | -----    | -----    |
| Net cash used in investing activities        | (19,097) | (53,804) | (97,238) |
|  | -----    | -----    | -----    |

(continued)

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

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SLADE'S FERRY BANCORP. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Concluded)

|   | Years Ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2006                     | 2005      | 2004      |
|   | -----                    | -----     | -----     |
|   | (In thousands)           |           |           |
| Cash flows from financing activities:                   |                          |           |           |
| Net (decrease) increase in noninterest-bearing deposits | (1,604)                  | 473       | 6,979     |
| Net increase in interest-bearing deposits               | 9,764                    | 15,468    | 59,780    |
| Short-term advances from Federal Home Loan Bank         | -                        | 15,500    | -         |
| Long-term advances from Federal Home Loan Bank          | 43,000                   | 29,500    | 35,476    |
| Payments on Federal Home Loan Bank short-term advances  | (7,000)                  | (8,500)   | (4,300)   |
| Payments on Federal Home Loan Bank long-term advances   | 24,807                   | (18,921)  | (1,364)   |
| Proceeds from issuance of common stock                  | 586                      | 627       | 710       |
| Stock options exercised                                 | 305                      | 316       | 533       |
| Retirement of shares of common stock                    | -                        | -         | (32)      |
| Proceeds from issuance of subordinated debentures       | -                        | -         | 10,160    |
| Purchase of treasury stock                              | (778)                    | -         | -         |
| Unearned compensation                                   | (887)                    | -         | -         |
| Dividends paid on common stock                          | (1,506)                  | (1,481)   | (1,453)   |
|   | -----                    | -----     | -----     |
| Net cash provided by financing activities               | 17,073                   | 32,982    | 106,489   |
|   | -----                    | -----     | -----     |
| Net increase (decrease) in cash and cash equivalents    | 2,337                    | (15,176)  | 12,488    |
| Cash and cash equivalents at beginning of year          | 20,018                   | 35,194    | 22,706    |
|   | -----                    | -----     | -----     |
| Cash and cash equivalents at end of year                | \$ 22,355                | \$ 20,018 | \$ 35,194 |

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|                           | =====     | =====     | =====    |
|---------------------------|-----------|-----------|----------|
| Supplemental disclosures: |           |           |          |
| Interest paid             | \$ 15,355 | \$ 10,576 | \$ 7,804 |
| Income taxes paid, net    | \$ 2,406  | \$ 1,749  | \$ 1,106 |

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

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## SLADE'S FERRY BANCORP. AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### Principles of Consolidation

The consolidated financial statements include the accounts of Slade's Ferry Bancorp. (the "Company"), its wholly-owned subsidiary, Slade's Ferry Trust Company (the "Bank") and the Bank's wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. The Company accounts for its other wholly-owned subsidiary, Slade's Ferry Statutory Trust I, using the equity method. (See Note 9.)

##### Nature of Operations

The Company is a Massachusetts company that was organized in 1990 to become the holding company of the Bank. The Bank is a state-chartered bank, which was incorporated in 1959 and is headquartered in Somerset, Massachusetts. The Bank operates its business from nine banking offices located in southeastern Massachusetts. The Bank is engaged principally in the business of attracting deposits from the general public and investing those deposits in commercial and residential real estate, commercial, consumer and small business loans.

##### Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and other-than-temporary impairment losses.

##### Significant Group Concentrations of Credit Risk

Most of the Company's activities are with customers located within southeastern Massachusetts and Rhode Island. Note 3 discusses the types of securities that the Company invests in and Note 4 discusses the types of lending that the Company engages in. The Company does not have any significant concentrations to any one industry or customer.

##### Cash and Cash Equivalents



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For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, interest-bearing deposits with other banks and federal funds sold, all of which mature within ninety days.

Interest-bearing Certificates of Deposit with other Banks

Interest-bearing certificates of deposit with other banks mature within one year and are carried at cost.

Reclassification

Certain amounts in the 2005 and 2004 consolidated financial statements have been reclassified to conform to the 2006 presentation.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

##### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

###### Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income, net of income tax effects.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary-impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

###### Loans

The Company grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout southeastern Massachusetts and Rhode Island. The ability of the Company's debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the

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interest method.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Other personal loans are typically charged off no later than when they are 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual status or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

##### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

###### Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that generally have been identified as impaired. For such loans an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers all other loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the

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probability of collecting scheduled principal and interest payments. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan's effective rate, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. The Company does not separately identify consumer loans for impairment disclosures. Prior to 2005, the Company did not separately identify residential loans for impairment disclosures.

### Bank-owned Life Insurance

Bank-owned life insurance policies are reflected on the consolidated balance sheet at cash surrender value. Changes in cash surrender value are reflected in non-interest income on the consolidated statement of income.

### Premises and Equipment

Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation and amortization computed on the straight-line method over the estimated useful lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured.

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## SLADE'S FERRY BANCORP. AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Goodwill

Goodwill is evaluated for impairment on an annual basis using the consolidated Company as the reporting unit for measurement purposes. No impairment has been recognized to date.

##### Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

##### Advertising Costs

Advertising costs are expensed as incurred.

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### Retirement Plan

The compensation cost of an employee's pension benefit is recognized on the projected unit credit method over the employee's approximate service period. The unit credit cost method is utilized for funding purposes.

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" ("SFAS 158"), which requires employers to (a) recognize in its statement of financial position the funded status of a benefit plan, (b) measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year, (c) recognize, through other comprehensive income, net of tax, changes in the funded status of the benefit plan that are not recognized as net periodic benefit cost, and (d) disclose additional information about certain effects on net periodic benefit cost for the next fiscal year that relate to the delayed recognition of certain benefit cost elements. The requirement to recognize the funded status of a benefit plan and provide additional disclosures is effective as of December 31, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end is effective for the year ending December 31, 2008.

The following table illustrates the incremental effect of applying SFAS 158 on individual line items in the consolidated balance sheet as of December 31, 2006.

|                                      | Before<br>Application<br>of SFAS 158<br>----- | Adjustments<br>-----<br>(In thousands) | After<br>Application<br>of SFAS 158<br>----- |
|--------------------------------------|---|--|--|
| Prepaid pension benefit              | \$ 607  | \$(377)                                | \$ 230                                       |
| Net deferred tax asset               | 1,885   | 154                                    | 2,039  |
| Total assets                         | 607,983                                       | (223)                                  | 607,760                                      |
| Accumulated other comprehensive loss | (241)   | (223)                                  | (464)  |
| Total stockholders' equity           | 51,468  | (223)                                  | 51,245                                       |

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Stock Compensation Plans

In December 2004, the FASB issued Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)" or the "Statement") which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost is measured based on the fair value of the equity or liability instruments issued. SFAS 123(R) covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. SFAS 123(R) is a replacement of SFAS No. 123, "Accounting for Stock-Based Compensation",

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and supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", and its related interpretive guidance. The Statement requires the Company to measure the cost of employee services received in exchange for stock options based on the grant-date fair value of the award, and to recognize the cost over the period the employee is required to provide services for the award. SFAS 123(R) permits the use of any option-pricing model that meets the fair value objective in the Statement.

The Company adopted SFAS 123(R) effective January 1, 2006, using the "modified prospective" method. Under this transition method, compensation costs include costs recognized for the non-vested portion of awards that were granted prior to January 1, 2006, based on the grant-date fair value of those awards under the original provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). Effective January 1, 2006 the Company is recognizing the cost of option grants on a straight line basis over the vesting period.

As a result of implementing the provisions of SFAS 123R, the Company recognized stock-based compensation expense of \$235,000 (\$184,000 net of tax effects) for the year ended December 31, 2006. The recognition of stock-based compensation expense resulted in a \$0.04 decrease in basic and diluted earnings per share for the year ended December 31, 2006.

Prior to January 1, 2006, stock compensation cost was measured using the intrinsic value-based method of accounting in accordance with APB Opinion No. 25, which, for the Company, resulted in no compensation expense to be recognized.

The following table illustrates the effect on the Company's reported net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation prior to the adoption of SFAS 123R:

|   | Years Ended December 31,              |         |
|---|---------------------------------------|---------|
|   | 2005                                  | 2004    |
|   | ----                                  | ----    |
|   | (In thousands, except per share data) |         |
| Net income, as reported                                 | \$4,020                               | \$3,617 |
| Additional expense had the Company adopted SFAS No. 123 | (168)                                 | (233)   |
| Related tax benefit                                     | 69                                    | 80      |
|   | -----                                 | -----   |
| Pro forma net income                                    | \$3,921                               | \$3,464 |
|   | =====                                 | =====   |
| Earnings per share (basic):                             |                                       |         |
| As reported   | \$ 0.98                               | \$ 0.89 |
| Pro forma   | \$ 0.95                               | \$ 0.86 |
| Earnings per share (diluted):                           |                                       |         |
| As reported   | \$ 0.97                               | \$ 0.88 |
| Pro forma   | \$ 0.94                               | \$ 0.85 |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Unearned Compensation

In May 2006, the Company's Board of Directors authorized the purchase of 50,000 shares of common stock to be held in trust for future restricted stock awards under the 2004 Equity Incentive Plan. At December 31, 2006, \$887,000 is reflected on the consolidated balance sheet as unearned compensation which reduces stockholder's equity. This amount represents the cost of 48,277 shares that have been acquired by the trust. No shares have been awarded to date. Accordingly, no shares held by the trust are deemed outstanding for earnings per share calculations. In January 2007, the Board of Directors authorized the purchase of an additional 25,000 shares to be held in the trust for future restricted stock awards.

