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1ST INDEPENDENCE FINANCIAL GROUP, INC.

Form 10-Q

November 07, 2006

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

FORM 10-Q

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

For the quarterly period ended September 30, 2006
or

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

For the transition period from _____ to _____

Commission File Number 0-26570

1ST INDEPENDENCE FINANCIAL GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware 61-1284899
(State or other jurisdiction of (I.R.S. Employer Identification No.)
incorporation or organization)

104 South Chiles Street 40330-1620
Harrodsburg, Kentucky (Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (502)753-0500

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The registrant had 1,987,658 shares of common stock outstanding at October 28, 2006.

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1st INDEPENDENCE FINANCIAL GROUP, INC.
FORM 10-Q
For the Quarter Ended September 30, 2006

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INDEX

Part I - Financial Information

Item 1. Financial Statements	Page Number -----
Condensed Consolidated Balance Sheets as of September 30, 2006 (unaudited) and December 31, 2005	3
Condensed Consolidated Statements of Operations for the three months and nine months ended September 30, 2006 and 2005 (unaudited)	4
Condensed Consolidated Statements of Comprehensive Income for the three months and nine months ended September 30, 2006 and 2005 (unaudited)	5
Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2006 and 2005 (unaudited)	6
Notes to Condensed Consolidated Financial Statements (unaudited)	7-10
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	11-16
Item 3. Quantitative and Qualitative Disclosures About Market Risk	17
Item 4. Controls and Procedures	17

Part II - Other Information

Item 1. Legal Proceedings	18
Item 1A. Risk Factors	18-24
Item 6. Exhibits	24
Signatures	25

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

1ST INDEPENDENCE FINANCIAL GROUP, INC.
Condensed Consolidated Balance Sheets
(in thousands except share data)

	(Unaudited) September 30, 2006 -----	Dec
Assets		
Cash and due from banks	\$ 3,851	
Interest-bearing demand deposits	5,671	
Federal funds sold	10,104	
	-----	-----

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Cash and cash equivalents	19,626	
Interest-bearing deposits	100	
Available-for-sale securities at fair value	15,913	
Held-to-maturity securities, fair value of \$1,923 and \$1,974 at September 30, 2006 and December 31, 2005, respectively	1,901	
Loans held for sale	588	
Loans, net of allowance for loan losses of \$3,569 and \$2,911 at September 30, 2006 and December 31, 2005, respectively	271,469	
Premises and equipment, net	8,104	
Federal Home Loan Bank (FHLB) stock	2,302	
Bank owned life insurance	3,384	
Goodwill	11,142	
Interest receivable and other assets	3,680	
	-----	-----
Total assets	\$ 338,209	=====
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Demand	\$ 16,002	
Savings, NOW and money market	66,869	
Time	182,661	
	-----	-----
Total deposits	265,532	
Short-term borrowings	20,919	
Long-term debt	10,279	
Interest payable and other liabilities	1,635	
	-----	-----
Total liabilities	298,365	-----
Commitments and contingencies		
Stockholders' equity		
Preferred stock, \$0.10 par value, 500,000 shares authorized, no shares issued or outstanding		
	-	
Common stock, \$0.10 par value, 5,000,000 shares authorized, 1,987,658 shares and 1,951,408 shares outstanding at September 30, 2006 and December 31, 2005, respectively		
	295	
Additional paid-in capital	39,683	
Retained earnings	14,856	
Unearned ESOP compensation	(313)	
Unearned compensation on restricted stock	-	
Accumulated other comprehensive (loss)	(102)	
Treasury stock, at cost, common, 969,835 shares and 969,835 shares at September 30, 2006 and December 31, 2005, respectively	(14,575)	
	-----	-----
Total stockholders' equity	39,844	-----
	-----	-----
Total liabilities and stockholders' equity	\$ 338,209	=====

See notes to condensed consolidated financial statements.

1ST INDEPENDENCE FINANCIAL GROUP, INC.
Condensed Consolidated Statements of Operations
(in thousands except per share data)

(Unaudited)
Three months ended
September 30

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	2006	2005
Interest and dividend income		
Interest and fees on loans	\$ 5,373	\$ 4,459
Interest on securities		
Taxable	164	166
Tax exempt	46	28
Interest on federal funds sold	101	36
Dividends	38	36
Interest on deposits with financial institutions	75	41
Total interest and dividend income	5,797	4,766
Interest expense		
Deposits	2,614	1,740
FHLB advances	301	212
Other	192	156
Total interest expense	3,107	2,108
Net interest income	2,690	2,658
Provision for loan losses	543	60
Net interest income after provision for loan losses	2,147	2,598
Noninterest income		
Service charges	134	114
Gain on loan sales	277	274
Gain (loss) on sale of premises and equipment	(32)	(144)
Increase in cash value of life insurance	51	47
Net realized gains (losses) on sales of available-for-sale securities	-	(129)
Other	83	129
Total noninterest income	513	291
Noninterest expense		
Salaries and employee benefits	1,004	1,151
Net occupancy	384	325
Data processing fees	190	169
Professional fees	219	158
Marketing	32	77
Other	371	368
Total noninterest expense	2,200	2,248
Income from continuing operations before income taxes and minority interest	460	641
Income tax expense from continuing operations	111	177
Income from continuing operations before minority interest and discontinued operations	349	464
Income from subsidiary held for disposal	-	-
Income tax expense from subsidiary held for disposal	-	-
Income before minority interest	349	464
Minority interest in (income) of consolidated subsidiary and subsidiary held for disposal	-	(2)
Net income	\$ 349	\$ 462

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	=====	=====
Income per share from continuing operations		
Basic	\$0.18	\$0.24
Diluted	0.18	0.24
Income per share from subsidiary held for disposal		
Basic	\$0.00	\$0.00
Diluted	0.00	0.00
Net income per share		
Basic	\$0.18	\$0.24
Diluted	0.18	0.24
Weighted average shares outstanding		
Basic	1,949	1,897
Diluted	1,963	1,939
Cash dividends declared per share	\$0.08	\$0.08

See notes to condensed consolidated financial statements.

1ST INDEPENDENCE FINANCIAL GROUP, INC.
Condensed Consolidated Statements of Comprehensive Income
(in thousands)

	(Unaudited)	
	Three months ended September 30,	
	----- 2006 -----	----- 2005 -----
Net income	\$ 349	\$ 462
Other comprehensive income, net of tax		
Change in unrealized gains and losses on available-for-sale securities	206	(59)
Less reclassification adjustment for realized gains (losses) included in net income	-	(85)
Other comprehensive income (loss)	206	26
Comprehensive income	\$ 555	\$ 488

See notes to condensed consolidated financial statements.

