

THIRD CENTURY BANCORP  
Form 10QSB  
August 11, 2006

**SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-QSB**

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

Commission file number: 000-50828

**THIRD CENTURY BANCORP**

(Exact name of small business issuer as specified in its charter)

Indiana  
(State or other jurisdiction of  
incorporation or organization)

20-0857725  
(I.R.S. Employer  
Identification Number)

80 East Jefferson Street  
Franklin, Indiana 46131  
(Address of principal executive offices)

(317) 736-7151  
(Issuer's telephone number)

Check whether the Issuer (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 twelve months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such requirements for the past 90 days. YES  NO

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

**APPLICABLE ONLY TO CORPORATE ISSUERS**

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: July 31, 2006 - 1,653,125 common shares

Transitional Small Business Disclosure Format (Check one): Yes  No



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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**THIRD CENTURY BANCORP**  
Consolidated Condensed Balance Sheets

	<b>As of</b>	<b>As of</b>
	<b>June 30, 2006</b>	<b>December 31,</b>
	<b>(Unaudited)</b>	<b>2005</b>
	(in thousands)	
<b>Assets</b>		
Cash and due from banks	\$ 691	\$ 602
Interest-earning demand deposits	5,236	7,251
Cash and cash equivalents	5,927	7,853
Interest-earning time deposits	--	200
Held to maturity securities	6,599	9,210
Loans, net of allowance for loan losses of \$931 and \$926	111,337	105,557
Premises and equipment	3,728	2,897
Federal Home Loan Bank stock	1,205	1,041
Interest receivable	603	592
Other assets	781	797
<b>Total assets</b>	<b>\$ 130,180</b>	<b>\$ 128,147</b>
<b>Liabilities</b>		
Deposits		
Demand	\$ 9,773	\$ 10,215
Savings, NOW and money market	42,876	44,264
Time	33,420	34,129
<b>Total deposits</b>	<b>86,069</b>	<b>88,608</b>
Federal Home Loan Bank advances	24,100	16,500
Other liabilities	465	486
<b>Total liabilities</b>	<b>110,634</b>	<b>105,594</b>
<b>Commitments and Contingencies</b>		
<b>Equity Contributed by ESOP</b>	<b>267</b>	<b>203</b>
<b>Stockholders' Equity</b>		
Preferred stock, without par value, authorized and unissued 2,000,000 shares	--	--
Common stock, without par value Authorized - 20,000,000 shares		
Issued and outstanding - 1,653,125 shares	13,591	14,290
Unearned RRP shares	--	(778)
Retained earnings	5,688	8,838
<b>Total stockholders' equity</b>	<b>19,279</b>	<b>22,350</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 130,180</b>	<b>\$ 128,147</b>

See notes to consolidated condensed financial statements.

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**THIRD CENTURY BANCORP**  
Consolidated Condensed Statements of Income  
(Unaudited)

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(in thousands)		(in thousands)	
<b>Interest income</b>				
Loans receivable	\$ 1,814	\$ 1,567	\$ 3,496	\$ 3,086
Investment securities	79	82	171	145
Federal Home Loan Bank stock	13	11	27	21
Interest-earning deposits	33	51	80	100
Total interest income	1,939	1,711	3,774	3,352
<b>Interest expense</b>				
Deposits	519	365	999	676
Federal Home Loan Bank advances	224	160	384	322
Total interest expense	743	525	1,383	998
<b>Net interest income</b>	1,196	1,186	2,391	2,354
Provision for loan losses	15	(20)	30	(20)
<b>Net interest income after provision for loan losses</b>	1,181	1,206	2,361	2,374
<b>Other income</b>				
Service charges on deposit accounts	71	53	145	98
Other service charges and fees	87	63	157	129
Net gains on loan sales	26	27	45	42
Other income	69	21	127	63
Total other income	253	164	474	332
<b>Other expenses</b>				
Salaries and employee benefits	732	706	1,465	1,456
Net occupancy and equipment expenses	128	117	238	234
Data processing fees	105	91	210	188
Professional Services	27	76	53	101
ATM Expense	30	27	59	52
Other expenses	181	152	345	342
Total other expenses	1,203	1,169	2,370	2,373
<b>Income before income tax</b>	231	201	465	333
Income tax expense	93	80	184	132
<b>Net income</b>	\$ 138	\$ 121	\$ 281	\$ 201
Weighted average common shares -				
basic	1,475	1,530	1,473	1,530
Weighted average common shares- diluted	1,475	1,530	1,473	1,530

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Earnings per share - basic	\$	0.09	\$	0.08	\$	0.19	\$	0.13
Earnings per share - diluted	\$	0.09	\$	0.08	\$	0.19	\$	0.13
Dividends declared per share	\$	0.04	\$	0.04	\$	0.08	\$	0.08
Return of capital declared per share		--		--	\$	2.00		--

See notes to consolidated condensed financial statements.