#### Income Taxes

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax basis of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

#### Earnings Per Common Share

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

Earnings per common share have been computed based on the following:

|   | Years Ended December 31, |         |         |
|---|--------------------------|---------|---------|
|   | 2006                     | 2005    | 2004    |
|   | (Dollars in thousands)   |         |         |
| Net income  | \$3,619                  | \$4,020 | \$3,617 |
|   | =====                    | =====   | =====   |
| Average number of common shares outstanding   | 4,146                    | 4,111   | 4,046   |
| Effect of dilutive options  | 15                       | 27      | 49      |
|   | -----                    | -----   | -----   |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 4,161                    | 4,138   | 4,095   |
|   | =====                    | =====   | =====   |
| Earnings per share:   |                          |         |         |
| Basic   | \$ 0.87                  | \$ 0.98 | \$ 0.89 |
|   | =====                    | =====   | =====   |

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|         |         |         |         |
|---------|---------|---------|---------|
| Diluted | \$ 0.87 | \$ 0.97 | \$ 0.88 |
|         | =====   | =====   | =====   |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities and certain pension liability adjustments, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

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

|   | Years Ended December 31, |            |        |
|---|--------------------------|------------|--------|
|   | 2006                     | 2005       | 2004   |
|   | ----                     | ----       | ----   |
|   | (In thousands)           |            |        |
| Unrealized gains (losses) on securities available for sale        | \$1,418                  | \$ (2,104) | \$ 122 |
| Reclassification adjustment for losses (gains) realized in income | 116                      | (29)       | 5      |
|   | -----                    | -----      | -----  |
| Net unrealized gains (losses)                                     | 1,534                    | (2,133)    | 127    |
| Tax effect  | (577)                    | 810        | 7      |
|   | -----                    | -----      | -----  |
| Net-of-tax amount   | 957                      | (1,323)    | 134    |
|   | -----                    | -----      | -----  |
| Minimum pension liability adjustment                              | -                        | -          | 682    |
| Tax effect  | -                        | -          | (279)  |
|   | -----                    | -----      | -----  |
| Net-of-tax amount   | -                        | -          | 403    |
|   | -----                    | -----      | -----  |
| Adjustment to initially apply SFAS No. 158                        | (377)                    | -          | -      |
| Tax effect  | 154                      | -          | -      |
|   | -----                    | -----      | -----  |
| Net-of-tax amount   | (223)                    | -          | -      |
|   | -----                    | -----      | -----  |
|   | \$ 734                   | \$ (1,323) | \$ 537 |
|   | =====                    | =====      | =====  |

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The components of accumulated other comprehensive income (loss), included in stockholders' equity, are as follows:

|  | December 31,   |           |
|--|----------------|-----------|
|  | 2006           | 2005      |
|  | -----          | -----     |
|  | (In thousands) |           |
| Net unrealized losses on securities available for sale             | \$(380)        | \$(1,914) |
| Tax effect   | 139            | 716       |
|  | -----          | -----     |
| Net-of-tax amount  | (241)          | (1,198)   |
|  | -----          | -----     |
| Unrecognized net actuarial loss pertaining to defined benefit plan | (377)          | -         |
| Tax effect   | 154            | -         |
|  | -----          | -----     |
| Net-of-tax amount  | (223)          | -         |
|  | -----          | -----     |
|  | \$(464)        | \$(1,198) |
|  | =====          | =====     |

Of the total actuarial loss included in accumulated other comprehensive income at December 31, 2006, \$19,000 is expected to be recognized as a component of net periodic pension cost for the year ending December 31, 2007.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Concluded)

##### Recent Accounting Pronouncements

In July 2006, the FASB issued Financial Accounting Standards Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48) which clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes". FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 is effective for fiscal years beginning after December 15, 2006. Management is currently evaluating the impact on the Company's consolidated financial statements.

In September 2006, the FASB issued Statement No. 157, "Fair Value Measurements" which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting



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principles, and expands disclosures about fair value measurements. This Statement is effective for the Company on January 1, 2008 and is not expected to have a material impact on the Company's consolidated financial statements.

On February 15, 2007, the FASB issued Statement No. 159, "The Fair Value Option for Financial Assets and Liabilities", which provides companies with an option to report selected financial assets and liabilities at fair value. Statement No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. This Statement is effective for the company's 2008 calendar year with early adoption in 2007 permitted, and is not expected to have a material impact on the Company's consolidated financial statements.

In September 2006, the FASB ratified EITF 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," which addresses accounting for split-dollar life insurance arrangements whereby the employer purchases a policy to insure the life of an employee or a director, and separately enters into an agreement to split the policy benefits between the employer and the employee/director. This EITF states that an obligation arises as a result of a substantive agreement with an employee or director to provide future postretirement benefits. Under EITF 06-4, the obligation is not settled upon entering into an insurance arrangement. Since the obligation is not settled, a liability should be recognized in accordance with applicable authoritative guidance. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. The Company is in the process of evaluating the potential impacts of adopting EITF 06-4 on its consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 108, which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a potential current year misstatement. Prior to SAB 108, companies might evaluate the materiality of financial-statement misstatements using either the income statement or balance sheet approach, with the income statement approach focusing on new misstatements added in the current year, and the balance sheet approach focusing on the cumulative amount of misstatement present in a company's balance sheet. Misstatements that would be material under one approach could be viewed as immaterial under another approach, and not be corrected. SAB 108 now requires that companies view financial statement misstatements as material if they are material according to either the income statement or balance sheet approach. SAB 108 is applicable to all financial statements issued by the Company for the year ended December 31, 2006.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### 2. RESTRICTIONS ON CASH AND AMOUNTS DUE FROM BANKS

The Bank is required to maintain average balances on hand or with the Federal Reserve Bank. At December 31, 2006 and 2005, these reserve balances amounted to \$3,799,000 and \$3,920,000, respectively.

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3. SECURITIES

The amortized cost and fair value of securities, with gross unrealized gains and losses, follows:

|                                      | December 31, 2006 |                              |                               |
|--------------------------------------|-------------------|------------------------------|-------------------------------|
|                                      | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |
|                                      | (In thousands)    |                              |                               |
| <u>Securities Available for Sale</u> |                   |                              |                               |
| Debt securities:                     |                   |                              |                               |
| Government-sponsored enterprises     | \$ 34,462         | \$ -                         | \$ 505                        |
| Corporate                            | 9,221             | -                            | 141                           |
| Mortgage-backed                      | 57,946            | 514                          | 480                           |
|                                      | -----             | -----                        | -----                         |
| Total debt securities                | 101,629           | 514                          | 1,126                         |
|                                      |                   |                              |                               |
| Marketable equity securities         | 3,139             | 302                          | 52                            |
| Mutual funds                         | 1,215             | -                            | 18                            |
|                                      | -----             | -----                        | -----                         |
| Total securities available for sale  | \$105,983         | \$816                        | \$1,196                       |
|                                      | =====             | =====                        | =====                         |
| <u>Securities Held to Maturity</u>   |                   |                              |                               |
|                                      |                   |                              |                               |
| State and municipal obligations      | \$ 5,001          | \$ 79                        | \$ 11                         |
| Mortgage-backed securities           | 19,622            | -                            | 472                           |
|                                      | -----             | -----                        | -----                         |
|                                      | \$ 24,623         | \$ 79                        | \$ 483                        |
|                                      | =====             | =====                        | =====                         |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SECURITIES (Continued)

|  | December 31, 2005 |                              |                               |
|--|-------------------|------------------------------|-------------------------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |
|  | (In thousands)    |                              |                               |
|  |                   |                              |                               |

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Securities Available for Sale

Debt securities:

|                                     |          |       |         |
|-------------------------------------|----------|-------|---------|
| Government-sponsored enterprises    | \$50,443 | \$ -  | \$ 862  |
| Corporate                           | 9,564    | 5     | 555     |
| Mortgage-backed                     | 31,574   | 75    | 417     |
|                                     | -----    | ----  | -----   |
| Total debt securities               | 91,581   | 80    | 1,834   |
| Marketable equity securities        | 3,426    | 116   | 271     |
| Mutual funds                        | 1,205    | -     | 5       |
|                                     | -----    | ----  | -----   |
| Total securities available for sale | \$96,212 | \$196 | \$2,110 |
|                                     | =====    | ===== | =====   |