1ST INDEPENDENCE FINANCIAL GROUP, INC.
Condensed Consolidated Statements of Cash Flows
(in thousands)

	(Unaudited)	
	Nine months ended Septe	
	----- 2006 -----	----- 2005 -----
Cash Flows from Operating Activities:		
Net income	\$ 1,470	\$ 4,
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation	539	

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Provision for loan losses	655	
Gain on loan sales	(703)	
Origination of loans held for sale	(38,113)	(47,
Proceeds from loans held for sale	39,506	48,
Compensation expense on stock options	34	
ESOP compensation	83	
Amortization of unearned compensation on restricted stock	12	
Amortization of premiums and discounts on securities	25	
Deferred income taxes	-	
FHLB stock dividend	(90)	
Amortization of loan fees	(278)	
Amortization of intangibles, net	195	
Net realized (gains) on available-for-sale securities	-	(4,
Loss on sale of premises and equipment	32	
Minority interest in income from subsidiary held for disposal	-	
Increase in cash value of life insurance	(148)	
(Income) from subsidiary held for disposal	-	
Changes in:		
(Increase) in interest receivable and other assets	(771)	
Increase (decrease) in interest payable and other liabilities	149	
	-----	-----
Net cash provided by operating activities	2,597	
	-----	-----
Cash Flows from Investing Activities:		
Purchase of interest-bearing deposits	(100)	
Proceeds from maturities of interest-bearing deposits	100	
Purchases of available-for-sale securities	(1,491)	(6,
Proceeds from maturities of available-for-sale securities	1,532	3,
Proceeds from sales of available-for-sale securities	211	11,
Proceeds from maturities of held-to-maturity securities	68	
Net (increase) in loans	(5,200)	(32,
Purchases of premises and equipment	(461)	(3,
Proceeds from sales of premises and equipment	-	
Proceeds from sale of FHLB stock	476	
Proceeds from sale of subsidiary	-	2,
	-----	-----
Net cash (used in) investing activities	(4,865)	(24,
	-----	-----
Cash Flows from Financing Activities:		
Net increase in deposits	1,210	35,
Net increase (decrease) in short-term borrowings	2,172	(4,
Repayment of long-term debt	(3,000)	(1,
Proceeds from exercise of stock options	412	
Cash dividends paid	(463)	
	-----	-----
Net cash provided by financing activities	331	29,
	-----	-----
Net (decrease) increase in cash and cash equivalents	(1,937)	5,
Cash and cash equivalents at beginning of period	21,563	9,
	-----	-----
Cash and cash equivalents at end of period	\$ 19,626	\$ 14,
	=====	=====
Supplemental Cash Flow Information:		
Interest paid	\$ 8,453	\$ 5,
Income taxes paid	985	1,
Net increase in cash and cash equivalents of discontinued operations (revised see note 8)		
Net cash (used in) operating activities	-	
Net cash provided by investing activities	-	1,
Net cash (used in) financing activities	-	
	-----	-----
Net increase in cash and cash equivalents of discontinued operations	-	1,

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Real estate acquired in settlement of loans

181

See notes to condensed consolidated financial statements.

1st INDEPENDENCE FINANCIAL GROUP, INC.

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of 1st Independence Financial Group, Inc. (the "Company") are presented in accordance with the requirements of Form 10-Q and accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These condensed consolidated financial statements and notes thereto included in this report should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Form 10-KSB annual report for the year ended December 31, 2005 filed with the United States Securities and Exchange Commission ("SEC"). In the opinion of management, all adjustments necessary to make the financial statements not misleading and to fairly present the financial position, results of operations and cash flows for the reporting interim periods have been made and were of a normal recurring nature. The results of operations for the period are not necessarily indicative of the results to be expected for the full year. The condensed consolidated balance sheet of the Company as of December 31, 2005 has been derived from the audited consolidated balance sheet of the Company as of that date.

The unaudited condensed financial statements include the accounts of the Company and its wholly-owned subsidiary, 1st Independence Bank, Inc. (the "Bank"), 1st Independence Mortgage, a division of the Bank and for periods prior to its sale on January 28, 2005, the Company's majority-owned subsidiary Citizens Financial Bank, Inc. ("Citizens"). As a result of the Company's sale of Citizens, the assets, liabilities, results of operations and cash flows of Citizens have been reported separately as discontinued operations in the Company's condensed consolidated financial statements and previously reported amounts have been reclassified to consistently present the discontinued operations.

2. Stock-Based Compensation

At September 30, 2006, the Company had two stock-based compensation plans. Prior to January 1, 2006, as permitted by Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), the Company followed the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations in accounting for its stock option plans under the intrinsic value based method. Accordingly, no stock-based compensation expense was recognized for the three months and nine months ended September 30, 2005 for stock options issued under the plans as all stock options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and basic and diluted net income per share had compensation expense been determined based on the fair value of the stock options at the grant date consistent with the provisions of SFAS No. 123 (in thousands except per share data):

	Three months ended September 30, 2005 -----
Net income as reported	\$462
Less total stock-based employee compensation expense (including forfeitures of \$20) determined under fair value method for all awards, net of related tax effects	(14)

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Pro forma net income	\$476
	=====
Basic net income per share	
As reported	\$0.24
Pro forma	0.25
Diluted net income per share	
As reported	\$0.24
Pro forma	0.25
	Nine months ended
	September 30, 2005

Net income as reported	\$4,054
Less total stock-based employee compensation expense (including forfeitures of \$65) determined under fair value method for all awards, net of related tax effects	(52)

Pro forma net income	\$4,106
	=====
Basic net income per share	
As reported	\$2.15
Pro forma	2.18
Diluted net income per share	
As reported	\$2.11
Pro forma	2.14

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No.123R, "Share-Based Payment" ("SFAS 123R"). This Statement requires expensing of stock options and other share-based payments over the related vesting period and supersedes FASB's earlier rule (the original SFAS 123) that had allowed companies to choose between expensing stock options and showing pro forma disclosure only. SFAS 123R permits companies to adopt its requirements using either a "modified prospective" method, or a "modified retrospective" method. Under the "modified prospective" method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. Under the "modified retrospective" method, the requirements are the same as under the "modified prospective" method but this method also permits entities to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS 123. Beginning in January 2006, the Company adopted the Statement as required and elected the "modified prospective" method and thus has not restated prior financial statements. For the three months and nine months ended September 30, 2006, the Company recorded \$8,000 and \$34,000, respectively, in employee stock-based compensation expense, which is included in salaries and employee benefits. As of September 30, 2006, there was \$31,000 of unrecognized stock-compensation expense for previously granted unvested options that will be recognized over a weighted-average period of 1.5 years.

3. Allowance for Loan Losses

An analysis of the changes in the allowance for loan losses for the nine months ended September 30 follows (in thousands):

	2006	2005
	----	----
Beginning balance	\$2,911	\$2,549
Provision for loan losses	655	262

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Loans charged off	(1)	(6)
Recoveries	4	12
	-----	-----
Ending balance	\$3,569	\$2,817
	=====	=====

4. Net Income Per Share Computations

The following is a reconciliation of the numerator and denominator of the basic and diluted per share computations (in thousands except per share data):

	Three months September 2006 ----
Income (numerator) amounts used for basic and diluted per share computations:	
Income from continuing operations	\$349 =====
Income from discontinued operations	\$ - =====
Net income	\$349 =====
Shares (denominator) used for basic per share computations:	
Weighted average shares of common stock outstanding	1,949 =====
Shares (denominator) used for diluted per share computations:	
Weighted average shares of common stock outstanding	1,949
Plus: dilutive effect of stock options	14 -----
Adjusted weighted average shares	1,963 =====
Basic net income per share data:	
Income from continuing operations	\$0.18 =====
Income from discontinued operations	\$ - =====
Net income	\$0.18 =====
Diluted net income per share data:	
Income from continuing operations	\$0.18 =====
Income from discontinued operations	\$ - =====
Net income	\$0.18 =====
	Nine months September 2006 ----
Income (numerator) amounts used for basic and diluted per share computations:	
Income from continuing operations	\$1,470 =====
Income from discontinued operations	\$ - =====
Net income	\$1,470

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	=====
Shares (denominator) used for basic per share computations:	
Weighted average shares of common stock outstanding	1,935
	=====
Shares (denominator) used for diluted per share computations:	
Weighted average shares of common stock outstanding	1,935
Plus: dilutive effect of stock options	19

Adjusted weighted average shares	1,954
	=====
Basic net income per share data:	
Income from continuing operations	\$0.76
	=====
Income from discontinued operations	\$ -
	=====
Net income	\$0.76
	=====
Diluted net income per share data:	
Income from continuing operations	\$0.75
	=====
Income from discontinued operations	\$ -
	=====
Net income	\$0.75
	=====

Options to purchase 17,000 common shares for the three months and nine months ended September 30, 2006 were excluded from the diluted calculations above because the exercise prices on the options were greater than the average market price for the period.

