PARKER HANNIFIN CORP
Form DEF 14A
September 22, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of the

Securities Exchange Act of 1934

(Amendment No. __)

Filed by the Registrant x Filed by a Party other than the Registrant ¨

Check the appropriate box:

¨ Preliminary Proxy Statement

¨ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**

x Definitive Proxy Statement

¨ Definitive Additional Materials

¨ Soliciting Material Pursuant to §240.14a-12

PARKER-HANNIFIN CORPORATION

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.

¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which the transaction applies:

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(2) Aggregate number of securities to which the transaction applies:

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(3) Per unit price or other underlying value of the transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

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¨ Fee paid previously with preliminary materials.

¨ Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

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(2) Form, Schedule or Registration Statement No.:

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(3) Filing Party:

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(4) Date Filed:

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PARKER-HANNIFIN CORPORATION

6035 Parkland Boulevard Cleveland, Ohio 44124-4141

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

OCTOBER 22, 2008

TO OUR SHAREHOLDERS:

You are cordially invited to attend the annual meeting of the shareholders of Parker-Hannifin Corporation. The meeting will be held at our headquarters located at 6035 Parkland Boulevard, Cleveland, Ohio 44124-4141, on Wednesday, October 22, 2008, at 9:00 a.m., Eastern Daylight Time, for the following purposes:

1. To elect William E. Kassling, Joseph M. Scaminace and Wolfgang R. Schmitt as Directors for a one-year term;

2. To ratify the appointment of Deloitte & Touche LLP as our independent registered public accounting firm for the fiscal year ending June 30, 2009; and

3. To transact such other business as may properly come before the meeting.

Shareholders of record at the close of business on August 29, 2008 are entitled to vote at the meeting. Your vote is important, so if you do not expect to attend the meeting, or if you do plan to attend but wish to vote by proxy, please mark, date, sign and return the enclosed proxy card promptly in the envelope provided or vote electronically via the internet or by telephone in accordance with the instructions on the enclosed proxy card.

Thank you for your support of Parker-Hannifin Corporation.

By Order of the Board of Directors

Thomas A. Piraino, Jr.
Secretary

September 22, 2008

Important Notice Regarding the Availability of Proxy Materials for

the Annual Meeting of Shareholders to be held on October 22, 2008.

This proxy statement, along with our Annual Report on Form 10-K for the fiscal year ended June 30, 2008 and our 2008 Annual Report, are available free of charge on our investor relations website (www.phstock.com).

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PARKER-HANNIFIN CORPORATION

6035 Parkland Boulevard Cleveland, Ohio 44124-4141

PROXY STATEMENT

This Proxy Statement is furnished in connection with the solicitation by our Board of Directors of proxies to be voted at the Annual Meeting of Shareholders scheduled to be held on October 22, 2008, and at all adjournments thereof. Only shareholders of record at the close of business on August 29, 2008 will be entitled to vote at the meeting. On August 29, 2008, 164,542,647 Common Shares were outstanding and entitled to vote at the meeting. Each share is entitled to one vote. This Proxy Statement and the form of proxy are being mailed to shareholders on or about September 22, 2008.

Our shareholders have cumulative voting rights in the election of Directors if any shareholder gives notice in writing to our President, a Vice President or the Secretary not less than 48 hours before the time fixed for holding the meeting that cumulative voting at such election is desired. The fact that such notice has been given must be announced upon the convening of the meeting by the Chairman, the Secretary or by or on behalf of the shareholder giving such notice. In such event, each shareholder has the right to cumulate votes and give one nominee the number of votes equal to the number of Directors to be elected multiplied by the number of votes to which the shareholder is entitled, or to distribute votes on the same principle among two or more nominees, as the shareholder sees fit. If voting at the election is cumulative, the persons named in the proxy will vote Common Shares represented by valid Board of Directors proxies on a cumulative basis for the election of the nominees named below, allocating the votes of such Common Shares in accordance with their judgment.

ELECTION OF DIRECTORS

The Board of Directors presently consists of 10 members divided into three classes. The class whose term expires in 2008 presently consists of three members, the class whose term expires in 2009 presently consists of four members and the class whose term expires in 2010 presently consists of three members. Prior to this year s Annual Meeting, one of the classes of Directors was elected at each Annual Meeting of Shareholders to serve a three-year term. In October 2007, our shareholders approved an amendment to our Code of Regulations to provide for the annual election of the entire Board of Directors, which is to be phased in over a three-year period beginning with this year s Annual Meeting. As a result of the amendment, Directors elected at this year s Annual Meeting, and each subsequent Annual Meeting of Shareholders, will hold office for one year or until their successors are elected at the next Annual Meeting of Shareholders. Directors not standing for election this year will continue in office for the remainder of their original three-year terms. None of our Directors are related to each other.

Shareholder approval is sought to elect William E. Kassling, Joseph M. Scaminace and Wolfgang R. Schmitt, Directors whose terms of office expire in 2008, for a one-year term of office that will expire in 2009. A plurality of the Common Shares voted in person or by proxy is required to elect a Director.

Should any nominee become unable to accept nomination or election, the proxies will be voted for the election of another person for Director as the Board of Directors may recommend. However, the Board of Directors has no reason to believe that this contingency will occur.

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NOMINEES FOR ELECTION AS DIRECTORS FOR TERMS EXPIRING IN 2009

WILLIAM E. KASSLING, 64, has served as a Director since 2001. He is Chairman of the Corporate Governance and Nominating Committee and a member of the Audit Committee. Mr. Kassling has been Chairman of the Board of Wabtec Corporation (technology-based equipment for the rail industry) since 1990. He was previously Chief Executive Officer of Wabtec from May 2004 to February 2006 and President of Wabtec from May 2004 to February 2006.

JOSEPH M. SCAMINACE, 55, has served as a Director since 2004. He is a member of the Corporate Governance and Nominating Committee and the Human Resources and Compensation Committee. Mr. Scaminace has been a Director and Chief Executive Officer of OM Group, Inc. (metal-based specialty chemicals) since June 2005 and Chairman of the Board of OM Group since August 2005. He was previously the President and Chief Operating Officer of The Sherwin Williams Company (paints and coatings) from October 1999 to May 2005. Mr. Scaminace is also a Director of The Boler Company.

WOLFGANG R. SCHMITT, 64, has served as a Director since 1992. He is Chairman of the Human Resources and Compensation Committee and a member of the Audit Committee. Mr. Schmitt has been the Chief Executive Officer of Trends 2 Innovation (strategic growth consultants) since May 2000.

The Board of Directors unanimously recommends a vote FOR each of the nominees to the Board of Directors.

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PRESENT DIRECTORS WHOSE TERMS EXPIRE IN 2009

ROBERT J. KOHLHEPP, 64, has served as a Director since 2002. He is Chairman of the Audit Committee and a member of the Corporate Governance and Nominating Committee. Mr. Kohlhepp has been Vice Chairman of Cintas Corporation (uniform rental) since July 2003 and has been a Director of Cintas since 1979.

GIULIO MAZZALUPI, 67, has served as a Director since 1999. He is a member of the Audit Committee and the Finance Committee. Now retired, Mr. Mazzalupi was the President, Chief Executive Officer and a Director of Atlas Copco AB (industrial manufacturing) in Sweden until July 2002.

KLAUS-PETER MÜLLER, 63, has served as a Director since 1998. He is Chairman of the Finance Committee and a member of the Corporate Governance and Nominating Committee. Mr. Müller has been Chairman of the Supervisory Board of Commerzbank AG (international banking) in Frankfurt, Germany since May 2008. He was previously Chairman of the Board of Managing Directors of Commerzbank from May 2001 to May 2008 and a member of the Board of Managing Directors of Commerzbank from 1990 to May 2008. In March 2005, Mr. Müller was named President of the Association of German Banks, Berlin, Germany.

MARKOS I. TAMBAKERAS, 57, has served as a Director since 2005. He is a member of the Human Resources and Compensation Committee and the Finance Committee. Now an independent investor, Mr. Tambakeras was the Chairman of the Board of Kennametal Inc. (global tooling solutions supplier) from July 2002 to December 2006 and the President and Chief Executive Officer of Kennametal from July 1999 to December 2005. He is also a Director of ITT Industries, Inc. and Newport Corporation and serves on the Board of Trustees of Arizona State University.