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**THIRD CENTURY BANCORP**  
Consolidated Condensed Statement of Stockholders' Equity  
(Unaudited)  
(Dollar amounts in thousands)

	Common Stock		Unearned RRP shares	Retained Earnings	Total
	Shares Outstanding	Amount			
<b>Balances, January 1, 2006</b>	1,653,125	\$ 14,290	\$ (778)	\$ 8,838	\$ 22,350
Net and comprehensive income	--	--	--	281	281
Reclassification of unearned compensation upon adoption of SFAS 123 (R)	--	(778)	778	--	--
Amortization of RRP	--	79	--	--	79
Return of capital paid (\$2.00 per share)	--	--	--	(3,306)	(3,306)
Dividends paid (\$.08 per share outstanding)	--	--	--	(125)	(125)
<b>Balance, June 30, 2006</b>	1,653,125	\$ 13,591	\$ —	\$ 5,688	\$ 19,279

See notes to consolidated condensed financial statements.

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**THIRD CENTURY BANCORP**  
Consolidated Condensed Statements of Cash Flows  
(Unaudited)

	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
	(in thousands)	
<b>Operating Activities</b>		
Net income	\$ 281	\$ 201
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	30	(20)
Depreciation	92	94
Investment securities (accretion) amortization, net	(8)	(23)
Capitalization of mortgage servicing rights	(30)	(8)
Gain on sale of loans	(45)	(17)
Loans originated for sale in the secondary market	(2,453)	(1,434)
Proceeds from sale of loans in the secondary market	2,498	1,452
RRP compensation expense	79	--
ESOP compensation expense	64	70
Net change in		
Interest receivable	(11)	(113)
Other assets	46	278
Other liabilities	(21)	222
Net cash provided (used) by operating activities	522	702
<b>Investing Activities</b>		
Purchases of FHLB stock	(164)	(22)
Purchases of securities held to maturity	(1,400)	(7,256)
Proceeds from maturities of securities held to maturity	4,019	5,985
Purchase of interest-bearing time deposits	--	(200)
Proceeds from maturities of interest-bearing time deposits	200	100
Net changes in loans	(5,810)	(5,094)
Purchases of premises and equipment	(923)	(62)
Net cash provided (used) by investing activities	(4,078)	(6,549)
<b>Financing Activities</b>		
Net change in		
Demand and savings deposits	(1,830)	1,072
Certificate of deposits	(709)	(233)
Cash dividend on common stock	(125)	(132)
Return of capital dividend on common stock	(3,306)	--
Proceeds from FHLB advances	9,600	--
Payments on FHLB advances	(2,000)	(500)
Net cash provided (used) by financing activities	1,630	207
<b>Net Change in Cash and Equivalents</b>	<b>(1,926)</b>	<b>(5,640)</b>
<b>Cash and Cash Equivalents, Beginning of Period</b>	<b>7,853</b>	<b>12,057</b>

<b>Cash and Cash Equivalents, End of Period</b>	<b>\$</b>	<b>5,927</b>	<b>\$</b>	<b>6,417</b>
<b>Additional Cash Flows Information</b>				
Interest paid	\$	1,355	\$	953
Income tax paid (net of refunds)	\$	210	\$	45

See notes to consolidated condensed financial statements.

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**THIRD CENTURY BANCORP**

Notes to Unaudited Consolidated Condensed Financial Statements

Third Century Bancorp (Third Century) is an Indiana corporation that was formed on March 15, 2004 for the purpose of owning all of the capital stock of Mutual Savings Bank (Mutual or Bank) following the completion of Mutual's mutual-to-stock conversion. Third Century offered for sale 1,653,125 shares of its common stock at \$10.00 per share in a public offering to eligible depositors that was completed on June 14, 2004. On June 29, 2004, Third Century purchased all of the capital stock issued by Mutual. Prior to that date, Third Century had no assets or liabilities.

The activities of Third Century are primarily limited to holding the stock of Mutual. Mutual conducts business primarily in Johnson County and surrounding counties. Mutual attracts deposits from the general public and originates loans for consumer, residential and commercial purposes. Mutual's profitability is significantly dependent on net interest income, which is the difference between interest income generated from interest-earning assets (i.e. loans and investments) and the interest expense paid on interest-bearing liabilities (i.e. customer deposits and borrowed funds). Net interest income is affected by the relative amount of interest-earning assets and interest-bearing liabilities and the interest received or paid on these balances. The level of interest paid or received by Mutual can be significantly influenced by a number of factors, such as governmental monetary policy, competition within our market area and the performance of the national and local economies.

Mutual also owns one subsidiary, Mutual Financial Services, Inc. (Financial), which is engaged primarily in mortgage life insurance sales and servicing.

Note 1: Basis of Presentation

The accompanying unaudited consolidated condensed financial statements were prepared in accordance with instructions for Form 10-QSB and, therefore, do not include information or footnotes necessary for a complete presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. Accordingly, these financial statements should be read in conjunction with the consolidated financial statements and notes thereto of Mutual for the fiscal year ended December 31, 2005 included in Third Century's Annual Report filed as an attachment to its 10-KSB. However, in the opinion of management, all adjustments (consisting of only normal recurring accruals) which are necessary for a fair representation of the financial statements have been included. The results of operations for the six-month period ended June 30, 2006, are not necessarily indicative of the results which may be expected for the entire year.