5. Contingencies

The Company is currently a defendant in a lawsuit that asserts that the Company made certain material misrepresentations in connection with certain statements made in connection with its offer to purchase up to 300,000 shares of stock in a tender offer in May 2003. The plaintiffs are seeking to recover damages in connection with the shares they sold in the tender offer and attorneys fees. This matter is currently scheduled for trial in July 2007. Based upon the advice of counsel, management records an estimate of the amount of ultimate expected loss for litigation, if any. Management has not recorded a loss provision for this litigation as, after discussion with legal counsel, management believes the ultimate results of this litigation will not have a material adverse effect on the Company's financial position, results of operations or cash flows. Events could occur that could cause the estimate of ultimate loss to differ materially in the near term. Reference is made to Part II, Item 1 of this report on Form 10-Q for additional information.

6. Recently Issued Accounting Standards

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No.123R, "Share-Based Payment" ("SFAS 123R"). This Statement required expensing of stock options and other share-based payments over the related vesting period beginning in 2005, and superseded FASB's earlier rule (the original SFAS 123) that had allowed companies to choose between expensing stock options and showing pro forma disclosure only. The Statement required that public entities apply SFAS 123R as of the first interim or annual reporting period that began after June 15, 2005. However, in April 2005 the United States Securities and Exchange Commission issued a rule that revised the required date of adoption under SFAS 123R. The

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new rule allowed for public entities to adopt the provisions of SFAS 123R at the beginning of the first fiscal year beginning after June 15, 2005. The Company adopted the Statement in the first quarter of 2006 as required and the effects of initial adoption were immaterial. See note 2, "Stock-Based Compensation" to this report for additional information.

In July 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109" ("FIN 48"). The Interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with FASB Statement No. 109, "Accounting for Income Taxes". FIN 48 also 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, disclosure and transition. The evaluation of a tax position in accordance with this Interpretation is a two-step process. The first step is a recognition process to determine whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step is a measurement process whereby a tax position that meets the more likely than not recognition threshold is calculated to determine the amount of benefit to recognize in the financial statements. FIN 48 is effective for fiscal years beginning after December 15, 2006 and the cumulative effect of applying the provisions of this statement will be recognized as an adjustment to the beginning balance of retained earnings. The Company is currently evaluating the potential impact this Statement may have on the Company's financial position and results of operations, but does not believe the impact of the adoption will be material.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS 157"), which provides guidance on how to measure assets and liabilities that use fair value. SFAS 157 will apply whenever another US GAAP standard requires (or permits) assets or liabilities to be measured at fair value but does not expand the use of fair value to any new circumstances. This Statement also will require additional disclosures in both annual and quarterly reports. SFAS 157 will be effective for financial statements issued for fiscal years beginning after November 15, 2007, and will be adopted by the Company beginning in the first quarter of 2008. The Company is currently evaluating the potential impact this Statement may have on the Company's financial position and results of operations, but does not believe the impact of the adoption will be material.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 was issued in order to eliminate the diversity of practice in how public companies quantify misstatements of financial statements, including misstatements that were not material to prior years' financial statements. The Company will initially apply the provisions of SAB 108 in connection with the preparation of our annual financial statements for the year ending December 31, 2006. The Company has evaluated the potential impact SAB 108 may have on the Company's financial position and results of operations and the Company does not believe the impact of the application of this guidance will be material.

7. Completion of Subsidiary Disposal

On January 28, 2005 the Company completed the sale of its entire interest in its majority owned subsidiary, Citizens Financial Bank, Inc., to Porter Bancorp, Inc. for \$2.3 million, pursuant to a Stock Purchase Agreement, dated as of October 22, 2004, between Porter Bancorp, Inc. and the Company. In a related transaction, on January 28, 2005, the Company's subsidiary bank, 1st Independence Bank, Inc., purchased a commercial building located in Louisville, Kentucky, for \$2.3 million from Ascencia Bank, Inc., an affiliate of Porter

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Bancorp, Inc. See note 4, "Completion of Subsidiary Disposal" to the consolidated financial statements included in the Company's Form 10-KSB for the year ended December 31, 2005 for additional information.

8. Revised Cash Flows of Discontinued Operations

In 2005 the Company has separately disclosed the operating, investing and financing portions of the cash flows attributable to its discontinued operations, which in prior periods were reported on a combined basis as a single amount.

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

This section should be read in conjunction with the condensed consolidated financial statements and notes thereto included in Item 1 of Part I of this report in addition to the consolidated financial statements of the Company and the notes thereto included in the Company's Form 10-KSB for the year ended December 31, 2005, including note 1 which describes the Company's significant accounting policies including its use of estimates. See the caption entitled "Application of Critical Accounting Policies" in this section for further information.

Forward-Looking Statements

The following discussion contains statements which are forward-looking rather than historical fact. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and involve known and unknown risks, uncertainties and other factors, which may cause the Company's actual results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such statements are subject to certain risks and uncertainties including among other things, changes in economic conditions in the market areas the Company conducts business, changes in policies by regulatory agencies, fluctuations in interest rates, demand for loans in the market areas the Company conducts business, competition that could cause actual results to differ materially from historical earnings and those presently anticipated or projected and other risks as detailed in the Company's various filings with the United States Securities and Exchange Commission. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made.

General

The Company provides commercial and retail banking services, including commercial real estate loans, one-to-four family residential mortgage loans via 1st Independence Mortgage, home equity loans and lines of credit and consumer loans as well as certificates of deposit, checking accounts, money-market accounts and savings accounts within its market area. At September 30, 2006, the Company had total assets, deposits and stockholders' equity of \$338.2 million, \$265.5 million, and \$39.8 million, respectively. The Company's business is conducted principally through the Bank. Unless otherwise indicated, all references to the Company refer collectively to the Company and the Bank.

The Company is currently a defendant in a lawsuit that asserts that the Company made certain material misrepresentations in connection with its offer to purchase up to 300,000 shares of stock in a tender offer in May 2003. The plaintiffs are seeking to recover damages in connection with the shares they sold in the tender offer and attorneys fees. This matter is currently scheduled for trial in July 2007. Based upon the advice of counsel, management records an estimate of the amount of ultimate expected loss for litigation, if any. Management has not recorded a loss provision for this litigation as, after discussion with legal counsel, management believes the ultimate result of this

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litigation will not have a material adverse effect on the Company's financial position, results of operations or cash flows. Events could occur that could cause the estimate of ultimate loss to differ materially in the near term.