Securities Held to Maturity

|                                 |          |       |        |
|---------------------------------|----------|-------|--------|
| State and municipal obligations | \$ 6,766 | \$138 | \$ 12  |
| Mortgage-backed securities      | 22,540   | -     | 574    |
|                                 | -----    | ----  | -----  |
|                                 | \$29,306 | \$138 | \$ 586 |
|                                 | =====    | ===== | =====  |

At December 31, 2006 and 2005, obligations of government-sponsored enterprises with a carrying value of \$3,860,000, were pledged to secure public deposits and for other purposes required or permitted by law. Also, obligations of government-sponsored enterprises and mortgage-backed securities, with a carrying value of \$44,835,000 and \$54,464,000 were pledged to secure Federal Home Loan Bank advances at December 31, 2006 and 2005, respectively.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SECURITIES (Continued)

The amortized cost and fair value of debt securities by contractual maturity at December 31, 2006 follows:

|                                | Available for Sale |            | Held to Maturity |            |
|--------------------------------|--------------------|------------|------------------|------------|
|                                | Amortized Cost     | Fair Value | Amortized Cost   | Fair Value |
|                                | -----              | -----      | -----            | -----      |
|                                | (In thousands)     |            |                  |            |
| Within 1 year                  | \$ 12,000          | \$ 11,890  | \$ 1,611         | \$ 1,612   |
| After 1 year through 5 years   | 31,683             | 31,147     | 1,446            | 1,462      |
| After 5 years through 10 years | -                  | -          | 1,223            | 1,241      |
| Over 10 years                  | -                  | -          | 721              | 754        |

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|                            |           |           |          |          |
|----------------------------|-----------|-----------|----------|----------|
|                            | -----     | -----     | -----    | -----    |
|                            | 43,683    | 43,037    | 5,001    | 5,069    |
| Mortgage-backed securities | 57,946    | 57,980    | 19,622   | 19,150   |
|                            | -----     | -----     | -----    | -----    |
|                            | \$101,629 | \$101,017 | \$24,623 | \$24,219 |
|                            | =====     | =====     | =====    | =====    |

For the years ended December 31, 2006, 2005 and 2004, proceeds from sales of securities available for sale amounted to \$17,021,000, \$2,590,000, and \$1,646,000, respectively. Gross realized gains amounted to \$269,000, \$244,000 and \$176,000, respectively. Gross realized losses amounted to \$385,000, \$215,000 and \$65,000, respectively. The tax provision (benefit) applicable to these net realized gains and losses amounted to \$(46,000), \$10,000 and \$39,000, respectively.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SECURITIES (Continued)

Information pertaining to securities with gross unrealized losses at December 31, 2006 and 2005, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

|                                  | Less Than Twelve Months       |                | Over Twelve Months            |               |
|----------------------------------|-------------------------------|----------------|-------------------------------|---------------|
|                                  | -----                         | -----          | -----                         | -----         |
|                                  | Gross<br>Unrealized<br>Losses | Fair<br>Value  | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|                                  | -----                         | -----          | -----                         | -----         |
| December 31, 2006:               |                               | (In thousands) |                               |               |
| Securities Available for Sale    |                               |                |                               |               |
| -----                            |                               |                |                               |               |
| Debt securities:                 |                               |                |                               |               |
| Government-sponsored enterprises | \$ 19                         | \$ 2,481       | \$ 486                        | \$31,476      |
| Corporate debt securities        | 13                            | 2,025          | 128                           | 7,053         |
| Mortgage-backed securities       | 8                             | 1,675          | 472                           | 19,580        |
|                                  | ----                          | -----          | -----                         | -----         |
|                                  | 40                            | 6,181          | 1,086                         | 58,109        |
| Marketable equity securities     | 49                            | 657            | 3                             | 335           |
| Mutual funds                     | 18                            | 1,197          | -                             | -             |
|                                  | ----                          | -----          | -----                         | -----         |
|                                  | \$107                         | \$ 8,035       | \$1,089                       | \$58,444      |
|                                  | =====                         | =====          | =====                         | =====         |
| Securities Held to Maturity      |                               |                |                               |               |
| -----                            |                               |                |                               |               |
| State and municipal obligations  | \$ -                          | \$ -           | \$ 11                         | \$ 783        |
| Mortgage--backed securities      | -                             | -              | 472                           | 19,150        |
|                                  | ----                          | -----          | -----                         | -----         |
|                                  | \$ -                          | \$ -           | \$ 483                        | \$19,933      |

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|                                  | ===== | =====    | =====   | =====    |
|----------------------------------|-------|----------|---------|----------|
| December 31, 2005:               |       |          |         |          |
| Securities available for sale    |       |          |         |          |
| -----                            |       |          |         |          |
| Debt securities:                 |       |          |         |          |
| Government-sponsored enterprises | \$284 | \$24,170 | \$ 578  | \$25,411 |
| Corporate debt securities        | 319   | 5,868    | 236     | 1,812    |
| Mortgage-backed securities       | 313   | 20,913   | 104     | 4,063    |
|                                  | ----  | -----    | -----   | -----    |
|                                  | 916   | 50,951   | 918     | 31,286   |
| Marketable equity securities     | 61    | 650      | 210     | 1,134    |
| Mutual funds                     | 5     | 1,200    | -       | -        |
|                                  | ----  | -----    | -----   | -----    |
|                                  | \$982 | \$52,801 | \$1,128 | \$32,420 |
|                                  | ===== | =====    | =====   | =====    |
| Securities Held to Maturity      |       |          |         |          |
| -----                            |       |          |         |          |
| State and municipal obligations  | \$ 12 | \$ 783   | \$ -    | \$ -     |
| Mortgage-backed securities       | 472   | 16,542   | 102     | 5,424    |
|                                  | ----  | -----    | -----   | -----    |
|                                  | \$484 | \$17,325 | \$ 102  | \$ 5,424 |
|                                  | ===== | =====    | =====   | =====    |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SECURITIES (Concluded)

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation.

At December 31, 2006, debt securities available for sale with unrealized losses for a period greater than twelve months had aggregate depreciation of 1.8% from the Company's cost basis. No single security has depreciated more than 4.0% from the Company's cost basis. Unrealized losses on corporate bonds include \$108,000 relating to the finance corporations of three automotive companies with an amortized cost of \$5.1 million that have been affected by the weaker operating results in the automotive industry. These bonds have maturity dates ranging from October 1, 2008 to September 1, 2009. The Company has reviewed the financial condition of these issuers and has determined that none of the declines are other than temporary.

At December 31, 2006, debt securities available for sale with unrealized losses for a period of less than twelve months had aggregate depreciation of less than 1% of the Company's cost basis, with unrealized depreciation for any single debt security not exceeding 1.0% of the Company's cost basis. The Company has determined that these temporary losses relate primarily to the increase in market interest rates over the past few years and the effect on market price for debt securities. The Company has the intent and ability to hold all of its debt securities until maturity, or for the foreseeable future if available for sale, and no declines are deemed to be other than temporary.

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At December 31, 2006, debt securities held to maturity with unrealized losses for a period greater than twelve months had aggregate depreciation of less than 2.4% of the company's cost basis, with unrealized depreciation for any single debt security not exceeding 4% of the Company's cost basis. Similar to the available-for-sale portfolio, the Company has determined that these temporary losses relate primarily to the increase in market interest rates and the corresponding effect on the market price for debt securities.