The consolidated condensed balance sheet of Third Century as of December 31, 2005 has been derived from the audited consolidated balance sheet of Third Century as of that date.

Note 2: Change in Accounting Principle

Effective January 1, 2006, Third Century adopted Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment* ("SFAS 123(R)"). SFAS 123(R) addresses all forms of share-based payment awards, including shares under employee stock purchase plans, stock options, restricted stock, and stock appreciation rights. SFAS 123(R) requires all share-based payments to be recognized as expense, based upon their fair values, in the financial statements over the vesting period of the awards. Third Century has elected the modified prospective application and, as a result, has recorded no compensation expense as all outstanding options were fully vested at December 31, 2005. Prior to the adoption of SFAS 123(R), Third Century accounted for its stock options in accordance with Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees." All options were granted with an exercise price equal to the fair value of the stock at the date of grant and accordingly, no compensation expense was recognized. Certain disclosures required by SFAS 123(R) have been omitted due to their immaterial nature. Prior to the adoption of SFAS 123(R), unearned compensation related to the RRP shares was classified as a separate

component of stockholders' equity. In accordance with SFAS 123(R), on January 1, 2006, the balance in unearned compensation was reclassified to the appropriate equity accounts.

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Note 3. Stock Option Plan

Pursuant to the Plan, options may be issued which are defined as incentive stock options or as non-qualified stock options. Incentive stock options are intended to qualify under the provisions of Internal Revenue Code Section 422 ("IRC"), which include, among other things, a requirement that the option price is not less than the fair value of the shares as of the date of grant. Non-qualified stock options are those that do not meet the requirements of the provisions of the IRC, and, accordingly, may contain terms that are different from those in place for incentive stock options. During the third quarter of 2005, Third Century awarded 146,300 options to employees and non-employee directors at an exercise price of \$13.10 which equaled the market price for the stock as of the date of the grant. As a result of the capital restructuring through the \$2.00 return of capital dividend, the exercise price of the options was adjusted to \$11.10. In accordance with SFAS 123(R), a comparison of the fair value of the modified award was made to the fair value of the original award and it was determined that no incremental value was transferred as a result of the modification and no compensation expense was recognized. These options were immediately vested. Through the six months ending June 30, 2006, there was no activity related to the option plan.

Note 4: Principles of Consolidation

The consolidated financial statements include the accounts of Third Century, Mutual and Financial. All significant intercompany balances and transactions have been eliminated in the accompanying consolidated financial statements.

Note 5: Earnings Per Share

Earnings per share is computed based upon the weighted average common shares outstanding during the period. Unearned ESOP shares and unearned RRP shares are not considered outstanding for the earnings per share calculation. The following table presents the factors used in the earnings per share computation for the three and six months ending June 30, 2006 and June 30, 2005:

	<b>Three Months Ended June 30, 2006</b>	<b>Three Months Ended June 30, 2005</b>	<b>Six Months Ended June 30, 2006</b>	<b>Six Months Ended June 30, 2005</b>
<b>Basic:</b>				
Net income	\$ 138	\$ 121	\$ 281	\$ 201
Weighted average common shares outstanding	1,475	1,530	1,473	1,530
Basic earnings per common share	\$ 0.09	\$ 0.08	\$ 0.19	\$ 0.13
<b>Diluted:</b>				
Net Income	\$ 138	\$ 121	\$ 281	\$ 201
Weighted average common shares outstanding	1,475	1,530	1,473	1,530
Add: Dilutive effects of assumed exercises of stock options	7	-	4	-
Average shares and dilutive	1,482	1,530	1,477	1,530

potential common shares

Diluted earnings per common share	\$	0.09	\$	0.08	\$	0.19	\$	0.13
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Note 6: Effect of Recent Accounting Pronouncements

The FASB has issued a proposed amendment to SFAS No. 128, Earnings Per Share, to clarify guidance for mandatory convertible instruments, the treasury stock method, contingently issuable shares, and contracts that may be settled in cash or share. The primary impact on Third Century of the proposed Statement is the change to the treasury stock method for year-to-date diluted earnings per share.

Currently, SFAS No. 128 requires that the number of incremental shares included in the denominator be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation. Under the proposed amendment to SFAS 128, the number of incremental shares included in year-to-date diluted earnings per share would be computed using the average market price of common shares for the year-to-date period, independent of the quarterly computations. This computational change is not expected to have a significant impact on the Third Century's diluted earnings per share.

In March 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 156. This Statement amends SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities.

SFAS No. 156 requires an entity to initially recognize a servicing asset or servicing liability at fair value each time it undertakes an obligation to service a financial asset by entering into a servicing contract in other specific situations.