In January 2005, the Company sold its 55.8% interest in Citizens Financial Bank, Inc., Glasgow, Kentucky ("Citizens") to Porter Bancorp, Inc., Shepherdsville, Kentucky ("Porter Bancorp") for \$2.3 million. The sale of Citizens reflected the Company's revised strategic plan to exit the south central Kentucky market and to focus on the growing markets of southern Indiana, central Kentucky, and greater Louisville, Kentucky.

Application of Critical Accounting Policies

The discussion and analysis of the Company's financial condition and results of operation is based upon the Company's unaudited condensed consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information and with the instructions for Form 10-Q. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company's most critical accounting policies require the use of estimates relating to other than temporary impairment of securities, the allowance for loan losses and the valuation of goodwill. See the caption entitled "Critical Accounting Policies" in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of the Company's Form 10-KSB for the year ended December 31, 2005 for additional information.

Overview

Net income for the quarter ended September 30, 2006 was \$349,000 or \$0.18 per diluted share compared to \$462,000 or \$0.24 per diluted share for the comparable period in 2005. Net income for the nine months ended September 30, 2006 was \$1,470,000 or \$0.75 per diluted share compared to \$4,054,000 or \$2.11 per diluted share for the comparable period in 2005. The decrease in net income and net income per diluted share for the nine-month period was primarily due to after tax securities gains of \$3,308,000 taken in the first quarter of 2005 and the increase of \$259,000 after taxes in the provision for loan losses in the first nine months of 2006 compared to the first nine months of 2005. Partially offsetting these factors was an increase in net interest income of \$352,000 after taxes and an after tax charge of \$235,000 recorded in the first quarter of 2005 for severance expenses related to the retirement of the Company's former Chairman and Chief Executive Officer. Other factors were decreased professional fees and other noninterest expense items. The decrease in net income and net income per diluted share for the quarter was primarily due to an increase of \$319,000 after taxes in the provision for loan losses in the third quarter of 2006 compared to the same period in 2005. Partially offsetting this factor was the decrease in the loss on sale of premises and equipment of \$74,000 after taxes in the third quarter of 2006 versus the third quarter of 2005 and the net realized losses on sales of available-for-sale securities of \$85,000 after taxes recorded in the third quarter of 2005 while no transactions were recorded in the third quarter of 2006. Decreases in other noninterest income and noninterest expenses which are described more fully in following sections accounted for most of the remaining net change.

Results of Operations

Net Interest Income

Net interest income is the most significant component of the Company's revenues. Net interest income is the difference between interest income on interest-earning assets (primarily loans and investment securities) and interest expense on interest-bearing liabilities (deposits and borrowed funds). Net

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interest income depends on the volume and rate earned on interest-earning assets and the volume and rate paid on interest-bearing liabilities.

Net interest income was \$2.7 million and \$8.1 million, respectively, for the three months and nine months ended September 30, 2006, which was flat and an increase of \$0.5 million or 7%, respectively, from \$2.7 million and \$7.5 million, respectively, for the comparable periods of 2005. On an annualized basis, the net interest spread and net interest margin were 2.94% and 3.39%, respectively, for the current quarter, compared to 3.21% and 3.51% for the same period of 2005. For the nine months ended September 30, 2006 the net interest spread and net interest margin were 3.03% and 3.45%, respectively, compared to 3.16% and 3.45% for the first half of 2005. The decrease in the net interest margin for the third quarter 2006 compared to the third quarter of 2005 and the net interest margin being the same for the nine months ended September 30, 2006 versus the same period in 2005 was primarily due to the reversal of \$57,000 of interest income on a \$2.6 million loan which was placed on nonaccrual in August 2006 and a faster increase in interest rates on interest-bearing liabilities, including the effect of the increasing rate on the \$4.1 million of variable rate subordinated debentures, compared to the rates on interest-earning assets. Partially offsetting these factors were increases in the volume of net earning assets. Changes in volume resulted in an increase in net interest income of \$0.1 million and \$0.8 million for the third quarter and first nine months of 2006 compared to the same periods in 2005, and changes in interest rates and the mix resulted in a decrease in net interest income of \$0.1 million and \$0.2 million for the third quarter and first nine months of 2006 versus the comparable periods in 2005.

The Bank, like many other financial institutions, is vulnerable to an increase in interest rates to the extent that interest-bearing liabilities mature or reprice more rapidly than interest-earning assets. Historically, the lending activities of commercial banks emphasized the origination of short to intermediate term variable rate loans that are more closely matched with the deposit maturities and repricing of interest-bearing liabilities which occur closer to the same general time period. While having interest-bearing liabilities that reprice more frequently than interest-earning assets is generally beneficial to net interest income during periods of declining interest rates, it is generally detrimental during periods of rising interest rates.

To reduce the effect of interest rate changes on net interest income, the Bank has adopted various strategies to improve matching interest-earning asset maturities to interest-bearing liability maturities. The principal elements of these strategies include; originating variable rate commercial loans that include interest rate floors; originating one-to-four family residential mortgage loans with adjustable rate features, or fixed rate loans with short maturities; maintaining interest-bearing demand deposits, federal funds sold, and U.S. government securities with short to intermediate term maturities; maintaining an investment portfolio that provides stable cash flows, thereby providing investable funds in varying interest rate cycles; lengthening the maturities of our time deposits and borrowings when it would be cost effective; and attracting low cost checking and transaction accounts, which tend to be less interest rate sensitive when interest rates increase.

The Bank measures its exposure to changes in interest rates using an overnight upward and downward shift (shock) in the Treasury yield curve. As of September 30, 2006, if interest rates increased 200 basis points and decreased 200 points, respectively, the Bank's net interest income would increase by 2.4% and decrease by 3.1%, respectively.

Provision for Loan Losses

The provision for loan losses was \$543,000 and \$655,000 for the three months and nine months ended September 30, 2006, compared to \$60,000 and \$262,000 for the same periods in 2005. Nonperforming loans were \$5.1 million at September 30,

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2006 and \$1.3 million at December 31, 2005, or 1.85% and 0.48%, respectively, of total loans. The increase in the level of nonperforming loans was primarily due the result of one loan of \$2.6 million that was placed on nonaccrual status in August 2006 in addition to several other smaller loans totaling \$0.9 million placed on nonaccrual status during the third quarter of 2006 and a \$0.4 million increase in loans delinquent over 90 days but still accruing at September 30, 2006 compared to the amount at December 31, 2005. A softening in the 1-4 family residential real estate and real estate construction markets contributed to the increase in nonperforming loans. The allowance for loan losses was \$3.6 million and \$2.9 million at September 30, 2006 and December 31, 2005, or 1.30% and 1.08%, respectively, of total loans.

The Company maintains the allowance for loan losses at a level that it considers to be adequate to provide for credit losses inherent in its loan portfolio. Management determines the level of the allowance by performing a quarterly analysis that considers concentrations of credit, past loss experience, current economic conditions, the amount and composition of the loan portfolio (including nonperforming and potential problem loans), estimated fair value of underlying collateral, loan commitments outstanding, and other information relevant to assessing the risk of loss inherent in the loan portfolio. As a result of management's analysis, a range of the potential amount of the allowance for loan losses is determined.