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PRESENT DIRECTORS WHOSE TERMS EXPIRE IN 2010

LINDA S. HARTY, 48, has served as a Director since 2007. She is a member of the Audit Committee and the Finance Committee. Ms. Harty has been an Executive Vice President and Treasurer of Cardinal Health, Inc. (health-care products and services) since May 2008. She was previously Executive Vice President Finance and Chief Financial Officer Healthcare Supply Chain Services of Cardinal Health from March 2007 to May 2008; Executive Vice President and Treasurer of Cardinal Health from August 2006 to March 2007; Senior Vice President of Cardinal Health from January 2005 to August 2006; and Senior Vice President and Chief Financial Officer of RTM Restaurant Group (restaurant franchisee group) from July 2003 to January 2005.

CANDY M. OBOURN, 58, has served as a Director since 2002. She is a member of the Corporate Governance and Nominating Committee and the Human Resources and Compensation Committee. Ms. Obourn has been Chief Executive Officer and President of ActivEase Healthcare, Inc. (women s health care products) since February 2006. She was previously General Manager, Film Capture, Digital & Film Imaging Systems of Eastman Kodak Company (photography and digital imaging) from November 2004 to February 2006; Senior Vice President of Eastman Kodak from January 2000 to February 2006; and Chief Operating Officer, Health Imaging Group of Eastman Kodak from January 2002 to November 2004.

DONALD E. WASHKEWICZ, 58, has served as a Director since 2000. Mr. Washkewicz has been our Chairman of the Board of Directors since October 2004; our Chief Executive Officer since July 2001; and our President since January 2007. He was previously our President from February 2000 to October 2004.

Director Independence. In making a determination as to the independence of our Directors for purposes of considering membership on our Board of Directors and Committees, we are in compliance with the rules of the New York Stock Exchange and our Independence Standards for Directors and have broadly considered the materiality of each Director s relationship with us. Based upon the foregoing criteria, the Board of Directors has determined that the following persons who served as Directors during any part of fiscal year 2008 are independent: Linda S. Harty, William E. Kassling, Robert J. Kohlhepp, Giulio Mazzalupi, Klaus-Peter Müller, Candy M. Obourn, Joseph M. Scaminace, Wolfgang R. Schmitt and Markos I. Tambakeras.

Board Meetings. During the fiscal year ended June 30, 2008, there were five meetings of our Board of Directors. Each Director attended at least 75% of the meetings held by the Board of Directors and the Committees of the Board of Directors on which he or she served.

Attendance at Annual Meeting. We hold a regularly scheduled meeting of our Board of Directors in conjunction with our Annual Meeting of Shareholders. Directors are expected to attend the Annual Meeting of Shareholders absent an appropriate reason. All of the members of the Board of Directors attended our 2008 Annual Meeting of Shareholders.

Audit Committee Financial Experts. We have a standing audit committee established in accordance with section 3(a)(58)(A) of the Securities Exchange Act of 1934. Our Board of Directors has determined that Robert J. Kohlhepp, the Chairman of the Audit Committee, and Linda S. Harty, a member of the Audit Committee, are audit committee financial experts as defined in the federal securities laws. Mr. Kohlhepp and Ms. Harty are independent as defined for audit committee members in the listing standards of the New York Stock Exchange.

The Audit Committee, which met seven times during the fiscal year ended June 30, 2008, is responsible for, among other things, appointing, determining the compensation of and overseeing the work of the independent registered public accounting firm and ensuring its independence, approving all non-audit engagements with the independent registered public accounting firm and reviewing with our financial management

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and our independent registered public accounting firm annual and quarterly financial statements, the proposed internal audit plan for each calendar year, the proposed independent audit plan for each fiscal year, the results of the audits and the adequacy of our internal control structure.

The Human Resources and Compensation Committee is our standing compensation committee. The Human Resources and Compensation Committee, which met seven times during the fiscal year ended June 30, 2008, is responsible for, among other things, annually reviewing and approving the salaries and other compensation (including stock incentives) of our executive officers, reviewing and determining the compensation of our non-employee Directors, engaging and determining the fees of compensation consultants, overseeing regulatory compliance with respect to compensation matters, reviewing management succession of key executives, and reviewing corporate policies and programs for the development of management personnel.

The Finance Committee, which met twice during the fiscal year ended June 30, 2008, is responsible for, among other things, reviewing our capital structure and tax and risk management strategies and reviewing and approving our debt and equity offerings, share repurchase programs and the funding and investment policies for our defined benefit plans, defined contribution plans and non-qualified plans.

The Corporate Governance and Nominating Committee is our standing nominating committee. The Corporate Governance and Nominating Committee, which met three times during the fiscal year ended June 30, 2008, is responsible for, among other things, evaluating and recommending to the Board of Directors qualified nominees for election as Directors and qualified Directors for committee membership, establishing evaluation procedures and completing an annual evaluation of the performance of the Board of Directors, developing and recommending corporate governance principles to the Board of Directors and considering other matters pertaining to the size and composition of the Board of Directors. The Corporate Governance and Nominating Committee will give appropriate consideration to qualified persons recommended by shareholders for nomination as our Directors, provided that such recommendations comply with the procedures set forth under the caption Procedures for Submission and Consideration of Director Candidates in this Proxy Statement.

The Board of Directors adopted a written charter for each of the committees of the Board of Directors. These charters, as well as our Code of Ethics, Guidelines on Corporate Governance Issues and Independence Standards for Directors, are posted and available under the Corporate Governance page on our investor relations internet website at www.phstock.com. Shareholders may request copies of these corporate governance documents, free of charge, by writing to Parker-Hannifin Corporation, 6035 Parkland Boulevard, Cleveland, Ohio 44124-4141, Attention: Secretary, or by calling (216) 896-3000.

Executive Sessions. In accordance with the listing standards of the New York Stock Exchange, the non-management Directors are scheduled to meet regularly in executive sessions without management, and if required, the independent Directors will meet at least once annually. Additional meetings of the non-management Directors may be scheduled from time to time when the non-management Directors decide such meetings are desirable. The Chairman of the Corporate Governance and Nominating Committee will preside at such meetings. The Corporate Governance and Nominating Committee Charter provides that the Chairman of the Corporate Governance and Nominating Committee has a term limit of three years. The non-management Directors met four times during the fiscal year ended June 30, 2008.

Review and Approval of Transactions with Related Persons. The Corporate Governance and Nominating Committee charter provides that the Corporate Governance and Nominating Committee is responsible for considering questions of possible conflicts of interest of Board members and management and for making recommendations to prevent, minimize or eliminate such conflicts of interest. Our Code of Ethics provides that our Directors, officers, employees, and their spouses and other close family members must avoid interests or activities that create any actual or potential conflict of interest. These restrictions cover, among other things, interests or activities that result in receipt of improper personal benefits by any person as a result of his or her position as our Director, officer, employee, or as a spouse or other close family member of any of our Directors, officers or employees. The Code of Ethics also requires our Directors, officers and employees to promptly disclose any potential

conflicts of interest to our General Counsel. We also require that each of our executive officers and Directors complete a detailed annual questionnaire which requires, among other things, disclosure of any transactions with a related person meeting the minimum threshold for disclosure under the relevant Securities and Exchange Commission, or SEC, rules. All responses to the annual questionnaires are reviewed and analyzed by our legal counsel and, if necessary or appropriate, presented to the Corporate Governance and Nominating Committee for analysis, consideration and, if appropriate, approval.

Certain Relationships and Related Transactions. Russell G. Chester, Vice President-Enterprise Compliance, is the spouse of Pamela J. Huggins, our Vice President and Treasurer. Mr. Chester s salary and bonus for the fiscal year ended June 30, 2008 was $325,723. We have taken the appropriate steps to ensure the avoidance of any conflicting interests resulting from this relationship.

Section 16(a) Beneficial Ownership Reporting Compliance. Section 16(a) of the Securities Exchange Act of 1934 requires our executive officers, Directors and beneficial owners of more than 10% of our Common Shares to file initial stock ownership reports and reports of changes in ownership with the SEC and the New York Stock Exchange. SEC regulations require that we are furnished with copies of these reports. Based solely on a review of these reports and written representations from the executive officers and Directors, we believe that there was compliance with all such filing requirements for the fiscal year ended June 30, 2008, except for the following: (1) Lee C. Banks, Executive Vice President and Operating Officer, inadvertently filed one late Form 4 to report the movement of shares to his wife s trust in 2005; (2) Robert P. Barker, Executive Vice President, Operating Officer and President of the Aerospace Group, inadvertently filed two late Form 4s to report the movement of shares to his family trust in 2004 and 2006; (3) William G. Eline, Vice President Chief Information Officer, inadvertently filed one late Form 4 to report the movement of shares to his wife s trust in 2006; (4) Giulio Mazzalupi, a Director, inadvertently filed one late Form 4 to report share withholding for taxes in 2007; (5) Klaus-Peter Müller, a Director, inadvertently filed one late Form 4 to report share withholding for taxes in 2007; and (6) Joseph M. Scaminace, a Director, inadvertently filed one late Form 4 to report a purchase of shares by his son.