In addition, SFAS No. 156 permits an entity to choose either of the following subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities:

- Amortization method—Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income or net servicing loss and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.
- Fair value measurement method—Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur.

SFAS No. 156 is effective at the beginning of an entity's first fiscal year that begins after September 15, 2006 and should be applied prospectively for recognition and initial measurement of servicing assets and servicing liabilities. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year.

Third Century did not early adopt SFAS No. 156 on January 1, 2006. Management is currently evaluating the effect of adoption of this Statement on Third Century's financial condition or results of operations.

Note 7. Construction of Franklin Central Branch

In August 2005, Mutual Savings Bank closed on the purchase of land in Franklin Township, which is located in southeastern Marion County, for \$407,550. Construction of a new branch, to be known as the Franklin Central Branch, began in the fourth quarter of 2005. The board of Mutual awarded a contract to Waugh Company for the construction of the Franklin Central Branch in southeast Marion County. In addition, the Bank entered into contracts with Diebold, Inc., a vendor who provides ATM, vault and teller equipment, and PrinceAlexander, an architectural firm, to perform work for and provide services to the Franklin Central Branch project. These contracts represented estimated construction costs to the Bank as follows:

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Land acquisition	\$ 407,550
Waugh & Company	\$ 766,322
Diebold, Inc.	\$ 92,179
PrinceAlexander	\$ 67,688
Total	\$ 1,333,739

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The Franklin Central Branch opened for business on June 1, 2006.

Note 8. Reclassifying Entries to the Consolidated Condensed Financial Statements

Reclassifications to the consolidated condensed income statements for the three and six months ended June 30, 2005 were made to conform to the consolidated condensed income statement presentation of the three and six months ended June 30, 2006.

**Item 2. Management's Discussion and Analysis or Plan of Operations**

**Forward Looking Statements**

This Quarterly Report on Form 10-QSB ("Form 10-QSB") contains statements which constitute forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements appear in a number of places in this Form 10-QSB and include statements regarding the intent, belief, outlook, estimate or expectations of Third Century (as defined in the notes to the consolidated condensed financial statements), its directors or its officers primarily with respect to future events and the future financial performance of Third Century. Readers of the Form 10-QSB are cautioned that any such forward looking statements are not guarantees of future events or performance and involve risks and uncertainties, and that actual results may differ materially from those in the forward looking statements as a result of various factors. The accompanying information contained in this Form 10-QSB identifies important factors that could cause such differences. These factors include changes in interest rates; loss of deposits and loan demand to other financial institutions; substantial changes in financial markets; changes in real estate values and the real estate market; or regulatory changes, as discussed further below:

(a) **Regulatory Risk.** The banking industry is heavily regulated. These regulations are intended to protect depositors, not shareholders. Third Century and Mutual are subject to regulation and supervision by the Indiana Department of Financial Institutions, Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System. The burden imposed by federal and state regulations puts banks at a competitive disadvantage compared to less regulated competitors such as finance companies, mortgage banking companies and leasing companies. The banking industry continues to lose market share to competitors.

(b) **Legislation.** Because of concerns relating to the competitiveness and the safety and soundness of the industry, Congress continues to consider a number of wide-ranging proposals for altering the structure, regulation, and competitive relationships of the nation's financial institutions. Management cannot predict whether or in what form any of these proposals will be adopted or the extent to which the business of Third Century or Mutual may be affected thereby.

(c) **Credit Risk.** One of the greatest risks facing lenders is credit risk, that is, the risk of losing principal and interest due to a borrower's failure to perform according to the terms of a loan agreement. While management attempts to provide an allowance for loan losses at a level adequate to cover probable incurred losses based on loan portfolio growth, past loss experience, general economic conditions, information about specific borrower situations, and other factors (all as discussed below in Critical Accounting Policies--Allowance for Loan Losses), future adjustments to reserves may become necessary, and net income could be significantly affected, if circumstances differ substantially from assumptions used with respect to such factors.

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(d) **Exposure to Local Economic Conditions.** Mutual's primary market area for deposits and loans encompasses Johnson County, in central Indiana. A substantial percent of the Bank's business activities are within this area. This concentration exposes the Bank to risks resulting from changes in the local economy. A dramatic drop in local real estate values would, for example, adversely affect the quality of the Bank's loan portfolio.

(e) **Interest Rate Risk.** Third Century's earnings depend to a great extent upon the level of net interest income, which is the difference between interest income earned on loans and investments and the interest expense paid on deposits and other borrowings. Interest rate risk is the risk that the earnings and capital will be adversely affected by changes in interest rates.

(f) **Competition.** The activities of Third Century and Mutual in the geographic market served involve competition with other banks as well as with other financial institutions and enterprises, many of which have substantially greater resources than those available to Third Century. In addition, non-bank competitors are generally not subject to the extensive regulation applicable to Third Century and Mutual.