At December 31, 2006, there were no marketable equity securities that had unrealized losses with aggregate depreciation of 30% from the Company's cost basis, which is management's guideline for evaluating other-than-temporary impairment. Evaluation will also occur at an earlier stage if conditions warrant. Equity securities are reviewed for impairment by examining several factors, such as financial condition and near-term prospects of the issuer, credit deterioration of the issuer, rating downgrades, business segment dynamics, extent to which the market value is less than cost, length of time held, and buy/hold/sell recommendations of investment advisors or market analyst. At December 31, 2006, no unrealized losses were deemed to be other than temporary.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### 4. LOANS

A summary of the balances of loans follows:

|                                 | December 31,   |           |
|---------------------------------|----------------|-----------|
|                                 | 2006           | 2005      |
|                                 | -----          | -----     |
|                                 | (In thousands) |           |
| Real estate mortgage loans:     |                |           |
| Multi-family and commercial     | \$209,172      | \$213,815 |
| Residential                     | 132,381        | 120,345   |
| Construction                    | 20,988         | 21,490    |
| Home equity lines of credit     | 13,917         | 17,915    |
| Commercial                      | 47,736         | 38,111    |
| Consumer                        | 2,766          | 2,623     |
|                                 | -----          | -----     |
| Total loans                     | 426,960        | 414,299   |
| Less: Allowance for loan losses | (4,385)        | (4,333)   |
| Net deferred loan fees          | (205)          | (356)     |
|                                 | -----          | -----     |
| Loans, net                      | \$422,370      | \$409,610 |
|                                 | =====          | =====     |

An analysis of the allowance for loan losses follows:

|  | Years Ended December 31, |       |       |
|--|--------------------------|-------|-------|
|  | 2006                     | 2005  | 2004  |
|  | -----                    | ----- | ----- |
|  | (In thousands)           |       |       |

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|  |         |         |         |
|--|---------|---------|---------|
| Balance at beginning of year               | \$4,333 | \$4,101 | \$4,154 |
| Provision for loan losses                  | 39      | 167     | 376     |
| Loans charged-off                          | (16)    | -       | (525)   |
| Recoveries of loans previously charged-off | 29      | 65      | 96      |
|  | -----   | -----   | -----   |
| Balance at end of year                     | \$4,385 | \$4,333 | \$4,101 |
|  | =====   | =====   | =====   |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

LOANS (Concluded)

The following is a summary of information pertaining to impaired and non-accrual loans:

|  | December 31,   |       |
|--|----------------|-------|
|  | 2006           | 2005  |
|  | -----          | ----- |
|  | (In thousands) |       |
| Impaired loans without a valuation allowance       | \$341          | \$ 49 |
| Impaired loans with a valuation allowance          | -              | 906   |
|  | -----          | ----- |
| Total impaired loans                               | \$341          | \$955 |
|  | =====          | ===== |
| Valuation allowance related to impaired loans      | \$ -           | \$ 87 |
|  | =====          | ===== |
| Total non-accrual loans                            | \$600          | \$906 |
|  | =====          | ===== |
| Total loans past-due ninety days or more and still | -              | -     |
|  | =====          | ===== |

|  | Years Ended December 31, |       |       |
|--|--------------------------|-------|-------|
|  | 2006                     | 2005  | 2004  |
|  | -----                    | ----- | ----- |
|  | (In thousands)           |       |       |
| Average investment in impaired loans                         | \$298                    | \$485 | \$933 |
|  | =====                    | ===== | ===== |
| Interest income recognized on impaired loans                 | \$ 43                    | \$ 26 | \$111 |
|  | =====                    | ===== | ===== |
| Interest income recognized on a cash basis on impaired loans | \$ 43                    | \$ 26 | \$ 17 |
|  | =====                    | ===== | ===== |

No additional funds are committed to be advanced in connection with

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impaired loans.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. PREMISES AND EQUIPMENT

A summary of the cost and accumulated depreciation and amortization of premises and equipment follows:

|  | December 31,   |          | Estimated    |
|--|----------------|----------|--------------|
|  | 2006           | 2005     | Useful Lives |
|  | -----          | -----    | -----        |
|  | (In thousands) |          |              |
| Premises:                                    |                |          |              |
| Land   | \$ 1,600       | \$ 1,600 | -            |
| Buildings                                    | 6,508          | 6,407    | 39 years     |
| Leasehold improvements                       | 436            | 436      | 4 - 24 years |
| Furniture and equipment                      | 5,212          | 4,812    | 3 - 5 years  |
| Assets in process                            | 54             | -        | -            |
|  | -----          | -----    |              |
|  | 13,810         | 13,255   |              |
| Accumulated depreciation<br>and amortization | (8,223)        | (7,338)  |              |
|  | -----          | -----    |              |
|  | \$ 5,587       | \$ 5,917 |              |
|  | =====          | =====    |              |

Depreciation and amortization expense for the years ended December 31, 2006, 2005 and 2004 amounted to \$894,000, \$813,000 and \$659,000, respectively.

The Company has embarked on a multi-year project to upgrade, modernize and present a common design theme at all of its retail locations. As part of this project, the Company has signed agreements to remodel three of its facilities - Somerset, New Bedford, and North Somerset, Massachusetts. At December 31, 2006, commitments related to these agreements aggregated \$1,649,000.

Pursuant to the terms of noncancelable lease agreements in effect at December 31, 2006, pertaining to premises and equipment, future minimum rent commitments under various operating leases are as follows:

| Year Ending<br>December 31, | Amount         |
|-----------------------------|----------------|
| -----                       | -----          |
|                             | (In thousands) |
| 2007                        | \$ 97          |
| 2008                        | 83             |
| 2009                        | 83             |
| 2010                        | 87             |
| 2011                        | 84             |
| Thereafter                  | 759            |
|                             | -----          |
|                             | \$1,193        |



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Certain leases contain provisions for escalation of minimum lease payments contingent upon increases in real estate taxes and percentage increases in the consumer price index. In addition, the leases contain options to extend for periods from five to ten years. The cost of such rental extensions is included above. Total rent expense for the years ended December 31, 2006, 2005 and 2004 amounted to \$103,000, \$127,000 and \$85,000, respectively.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. DEPOSITS

A summary of deposits by type is as follows:

|  | December 31,   |           |
|--|----------------|-----------|
|  | 2006           | 2005      |
|  | (In thousands) |           |
| Demand deposits                        | \$ 79,101      | \$ 80,705 |
| NOW                                    | 55,071         | 55,493    |
| Regular and other savings              | 77,189         | 87,146    |
| Money market deposits                  | 24,021         | 29,835    |
|  | -----          | -----     |
| Total non-certificate accounts         | 235,382        | 253,179   |
|  | -----          | -----     |
| Term certificates less than \$100,000  | 121,730        | 116,861   |
| Term certificates of \$100,000 or more | 66,894         | 45,806    |
|  | -----          | -----     |
| Total certificate accounts             | 188,624        | 162,667   |
|  | -----          | -----     |
| Total deposits                         | \$424,006      | \$415,846 |
|  | =====          | =====     |

At December 31, 2006 and 2005, the scheduled maturities of time deposits are as follows:

| Maturing In | 2006           |                          | 2005           |                          |
|-------------|----------------|--------------------------|----------------|--------------------------|
|             | Amount         | Weighted<br>Average Rate | Amount         | Weighted<br>Average Rate |
|             | (In thousands) |                          | (In thousands) |                          |
| 2006        | \$ -           | -                        | \$135,606      | 3.2%                     |
| 2007        | 180,284        | 4.3%                     | 22,182         | 3.8                      |
| 2008        | 3,704          | 3.1                      | 2,341          | 3.4                      |
| 2009        | 2,858          | 3.4                      | 1,372          | 3.5                      |
| 2010        | 850            | 4.0                      | 1,166          | 4.0                      |
| 2011        | 928            | 5.7                      | -              | -                        |
|             | -----          |                          | -----          |                          |

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|           |      |           |      |
|-----------|------|-----------|------|
| \$188,624 | 4.3% | \$162,667 | 3.3% |
| =====     |      | =====     |      |

7. SHORT-TERM BORROWINGS

Short-term borrowings consist of Federal Home Loan Bank of Boston ("FHLB") advances amounting to \$7,000,000 at December 31, 2005, with an original maturity of less than one year at a weighted average rate of 4.07%. There were no short-term borrowings at December 31, 2006.

The Bank also has an available line of credit in the amount of \$500,000 with the FHLB at an interest rate that adjusts daily. Borrowings under the line are limited to 2% of the Bank's total assets. All borrowings from the FHLB are secured by a blanket lien on qualified collateral, defined principally as 75% of the carrying value of first mortgage loans on owner-occupied residential property and 90% of the market value of obligations of government-sponsored enterprises.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. LONG-TERM BORROWINGS

Long-term borrowings at December 31, 2006 and 2005 consist of the following FHLB advances:

|  | Amount         |        | Weighted Average Rate |      |
|--|----------------|--------|-----------------------|------|
|  | 2006           | 2005   | 2006                  | 2005 |
|  | -----          |        | -----                 |      |
|  | (In thousands) |        |                       |      |
| Fixed-rate advances maturing:            |                |        |                       |      |
| 2006                                     | \$ -           | 8,000  | -                     | 2.7% |
| 2007                                     | 27,000         | 27,000 | 3.4%                  | 3.4  |
| 2008                                     | 14,500         | 14,500 | 3.8                   | 3.8  |
| 2009                                     | 10,000         | 21,000 | 4.2                   | 3.2  |
| 2010                                     | 7,000          | 7,000  | 4.5                   | 4.5  |
| Thereafter*                              | 6,430          | 6,430  | 5.2                   | 5.2  |
|  | -----          | -----  |                       |      |
|  | 64,930         | 83,930 | 3.9                   | 3.6  |
|  | -----          | -----  |                       |      |
| Floating-rate advances maturing:         |                |        |                       |      |
| 2008**                                   | 10,000         | -      | 5.3                   | -    |
| 2009**                                   | 30,000         | -      | 5.3                   | -    |
|  | -----          | -----  |                       |      |
|  | 40,000         | -      | 5.3                   | -    |
|  | -----          | -----  |                       |      |
| Fixed-rate amortizing advances maturing: |                |        |                       |      |
| 2008                                     | 639            | 739    | 6.0                   | 6.0  |
| 2011                                     | 13,489         | 16,196 | 6.7                   | 6.8  |
|  | -----          | -----  |                       |      |
|  | 14,128         | 16,935 | 6.7                   | 6.7  |

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|                     |                             |                             |      |      |
|---------------------|-----------------------------|-----------------------------|------|------|
| Total FHLB advances | -----<br>\$119,058<br>===== | -----<br>\$100,865<br>===== | 4.7% | 4.1% |
|---------------------|-----------------------------|-----------------------------|------|------|

- \* Includes \$3,000,000 maturing in 2015 and callable hereafter.  
 \*\* Advances reprice every 28 days and are redeemable at the option of the Company at each repricing date.