The Company will continue to monitor the adequacy of the allowance for loan losses and make additions to the allowance in accordance with the analysis referred to above. Because of uncertainties inherent in estimating the appropriate level of the allowance for loan losses, actual results may differ from management's estimate of credit losses and the related allowance.

Noninterest Income

Noninterest income was \$0.5 million for the three months ended September 30, 2006, compared to \$0.3 million for the same period in 2005 and \$1.4 million for the nine months ended September 30, 2006, compared to \$6.4 million for the first nine months of 2005. The significant decrease in noninterest income for the nine-month period in 2006 compared to the same period in 2005 resulted primarily from a \$5.0 million gain on sale of Federal Home Loan Mortgage Corporation ("FHLMC") preferred stock recorded in the first quarter of 2005. The gain on loan sales was basically flat for the third quarter of 2006 versus the third quarter of 2005 and decreased for the first nine months of 2006 compared to the same period in 2005 due to a slow down in secondary market mortgage activity and lower margins in 2006. The gain on loan sales was \$277,000 for the three months ended September 30, 2006, compared to \$274,000 for the comparable period in 2005 and \$703,000 for the first nine months of 2006 compared to \$811,000 for the first nine months of 2005. Service charge income was \$134,000 for the three months ended September 30, 2006, compared to \$114,000 for the comparable period in 2005 and \$380,000 for the first nine months of 2006 compared to \$274,000 for the first half of 2005. The Company continues to evaluate its deposit product offerings with the intention of continuing to expand its offerings to the consumer and business depositor. During March 2005, the Bank began offering products which include overdraft privileges on certain individual deposit products and cash management services for business depositors. Both of these products are fee-based and should result in further increases in service charge income. The Bank also introduced a new deposit product known as "ATM Advantage" during September 2005. This product offers unlimited use of competitor's ATM networks with reimbursement of all foreign and surcharge fees. The product does not pay interest but requires a minimum balance to avoid a monthly service charge. This product could reduce service charge income but the effect would be offset by more noninterest bearing deposits which should contribute to additional net interest income. Factors contributing to the decrease in other noninterest income for both the third quarter and nine-month period was the Company's decision to exit the title insurance business at the end of November 2005 and a decrease in fees due to reduced activity relating to secondary market

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mortgage lending and effecting the nine-month period only was a one time gain of \$32,000 on long-term portfolio loans sold in the first quarter of 2005. The Company's title insurance company had approximately \$70,000 and \$201,000 of title insurance revenue for the three months and nine months ended September 30, 2005, respectively.

Noninterest Expense

Noninterest expense was \$2.2 million for both the quarter ended September 30, 2006 and 2005 and \$6.7 million for the nine months ended September 30, 2006 compared to \$7.5 million for the first nine months of 2005. Contributing to the decrease was a decrease in salaries and employee benefits due to the \$356,000 which the Company accrued during the first quarter of 2005 for the severance expense relating to the retirement of the Company's former Chairman and Chief Executive Officer, a reduction in the commissions related to reduced activity in mortgage loan sales, a reduction in incentive accruals and a reduction in professional fees in the first nine months of 2006 compared to the first nine months of 2005 due to a reduced amount of services required notwithstanding that professional fees were higher in the third quarter of 2006 compared to the third quarter of 2005 due to certain previously deferred fees being expensed in the third quarter of 2006. Other factors impacting the nine-month period only included a higher level of other noninterest expenses in the first quarter of 2005 primarily related to integration items associated with the merger with Independence Bancorp, the Citizens disposal in January 2005 and the expenses relating to the title insurance company that was sold which was previously mentioned. Partially offsetting those factors was an increase in net occupancy expenses due to the Bank's purchase of a building, located in Louisville, Kentucky to accommodate expansion. In April 2005, the Bank moved its finance and accounting, loan and deposit operations, and mortgage banking operations into the building and in November 2005 established a full service branch at this location. An additional factor offsetting the overall decrease in noninterest expenses was an increase in data processing expenses which was primarily due to the growth of the Bank's services and its commitment to upgrade systems productivity and the effects of a refund received in the first quarter of 2005 from a previous third party data processing company of the Bank.

Income Tax Expense (Benefit)

The effective income tax rate on income from continuing operations was 24.1% for the three months ended September 30, 2006 compared to 27.6% for the same period in 2005 and 29.5% for the first nine months of 2006 compared to 33.9% for the first nine months of 2005. The decrease in the effective tax rate for the quarter and nine-month periods is primarily due to an increase in the percentage of tax exempt interest income compared to income from continuing operations.

Financial Condition

The Company's total assets were \$338.2 million at September 30, 2006 compared to \$336.2 million at December 31, 2005, an increase of 2.0 million or 0.6%. Net loans increased \$4.5 million, loans held for sale went down \$0.7 million and interest receivable and other assets increased \$0.8 million while cash and cash equivalents decreased \$1.9 million, investments decreased \$0.3 million and Federal Home Loan Bank ("FHLB") stock went down \$0.4 million.

Net loans were \$271.5 million at September 30, 2006, compared to \$267.0 million at December 31, 2005, an increase of \$4.5 million or 1.7%. The increases in loans were in the real estate construction and real estate commercial loan portfolios, which increased \$10.7 million or 21% and \$1.0 million or 2%, respectively. The increases were primarily a result of lending activity in the Louisville, Kentucky metro market. All loan categories increased or remained the same as a percentage of total loans, except residential real estate loans, which decreased from approximately 48% to 44% of total loans and commercial loans which decreased from 9% to 8% of total loans. The decrease in residential real estate loans as a percentage of total loans is primarily due to those loans now being sold in the secondary market through 1st Independence Mortgage, a division

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of the Bank, rather than being retained for the Company's loan portfolio. The Company continues to identify opportunities to cross sell its other products, including home equity and consumer loans for its loan portfolio resulting from customer relationships established through the origination of loans by 1st Independence Mortgage.

Deposits increased \$1.2 million or less than 0.5% to \$265.5 million at September 30, 2006 compared to \$264.3 million at December 31, 2005. This slight increase was largely attributable to increases in savings, NOW and money market deposits of \$15.7 million and demand deposits of \$0.4 million which more than offset a \$14.9 million decrease in time deposits. The increase in savings, NOW and money market deposits resulted primarily from the effects of a general marketing campaign during the first nine months of 2005 focusing on existing products and print advertisements only. As previously mentioned, during September 2005 the Company introduced a new deposit product known as "ATM Advantage" as part of its efforts to continue to grow core deposits. This new product offers unlimited use of competitor's ATM networks with reimbursement of all foreign and surcharge fees. The product does not pay interest but requires a minimum balance to avoid a monthly service charge.

Short-term borrowings increased \$2.2 million or 11.6% to \$20.9 million at September 30, 2006, compared to \$18.7 million at December 31, 2005. The Company uses short-term borrowings, primarily short-term FHLB advances, to fund short-term liquidity needs and manage net interest margin.

Off-Balance Sheet Arrangements

In the normal course of operations, the Company engages in financial transactions that contain credit, interest rate, and liquidity risk that are not recorded in the financial statements such as loan commitments and performance letters of credit. As of September 30, 2006, unused loan commitments and performance letters of credit were \$44,169,000 and \$2,146,000, respectively.