### **Critical Accounting Policies**

Generally accepted accounting principles are complex and require management to apply significant judgments to various accounting, reporting and disclosure matters. Management of Third Century must use assumptions and estimates to apply these principles where actual measurement is not possible or practical. For a complete discussion of Third Century's significant accounting policies, see Note 1 to the Consolidated Financial Statements as of December 31, 2005. Certain policies are considered critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. Management has reviewed the application of these policies with the Audit Committee of Third Century's Board of Directors. Those policies include the following:

#### **Allowance for Loan Losses**

The allowance for loan losses represents management's estimate of probable losses inherent in the Bank's loan portfolios. In determining the appropriate amount of the allowance for loan losses, management makes numerous assumptions, estimates and assessments.

The strategy also emphasizes diversification on an industry and customer level, regular credit quality reviews and quarterly management reviews of large credit exposures and loans experiencing deterioration of credit quality.

Mutual's allowance consists of three components: probable losses estimated from individual reviews of specific loans, probable losses estimated from historical loss rates, and probable losses resulting from economic or other deterioration above and beyond what is reflected in the first two components of the allowance.

Larger commercial loans that exhibit probable or observed credit weaknesses are subject to individual review. Where appropriate, reserves are allocated to individual loans based on management's estimate of the borrower's ability to repay the loan given the availability of collateral, other sources of cash flow and legal options available to Mutual. Included in the review of individual loans are those that are impaired as provided in SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*. Any allowances for impaired loans are determined by the present value of expected future cash flows discounted at the loan's effective interest rate or fair value of the underlying collateral. Mutual evaluates the collectibility of both principal and interest when assessing the need for a loss accrual. Historical loss rates are applied to other commercial loans not subject to specific reserve allocations.

Homogenous smaller balance loans, such as consumer installment and residential mortgage loans are not individually risk graded. Reserves are established for each pool of loans based on the expected net charge-offs for one year. Loss

rates are based on the average net charge-off history by loan category.

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Historical loss rates for commercial and consumer loans may be adjusted for significant factors that, in management's judgment, reflect the impact of any current conditions on loss recognition. Factors which management considers in the analysis include the effects of the national and local economies, trends in the nature and volume of loans (delinquencies, charge-offs and nonaccrual loans), changes in mix, asset quality trends, risk management and loan administration, changes in the internal lending policies and credit standards, collection practices and examination results from bank regulatory agencies and the Bank's internal loan review.

An unallocated reserve is maintained to recognize the imprecision in estimating and measuring loss when evaluating reserves for individual loans or pools of loans. Allowances on individual loans are reviewed quarterly and historical loss rates are reviewed annually and adjusted as necessary based on changing borrower and/or collateral conditions and actual collection and charge-off experience.

Mutual's primary market area for lending is Johnson County, Indiana. When evaluating the adequacy of the allowance, consideration is given to this regional geographic concentration and the closely associated effect changing economic conditions have on Mutual's customers.

### **Mortgage Servicing Rights**

Mortgage servicing rights (MSRs) associated with loans originated and sold, where servicing is retained, are capitalized and included in other intangible assets in the consolidated balance sheet. The value of the capitalized servicing rights represents the present value of future servicing fees arising from the right to service loans in the portfolio. Critical accounting policies for MSRs relate to the initial valuation and subsequent impairment tests. The methodology used to determine the valuation of MSRs requires the development and use of a number of estimates, including anticipated principal amortization and prepayments of that principal balance. Events that may significantly affect the estimates used are changes in interest rates, mortgage loan prepayment speeds and the payment performance of the underlying loans. The carrying value of the MSRs is periodically reviewed for impairment based on a determination of fair value. For purposes of measuring impairment, the servicing rights are compared to a valuation prepared based on a discounted cash flow methodology, utilizing current prepayment speeds and discount rates. Impairment, if any, is recognized through a valuation allowance and is recorded as amortization of intangible assets.

### **Comparison of Financial Condition at June 30, 2006 and at December 31, 2005**

Total assets increased \$2.0 million or 1.59% to \$130.2 million at June 30, 2006 from \$128.1 million at December 31, 2005. Total net loans outstanding grew by \$5.8 million or 5.48% to \$111.3 million at June 30, 2006 from \$105.6 million at December 31, 2005. The majority of this loan growth consisted of commercial lines of credit (\$1.7 million or 29.08%), installment loans secured by receivables and inventories of commercial businesses (\$1.4 million or 25.00%) and residential construction loans (\$1.3 million or 23.82%). Cash and cash equivalents decreased \$1.9 million or 24.53% and held to maturity securities decreased \$2.6 million or 28.35% to fund loans through June 30, 2006.

Total liabilities increased by \$5.0 million or 4.77% to \$110.6 million at June 30, 2006 from \$105.6 million at December 31, 2005. The Bank paid off \$2.0 million in advances and borrowed an additional \$9.6 million to meet the daily operational cash flow needs during the quarter, which resulted in a net increase in Federal Home Loan Bank advances of \$7.6 million or 46.06%. Total deposits decreased \$2.5 million or 2.87% to \$86.1 million at June 30, 2006 from \$88.6 million at December 31, 2005. The majority of the decrease in deposits was in the NOW checking accounts which declined \$1.4 million or 8.26%.