See Note 7 for collateral securing all FHLB borrowings.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. SUBORDINATED DEBENTURES

On March 17, 2004, Slade's Ferry Statutory Trust I (the "Trust") , a Connecticut Statutory trust formed by the Company, completed the sale of \$10,000,000 of floating rate trust preferred securities (liquidation amount of \$1,000 per security) in a private placement as part of a pooled trust preferred securities transaction. The Trust also issued common securities in the amount of \$310,000 to the Company and used the net proceeds from the preferred and common securities to purchase subordinated debentures of the Company. The subordinated debentures are the sole assets of the Trust. The Company contributed \$10,000,000 of the proceeds from the sale of the subordinated debentures to the Bank as Tier I Capital to support the Bank's growth. Total expenses associated with the offering approximating \$150,000 are included in other assets and are being amortized on a straight-line basis over the life of the subordinated debentures.

The subordinated debentures and the trust preferred securities accrue and pay distributions quarterly at a floating rate of 3-Month LIBOR plus 2.79%. At December 31, 2006 and 2005, this rate was 8.18% and 7.29%, respectively. The Company has the option to defer interest payments on the subordinated debentures for up to five years and, accordingly, the trust may defer dividend distributions for up to five years. The Company has fully and unconditionally guaranteed all of the obligations of the Trust, including the semi-annual distributions and payments on liquidation or redemption of the trust preferred securities.

The Company has the right to redeem the subordinated debentures, in whole or in part, on or after March 17, 2009 at par value, plus any accrued but unpaid interest to the redemption date. Redemption may occur prior to March 17, 2009 under certain conditions, at a premium to par value. The trust preferred securities are mandatorily redeemable upon the maturing of the subordinated debentures on March 17, 2034, or upon earlier redemption of the subordinated debentures.

10. INCOME TAXES

Allocation of federal and state income taxes between current and deferred portions is as follows:

| Years Ended December 31, |       |       |
|--------------------------|-------|-------|
| -----                    | ----- | ----- |
| 2006                     | 2005  | 2004  |
| -----                    | ----- | ----- |

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(In thousands)

|  |         |         |         |
|--|---------|---------|---------|
| Current tax provision  |         |         |         |
| Federal  | \$1,998 | \$1,854 | \$ 878  |
| State  | 624     | 502     | 323     |
|  | -----   | -----   | -----   |
|  | 2,622   | 2,356   | 1,201   |
|  | -----   | -----   | -----   |
| Deferred tax provision (benefit):                            |         |         |         |
| Federal  | (296)   | (153)   | 540     |
| State  | (77)    | (42)    | 161     |
| Change in the valuation allowance<br>for deferred tax assets | -       | -       | (15)    |
|  | -----   | -----   | -----   |
|  | (373)   | (195)   | 686     |
|  | -----   | -----   | -----   |
| Total provision for income taxes                             | \$2,249 | \$2,161 | \$1,887 |
|  | =====   | =====   | =====   |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

INCOME TAXES (Concluded)

The reasons for the differences between the statutory federal income tax rate and effective tax rates are summarized as follows:

|  | Years Ended December 31, |       |       |
|--|--------------------------|-------|-------|
|  | 2006                     | 2005  | 2004  |
|  | ----                     | ----  | ----  |
| Statutory federal tax rate                             | 34.0%                    | 34.0% | 34.0% |
| Increase (decrease) resulting from:                    |                          |       |       |
| Tax-exempt income                                      | (1.6)                    | (1.7) | (2.5) |
| Dividends received deduction                           | (0.4)                    | (0.4) | (0.4) |
| State tax, net of federal tax benefit                  | 6.2                      | 4.9   | 5.8   |
| Officers' life insurance                               | (2.5)                    | (2.4) | (2.7) |
| Employee benefit and stock-based<br>compensation plans | 0.5                      | -     | -     |
| Change in valuation allowance                          | -                        | -     | (0.3) |
| Other, net   | 2.1                      | 0.6   | 0.4   |
|  | -----                    | ----- | ----- |
| Effective tax rate                                     | 38.3%                    | 35.0% | 34.3% |
|  | =====                    | ===== | ===== |

The components of the net deferred tax asset are as follows:

|                           | December 31,   |         |
|---------------------------|----------------|---------|
|                           | 2006           | 2005    |
|                           | -----          | -----   |
|                           | (In thousands) |         |
| Deferred tax assets:      |                |         |
| Allowance for loan losses | \$1,635        | \$1,568 |

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|   |         |         |
|---|---------|---------|
| Deferred loan fees  | 84      | 118     |
| Interest on non-performing loans                                | 45      | 48      |
| Accrued employee benefits                                       | 35      | 117     |
| Deferred compensation   | 104     | 145     |
| Employee benefit and stock-based compensation plans             | 202     | -       |
| Write-down of securities  | 19      | 18      |
| Minimum pension liability                                       | 154     | -       |
| Net unrealized holding loss on available<br>for sale securities | 139     | 716     |
|   | -----   | -----   |
|   | 2,417   | 2,730   |
|   | -----   | -----   |
| Deferred tax liabilities:                                       |         |         |
| Accelerated depreciation  | (128)   | (283)   |
| Prepaid pension contribution                                    | (249)   | (358)   |
| Discount Accretion  | (1)     | (2)     |
|   | -----   | -----   |
|   | (378)   | (641)   |
|   | -----   | -----   |
| Net deferred tax asset  | \$2,039 | \$2,089 |
|   | =====   | =====   |

Deferred tax assets as of December 31, 2006 and 2005 have not been reduced by a valuation allowance because management believes that it is more likely than not that the full amount of deferred taxes will be realized.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. OFF-BALANCE SHEET ACTIVITIES

The Company is a party to credit related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2006 and 2005, the following financial instruments were outstanding for which the contract amounts represent credit risk:

|   | Contract Amount |          |
|---|-----------------|----------|
|   | 2006            | 2005     |
|   | -----           | -----    |
|   | (In thousands)  |          |
| Commitments to grant loans                    | \$ 8,379        | \$ 6,375 |
| Unfunded commitments under lines of credit    | 24,402          | 25,041   |
| Unfunded commitments under construction loans | 12,444          | 14,863   |
| Equity lines of credit                        | 16,927          | 17,711   |
| Standby letters of credit                     | 3,423           | 3,188    |

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Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines-of-credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines-of-credit are uncollateralized and usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Company is committed.

Standby letters-of-credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters-of-credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters-of-credit is essentially the same as that involved in extending loan facilities to customers. The Company generally holds collateral supporting those commitments, and at December 31, 2006 and 2005 such collateral amounted to \$3,406,000 and \$3,128,000, respectively.

Guarantees that are not derivative contracts have been recorded on the Company's consolidated balance sheet at their fair value at inception. The Company considers standby letters of credit to be guarantees, and the amount of the recorded liability related to such guarantees at December 31, 2006 and 2005 was \$18,000, and \$65,000, respectively.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

##### 12. LEGAL CONTINGENCIES

Various claims also arise from time to time in the normal course of business which, in the opinion of management, will have no material effect on the Company's consolidated financial statements.