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REPORT OF THE AUDIT COMMITTEE

The Audit Committee of the Board of Directors is composed of five Directors, each of whom is independent in compliance with the independence standards applicable to audit committee members in the listing standards of the New York Stock Exchange. The responsibilities of the Audit Committee are set forth in the written Audit Committee Charter, a copy of which is available on the Corporate Governance page of Parker-Hannifin s investor relations website at *www.phstock.com.*

In fulfilling its responsibilities, the Audit Committee has reviewed and discussed Parker-Hannifin s audited consolidated financial statements for the fiscal year ended June 30, 2008 with management and with Deloitte & Touche LLP, or D&T, Parker-Hannifin s independent registered public accounting firm for the fiscal year ended June 30, 2008.

The Audit Committee has discussed with D&T the matters required to be discussed by the statement on Auditing Standards No. 61, as amended (AICPA, *Professional Standards*, Vol. 1. AU Section 380), as adopted by the Public Company Accounting Oversight Board in Rule 3200T. In addition, the Audit Committee has received and reviewed the written disclosures and the letter from D&T required by Independence Standards Board Standard No. 1 (Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*), as adopted by the Public Company Accounting Oversight Board in Rule 3600T, and has discussed with D&T their objectivity and independence.

Based on the review and discussions described above, the Audit Committee recommended to the Board of Directors that Parker-Hannifin s audited consolidated financial statements for the fiscal year ended June 30, 2008 be included in its Annual Report on Form 10-K for the fiscal year ended June 30, 2008 filed with the SEC.

Audit Committee:

Robert J. Kohlhepp, Chairman

Linda S. Harty

William E. Kassling

Giulio Mazzalupi

Wolfgang R. Schmitt

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COMPENSATION DISCUSSION AND ANALYSIS

The information contained in this Compensation Discussion and Analysis has been adjusted to give effect to the three-for-two stock split authorized by our Board of Directors on August 16, 2007. The stock split was completed on October 1, 2007.

Objectives and Philosophies of the Executive Compensation Program.

In fiscal year 2001, we introduced the Win Strategy as the foundation of our business. The Win Strategy represents the unified vision of our employees worldwide, and defines the key goals, operational priorities and metrics used to profitably grow our business. The Win Strategy also provides the means by which we can measure and reward success.

The Win Strategy centers on three fundamental goals: premier customer service; financial performance; and profitable growth. The Win Strategy outlines various strategic components intended to advance those goals in all aspects of our business. Those strategic components include on-time delivery of quality products, value-added services and systems, strategic purchasing of goods and services, lean operations, talent development, strategic pricing, product innovation and strong distribution. We are confident that a worldwide focus on the goals of the Win Strategy will maximize the long-term value of our shareholders investments by helping us to achieve our objectives of top-quartile performance among our competitors and peers and steady appreciation of our stock price.

Our executive compensation program covers all compensation paid to our executive officers. Our executive officers include the Chief Executive Officer, Chief Financial Officer and the four other most highly compensated executive officers identified in the Summary Compensation Table for Fiscal Year 2008 on page 30, which we refer to as the Named Executive Officers. Mr. Myslenski retired as Executive Vice President effective May 2, 2008, but still qualifies as a Named Executive Officer based on his fiscal year 2008 compensation.

The objective of our executive compensation program is to encourage and reward performance that advances each of the three fundamental goals of the Win Strategy. The program is designed to:

- align the financial interests of our executive officers and our shareholders by encouraging and rewarding performance that achieves significant financial and operational performance goals;
- encourage and reward our executive officers for experience, expertise, level of responsibility, seniority, leadership qualities, advancement, individual accomplishment and other significant contributions to the enhancement of shareholder value and to the success of our business;
- attract, retain and motivate highly-talented and ethical individuals at all levels who are focused on the long-term success of our business and who are equipped, motivated and poised to lead and manage our business presently and in the future;
- offer compensation that keeps us competitive with companies that compete with us for talented employees and shareholder investment;

promote internal equity by allocating a greater proportion of the compensation for executive officers, as compared to other employees, to elements that are dependent on the performance of our business, and holding executive officers accountable for performance that falls short of expectations; and

maintain a level of flexibility sufficient to adjust for trends and changes in the continuously expanding and evolving global business and regulatory environment.

Administration, Oversight and Determination of Executive Compensation.

Human Resources and Compensation Committee.

The Human Resources and Compensation Committee of the Board of Directors, which we refer to as the Committee, consists of four directors. Each member of the Committee is independent as defined in the listing standards of the New York Stock Exchange, Inc. The responsibilities of the Committee are described in a written Human Resources and Compensation Committee Charter amended by the Board of Directors on April 16, 2007.

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The Charter specifically describes the duties and responsibilities of the Committee with respect to the administration, oversight and determination of executive compensation. These duties and responsibilities include:

- setting and reviewing the compensation of the Chief Executive Officer, and reviewing and approving the compensation programs for other executive officers;
- reviewing and evaluating the performance of the Chief Executive Officer, and reviewing performance evaluations of other executive officers;
- monitoring the operation and performance of the executive compensation program;
- establishing the relevant performance goals of the Chief Executive Officer and determining whether they have been achieved; and
- performing other duties and responsibilities assigned by the Board of Directors.

The Committee also retains the discretion to authorize periodic compensation adjustments due to promotions or increases in the responsibilities of our executive officers.

In fulfilling its duties and responsibilities, the Committee seeks periodic input, advice and recommendations from the Board of Directors, the executive officers, executive compensation consultants and other resources, including recommendations from the Vice President Human Resources. The Committee is not bound by that input or advice or those recommendations. The Committee at all times exercises independent discretion in its executive compensation decisions.

Board of Directors.

The Board of Directors approves all incentive compensation plans and equity-based plans reviewed and recommended by the Committee. The Board of Directors does not authorize or approve any other specific executive compensation matters. The Board of Directors oversees the Committee s performance and reviews all material information relating to other executive compensation matters approved by the Committee. This oversight ensures that the Committee fulfills its duties and responsibilities and that the executive compensation program is reasonable and appropriate, meets its objectives and effectively serves the interests of our business and our shareholders.

Executive Officers.

Executive officers also play a role in the administration, oversight and determination of executive compensation. At the beginning of each fiscal year, each executive officer sets annual performance goals for his or her direct reports, which may include other executive officers. The performance goals are designed to promote individual performance that advances the goals of the Win Strategy. Throughout the fiscal year, each executive officer s performance is reviewed and evaluated against his or her performance goals. At the end of the fiscal year, each executive officer conducts a final performance review for each of his or her direct reports. Based on those reviews, the executive officers, other than the

Chief Executive Officer, recommend any annual compensation adjustments and awards for their executive officer direct reports to the Chief Executive Officer.

The Chief Executive Officer similarly reviews and evaluates his direct reports, which include Mr. Pistell, Mr. Kashkoush, Mr. Banks and Mr. Barker, and which included Mr. Myslenski prior to his May 2, 2008 retirement. The Chief Executive Officer also reviews and evaluates the recommendations made with respect to all other executive officers and makes any modifications that he deems appropriate. The Chief Executive Officer then recommends to the Committee annual compensation adjustments and awards for all executive officers other than himself.

The Chief Executive Officer, the Vice President Human Resources and the Secretary attend all meetings of the Committee other than those relating to the performance or compensation of the Chief Executive Officer. The executive officers also periodically consult with and assist the Committee in calculating incentive compensation payouts, establishing and monitoring performance goals and attending to other executive compensation matters.

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Compensation Consultants and Benchmarking.

The Committee annually reviews and evaluates our executive compensation program to verify that it provides reasonable compensation ranges at appropriate levels and remains competitive and effective. The Committee engages Towers, Perrin, Forster & Crosby, Inc., an independent human resources and compensation consulting firm, which we refer to as Towers Perrin, to assist the Committee in its review and evaluation.