Total stockholders' equity decreased to \$19.3 million at June 30, 2006 from \$22.4 million at December 31, 2005, representing a decrease of \$3.1 million or 13.74%. The \$3.3 million return of capital was recognized by the Bank as a reduction of retained earnings as of March 16, 2006 and represented a significant portion of the decrease. The equity

contributed by the ESOP increased \$64,000 to \$267,000 at June 30, 2006 from \$203,000 at December 31, 2005. Third Century paid year-to-date cash dividends, exclusive of the return of capital dividend, of \$125,000.

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### **Comparison of Operating Results for the Three Months Ended June 30, 2006 and 2005**

*General.* Net income for the quarter ended June 30, 2006 was \$138,000 compared to net income of \$121,000 for the quarter ended June 30, 2005. Net interest income increased \$10,000 or 0.84%, other income increased \$89,000 or 54.27% and other expense increased by \$34,000 or 2.91%. See the following subsections for further discussion of these changes.

*Interest Income.* Interest income for the quarter ended June 30, 2006 was \$1.9 million compared to \$1.7 million for the quarter ended June 30, 2005. The increase during the comparative periods reflected an increase of \$228,000, which consisted primarily of an increase in interest income on loans by \$247,000 or 15.76%.

Average interest-earning assets for the quarter ended June 30, 2006 was \$124.5 million, which represented an increase of \$1.5 million or 1.29%, from the quarter ended June 30, 2005. The yield on those assets increased to 6.23% at June 30, 2006 from 5.57% at June 30, 2005. The average yield on loans increased by 36 basis points, the average yield on interest-earning deposits increased 108 basis points and the average yield on investments increased 89 basis points. The average balances for loans increased \$9.5 million to \$111.6 million and the average balances for interest-earning deposits increased \$3.3 million to \$4.2 million, while the average balances for investments decreased \$2.4 million to \$7.6 million at June 30, 2006.

*Interest Expense.* Interest expense for the quarter ended June 30, 2006 was \$743,000 compared to \$525,000 for the quarter ended June 30, 2005, an increase of \$218,000 or 41.52%. Average interest-bearing liabilities increased to \$96.9 million for the quarter ended June 30, 2006 from \$94.6 million for the quarter ended June 30, 2005, with the average interest rate increasing to 3.07% for the quarter ended June 30, 2006 from 2.22% for the quarter ended June 30, 2005.

*Net Interest Income.* Net interest income of \$1.2 million for the quarter ended June 30, 2006 reflects a \$10,000 or 0.84% change from the net interest income for the quarter ended June 30, 2005.

*Provision for Loan Losses.* Mutual Savings Bank recorded a provision for loan losses of \$15,000 during the quarter ended June 30, 2006, while a negative provision of \$20,000 was made during the quarter ended June 30, 2005. In evaluating the adequacy of loan loss allowances, management considers factors such as delinquency trends, portfolio composition, past loss experience and other factors such as general economic conditions. During the past year, Mutual Savings Bank's nonperforming assets decreased to \$86,000 at June 30, 2006 from \$100,000 at June 30, 2005 and the percentage of nonperforming assets to total assets decreased to 0.07% from 0.08% for the same respective time periods. Mutual Savings Bank recorded net charge offs of \$26,000 for the quarter ended June 30, 2006 and \$4,000 for the quarter ended June 30, 2005.

*Other Income.* Total other income was \$253,000 for the quarter ended June 30, 2006 and \$164,000 for the quarter ended June 30, 2005, which represented an increase of \$89,000 or 54.27%. Other income increased \$48,000 or 228.57% to \$69,000 for the quarter ended June 30, 2006 from \$21,000 for the quarter ended June 30, 2005. This category included gains and losses on the sale of REO properties. For the quarter ended June 30, 2006, the Bank recorded a gain on the sale of a REO property for \$20,000 while the Bank recorded a loss of \$20,000 on the sale of a REO property during the quarter ended June 30, 2005. The change in reporting periods represented an increase of \$40,000 or 200%.

In addition, other service charges and fees increased \$24,000 or 38.10% to \$87,000 for the quarter ended June 30, 2006 from \$63,000 for the quarter ended June 30, 2005. The majority of this increase consisted of fees collected on loans sold to and underwritten for another bank, which were \$6,000 for the quarter ended June 30, 2006. No income was recorded for the quarter ended June 30, 2005. Commissions and fees collected on funds provided to immediately

clear monetary instruments drawn on the bank through Travelers Express increased \$6,000 or 280.88% to \$8,000 for the quarter ended June 30, 2006 from \$2,000 for the quarter ended June 30, 2005.