##### 13. MINIMUM REGULATORY CAPITAL REQUIREMENTS

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Their capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

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Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2006 and 2005, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

##### MINIMUM REGULATORY CAPITAL REQUIREMENTS (Concluded)

As of December 31, 2006, the most recent notification from the Federal Deposit Insurance Company categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notification that management believes have changed the Bank's category. The Company's and the Bank's actual capital amounts and ratios as of December 31, 2006 and 2005 are also presented in the table.

|   | Actual                 |        | Minimum Capital Requirement |       |
|---|------------------------|--------|-----------------------------|-------|
|   | Amount                 | Ratio  | Amount                      | Ratio |
|   | (Dollars in thousands) |        |                             |       |
| As of December 31, 2006:                |                        |        |                             |       |
| Total Capital to Risk Weighted Assets:  |                        |        |                             |       |
| Consolidated                            | \$64,343               | 15.25% | \$33,755                    | 8.0%  |
| Bank                                    | 57,485                 | 13.67  | 33,654                      | 8.0   |
| Tier 1 Capital to Risk Weighted Assets: |                        |        |                             |       |
| Consolidated                            | 59,846                 | 14.18  | 16,878                      | 4.0   |
| Bank                                    | 52,988                 | 12.60  | 16,827                      | 4.0   |
| Tier 1 Capital to Average Assets:       |                        |        |                             |       |
| Consolidated                            | 59,846                 | 9.90   | 24,184                      | 4.0   |
| Bank                                    | 52,988                 | 8.78   | 24,133                      | 4.0   |
| As of December 31, 2005:                |                        |        |                             |       |
| Total Capital to Risk Weighted Assets:  |                        |        |                             |       |
| Consolidated                            | \$62,240               | 15.72% | \$31,668                    | 8.0%  |
| Bank                                    | 53,555                 | 13.58  | 31,540                      | 8.0   |
| Tier 1 Capital to Risk Weighted         |                        |        |                             |       |

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|                           |        |       |        |     |
|---------------------------|--------|-------|--------|-----|
| Assets:                   |        |       |        |     |
| Consolidated              | 58,014 | 14.66 | 15,834 | 4.0 |
| Bank                      | 49,329 | 12.51 | 15,770 | 4.0 |
| Tier 1 Capital to Average |        |       |        |     |
| Assets:                   |        |       |        |     |
| Consolidated              | 58,014 | 10.07 | 23,038 | 4.0 |
| Bank                      | 49,329 | 8.56  | 23,038 | 4.0 |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. EMPLOYEE BENEFIT PLANS

Pension Plan

The Company has a defined benefit plan that up to January 1, 1998 covered substantially all of its full time employees who met certain eligibility requirements. On January 1, 1998, the Bank suspended the plan so that employees no longer earn additional defined benefits for future service. The benefits paid are based on 1.5% of total salary plus .5% of compensation in excess of the integration level per year of service. The integration level was the first \$750 of monthly compensation. The accrued benefit is based on years of service. Information pertaining to the activity in the plan is as follows:

|  | Years Ended December 31, |         |         |
|--|--------------------------|---------|---------|
|  | 2006                     | 2005    | 2004    |
|  | -----                    | -----   | -----   |
|  | (In thousands)           |         |         |
| Change in benefit obligation:                  |                          |         |         |
| Benefit obligation at beginning of year        | \$1,287                  | \$1,663 | \$1,747 |
| Interest cost                                  | 61                       | 86      | 105     |
| Actuarial loss                                 | 63                       | 148     | 74      |
| Settlements                                    | (535)                    | (610)   | (263)   |
| Benefits paid                                  | (1)                      | --      | --      |
|  | -----                    | -----   | -----   |
| Benefit obligation at end of year              | 875                      | 1,287   | 1,663   |
|  | -----                    | -----   | -----   |
| Change in plan assets:                         |                          |         |         |
| Fair value of plan assets at beginning of year | 1,573                    | 2,094   | 622     |
| Actual return on plan assets                   | 129                      | 89      | 25      |
| Employer contribution                          | -                        | -       | 1,710   |
| Benefits paid                                  | (1)                      | -       | -       |
| Settlements                                    | (535)                    | (610)   | (263)   |
| Administrative expense                         | (61)                     | -       | -       |
|  | -----                    | -----   | -----   |
| Fair value of plan assets at end of year       | 1,105                    | 1,573   | 2,094   |
|  | -----                    | -----   | -----   |
| Funded status                                  | 230                      | 286     | 431     |



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|  |        |        |         |
|--|--------|--------|---------|
| Unrecognized net actuarial loss                  | -      | 583    | 687     |
|  | -----  | -----  | -----   |
| Prepaid pension cost recognized on balance sheet | \$ 230 | \$ 869 | \$1,118 |
|  | =====  | =====  | =====   |

The assumptions used to determine the benefit obligation are as follows:

|                        |              |       |
|------------------------|--------------|-------|
|                        | December 31, |       |
|                        | -----        | ----- |
|                        | 2006         | 2005  |
|                        | ----         | ----  |
| Discount rate          | 6.00%        | 5.75% |
| Lump sum interest rate | 5.25         | -     |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

EMPLOYEE BENEFIT PLANS (Continued)

Pension Plan (Continued)

The components of net periodic pension cost are as follows:

|                               |                          |        |        |
|-------------------------------|--------------------------|--------|--------|
|                               | Years Ended December 31, |        |        |
|                               | -----                    | -----  | -----  |
|                               | 2006                     | 2005   | 2004   |
|                               | -----                    | -----  | -----  |
|                               | (In thousands)           |        |        |
| Interest cost                 | \$ 61                    | \$ 86  | \$ 105 |
| Expected return on assets     | (106)                    | (148)  | (107)  |
| Settlements                   | 280                      | 276    | 109    |
| Recognized net actuarial loss | 26                       | 35     | 42     |
|                               | -----                    | -----  | -----  |
|                               | \$ 261                   | \$ 249 | \$ 149 |
|                               | =====                    | =====  | =====  |

For the years ended December 31, 2005, 2004 and 2003, the assumptions used to determine the

The assumptions used to determine net periodic pension cost are as follows:

|  |                          |       |       |
|--|--------------------------|-------|-------|
|  | Years Ended December 31, |       |       |
|  | -----                    | ----- | ----- |
|  | 2006                     | 2005  | 2004  |
|  | ----                     | ----  | ----  |
| Discount rate                                    | 5.75%                    | 6.25% | 6.25% |
| Expected long term rate of return on plan assets | 8.00                     | 8.00  | 8.00  |
| Lump sum interest rate                           | 5.25                     | -     | -     |

The expected long-term rate of return on plan assets reflects management's expectations of long-term average rates of returns on funds

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invested to provide benefits included in the projected benefit obligations. The expected rate of return is based on the outlook for inflation, fixed income returns, and equity returns, which in turn is based upon historical returns and asset allocation. Applying the actual allocation percentages to the anticipated rate of return results in an overall rate of compensation assumption of 8.00%.

The Company's pension plan weighted average asset allocations are as follows:

|                    | Percentage of Plan Assets<br>at December 31, |         |
|--------------------|--|---------|
|                    | 2006   | 2005    |
| Asset Category     |  |         |
| Equity securities  | 65.50%                                       | 65.50%  |
| Debt securities    | 33.80  | 32.70   |
| Money market funds | 0.70   | 1.80    |
| Total              | 100.00%                                      | 100.00% |
|                    | =====  | =====   |

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

##### EMPLOYEE BENEFIT PLANS (Continued)

##### Pension Plan (Concluded)

Equity securities do not include any of the Company's common stock at December 31, 2006 and 2005, respectively.

The investment portfolio serves as the primary source of earnings for the defined benefit pension plan and provides the plan with a source of liquidity. As funds are available to invest, the Company obtains the recommendation from investment advisors regarding the best and most suitable type of security to purchase. Debt securities are purchased with the ability and intent to hold the security to its stated maturity, or in the case of equity securities, viewed as a long-term hold. Securities may be sold from time to time prior to maturity should liquidity requirements necessitate the sale.

No contribution is expected for the plan year beginning January 1, 2007.

Estimated future benefit payments are as follows:

| Years Ending December 31, | Amount         |
|---------------------------|----------------|
|                           | (In thousands) |
| 2007                      | \$121          |
| 2008                      | 16             |
| 2009                      | 12             |
| 2010                      | 11             |
| 2011                      | 11             |

## 401(k) Plan

The Company has a 401(k) Plan whereby substantially all employees who attain the age of 21 and complete three months of service are eligible to participate in the Plan. Employees may contribute up to 100 percent of their compensation subject to certain limits based on federal tax laws. The Company makes matching contributions equal to 3 percent of the first 6 percent of an employee's compensation contributed to the Plan. Matching contributions vest to the employee after a one-year period. For the years ended December 31, 2006, 2005 and 2004, expense attributable to the Plan amounted to \$104,000, \$97,000 and \$104,000, respectively.

Employees who attain age 21 and complete one year of service (1,000 hours) are also eligible to receive profit sharing contributions under the 401(k) plan. The Company contributes amounts at the Company's discretion. Costs recognized by the Company for profit-sharing amounted to \$85,000, \$114,000 and \$101,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

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## SLADE'S FERRY BANCORP. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## EMPLOYEE BENEFIT PLANS (Continued)

## Employment and Change of Control Agreements

The Company has entered into an Employment Agreement with the President of the Company and two additional executive officers. Under the agreements, the President and executive officers are entitled to severance benefits upon a change-in-control as defined in the agreements. The severance benefits include, among other things, the value of the cash compensation, value of employer contributions to employer-provided benefit plans and continued fringe benefits that the President would have received had she worked an additional three years and the executive officers would have received had they worked an additional two years. In addition, the President and executive officers would be entitled to accelerated vesting in other benefit plans upon a change of control or termination without cause. The President would also be indemnified for any impact from excise taxes due under Section 4999 of the Code, while the executive officers would have any benefits limited to avoid excise taxes under Section 4999 of the Code.