Towers Perrin collects and analyzes proxy statement data and prepares market studies of base salaries, annual bonuses, long-term incentive compensation and total cash and direct compensation offered to executives of other multi-national diversified manufacturing companies, which we refer to as the Peer Group. The Committee regularly reviews and updates the Peer Group to make sure that it consists of companies which directly compete with us for talented employees and shareholder investment. The Peer Group for fiscal year 2008, which was the same as the Peer Group for fiscal year 2007, consisted of the following companies:

Caterpillar Inc.	Emerson Electric Co.	Johnson Controls, Inc.
Cooper Industries, Ltd.	Flowserve Corporation	Pall Corporation
Cummins Inc.	Goodrich Corporation	Rockwell Automation, Inc.
Danaher Corporation	Honeywell International, Inc.	SPX Corporation
Deere & Company	Illinois Tool Works Inc.	Textron, Inc.
Dover Corporation	Ingersoll-Rand Company Limited	
Eaton Corporation	ITT Industries, Inc.	

Towers Perrin also reviews and analyzes market studies prepared by leading human resources and compensation consultants for other industrial companies, as well as proxy statement data for approximately 100 of the Fortune 500 companies with annual revenues between $7.5 billion and $12.5 billion.

Based on the data and market studies, Towers Perrin provides the Committee with a comprehensive annual review of total compensation for the Chief Executive Officer and base salaries, annual cash incentive compensation and long-term incentive compensation for other executive officers. Towers Perrin uses its annual review to advise the Committee with respect to the effectiveness and competitiveness of the executive compensation program. The Committee uses the annual review to establish competitive base salaries, annual cash incentive compensation and long-term incentive compensation.

Towers Perrin periodically interacts directly with management to gather information on proposals that management may make to the Committee and to better understand our executive compensation program and its objectives. Towers Perrin also periodically assists management in calculating payouts of incentive compensation and addressing other matters relating to executive compensation.

General Policies and Practices Relating to Executive Compensation.

General Categories of Executive Compensation.

Our executive compensation program offers the specific elements of compensation described in the Elements of Executive Compensation section beginning on page 13. Each specific element can be classified under one of the following general categories:

- Base Salaries
- Annual Cash Incentive Compensation
- Long-Term Incentive Compensation
- Employee Benefits
- Executive Perquisites

The program is structured to offer a reasonable balance of cash and non-cash and short-term and long-term elements of compensation. The program provides a mix of those elements specifically designed to encourage and reward contributions to the advancement of the Win Strategy.

Allocation of Executive Compensation.

The Committee seeks to provide base salaries, annual cash incentive compensation and long-term incentive compensation to each executive officer, and to all executive officers as a group, at approximately the median of the companies included in the Towers Perrin annual review. The Committee does not take into account Con-

verted RONA Bonuses, which we describe beginning on page 16, in measuring whether or not it meets this objective. The Committee seeks to provide a package of Converted RONA Bonuses, employee benefits and executive perquisites which is adequate to keep us competitive in attracting, retaining and motivating present and future executive officers.

When deciding whether to materially increase or decrease the amount of any element of compensation, the Committee evaluates the Towers Perrin annual review, the annual performance reviews of the executive officers and the performance of our business as a whole. The Committee does not consider amounts realized from prior or other compensation in determining the levels of compensation paid to executive officers.

The Committee makes sure that executive officers, as compared to other employees, have a greater proportion of their total compensation allocated to elements that are based on long-term and short-term corporate performance. The Committee structures the program in this manner because executive officers have greater responsibility and influence over the performance of our business. The Committee does not have any formal policies or guidelines with respect to the allocation of executive compensation between short-term and long-term elements, cash and non-cash elements or different forms of non-cash elements. In practice, however, the Committee has taken the following approaches.

Allocation between short-term and long-term elements. The Committee uses the Towers Perrin annual review to set the total of each executive officer s base salary and annual cash incentive compensation, other than Converted RONA Bonuses, at approximately the midpoint value of his or her comparable position within the companies included in the annual review. The Committee also uses the Towers Perrin annual review to set the total target value of each executive officer s long-term incentive compensation as a multiple of the midpoint of the base salary range of his or her comparable position within the companies included in the annual review.

Allocation between cash and non-cash elements. Base salaries and annual cash incentive compensation are paid in cash. Long-term incentive compensation is generally paid in equity because of the long-term nature of equity awards and our desire to encourage performance that drives long-term appreciation of our stock price.

Allocation between different forms of non-cash elements. The Committee generally allocates 50% of the total target value of each executive officer s long-term incentive compensation to Stock Incentives, which we describe beginning on page 21, and 50% to LTI Awards, which we describe beginning on page 19. The Committee takes this approach to balance the allocation between elements based on long-term financial, operational and strategic metrics and those based on long-term performance of our common stock. The Committee generally tries to allocate half of the total target value to Stock Incentives and half to LTI Awards to avoid any appearance that the executive compensation program is a positive or negative indicator of current common stock value or anticipated common stock performance.

The Committee generally makes all elements of executive compensation available to all executive officers and makes executive compensation decisions on a consistent and equitable basis. The Committee generally does not offer any element to an executive officer that is not available to other executive officers. The Committee does, however, provide only to operating group presidents Volume Incentive Bonuses, which we describe on page 18.

Accounting and Tax Considerations.

Our executive compensation program is structured to achieve flexibility, maximize benefits and minimize detriments to our business and our executive officers from a tax and accounting perspective. As a result, we continuously review and evaluate the impact of changes in tax laws and accounting practices and interpretations and similar factors affecting our executive compensation program. For example, FAS 123R, which results in recognition of compensation expense for Stock Incentives, and Section 409A of the Internal Revenue Code, which impacts deferred

compensation arrangements, are considered as we evaluate the structure of and contemplate future changes to the program.

In addition, we try to structure the program to maximize our ability to deduct compensation payments for tax purposes. The Committee takes into account whether particular elements are performance-based compensation under Section 162(m) of the Internal Revenue Code. Section 162(m) sets a limit of $1,000,000 on the amount we can deduct for compensation paid to each of the Chief Executive Officer and the three other most highly compensated executive officers other than the Chief Financial Officer. Compensation that qualifies as performance-based compensation under Section 162(m) does not count toward the $1,000,000 limit.

Base salary does not qualify as performance-based compensation under Section 162(m). The Committee tries to make sure that annual cash incentive compensation and long-term incentive compensation qualify as fully deductible performance-based compensation under Section 162(m). At the 2005 Annual Meeting of Shareholders, the shareholders approved our Performance Bonus Plan. The Performance Bonus Plan is designed to ensure that annual cash incentive compensation and long-term incentive compensation awarded under the plan is performance-based compensation exempt from the $1,000,000 deduction limit under Section 162(m).

For fiscal year 2008, Converted RONA Bonuses did not qualify as performance-based compensation under Section 162(m) because they were awarded more than 90 days after the beginning of the fiscal year 2008 performance period. In future fiscal years, the Committee expects that Converted RONA Bonuses will qualify as performance-based compensation under Section 162(m).

Policies and Practices Relating to Performance-Based Compensation.

General Policies and Practices.

To ensure that our executive compensation program meets its objective to drive and support the Win Strategy, the Committee allocates the majority of compensation for executive officers to annual cash incentive compensation and long-term incentive compensation. Each of the performance-based elements of compensation within those categories are directly tied to appreciation of our stock price and/or to significant financial and operational performance goals. More than one-half of the targeted total compensation for the executive officers is, therefore, at risk and may significantly fluctuate from year to year based on our financial, operational and stock performance. The Committee uses performance-based elements to align the financial interests of our executive officers and our shareholders.

Stock Incentives provide a return to the recipient only if our stock price increases. Each other element of annual cash incentive compensation and long-term incentive compensation provides a return to the recipient only if we meet certain financial and operational performance goals. At the beginning of the applicable performance period, the Committee establishes the performance goals and the target payment amount or payment formula to be used upon achieving those goals. At the end of the period, the Committee determines whether or not the goals were achieved and the final payment amounts. The Committee reviews and evaluates the performance goals at least annually to ensure that they remain consistent with the objectives of the executive compensation program.

Committee Discretion.

Annual cash incentive compensation and long-term incentive compensation are generally structured to maximize their deductibility under Section 162(m) of the Internal Revenue Code. The Committee grants all LTI Awards under the Performance Bonus Plan because it is difficult to predict over a long-term period which executive officers will be covered by Section 162(m) and whether or not annual compensation to those executive officers in future years will exceed $1,000,000.