Since many of the unused loan commitments are expected to expire or be only partially used, the total amount of commitments does not necessarily represent future cash requirements.

Liquidity and Capital Resources

Liquidity to meet borrowers' credit and depositors' withdrawal demands is provided by maturing assets, short-term liquid assets that can be converted to cash and the ability to attract funds from depositors. Additional sources of liquidity include brokered deposits, advances from the FHLB and other short-term borrowings, such as federal funds purchased and securities sold under repurchase agreements.

At September 30, 2006 and December 31, 2005, brokered deposits were \$35.3 million and \$59.6 million, respectively. The weighted average cost and maturity of brokered deposits were 4.93% and four months at September 30, 2006 compared to 3.90% and nine months at December 31, 2005. The Company plans to continue using brokered deposits for the foreseeable future to support loan demand when pricing for brokered deposits is more favorable than short-term borrowings.

At September 30, 2006 and December 31, 2005, the Bank had total FHLB advances outstanding of \$21.0 million and \$22.0 million, respectively, with \$1.0 million and \$4.0 million, respectively, included in long-term debt in the accompanying condensed consolidated balance sheet and the remaining amount included in short-term borrowings. Additionally, the Bank had \$40.0 million of unused commitments under its line of credit with the FHLB and sufficient collateral to borrow an additional \$61.5 million.

The Company's liquidity depends primarily on dividends paid to it as sole shareholder of the Bank. At September 30, 2006, the Bank may pay up to \$7.3 million in dividends to the Company without regulatory approval, subject to the

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ongoing capital requirements of the Bank.

The Company has \$9.3 million of subordinated debentures outstanding, which are included in long-term debt in the accompanying condensed consolidated balance sheet with \$4.1 million of the debentures being variable rate obligations with interest rates that reprice quarterly, and are tied to the three-month London Interbank Offering Rate ("LIBOR") plus 3.15%. At September 30, 2006 the rate on the variable rate obligations was 8.52% compared to 7.67% at September 30, 2005. The remaining \$5.2 million of debentures carry a fixed interest rate of 6.4% until March 26, 2008 when the debentures become variable rate obligations that reprice quarterly at the three-month LIBOR rate plus 3.15%.

Stockholders' equity increased \$1.5 million from \$38.3 million at December 31, 2005 to \$39.8 million at September 30, 2006. The significant drivers of the change were net income of \$1.5 million, cash dividends declared of \$0.5 million (\$0.24 per share) and an increase of \$0.5 million relating to stock option and ESOP plan transactions.

Bank holding companies and their subsidiary banks are required by regulators to meet risk based capital standards. These standards, or ratios, measure the relationship of capital to a combination of balance sheet and off-balance sheet risks. The following table presents these ratios as of September 30, 2006 and December 31, 2005 for the Consolidated Company and the Bank along with the regulator's minimum ratio to be considered well capitalized.

	September 30, 2006	December 31, 2005
Total risk-based capital to risk-weighted assets		
Consolidated company	15.6%	15.1%
Bank	14.4	13.6
Tier 1 capital to risk-weighted assets		
Consolidated company	14.4	13.1
Bank	13.1	12.5
Tier 1 capital to average assets		
Consolidated company	11.3	10.2
Bank	10.4	9.7

Regulatory Matters

On July 20, 2006, the Bank received its most recent Community Reinvestment Act ("CRA") Performance Evaluation prepared as of May 15, 2006. The Bank was assigned a "Needs to Improve" rating due in part to the Bank's low level of residential lending to low and moderate income borrowers within the Louisville, Kentucky Metropolitan Statistical Area. Management has taken appropriate steps to improve the residential lending issues cited by the Federal Deposit Insurance Corporation ("FDIC") during the CRA Performance Evaluation. By statute, a bank with a "less than satisfactory" CRA rating has limitations on certain future business activities until the CRA rating improves. Management does not believe these limitations will have any material affect on the Bank's current business plan.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Information required by this item is included in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

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Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

As required by Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the Company's management carried out an evaluation, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures as of the end of the quarter ended September 30, 2006. 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 its reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the United States Securities and Exchange Commission's rules and forms.

(b) Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during the quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

The Company, from time to time, is a party to ordinary routine litigation, which arises in the normal course of business, such as claims to enforce liens, condemnation proceedings on properties in which the Company holds security interests, claims involving the making and servicing of real property loans, and other issues incident to its business. Except as discussed below, there were no potentially material lawsuits or other legal proceedings pending or known to be contemplated against the Company at September 30, 2006.

On or about May 28, 2004, a complaint was filed in the Circuit Court of Anderson County in the Commonwealth of Kentucky by Larry Sutherland, Judy Sutherland, John Henry Disponett, Brenda Disponett, Todd Hyatt, Lois Ann Disponett, Sue Saufley, and Hugh Coomer. Soon thereafter, an amended complaint was filed which added Lois Hawkins and Norma K. Barnett as plaintiffs. The lawsuit arises from offers to purchase securities made by the Company in connection with an offer to purchase up to 300,000 shares of its stock in a tender offer on or about May 28, 2003. The Plaintiffs allege that the Company made certain material misrepresentations in connection with certain statements made in the tender offer. The Plaintiffs are seeking to recover compensatory and punitive damages in connection with the shares it sold in the tender offer and their attorneys' fees. Discovery in the matter is currently underway. On April 14, 2006 a partial summary judgment was entered against the plaintiffs. In the partial summary judgment, the Circuit Court held that the only remedy available to the plaintiffs is the return of the stock upon the tender of the consideration received by the plaintiffs in exchange for the stock. Subsequent to the partial summary judgment, the plaintiffs amended their complaint to allege certain additional material misrepresentations had been made by the Company. This matter is currently scheduled for trial in July 2007. Based upon the advice of counsel, management records an estimate of the amount of ultimate expected loss for litigation, if any. Management, after discussion with legal counsel, believes the ultimate result of this litigation will not have a material adverse effect on the Company's financial position, results of

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operations or cash flows. However, events could occur that could cause any estimate of ultimate loss to differ materially in the near term.

Item 1A. Risk Factors

Risks Related to our Business

We are subject to extensive regulation that could limit or restrict our activities and impose financial requirements or limitations on the conduct of our business, which limitations or restrictions could adversely affect our profitability.

As a bank holding company, we are primarily regulated by the Board of Governors of the Federal Reserve System. Our subsidiary is primarily regulated by the FDIC and the Kentucky Office of Financial Institutions. Our compliance with Federal Reserve Board, FDIC and Kentucky banking regulations is costly. A failure to comply with the banking regulations may limit our growth and restrict certain of our activities, including payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits and locations of offices. We are also subject to the capital requirements of our regulators.

The laws and regulations applicable to the banking industry could change at any time, and we cannot predict the effects of these changes on our business and profitability. Because government regulation greatly affects our business and financial results, our cost of compliance could adversely affect our ability to operate profitably and a failure to comply could limit our ability to implement our business strategy. See the caption entitled "Regulatory Matters" included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of this report, which is Part I Item 2 of this report, for further information.

Our business strategy includes the continuation of growth plans, and our financial condition and results of operations could be negatively affected if we fail to grow.