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*Other Expense.* Total other expense for each of the quarters ended June 30, 2006 and 2005 was \$1.2 million. The category increased \$34,000 or 2.91% between the two reporting periods. Salaries and employee benefits increased \$26,000 or 3.68% to \$732,000 for the three months ended June 30, 2006 from \$706,000 for the three months ended June 30, 2005. Some of the more significant components that contributed to the increase included the following: an increase in officer and employee salaries of \$41,000 or 8.94% due to staff hired for the new Franklin Central branch; and, Mutual started to expense earned shares of its RRP during the third quarter of 2005 and recognized RRP expense of \$39,000 during the quarter ending June 30, 2006. A decrease in retirement contributions of \$38,000 or 55.61% due to the freezing of the defined benefit plan on May 1, 2005 partially offset the noted increases.

Professional services decreased \$49,000 or 64.47% to \$27,000 for the quarter ended June 30, 2006 from \$76,000 for the quarter ended June 30, 2005. Third Century changed attorneys as of January 1, 2006. Fees paid to attorneys for services performed in support of a public company decreased \$33,000 or 68.66%.

Other expenses increased \$29,000 or 19.08% to \$181,000 for the quarter ended June 30, 2006 from \$152,000 for the quarter ended June 30, 2005. The majority of this increase was due to an increase of \$13,000 or 125.35% in advertising expense to \$24,000 for the quarter ended June 30, 2006 from \$11,000 for the quarter ended June 30, 2005. Mutual purchased promotional materials and items to advertise the opening of the Franklin Central branch.

Net occupancy and equipment expenses increased \$11,000 or 9.40% to \$128,000 for the quarter ended June 30, 2006 from \$117,000 for the quarter ended June 30, 2005. In May 2006, Mutual paid real estate taxes which included 72 E. Jefferson Street and the Clark Street properties both acquired in 2005. These asset additions, as well as increased property tax rates, resulted in increased real estate taxes of \$6,600 or 94.29% to \$14,000 for the quarter ended June 30, 2006 from \$7,000 for the quarter ended June 30, 2005. Also in May 2006, Mutual repaired an ATM terminal at Main Street which was struck by lightning. The repair cost \$5,000, net of proceeds received from the insurance company.

Data processing fees increased \$14,000 or 15.38% to \$105,000 for the quarter ended June 30, 2006 from \$91,000 for the quarter ended June 30, 2005 as a result of increased billings.

*Income Taxes.* Mutual Savings Bank recognized income tax expense of \$93,000 for the quarter ended June 30, 2006, as compared to \$80,000 for the quarter ended June 30, 2005, which represents an increase in the effective tax rate to 40.26% at June 30, 2006 from 39.80% at June 30, 2005.

### **Comparison of Operating Results for the Six Months Ended June 30, 2006 and 2005**

*General.* Net income for the six months ended June 30, 2006 was \$281,000 compared to net income of \$201,000 for the six months ended June 30, 2005. Net interest income increased \$37,000 or 1.57% and other income increased \$142,000 or 42.77% while other expense decreased by \$3,000 or 0.13%. See the following subsections for further discussion of these changes.

*Interest Income.* Interest income for the six months ended June 30, 2006 was \$3.8 million compared to \$3.4 million for the six months ended June 30, 2005. The increase during the comparative periods reflected an increase of \$422,000, which consisted primarily of an increase in interest income on loans by \$410,000 or 13.29%. Additionally, investment income increased by \$26,000, or 17.93%, to \$171,000 at June 30, 2006 from \$145,000 at June 30, 2005.

Average interest-earning assets for the six months ended June 30, 2006 was \$123.8 million, which represented an increase of \$1.0 million or 0.82% from the \$122.7 million for the six months ended June 30, 2005. The average yield on those assets increased to 6.10% for the six months ended June 30, 2006 from 5.46% for the six months ended June 30, 2005. The average yield on loans increased by 27 basis points, the average yield on interest-earning deposits increased 159 basis points and the average yield on investments increased 115 basis points. The average balances for



loans increased \$8.5 million to \$109.6 million while the average balances for interest-earning deposits decreased \$5.7 million to \$4.7 million and investments decreased \$1.5 million to \$8.4 million at June 30, 2006.

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*Interest Expense.* Interest expense for the six months ended June 30, 2006 was \$1.4 million compared to \$998,000 for the six months ended June 30, 2005, an increase of \$385,000 or 38.58%.

Average interest-bearing liabilities increased to \$95.6 million for the six months ended June 30, 2006 from \$94.7 million for the six months ended June 30, 2005, with the average interest rate increasing to 2.89% for the six months ended June 30, 2006 from 2.11% for the six months ended June 30, 2005.

*Net Interest Income.* Net interest income of \$2.4 million for the six months ended June 30, 2006 reflects a \$37,000 or 1.57% change from the net interest income for the six months ended June 30, 2005.

*Provision for Loan Losses.* Mutual Savings Bank recorded a provision for loan losses of \$30,000 during the six months ended June 30, 2006, while a \$20,000 negative provision was made during the six months ended June 30, 2005. In evaluating the adequacy of loan loss allowances, management considers factors such as delinquency trends, portfolio composition, past loss experience and other factors such as general economic conditions. During the past year, Mutual Savings Bank's nonperforming assets decreased to \$86,000 at June 30, 2006 from \$100,000 at June 30, 2005 and the percentage of nonperforming assets to total assets decreased to 0.07% from 0.08% for the same respective time periods. Mutual Savings Bank recorded net charge offs of \$25,000 for the six months ended June 30, 2006 and \$14,000 for the six months ended June 30, 2005.