The Committee also grants Target Incentive Bonuses and RONA Bonuses under the Performance Bonus Plan to executive officers who may potentially be subject to Section 162(m), and then only to the extent that the Committee deems necessary to maximize their deductibility under Section 162(m). In fiscal year 2008, the Committee awarded Target Incentive Bonuses under the Performance Bonus Plan to Mr. Washkewicz, Mr. Pistell, Mr. Banks, Mr. Barker and Mr. Myslenski, and General RONA Bonuses, which we describe beginning on page 16, under the Performance Bonus Plan to Mr. Washkewicz, Mr. Pistell and Mr. Myslenski. The Committee did not award any Converted RONA Bonuses or

Volume Incentive Bonuses under the Performance Bonus Plan in fiscal year 2008.

The Committee does not relax the pre-determined performance goals and generally does not increase the amount of any performance-based compensation following the grant date. The Committee can, however, increase the amount of any award of annual cash incentive compensation made outside of the Performance Bonus Plan if appropriate to account for corporate policy changes, executive compensation program changes and major corporate programs, and to account for the negative impact of acquisitions on goodwill and amortization expense, losses on dispositions of real property during plant moves or shutdowns and other unexpected occurrences that negatively impact awards. The Committee has historically exercised this discretion only with respect to General RONA Bonuses. The Committee exercises this discretion to encourage our employees to

engage in activities and initiatives that drive and support the Win Strategy but have an adverse impact on General RONA Bonuses, such as significant restructuring initiatives.

The Committee can reduce the amount of any award of annual cash incentive compensation or long-term incentive compensation other than Stock Incentives made outside of the Performance Bonus Plan. The Committee also can reduce the amount of any award made under the Performance Bonus Plan as long as the award would continue to qualify as performance-based compensation under Section 162(m). The Committee retains this discretion for the following purposes:

- to ensure greater control over final performance-based compensation amounts based on its assessment of our overall financial performance;
- to preserve the integrity and deductibility of payments and ensure that performance-based compensation continues to effectively serve the interests of our business and our shareholders; and
- to avoid inappropriately rewarding or penalizing executive officers based on events or circumstances that were not expected at the beginning of the performance period.

The Committee has historically exercised this discretion only with respect to General RONA Bonuses awarded under the Performance Bonus Plan to the Chief Executive Officer, the Chief Financial Officer and the Executive Vice President Sales, Marketing and Operations Support, which we refer to as the Office of the Chief Executive. At the beginning of the year, the Committee determines for each member of the Office of the Chief Executive a target General RONA Bonus that is large enough to ensure that we meet our objectives for annual cash incentive compensation and, at the same time, preserve the ability of the Committee to exercise its discretion to reduce the amount of the award to an appropriate level as compared to the final amounts paid to executive officers who are awarded General RONA Bonuses outside the Performance Bonus Plan.

Stock Ownership Guidelines.

In August 1996, the Committee recommended and our Board of Directors adopted stock ownership guidelines to further align the financial interests of our executive officers, directors and shareholders by encouraging the accumulation and retention of our common stock by directors and executive officers. On August 15, 2007, the Committee increased the guidelines for our executive officers. The current guidelines for our directors and executive officers are as follows:

Participants	Guidelines
Chief Executive Officer	Five times annual base salary
Executive or Senior Vice Presidents	Three times annual base salary
Other executive officers	Two times annual base salary
Non-management directors	Four times annual retainer

To accommodate for the increases, the Committee also extended the recommended time period for achieving compliance with the guidelines to June 30, 2012 for all individuals who were serving as executive officers on August 15, 2007. For all other executive officers and all non-management directors, the recommended time period for achieving compliance with the guidelines is five years from election or appointment to the position that is subject to the guidelines. The Committee reviews share ownership information with the Chief Executive

Officer in August of each year to ensure compliance with the guidelines. As of June 30, 2008, all executive officers and directors in their positions for at least five years were in compliance with the guidelines.

We also maintain an insider trading policy which, among other things, prohibits the hedging of stock ownership positions by executive officers.

Elements of Executive Compensation.

Our executive compensation program provides the Named Executive Officers with the elements of compensation described below. All of these elements are designed to work together to contribute to our continuing effort to achieve top-quartile performance among our peers and increase our stock price by adhering to the goals of the Win Strategy.

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Base Salaries.

Each of the Named Executive Officers receives an annual base salary, paid monthly, as compensation for services rendered during the fiscal year. Base salaries encourage and reward attainment of individual performance goals established during the annual performance review process. Base salaries recognize experience, expertise, level of responsibility, seniority, leadership qualities, advancement, individual accomplishment and other significant contributions to the enhancement of shareholder value and the success of our business. We also use base salaries to ensure that the executive compensation program remains competitive to attract, retain and motivate the highly-talented and ethical individuals necessary to advance the goals of the Win Strategy.

The Committee establishes a base salary range for each Named Executive Officer by using the Towers Perrin annual review to analyze base salaries of persons holding comparable positions within the companies included in the Towers Perrin annual review. The Committee determines the base salary for each Named Executive Officer for the next fiscal year based on the Named Executive Officer s annual performance review, and compares the amount to the applicable market range to make sure that it is reasonable. The Committee may also increase base salaries, where appropriate, periodically throughout the fiscal year based on the results of interim performance reviews. The Committee generally tries to target base salary amounts at approximately the median of the companies included in the Towers Perrin annual review.

During fiscal year 2008, the Named Executive Officers received the base salaries included in the Salary column of the Summary Compensation Table for Fiscal Year 2008 on page 30. Those amounts reflect the following percentage increases in base salaries of the Named Executive Officers at the end of fiscal year 2008 as compared to their base salaries at the end of fiscal year 2007:

Named Executive Officer	Percentage Increase in Base Salary
Donald E. Washkewicz*	0.00%
Timothy K. Pistell	4.19%
Marwan M. Kashkoush**	11.91%
Lee C. Banks	4.58%
Robert P. Barker	4.89%
John D. Myslenski	4.24%

* The Committee did not increase the base salary for Mr. Washkewicz in fiscal year 2008. The Committee instead granted additional General RONA Bonus shares to Mr. Washkewicz at the beginning of fiscal year 2008 in an effort to place a higher percentage of his total compensation at risk and subject to fluctuation based on our financial performance.

** Mr. Kashkoush received a percentage increase of 4.29% at the beginning of fiscal year 2008, with the remainder of his increase being awarded on December 7, 2007 due to his October 24, 2007 promotion from Vice President Worldwide Sales and Marketing to Executive Vice President Sales, Marketing and Operations Support.

Annual Cash Incentive Compensation.

The Named Executive Officers are eligible to receive annual cash incentive compensation based on pre-determined financial and growth objectives relating to free cash flow, return on net assets and revenue growth. This category of compensation consists of four specific elements, which we refer to as Target Incentive Bonuses, General RONA Bonuses, Converted RONA Bonuses and Volume Incentive Bonuses. All of the Named Executive Officers are eligible to receive Target Incentive Bonuses, General RONA Bonuses and Converted RONA Bonuses. The only executive officers who are eligible to receive Volume Incentive Bonuses are our operating group presidents, other than Mr. Barker, as described on page 18.

The Committee allocates a significant portion of the total compensation for executive officers to annual cash incentive compensation, which is wholly dependent on achieving pre-determined financial and operational goals. For fiscal year 2008, for example, the Committee targeted General RONA Bonuses and Target Incentive Bonuses to represent 122% of base salary for the Chief Executive Officer, 48-68% of base salary for the Chief Financial Officer, the Executive Vice President Sales, Marketing and Operations Support, and other executive officers with operational profit and loss responsibility, and 36-59% of base salary for all other executive

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officers. The following table reflects the target percentage of base salary represented by Target Incentive Bonuses and General RONA Bonuses for each Named Executive Officer in fiscal year 2008:

Named Executive Officer	Target Percentage of Base Salary Target Incentive Bonuses and General RONA Bonuses
Donald E. Washkewicz	122%
Timothy K. Pistell	68%
Marwan M. Kashkoush*	61%
Lee C. Banks	64%
Robert P. Barker	61%
John D. Myslenski	68%

* For Mr. Kashkoush, the target percentage of base salary represented by his Target Incentive Bonus and General RONA Bonus was 39% at the beginning of fiscal year 2008. This target percentage increased to 61% on December 7, 2007, which was the date on which the Committee adjusted Mr. Kashkoush s base salary and annual cash incentive compensation to account for his October 24, 2007 promotion from Vice President Worldwide Sales and Marketing to Executive Vice President Sales, Marketing and Operations Support.