We have grown rapidly in terms of branch expansion, total assets, net loans, and deposits. We may not be able to continue to grow at the same rate that we have grown in the past. We currently serve our customers through a network of eight banking offices, consisting of two full-service banking locations in Louisville, Kentucky, and one full-service banking location in each of New Albany, Jeffersonville, and Clarksville, Indiana. We also have one full-service banking location in Harrodsburg, Kentucky, Lawrenceburg, Kentucky, and Marengo, Indiana. Our business strategy calls for continued expansion and the opening of additional branches during the next three to five years. We have not yet attempted to establish branches in any of the other counties in Kentucky or southern Indiana. Our branch expansion strategy entails other risks, including:

- o the entrance into new markets where we lack experience;
- o the experience of unexpected competition;
- o the introduction of new products and services into our business with which we have no prior experience;
- o the time and costs of evaluating new markets, hiring experienced local management and opening new offices;
- o the ability to implement and improve our operational, credit, financial, management and other internal risk controls and processes and our reporting systems and procedures;
- o the ability to manage a growing number of client relationships;
- o the ability to recruit and retain additional experienced bankers to accommodate growth;
- o the ability to maintain controls and procedures sufficient to

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- o accommodate an increase in expected loan volume and infrastructure;
- o the diversion of our management's attention from our existing businesses as a result of our growth strategy;
- o the additional expenditures our asset growth may require to expand our administrative and operational infrastructure; and
- o the ability to maintain cost controls and asset quality while attracting additional loans and deposits on favorable terms.

The occurrence of any of these factors could have an adverse effect on our financial condition. We can provide no assurance that we will be able to overcome the risks associated with growth or any other problems encountered in executing our growth strategy.

Our recent results do not indicate our future results, and may not provide guidance to assess the risk of an investment in our common stock.

We are unlikely to sustain our historical rate of growth, and may not even be able to expand our business at all. Further, our recent growth may distort some of our historical financial ratios and statistics. In the future, we may not have the ability to find suitable expansion opportunities. Various factors, such as economic conditions, regulatory and legislative considerations and competition, may also impede or prohibit our ability to expand our market presence. If we are not able to successfully grow and expand our business, our financial condition and results of operations could be adversely affected.

Our business would be harmed if we lost the services of any of our senior management team and are unable to recruit or retain suitable replacements.

We believe that our success to date and our prospects for future success depend significantly on the efforts of our senior management team, which includes N. William White, our President and Chief Executive Officer, R. Michael Wilbourn, our Executive Vice President and Chief Financial Officer, Gregory A. DeMuth, our Executive Vice President and the Chief Lending Officer of the Bank, David M. Hall, our Executive Vice President-Retail Banking of the Bank, Kathy Beach, our Executive Vice President and Chief Operations Officer, Alan D. Shepard, our Executive Vice President and Chief Credit Officer of the Bank and certain of our senior bankers. We have \$0.5 million of key-man life insurance on both Mr. White and Mr. Wilbourn. There is no assurance, however, that \$0.5 million would be enough to compensate us for the loss of Mr. White or Mr. Wilbourn. We do not have key-man insurance on any other officer of the Company or the Bank. In addition to their skills and experience as bankers, these persons provide us with extensive community ties upon which our competitive strategy is based.

A significant portion of our loan portfolio is secured by real estate, and events that negatively impact the real estate market could hurt our business.

A significant portion of our loan portfolio is secured by real estate. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. A weakening of the real estate market in our market areas could result in an increase in the number of borrowers who default on their loans and a reduction in the value of the collateral securing their loans, which in turn could have an adverse effect on our profitability and asset quality. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, our earnings and capital could be adversely affected. Acts of nature, including hurricanes, tornados, earthquakes, fires and floods, which may cause uninsured damage and other loss of value to real estate that secures these loans, may also negatively impact our financial

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condition. Additionally, a slowdown in real estate activity in the markets we serve may also negatively impact our financial condition.

An economic downturn, either nationally or in the local market area, could adversely affect our financial condition, results of operations and cash flows.

Deterioration in local, regional, national or global economic conditions could result in, among other things, an increase in loan delinquencies, a change in the housing turnover rate or a reduction in the level of available wholesale deposits. If the communities in which we operate do not grow, or if the prevailing local or national economic conditions are unfavorable, our business strategy may not succeed. A weakening of the employment market in our primary market area could result in an increase in the number of borrowers who default on their loans. Further, the banking industry is affected by general economic conditions such as inflation, interest rates, recession, unemployment and other factors beyond our control. Moreover, we cannot give any assurance that we will benefit from any market growth or favorable economic conditions in our primary market areas even if they do occur.

Our cost of funds for banking operations may increase as a result of general economic conditions, interest rates and competitive pressures.

Our cost of funds for banking operations may increase as a result of general economic conditions, interest rates and competitive pressures. In the past, the Bank has relied heavily on brokered certificates of deposits and borrowings for the funds necessary for banking operations. As a general matter, deposits are a cheaper source of funds than brokered certificates of deposit or borrowings, because interest rates paid for deposits are typically less than interest rates charged for brokered certificates of deposit or borrowings. Our business strategy includes funding more of our operations with deposits; however, we cannot provide any assurances that we will be able attract sufficient deposits.

Competition from other financial institutions and others may adversely affect our profitability.

The banking business generally, and because of its desirability and the opportunities for growth, the Louisville, Kentucky and southern Indiana market area in particular, is highly competitive, and we experience strong competition from many other financial institutions. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market funds and other financial institutions, which operate in our primary market area and elsewhere.

We compete with these institutions to make loans and to attract new customers and in pricing loans and deposits. Many of our competitors are well-established and much larger financial institutions and can offer customers more attractive pricing terms. While we believe we can and do successfully compete with these other financial institutions in our markets, we may face a competitive disadvantage as a result of our smaller size.

We also compete with private lenders, mezzanine and venture capital firms and angel investors in some of our lending divisions, including our community redevelopment lending and mezzanine financing divisions. Many of these competitors are subject to minimal or no regulation and may be able to make accommodations for customers that we are unable to make.

We are currently subject to claims regarding the merger of Independence Bancorp with Harrodsburg First Financial Bancorp, Inc. that could result in substantial

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defense, judgment or settlement costs.

On or about May 28, 2004, a complaint was filed in the Circuit Court of Anderson County in the Commonwealth of Kentucky by Larry Sutherland, Judy Sutherland, John Henry Disponett, Brenda Disponett, Todd Hyatt, Lois Ann Disponett, Sue Saufley, and Hugh Coomer. Soon thereafter, an amended complaint was filed which added Lois Hawkins and Norma K. Barnett as plaintiffs. The lawsuit arises from offers to purchase securities made by us in connection with an offer to purchase up to 300,000 shares of our stock in a tender offer on or about May 28, 2003. The Plaintiffs allege that we made certain material misrepresentations in connection with certain statements made in the tender offer. The Plaintiffs are seeking to recover compensatory and punitive damages in connection with the shares they sold in the tender offer and their attorneys' fees. Discovery in the matter is currently underway.

On April 14, 2006 a partial summary judgment was entered against the plaintiffs. In the partial summary judgment, the Circuit Court held that the only remedy available to the plaintiffs is the return of the stock upon the tender of the consideration received by the Plaintiffs in exchange for the stock. Subsequent to the partial summary judgment, the plaintiffs amended their complaint to allege certain additional material misrepresentations had been made by the Company. This matter is currently scheduled for trial in July 2007. If we are ultimately unsuccessful in this litigation, it may have a negative effect on our results of operations or cash flows.