*Other Income.* Total other income was \$474,000 for the six months ended June 30, 2006 and \$332,000 for the six months ended June 30, 2005, which represented an increase of \$142,000 or 42.77%. Other income increased \$64,000 or 101.59% to \$127,000 for the six months ended June 30, 2006 from \$63,000 for the six months ended June 30, 2005. This category included gains and losses on the sale of REO properties. For the six months ended June 30, 2006, the Bank recorded a gain on the sale of a REO property for \$20,000 while the Bank recorded a loss of \$20,000 on the sale of a REO property during the six months ended June 30, 2005. In addition, fiduciary services increased \$19,000 or 68.12% to \$46,000 for the six months ended June 30, 2006 from \$27,000 for the six months ended June 30, 2005 due to fees of \$10,000 and \$9,800 collected on two larger trusts.

Service charges on deposit accounts increased \$47,000 or 47.96% to \$145,000 for the six months ended June 30, 2006 from \$98,000 for the six months ended June 30, 2005. This increase resulted from Mutual implementing changes to its deposit fee structure.

*Other Expense.* Total other expense for the six months ended June 30, 2006 and 2005 was \$2.4 million. Data processing fees increased \$22,000 or 11.70% to \$210,000 for the six months ended June 30, 2006 from \$188,000 for the six months ended June 30, 2005 as a result of increased billings.

Professional services decreased \$48,000 or 47.52% to \$53,000 for the six months ended June 30, 2006 from \$101,000 for the six months ended June 30, 2005. Fees paid to attorneys for services performed in support of a public company decreased \$20,000 or 40.33%. In addition, audit and accounting fees decreased \$28,000 or 53.50%.

*Income Taxes.* Mutual Savings Bank recognized income tax expense of \$184,000 for the six months ended June 30, 2006, as compared to \$132,000 for the six months ended June 30, 2005, which represents a decrease in the effective tax rate to 39.57% at June 30, 2006 from 39.64% at June 30, 2005.

## **Other**

The Securities and Exchange Commission maintains a Web site that contains reports, proxy information statements, and other information regarding registrants that file electronically with the Commission, including Third Century. The address is <http://www.sec.gov>.

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**Item 3. Controls and Procedures**

A. Evaluation of disclosure controls and procedures. Third Century's chief executive officer and chief financial officer, after evaluating the effectiveness of Third Century's disclosure controls and procedures (as defined in Sections 13a-15(e) and 15d-15(e) of regulations promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act")), as of the end of the most recent fiscal quarter covered by this quarterly report (the "Evaluation Date"), have concluded that as of the Evaluation Date, Third Century's disclosure controls and procedures were effective in ensuring that information required to be disclosed by Third Century in reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

B. Changes in internal control over financial reporting. There were no changes in Third Century's internal control over financial reporting identified in connection with Third Century's evaluation of controls that occurred during Third Century's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, Third Century's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

Third Century, from time to time, is a party to routine litigation, which arises in the normal course of business, such as claims to enforce liens, condemnation proceedings on properties in which Mutual Savings Bank holds security interests, claims involving the making and servicing of real property loans, and other issues incident to the business of Third Century. There were no lawsuits pending or known to be contemplated against Third Century at June 30, 2006 that would have a material effect on Third Century's operations or income.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

On May 17, 2006, Third Century Bancorp held its annual meeting of shareholders. There were present at the meeting in person or by proxy the holders of 1,429,976 votes. At the annual meeting, the following matters were submitted to a vote of security holders:

(a) Election of Directors. The following persons were elected as members of the Board of Directors, for the terms set forth below:

**Term Expires**

**Votes For**

**Votes Withheld**

David A. Coffey	2009	1,412,307	17,669
Jerry D. Petro	2009	1,409,175	20,801

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

The exhibits filed as part of this Form 10-QSB are listed in the Exhibit Index, which is incorporated by this reference.

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**Signatures**

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

**THIRD CENTURY BANCORP**

Date: August 11, 2006

By: /s/ Robert D. Heuchan  
Robert D. Heuchan  
President and Chief  
Executive Officer

By: /s/ Debra K. Harlow  
Debra K. Harlow  
Chief Financial Officer

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**Exhibit Index**

<b>Exhibit No.</b>	<b>Description</b>
<u>31.1</u>	<u>Rule 13a-14(a) Certification of Robert D. Heuchan, President and Chief Executive Officer</u>
<u>31.2</u>	<u>Rule 13a-14(a) Certification of Debra K. Harlow, Vice President and Chief Financial Officer</u>
<u>32.1</u>	<u>Section 1350 Certification of Robert D. Heuchan</u>
<u>32.2</u>	<u>Section 1350 Certification of Debra K. Harlow</u>

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