The Committee pre-determines the performance measures applicable to each element by analyzing our annual goals and objectives for each performance measure and, for Target Incentive Bonuses, the Towers Perrin annual review. The Committee directly and materially links annual cash incentive compensation to performance that drives and supports the Win Strategy.

Target Incentive Bonuses.

During fiscal year 2008, the Named Executive Officers received annual cash incentive compensation based on our free cash flow margin, which we refer to as Target Incentive Bonuses. Free cash flow margin is calculated as the percentage of sales represented by actual operating cash flow less capital expenditures, excluding discretionary pension contributions made during the fiscal year.

The Committee identified free cash flow margin as a performance measure critical to the financial performance and profitable growth goals of the Win Strategy. Maximizing free cash flow allows us to continue to pay annual dividends, acquire our outstanding shares to prevent shareholder dilution caused by Stock Incentives, and reinvest in our business by funding innovation and financing growth through acquisitions of businesses and technologies. Target Incentive Bonuses encourage executive officers to maximize free cash flow by increasing net income, implementing lean initiatives, controlling inventory, collecting receivables, controlling accounts payable and limiting capital expenditures. We have also identified a strong correlation between increases in free cash flow and increases in operating earnings.

During the first quarter of fiscal year 2008, the Committee set the following target awards for each of the Named Executive Officers after evaluating our annual plan for free cash flow margin and comparing the plan to the historical performance of the Peer Group to ensure its reasonableness:

Named Executive Officer	Target Awards Target Incentive Bonuses
Donald E. Washkewicz	$600,000
Timothy K. Pistell	$210,000
Marwan M. Kashkoush*	$ 90,000
Lee C. Banks	$120,000
Robert P. Barker	$100,000
John D. Myslenski	$225,000

* Mr. Kashkoush received a target award of $60,000 at the beginning of fiscal year 2008, with the remainder of his award being granted on December 7, 2007 due to his October 24, 2007 promotion from Vice President Worldwide Sales and Marketing to Executive Vice President Sales, Marketing and Operations Support.

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The Committee developed the following table to illustrate how final Target Incentive Bonus amounts would be calculated at the end of fiscal year 2008:

	Less than							Greater than or equal
FY08 Free Cash Flow Margin:	3%	3%	4%	5%	6%	7%	8%	to 9%
Payout %	0%	25%	50%	75%	100%	133%	167%	200%

This table illustrates that each recipient of a Target Incentive Bonus would receive a year-end payout of 100% of his or her target award if our free cash flow margin for fiscal year 2008 was 6%, and a maximum payout of 200% of his or her target award if our free cash flow margin was greater than or equal to 9%. This table also illustrates that no Target Incentive Bonuses would be paid if our free cash flow margin for fiscal year 2008 was less than 3%. The payouts are calculated on a sliding-scale basis using this table. For example, a free cash flow margin of 6.5% would result in a payout of 116.67% of the applicable target award.

The Committee designed the Target Incentive Bonuses to reward executive officers directly for performance in relation to our fiscal year 2008 annual plan and against the Peer Group. The Committee determined that a 6% free cash flow margin would meet our fiscal year 2008 annual plan. The Committee also estimated that 3%, 6% and 9% margins would represent bottom-quartile, median and top-quartile free cash flow margin results, respectively, within the Peer Group during fiscal year 2008.

Our actual free cash flow margin for fiscal year 2008 was 8.50%. As a result, each of the Named Executive Officers received 183.33% of his target award, as included in the Non-Equity Incentive Plan Compensation column of the Summary Compensation Table for Fiscal Year 2008 on page 30. Target Incentive Bonuses are paid in one lump sum in August for each executive officer whose Target Incentive Bonus is awarded under the Performance Bonus Plan, and are paid in three installments in March, June and August for all other executive officers. The March and June payments are estimated based on year-to-date results and the August payment represents the balance of the Target Incentive Bonus payable based on the actual results for the entire fiscal year. All payments are made in cash, except that the August payment may, at the election of the recipient, be deferred as a credit to the recipient s account under the Executive Deferral Plan, which we describe on page 25.

General RONA Bonuses and Converted RONA Bonuses.

During fiscal year 2008, each of the Named Executive Officers received annual cash incentive compensation, which we refer to as General RONA Bonuses and Converted RONA Bonuses. The Committee awards General RONA Bonuses to our executive officers based on our annual plan for return on net assets, and awards Converted RONA Bonuses to our executive officers in place of certain executive perquisites that were eliminated by the Committee effective January 1, 2008. The performance measure used to determine the amount of the payouts on Converted RONA Bonuses is the return on average net assets for all of our divisions. The performance measures used to determine the amount of the payouts on General RONA Bonuses are as follows:

- for the members of the Office of the Chief Executive, return on consolidated net assets;
- for operating group presidents other than Mr. Barker, the return on average division net assets for the divisions in his or her operating group; and

for Mr. Barker and all other executive officers, return on average net assets for all divisions.

Return on net assets is calculated by dividing earnings (segment operating income for the fiscal year) by average assets (average of inventory, accounts receivable, prepaid expenses, property, plant and equipment, goodwill and intangibles, less trade accounts payable and contract reserves, at the beginning of the fiscal year and at the end of each quarter of the fiscal year).

The Committee identified return on net assets as a performance measure critical to the financial performance and profitable growth goals of the Win Strategy. The Committee uses General RONA Bonuses and Converted RONA Bonuses to encourage executive officers and other employees to increase segment revenues and control net average assets by reducing investments in assets and increasing efficiency in managing those investments. In addition, General RONA Bonuses and Converted RONA Bonuses encourage executive officers and other employees to increase sales and to reduce materials handling and other costs associated with excess inventory levels by taking profit margins, asset turnover and outside leveraging into account in measuring overall performance. The Committee also believes that offering Converted RONA Bonuses in lieu of certain eliminated executive perquisites is appropriate to keep us competitive in attracting, retaining and motivating present and future executive officers.

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General RONA Bonuses are paid in one lump sum in August for each executive officer whose General RONA Bonus is awarded under the Performance Bonus Plan, and are paid in four installments in October, January, April and August for all other executive officers. Converted RONA Bonuses for fiscal year 2008 were paid in one lump sum in August 2008 to Mr. Washkewicz, Mr. Pistell and Mr. Myslenski, and were paid in two installments in April 2008 and August 2008 to all other executive officers. Each installment is based on actual year-to-date results. We hold back 25% of the year-end estimate from each installment other than the August payments to ensure that we have the flexibility to reconcile the August payments to final year-end results. All payments are made in cash, except that General RONA Bonus payments made in August may, at the election of the recipient, be deferred as a credit to the recipient s Executive Deferral Plan account.

Converted RONA Bonus payments are not eligible for deferral under the Executive Deferral Plan, the Retirement Savings Plan described on page 23 or the Savings Restoration Plan described on page 24. Converted RONA Bonuses are also not considered in calculating benefits under the Pension Plan described on page 22, the Pension Restoration Plan described on page 25, the Supplemental Retirement Program described on page 25, the Executive Long-Term Disability Plan described on page 26 and the Change in Control Agreements described on page 26. The Committee determined that it would not be appropriate to allow Converted RONA Bonuses to be deferred under those plans or considered in those calculations because they are awarded in place of executive perquisites which, traditionally, have not been used or taken into account for those purposes.

The Committee calculates General RONA Bonuses and Converted RONA Bonuses at each payment date as follows:

- The applicable return on net assets is calculated by dividing earnings (year-to-date segment operating income) by average assets (average of inventory, accounts receivable, prepaid expenses, property, plant and equipment, goodwill and intangibles, less trade accounts payable and contract reserves, at the beginning of the fiscal year and at the end of each applicable quarter-end to date).

- The multiple is calculated as follows:

  - For that portion of the applicable return on net assets which is less than or equal to 35%, the multiple is 1% for every 5.6% of return on net assets.

  - For that portion of return on net assets in excess of 35%, the multiple is 1% for every 11.2% of the excess.

- For General RONA Bonuses, the amount of the payout is calculated by multiplying the number of General RONA Bonus shares awarded to the recipient by the multiple, and multiplying that total by the recipient s base salary for the fiscal year.