In October 2006 and December 2006, the Bank entered into Change of Control Agreements with two additional executive officers of the Bank. These agreements provide for a one-year severance payment upon a change of control that results in a termination of the executives' employment.

## Supplemental Retirement Plans

The Company has entered into supplemental retirement plans with certain executive officers and directors that provide for supplemental benefits commencing with retirement. The present value of estimated future benefits payable is accrued over the required service periods. During 2006, the Company approved the termination of all supplemental plan arrangements with its directors and accrued all termination benefits. For the years ended December 31, 2006, 2005 and 2004, expense attributable to

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the supplemental retirement plans amounted to \$44,000, \$40,000 and \$30,000, respectively.

In connection with the supplemental retirement plans, the Bank has purchased life insurance policies applicable to the executive officers and Directors included in the plans.

### Endorsement Split-Dollar Life Insurance Arrangements

The Company is the sole owner of life insurance policies pertaining to certain of the Company's executives. The Company has entered into agreements with these executives whereby the Company will pay to the executives' estates or beneficiaries a portion of the death benefit that the Company will receive as beneficiary of such policies. No liability has been recognized on the consolidated balance sheet for such death benefits. In September 2006, the Emerging Issues Task Force reached a consensus on Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." As a result, effective for fiscal years beginning after December 15, 2007, the Company will be required to recognize a liability for future death benefits, and may choose to retroactively apply the accounting change to all periods presented, or to cumulatively adjust the financial statements as of the beginning of the year of adoption. Management is in the process of evaluating the impact of Issue No. 06-4 on the Company's consolidated financial statements. See Note 1 - Recent Accounting Pronouncements.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### 15. STOCK COMPENSATION PLANS

##### Slade's Ferry Bancorp. Stock Option Plan (Stock Option Plan)

The Stock Option Plan includes a Discretionary Grant Program and an Automatic Grant Program. The maximum number of shares of common stock issuable over the term of the Stock Option Plan may not exceed 275,625 shares and the maximum aggregate number of shares issuable under both programs in any plan year may not exceed 55,125 shares. The Stock Option Plan expired on March 11, 2006.

Under the Discretionary Grant Program, key employees, including officers, were granted incentive stock options to purchase shares of common stock of the Company. The exercise price per share could not be less than one hundred percent of the fair market value of common stock at the grant date and options became exercisable upon grant. The maximum term of each option was ten years.

The Automatic Grant Program was limited to non-employee directors of the Company or its subsidiary. A non-statutory option for 2,000 shares of common stock was granted each plan year to eligible directors. The exercise price per share was equal to one hundred percent of the fair market value of common stock at the grant date and options became exercisable upon grant. The maximum term of each option was five years.

##### Slade's Ferry Bancorp. 2004 Equity Incentive Plan (2004 Plan)

The maximum number of shares of stock reserved and available for issuance

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under the 2004 Plan is 300,000 shares, subject to adjustment as provided in the Plan (through the application of certain anti-dilution provisions); provided that not more than 100,000 shares shall be issued in the form of Unrestricted Stock Awards, Restricted Stock Awards or Deferred Stock Awards.

Stock options granted under the 2004 Plan may be either incentive stock options or non-qualified stock options. The exercise price for incentive stock options granted to employees shall not be less than 100 percent of the fair market value at grant date. No stock option shall be exercisable more than 10 years after the date the stock option is granted.

Each non-employee director who is serving as director of the Company on the day after each annual meeting of shareholders or any special meeting in lieu thereof, beginning with the 2004 annual meeting, shall automatically be granted on such day a non-qualified stock option to acquire 2,000 shares of stock with an exercise price equal to the fair market value of the stock on date of grant. No stock option shall be exercisable more than 10 years after the grant date.

Unrestricted Stock Awards may be granted in respect of past services or other valid consideration. Restricted Stock Awards entitle the recipient to acquire, at such purchase price as determined by the Company, shares of stock subject to such restrictions and conditions as the Company may determine at time of grant. A Deferred Stock Award is an award of a restricted unit to a grantee, subject to restrictions and conditions as the Company may determine at the time of grant. If any Restricted Stock Award or Deferred Stock Award granted is intended to qualify as "Performance-based Compensation", such Award shall comply with provisions as set forth in the 2004 Plan. As of December 31, 2006, no Unrestricted Stock Awards have been granted by the Company.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

##### STOCK COMPENSATION PLANS (Concluded)

##### Slade's Ferry Bancorp. 2004 Equity Incentive Plan (2004 Plan) (Concluded)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

|                         | Years Ended December 31, |          |         |
|-------------------------|--------------------------|----------|---------|
|                         | 2006                     | 2005     | 2004    |
|                         | -----                    | -----    | -----   |
| Expected Dividends      | 2.0%                     | 1.9%     | 1.9%    |
| Expected Term           | 5 years                  | 10 years | 9 years |
| Expected Volatility     | 24%                      | 28%      | 27%     |
| Risk-free interest rate | 5.1%                     | 4.2%     | 4.1%    |

The expected volatility is based on historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on the Company's history and

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expectation of dividend payouts.

A summary of options under the Plan as of December 31, 2006, and changes during the year then ended, (shares in thousands) is presented below:

|                                  | Shares | Weighted Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>(in years) | Aggr<br>Intrin |
|----------------------------------|--------|------------------------------------|---|----------------|
|                                  | -----  | -----                              | -----   | -----          |
| Outstanding at January 1, 2006   | 255    | \$17.35                            |   |                |
| Granted                          | 8      | 18.40                              |   |                |
| Exercised                        | (28)   | 10.89                              |   |                |
| Forfeited                        | (2)    | 18.85                              |   |                |
| Expired                          | (2)    | 9.50                               |   |                |
|                                  | -----  | -----                              | -----   |                |
| Outstanding at December 31, 2006 | 231    | 18.18                              | 4.3   |                |
|                                  | =====  | =====                              | =====   |                |
| Exercisable at December 31, 2006 | 199    | \$18.04                            | 4.1   |                |
|                                  | =====  | =====                              | =====   |                |

The weighted-average grant-date fair value of options granted during the years ended December 31, 2006, 2005 and 2004 was \$4.56, \$6.46, and \$6.08, respectively. The total intrinsic value of options exercised during the year ended December 31, 2006 was \$200,000.

For the year ended December 31, 2006, stock-based compensation expense applicable to the Plan was \$235,000, and the recognized tax benefit related to this expense was \$51,000.

As of December 31, 2006, unrecognized stock-based compensation expense related to nonvested options amounted to \$61,000. This amount is expected to be recognized during the year ending December 31, 2007.

When issuing shares upon the exercise of a stock option, the Company issues new shares from the authorized but unissued pool.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### 16. RELATED PARTY TRANSACTIONS

In the ordinary course of business, the Bank has granted loans to principal officers and directors and their affiliates amounting to \$10,448,000 at December 31, 2006 and \$11,455,000 at December 31, 2005. In addition, the beginning balance was decreased by \$4,915,000 to account for certain individuals who are no longer deemed to be related parties and other non-material revisions. During the year ended December 31, 2006, total principal additions were \$7,522,000 and total principal payments were \$3,614,000.

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Deposits from related parties held by the Bank at December 31, 2006 and 2005 amounted to \$4,231,000 and \$3,867,000, respectively.

### 17. RESTRICTIONS ON DIVIDENDS, LOANS AND ADVANCES

Federal and state banking regulations place certain restrictions on dividends paid and loans or advances made by the Bank to the Company. The total amount of dividends which may be paid at any date is generally limited to the retained earnings of the Bank, and loans or advances are limited to 10 percent of the Bank's capital stock and surplus on a secured basis.

In addition, dividends paid by the Bank to the Company would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements.

At December 31, 2006, the Bank's retained earnings available for the payment of dividends was \$5,474,000. Accordingly, \$49,269,000 of the Company's equity in the net assets of the Bank was restricted at December 31, 2006. Funds available for loans or advances by the Bank to the Company amounted to \$10,949,000.

### 18. FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. SFAS 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

Cash and cash equivalents - The carrying amounts of cash and cash equivalents approximate fair values.

Interest-bearing certificates of deposit with other banks -The carrying amounts of interest-bearing deposits maturing within ninety days approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Securities - Fair values for securities, excluding Federal Home Loan Bank stock, are based on quoted market prices. The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

Loans receivable - For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for non-performing loans are estimated using

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discounted cash flow analyses or underlying collateral values, where applicable.