Risks Related to Our Industry

Our profitability is vulnerable to interest rate fluctuations.

Most of our assets and liabilities are monetary in nature, and thus subject us to significant risks from changes in interest rates. Consequently, our results of operations can be significantly affected by changes in interest rates and our ability to manage interest rate risk. Changes in market interest rates, or changes in the relationships between short-term and long-term market interest rates, or changes in the relationship between different interest rate indices can affect the interest rates charged on interest-earning assets differently than the interest paid on interest-bearing liabilities. This difference could result in an increase in interest expense relative to interest income or a decrease in interest rate spread. In addition to affecting our profitability, changes in interest rates can impact the valuation of our assets and liabilities. A discussion of how we measure our exposure to interest rate changes is provided in Part I, Item II of this Form 10-Q.

We could suffer loan losses from a decline in credit quality.

We could sustain losses if borrowers, guarantors or related parties fail to perform in accordance with the terms of their loans. We have adopted underwriting and credit monitoring procedures and policies, including the establishment and review of the allowance for credit losses, that we believe are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan performance and diversifying our credit portfolio. These policies and procedures, however, may not prevent unexpected losses that could materially adversely affect our results of operations and financial condition.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could decrease.

We manage our credit exposure through careful monitoring of loan applicants

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and loan concentrations in particular industries, and through loan approval and review procedures. We have established an evaluation process designed to determine the adequacy of our allowance for loan losses. While this evaluation process uses historical and other objective information, the classification of loans and the establishment of loan losses is an estimate based on experience, judgment and expectations regarding our borrowers, the economies in which we and our borrowers operate, as well as the judgment of our regulators.

There is no precise method of predicting loan losses, so we cannot assure you that our loan loss allowance will be sufficient to absorb future loan losses or prevent a material adverse effect on our business, financial condition or results of operations.

Failure to achieve and maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act could have a material adverse effect on our ability to report our financial results timely and accurately and on our stock price.

Section 404 of the Sarbanes-Oxley Act requires annual assessments of the effectiveness of our internal controls over financial reporting and a report by our independent registered public accounting firm addressing these assessments. We are required to complete our initial assessment by the filing of our Form 10-K for the year ended December 31, 2007. During the course of our assessment, we may identify deficiencies in our internal controls over financial reporting which we may not be able to remediate in time to meet this deadline. A failure to maintain adequate internal controls may result in material misstatements in our financial statements and a failure to meet our reporting obligations. As result investors may lose confidence in our reported financial information and our stock price could decline.

Our operations could be interrupted if our network or computer systems fail or experience a security breach.

Our computer systems and network infrastructure could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from fire, power loss, telecommunications failure or a similar catastrophic event. Any damage or failure that causes an interruption in our operations could result in a loss of customers and thereby have a material adverse effect on our business, operating results and financial condition.

Risks Relating to an Investment in Our Common Stock

Additional growth may require us to raise additional capital in the future, but that capital may not be available when it is needed, which could adversely affect our financial condition and results of operations.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. We anticipate that our current capital resources will satisfy our capital requirements for the foreseeable future. We may at some point, however, need to raise additional capital to support our continued growth. Our ability to raise capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise capital, if needed, on terms acceptable to us. If we cannot raise capital when needed, our ability to implement our business strategy could be materially impaired.

Our stock price may fluctuate and be volatile.

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The prices at which our common stock has traded may not be indicative of future market prices. The trading price of our common stock has, in the past, and could continue in the future to fluctuate significantly. Volatility in our stock price could result from the following factors, among others:

- o variations in quarterly operating results;
- o changes in financial estimates by securities analysts;
- o the operating and stock price performance of other companies in the banking industry; and
- o general stock market or economic conditions.

The stock market in recent years has experienced price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of affected companies.

Our ability to pay dividends is limited, and we may be unable to pay future dividends if we decide to do so.

Our ability to continue our current dividends is limited by regulatory restrictions, by the bank's ability to pay dividends to us based on its capital position and profitability, and by our need to maintain sufficient capital to support the bank's operations. The ability of the bank to pay dividends to us is limited by its obligations to maintain sufficient capital and by other restrictions on its dividends that are applicable to banks that are regulated by the FDIC. If the bank does not satisfy these regulatory requirements it will be unable to pay dividends to us and we will be unable to pay dividends on our common stock to you.

The holders of our junior subordinated debentures have rights that are senior to those of our common shareholders.

At the time of the merger of Harrodsburg First Financial Bancorp and Independence Bancorp, Harrodsburg First Financial Bancorp had \$5.2 million of trust preferred securities outstanding and Independence Bancorp had \$4.1 million of trust preferred securities outstanding. Payments of the principal and interest on the trust preferred securities are conditionally guaranteed by us. Further, the accompanying junior subordinated debentures that were issued by Harrodsburg First Financial Bancorp and Independence Bancorp are senior to our shares of common stock. As of September 30, 2006, we had approximately \$9.3 million of junior subordinated debentures outstanding. We have the right to defer payment of interest on the junior subordinated debentures for a period not exceeding 20 consecutive quarters. If we defer, or fail to make, interest payments on the junior subordinated debentures, we will be prohibited, subject to certain exceptions, from paying cash dividends on our common stock until we pay all deferred interest and resume interest payments on the junior subordinated debentures.

We have implemented anti-takeover devices that could make it more difficult for another company to purchase us, even though such a purchase may increase shareholder value.

In many cases, shareholders would receive a premium for their shares if we were purchased by another company. However, state and federal law and our certificate of incorporation and bylaws make it difficult for anyone to purchase us without approval of our board of directors. For example, our articles of incorporation divide the board of directors into three classes of directors serving staggered three-year terms with approximately one-third of the board of directors elected at each annual meeting of shareholders. The classification of directors makes it more difficult for

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shareholders to change the composition of the board of directors. As a result, at least two annual meetings of shareholders would be required for the shareholders to change a majority of the directors, whether or not a change in the board of directors would be beneficial and whether or not a majority of shareholders believe that such a change would be desirable. In addition, our certificate of incorporation provides that in no event shall any record owner of any outstanding common stock which is beneficially owned, directly or indirectly, by a person who beneficially owns in excess of 10% of the then outstanding shares of common stock be entitled or permitted to any vote with respect to the shares held in excess of the 10% limit. Consequently, a takeover attempt may prove difficult, and shareholders may not realize the highest possible price for their securities.

Item 6. Exhibits

(a) Exhibits

- | | |
|------|---|
| 31.1 | Rule 13a-14(a) / 15d-14(a) Certification of Principal Executive Officer ("Section 302 Certifications"). |
| 31.2 | Rule 13a-14(a) / 15d-14(a) Certification of Principal Financial Officer ("Section 302 Certifications"). |
| 32.1 | Section 1350 Certifications ("Section 906 Certifications"). |

SIGNATURES

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

1st INDEPENDENCE FINANCIAL GROUP, INC.

Date: October 31, 2006

By: /s/ R. Michael Wilbourn

R. Michael Wilbourn
Executive Vice President
and Chief Financial Officer

Exhibit Index

- | Exhibit Number | Description |
|----------------|---|
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