- For Converted RONA Bonuses, the amount of the payout is calculated by multiplying the number of Converted RONA Bonus shares awarded to the recipient by the multiple, and multiplying that total by the midpoint of the recipient s base salary range by comparable position within the companies included in the Towers Perrin annual review.

In fiscal year 2008, all Converted RONA Bonus payments were reduced by 50% because Converted RONA Bonuses were awarded after the end of the second quarter on January 1, 2008.

During the first quarter of fiscal year 2008, the Committee awarded to each of the Named Executive Officers the following number of General RONA Bonus shares based on the following General RONA Bonus target amounts after evaluating our annual plan for returns on net assets:

Named Executive Officer	General RONA Bonus Shares	General RONA Bonus Target Amount
Donald E. Washkewicz	28	$808,500
Timothy K. Pistell	14	$226,100
Marwan M. Kashkoush*	8	$188,000
Lee C. Banks	8	$200,800
Robert P. Barker	8	$188,800
John D. Myslenski	14	$240,800

* Mr. Kashkoush received five General RONA Bonus shares representing a General RONA Bonus target amount of $109,500 at the beginning of fiscal year 2008, with the remainder of his General RONA Bonus shares being awarded on

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December 7, 2007 due to his October 24, 2007 promotion from Vice President Worldwide Sales and Marketing to Executive Vice President Sales, Marketing and Operations Support.

Effective January 1, 2008, the Committee eliminated certain executive perquisites from our executive compensation program and awarded Converted RONA Bonuses to our executive officers in place of those perquisites. Specifically, the Committee eliminated the following executive perquisites and calculated the following target values based on the average historical cost of each eliminated perquisite:

Executive Perquisite	Target Value Chief Executive Officer	Target Value Other Executive Officers
Health and fitness clubs	$ 1,000	$ 1,000
Financial planning, tax preparation and estate planning	$10,500	$10,500
Home security	$ 2,000	$ 2,000
Monthly dues and tax gross-ups (private clubs)	$43,200	$20,000*
Tax gross-ups (spousal travel)	$16,000	$ 8,000
TOTAL:	$72,700	$41,500

* This amount represents a per-club amount. If, for example, an executive officer belongs to two private clubs in accordance with our policy on private club memberships, this amount would be $40,000 for that executive officer.

The Committee then estimated the number of Converted RONA Bonus shares to be awarded by converting the above target values into a target number of Converted RONA Bonus shares based on a target payout per Converted RONA Bonus share of 5% of the midpoint of each executive officer s base salary range by comparable position within the companies included in the Towers Perrin annual review. This calculation resulted in the Committee awarding to each of the Named Executive Officers the following number of Converted RONA Bonus shares based on the following Converted RONA Bonus target amounts:

Named Executive Officer	Converted RONA Bonus Shares	Converted RONA Bonus Target Amount
Donald E. Washkewicz	1.30	$74,750
Timothy K. Pistell	2.00	$60,000
Marwan M. Kashkoush	1.60	$40,000
Lee C. Banks	1.60	$40,000
Robert P. Barker	1.60	$40,000
John D. Myslenski	2.00	$60,000

During fiscal year 2008, each of the Named Executive Officers received the General RONA Bonuses and Converted RONA Bonuses included in the Non-Equity Incentive Plan Compensation column of the Summary Compensation Table for Fiscal Year 2008 on page 30. On August 13, 2008, the Committee compared the original General RONA Bonus amounts awarded to the members of the Office of the Chief Executive at the beginning of fiscal year 2008 with the final amounts paid to the other executive officers. Based on that comparison, the Committee determined that it would be appropriate to reduce the final General RONA Bonus amounts awarded to Mr. Washkewicz, Mr. Pistell and Mr. Myslenski by 15.44%. The amounts reported in the table represent the final amounts paid to Mr. Washkewicz, Mr. Pistell, Mr. Myslenski and the other Named Executive Officers following that exercise of discretion.

Volume Incentive Bonuses.

During fiscal year 2008, each of our operating group presidents other than Mr. Barker received additional annual cash incentive compensation under our Volume Incentive Plan, which we refer to as Volume Incentive Bonuses. In fiscal year 2007, we determined that Mr. Barker was no longer eligible to receive Volume Incentive Bonuses due to his promotion to Senior Vice President and Operating Officer.

Volume Incentive Bonuses encourage our operating group presidents and other participants to maximize sales growth within their operating groups internally and through acquisitions. Based on our continued focus on increased market share, returns on invested capital and price-earnings multiples, the Committee identified sales

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growth as a performance measure critical to advance the financial performance and profitable growth goals of the Win Strategy. The Committee uses Volume Incentive Bonuses to reward participants for performance that exceeds our annual sales growth goals. Volume Incentive Bonuses are only available if sales growth within the applicable operating group exceeds our annual goal of 10% sales growth for that operating group.

Each operating group president receives a Volume Incentive Bonus equal to 1% of base salary for each 1% of sales by which his or her operating group exceeds its sales for the prior year by between 10% and 15%, and 2% of base salary for each 1% of sales by which his or her operating group exceeds its sales for the prior year by more than 15%. Volume Incentive Bonuses are capped at an overall maximum of 15% of base salary. Volume Incentive Bonuses are paid in cash and in one lump sum in August.

Mr. Barker is the only Named Executive Officer who served as an operating group president during fiscal year 2008. Based on the fact that Mr. Barker is no longer eligible to accrue Volume Incentive Bonuses, none of the Named Executive Officers received a Volume Incentive Bonus in fiscal year 2008.

Long-Term Incentive Compensation.

The Named Executive Officers receive long-term incentive compensation consisting of long-term incentive awards, which we refer to as LTI Awards, and stock options with tandem stock appreciation rights, which we refer to as Stock Incentives. The target amounts of LTI Awards and the number of Stock Incentives awarded to the Named Executive Officers are based on similar compensation awarded to persons holding comparable positions within the companies included in the Towers Perrin annual review.

LTI Awards and Stock Incentives encourage long-term focus on shareholder value and are directly and materially linked to performance that advances both the financial performance and profitable growth goals of the Win Strategy over the long-term. LTI Award payouts are based on a comparison of our performance against the Peer Group in certain annual revenues, earnings and return on invested capital results over a three-year performance period. The holders of Stock Incentives realize a payout only if our stock price increases above the applicable grant price over a long-term vesting period. LTI Awards and Stock Incentives work together to align the long-term financial interests of our executive officers and shareholders.

LTI Awards and Stock Incentives are granted to eligible employees on an annual basis at the first meeting of the Committee following our public earnings release for the fourth-quarter of the preceding fiscal year. This meeting is typically held in August of each year and is scheduled at least one year in advance. The only exceptions to this practice are that pro-rated LTI Awards are granted to individuals who become executive officers, are promoted to new executive officer positions or are given increased responsibilities during a performance period, and reload grants of Stock Incentives occur automatically upon certain exercises of Stock Incentives. For example, as previously disclosed in our Compensation Discussion and Analysis for fiscal year 2007, on August 15, 2007 the Committee granted Mr. Pistell a pro rata adjustment to his LTI Awards for the fiscal year 2006-07-08 and 2007-08-09 performance periods due to an overall increase in his day-to-day responsibilities and a corresponding increase in his base salary. Specifically, the Committee adjusted the original awards to Mr. Pistell of 7,925 target LTI Award restricted shares at the beginning of fiscal year 2006 and 8,650 target LTI Award restricted shares at the beginning of fiscal year 2007 to 9,050 and 10,500 target LTI Award restricted shares, respectively.

The Committee does not grant LTI Awards or Stock Incentives to executive officers in anticipation of the release of significant positive earnings announcements or other material non-public information likely to result in changes to the price of our common stock. Similarly, the Committee does not time the release of material non-public information based on Stock Incentive grant dates.

LTI Awards.

Each of the Named Executive Officers received a target LTI Award of restricted shares during the first quarter of fiscal year 2008. The actual LTI Award payouts will be calculated following the three-year performance period ending June 30, 2010 by comparing our compound annual revenue growth, compound annual growth in fully diluted earnings per share from continuing operations and average return on invested capital from continuing operations against the corresponding results for all members of the Peer Group during that period.

The Committee has identified long-term revenue growth, earnings per share growth and returns on invested capital as performance measures critical to the financial performance and profitable growth goals of the Win

Strategy. The Committee uses LTI Awards to encourage executive officers to maximize those measures by providing on-time delivery of quality products, value-added services and systems, strategic procurement of goods and services, lean operations, strategic pricing, product innovation and strong distribution.