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

##### FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Deposit liabilities - The fair values disclosed for demand deposits (e.g., interest and noninterest checking, regular and other savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts of variable-rate market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Short-term borrowings - For short-term borrowings maturing within ninety days, carrying values approximate fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Long-term borrowings and subordinated debt - The fair values of the Company's long-term borrowings and subordinated debt are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Accrued interest - The carrying amounts of accrued interest approximate fair value.

Off-balance sheet credit-related instruments - Fair values for off-balance-sheet, credit related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing and are not material.

The estimated fair values, and related carrying or notional amounts, of the Company's financial instruments are as follows:

|  | December 31,       |               |                    |
|--|--------------------|---------------|--------------------|
|  | 2006               |               | 2005               |
|  | Carrying<br>Amount | Fair<br>Value | Carrying<br>Amount |
|  | (In thousands)     |               |                    |
| Financial assets:  |                    |               |                    |
| Cash and cash equivalents                                    | \$ 22,355          | \$ 22,355     | \$ 20,018          |
| Interest-bearing certificates of deposit with<br>other banks | 100                | 100           | 100                |



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|                               |         |         |         |
|-------------------------------|---------|---------|---------|
| Securities available for sale | 105,603 | 105,603 | 94,298  |
| Securities held to maturity   | 24,623  | 24,219  | 29,306  |
| Federal Home Loan Bank stock  | 6,856   | 6,856   | 6,304   |
| Loans, net                    | 422,370 | 418,980 | 409,610 |
| Accrued interest receivable   | 2,311   | 2,311   | 2,298   |
| Financial liabilities:        |         |         |         |
| Deposits                      | 424,006 | 424,008 | 415,846 |
| Short-term borrowings         | -       | -       | 7,000   |
| Long-term borrowings          | 119,058 | 119,165 | 100,865 |
| Subordinated debt             | 10,310  | 10,310  | 10,310  |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

19. CONDENSED FINANCIAL STATEMENTS OF PARENT COMPANY

Financial information pertaining only to Slade's Ferry Bancorp. is as follows:

|  | December 31,   |          |
|--|----------------|----------|
|  | 2006           | 2005     |
|  | (In thousands) |          |
| BALANCE SHEETS                             |                |          |
| -----                                      |                |          |
| Assets                                     |                |          |
| -----                                      |                |          |
| Cash and cash equivalents                  | \$ 834         | \$ 2,621 |
| Securities available for sale              | 5,812          | 5,868    |
| Investment in Bank subsidiary              | 54,743         | 50,480   |
| Investment in Trust subsidiary             | 310            | 310      |
| Other assets                               | 365            | 266      |
|  | -----          | -----    |
| Total assets                               | \$62,064       | \$59,545 |
|  | =====          | =====    |
| Liabilities and Stockholders' Equity       |                |          |
| -----                                      |                |          |
| Subordinated debentures                    | \$10,310       | \$10,310 |
| Accrued expenses and other liabilities     | 509            | 380      |
|  | -----          | -----    |
| Total liabilities                          | 10,819         | 10,690   |
|  | -----          | -----    |
| Stockholders' equity                       | 51,245         | 48,855   |
|  | -----          | -----    |
| Total liabilities and stockholders' equity | \$62,064       | \$59,545 |
|  | =====          | =====    |

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STATEMENTS OF INCOME

|  | Years Ended December 31, |         |         |
|--|--------------------------|---------|---------|
|  | 2006                     | 2005    | 2004    |
|  | (In thousands)           |         |         |
| Income:  |                          |         |         |
| Dividends from Bank subsidiary   | \$1,125                  | \$1,470 | \$1,440 |
| Dividends from Trust subsidiary  | 25                       | 19      | 10      |
| Interest on investments  | 243                      | 240     | 193     |
| Management fee income from subsidiary  | 54                       | 316     | 412     |
| Loss on sale of asset  | (5)                      | -       | -       |
| Gain (loss) on sale of securities available for sale, net                                | (18)                     | -       | 3       |
|  | 1,424                    | 2,045   | 2,058   |
| Operating expenses   | (1,731)                  | (1,256) | (1,143) |
|  |                          |         |         |
| Income (loss) before income taxes and equity in undistributed net income of subsidiaries | (307)                    | 789     | 915     |
| Applicable income tax benefit  | (456)                    | (231)   | (175)   |
|  | 149                      | 1,020   | 1,090   |
| Equity in undistributed net income of Bank subsidiary                                    | 3,470                    | 3,000   | 2,527   |
|  |                          |         |         |
| Net income   | \$3,619                  | \$4,020 | \$3,617 |

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONDENSED FINANCIAL STATEMENTS OF PARENT COMPANY (Concluded)

|   | Years    |
|---|----------|
|   | -----    |
|   | 2006     |
|   | -----    |
| Cash flows from operating activities:   |          |
| Net income  | \$ 3,619 |
| Adjustments to reconcile net income to net cash provided by operating activities: |          |
| Equity in undistributed net income of Bank subsidiary                             | (3,470)  |
| Loss on sale of asset   | 5        |
| (Increase) decrease in other assets   | (132)    |
| Stock-based compensation  | 235      |

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|   |         |
|---|---------|
| Excess tax benefits from stock-based compensation             | 82      |
| Loss (gain) on sales of available-for-sale securities         | 18      |
| Increase (decrease) in accrued expenses and other liabilities | 129     |
|   | -----   |
| Net cash provided by operating activities                     | 486     |
|   | -----   |
| Cash flows from investing activities:                         |         |
| Purchases of securities available for sale                    | (921)   |
| Proceeds from maturities of securities available for sale     | 982     |
| Investment in Bank subsidiary                                 | -       |
| Investment in Trust subsidiary                                | -       |
| Capital expenditures  | (54)    |
|   | -----   |
| Net cash (used in) provided by investing activities           | 7       |
|   | -----   |
| Cash flows from financing activities:                         |         |
| Proceeds from issuance of common stock                        | 586     |
| Stock options exercised                                       | 305     |
| Dividends paid on common stock                                | (1,506) |
| Retirement of shares of common stock                          | -       |
| Purchase of treasury stock                                    | (778)   |
| Unearned compensation   | (887)   |
| Proceeds from issuance of subordinated debentures             | -       |
|   | -----   |
| Net cash (used in) provided by financing activities           | (2,280) |
|   | -----   |
| Net increase (decrease) in cash and cash equivalents          | (1,787) |
| Cash and cash equivalents at beginning of year                | 2,621   |
|   | -----   |
| Cash and cash equivalents at end of year                      | \$ 834  |
|   | =====   |

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### SLADE'S FERRY BANCORP. AND SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Concluded)

#### 20. QUARTERLY DATA (UNAUDITED)

|                              | Years Ended December 31,              |                  |                   |                  |                   |
|------------------------------|---------------------------------------|------------------|-------------------|------------------|-------------------|
|                              | -----                                 |                  |                   |                  |                   |
|                              | 2006                                  |                  |                   |                  |                   |
|                              | Fourth<br>Quarter                     | Third<br>Quarter | Second<br>Quarter | First<br>Quarter | Fourth<br>Quarter |
|                              | -----                                 |                  |                   |                  |                   |
|                              | (In thousands, except per share data) |                  |                   |                  |                   |
| Interest and dividend income | \$ 8,821                              | \$ 8,693         | \$ 8,030          | \$ 7,856         | \$ 7,691          |
| Interest expense             | (4,383)                               | (4,029)          | (3,635)           | (3,291)          | (3,123)           |
|                              | -----                                 |                  |                   |                  |                   |

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|   |          |          |         |         |          |
|---|----------|----------|---------|---------|----------|
| Net interest income                                     | 4,438    | 4,664    | 4,395   | 4,565   | 4,568    |
| Provision for loan losses                               | -        | -        | -       | (39)    | (58)     |
| -----   |          |          |         |         |          |
| Net interest income, after<br>provision for loan losses | 4,438    | 4,664    | 4,395   | 4,526   | 4,510    |
| Noninterest income                                      | 767      | 732      | 546     | 703     | 609      |
| Noninterest expense                                     | (3,462)  | (3,738)  | (3,952) | (3,750) | (3,277)  |
| -----   |          |          |         |         |          |
| Income before income taxes                              | 1,743    | 1,658    | 989     | 1,479   | 1,842    |
| Provision for income taxes                              | (700)    | (615)    | (363)   | (572)   | (670)    |
| -----   |          |          |         |         |          |
| Net income  | \$ 1,043 | \$ 1,043 | \$ 626  | \$ 907  | \$ 1,172 |
| =====   |          |          |         |         |          |
| Earnings per common share:                              |          |          |         |         |          |
| Basic   | \$ 0.25  | \$ 0.25  | \$ 0.15 | \$ 0.22 | \$ 0.28  |
| =====   |          |          |         |         |          |
| Diluted   | \$ 0.25  | \$ 0.25  | \$ 0.15 | \$ 0.22 | \$ 0.28  |
| =====   |          |          |         |         |          |

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