During the first quarter of fiscal year 2008, the Committee established weights of 20% for compound annual revenue growth, 40% for compound annual growth in fully diluted earnings per share from continuing operations and 40% for average return on invested capital from continuing operations for the fiscal year 2008-09-10 performance period. The Committee determined that higher weights for the earnings per share and return on invested capital measures would allow the more profitable growth measures to have a greater impact on LTI Award payouts. The Committee granted to each of the Named Executive Officers the following target LTI Award based on the following target LTI Award values, which the Committee determined to be competitive compared to similar long-term incentive compensation offered within the companies included in the Towers Perrin annual review:

Named Executive Officer	Target LTI Award Restricted Shares	Target LTI Award Values
Donald E. Washkewicz	55,500	$ 2,925,000
Timothy K. Pistell	16,800	$ 855,000
Marwan M. Kashkoush*	10,113	$ 529,667
Lee C. Banks	10,500	$ 550,000
Robert P. Barker	10,500	$ 550,000
John D. Myslenski	16,800	$ 855,000

* Mr. Kashkoush received a grant of 5,850 target LTI Award restricted shares with a target LTI Award value of $306,000 at the beginning of fiscal year 2008, with his target amount being increased on December 7, 2007 due to his October 24, 2007 promotion from Vice President Worldwide Sales and Marketing to Executive Vice President Sales, Marketing and Operations Support. Mr. Kashkoush s target LTI Award restricted shares for the fiscal year 2006-07-08 and 2007-08-09 performance periods were also increased from 5,700 to 6,792 and 5,925 to 8,843, respectively, due to his promotion.

The target LTI Award restricted shares shown in this table are also included in the Estimated Future Payouts Under Equity Incentive Plan Awards Target column of the Grants of Plan-Based Awards for Fiscal Year 2008 table on page 33. The Stock Awards column of the Summary Compensation Table for Fiscal Year 2008 on page 30 includes the Financial Accounting Standards Board Statement No. 123(R) expense that we recognized for these awards in fiscal year 2008.

The Committee developed the following table to illustrate how final LTI Award payouts would be calculated at the end of fiscal year 2010:

Peer Group Percentile Rank:	Less than or equal to 35	42.5	50	62.5	Greater than or equal to 75
Payout %	0%	50%	100%	150%	200%

At the end of fiscal year 2010, the Committee will determine our percentile rank as compared to the Peer Group for each of the three performance measures. Using this table, the Committee will calculate the portion of the target LTI Award value earned with respect to each performance measure. The Committee will multiply each portion by its applicable weight and add up the total to determine the total LTI Award payout for the fiscal year 2008-09-10 performance period. This table illustrates that LTI Award participants will receive the maximum payout of 200% of the applicable target LTI Award value if we rank at or above the 75th percentile among the Peer Group in the aggregate based on all three performance measures, and will receive no payout if we rank at or below the 35th percentile in the aggregate based on all three

performance measures. LTI Awards are paid after the end of the applicable three-year performance period in restricted shares or, at the election of the recipient, as a contribution to the recipient s Executive Deferral Plan account. LTI Awards may also be paid in cash if the recipient is retired and did not elect to participate in the Executive Deferral Plan. The restricted shares have a three-year vesting period and entitle the holder to receive non-refundable dividends and vote the shares during that vesting period. The amount of any Executive Deferral Plan contribution will be the number of restricted shares earned multiplied by the closing price of our common stock on June 30, 2010.

The Committee designed LTI Awards to reward executive officers directly in relation to our long-term performance against the Peer Group. The Committee determined that requiring performance in excess of the 50th

percentile for a payout in excess of 100% would encourage executive officers to achieve performance above median Peer Group performance. The Committee also determined that requiring performance at the 75th percentile for a maximum payout, and awarding no payout for performance at or below the 35th percentile, would further encourage executive officers to achieve top-quartile performance within the Peer Group.

In addition, each of the Named Executive Officers received a payout under LTI Awards granted in fiscal year 2006 for the three-year performance period ended June 30, 2008. The Committee determined that we achieved the following percentile rankings among the Peer Group with respect to the LTI Award performance measures for that performance period:

Performance Measure	Result	Percentile Rank**
Compound annual revenue growth	13.92%	81st
Compound annual growth in fully diluted EPS*	19.38%	23rd
Average return on invested capital*	21.11%	72nd

* Unlike the performance measures described above for the fiscal year 2008-09-10 performance period, the compound annual growth in fully diluted earnings per share and average return on invested capital performance measures for the fiscal year 2006-07-08 performance period shown in this table include discontinued operations.

** Unlike the Peer Group percentile ranks described above for the fiscal year 2008-09-10 performance period, payouts of 50%, 100% or 150% of the applicable target LTI Award value for the fiscal year 2006-07-08 performance period shown in this table, as well as for the fiscal year 2007-08-09 performance period, require Peer Group percentile ranks of 45th, 55th and 65th, respectively.

As a result, each of the Named Executive Officers received the LTI payout in fiscal year 2008 included in the Stock Awards Number of Shares or Units of Stock That Have Not Vested column of the Outstanding Equity Awards at June 30, 2008 table on page 36. Each payment represents a total payout of 113.88% of the target LTI Award values for the three-year performance period ended June 30, 2008.

As previously disclosed in our Compensation Discussion and Analysis for fiscal year 2007, on August 15, 2007 the Committee approved the vesting of Mr. Myslenski in all of his outstanding LTI Awards effective as of his May 2, 2008 retirement. Mr. Myslenski, who was age 57 at the time of his retirement, would have received immediate vesting in his LTI Awards if he retired after age 60. The Committee approved this early vesting in connection with Mr. Myslenski s service as a senior executive officer because he was identified by the Committee as an essential contributor to our efforts to drive and support the Win Strategy.

Stock Incentives.

Each of the Named Executive Officers received Stock Incentives under our 2003 Stock Incentive Plan during the first quarter of fiscal year 2008. The Committee grants Stock Incentives to executive officers to encourage and reward efforts and accomplishments that advance the goals of the Win Strategy and make other contributions to maximize our stock price.

The number of Stock Incentives granted by the Committee is determined by utilizing the Black-Scholes valuation model to convert a target dollar value (adjusted for risk of non-vesting) into the number of Stock Incentives to be granted. The Committee uses the Towers Perrin annual review to set the target dollar values at the median of similar compensation offered within the companies included in the Towers Perrin annual review. The following table shows the Black-Scholes Value and the number of Stock Incentives granted to each of the Named Executive

Officers in the first quarter of fiscal year 2008:

Named Executive Officer	Black-Scholes Target Value	Fiscal Year 2008 Stock Incentive Grants (# of Underlying Shares)
Donald E. Washkewicz	$2,925,000	155,250
Timothy K. Pistell	$ 855,000	48,450
Marwan M. Kashkoush	$ 306,000	17,400
Lee C. Banks	$ 550,000	29,700
Robert P. Barker	$ 550,000	29,700
John D. Myslenski	$ 855,000	48,450

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The fiscal year 2008 Stock Incentive grants shown in this table are also included in the All Other Option Awards: Number of Securities Underlying Options column of the Grants of Plan-Based Awards for Fiscal Year 2008 table on page 33 and the Option Awards Number of Securities Underlying Unexercised Options Unexercisable column of the Outstanding Equity Awards at June 30, 2008 table on page 36. The Option Awards column of the Summary Compensation Table for Fiscal Year 2008 on page 30 includes the Financial Accounting Standards Board Statement No. 123(R) expense that we recognized for these awards in fiscal year 2008.

As required by the terms of our 2003 Stock Incentive Plan, all Stock Incentives have an exercise price equal to the closing price of our common stock on the date of grant. The plan does not permit the re-pricing of Stock Incentives. The Committee analyzes the terms of our 2003 Stock Incentive Plan and the Towers Perrin annual review to establish all other terms of Stock Incentives. Stock Incentives have a ten-year term and vest in one-third increments over three years following the grant date. Upon vesting, the holder may exercise all or any portion of the award as either a stock option or a stock appreciation right, but not both. When vested, each option entitles the holder to purchase the shares underlying the option at the grant price. When vested, each stock appreciation right entitles the holder to receive the increase in value of one common share from the grant date to the date of exercise.

Upon exercise of options or stock appreciation rights, common shares are issued directly to the holder. The appreciation in stock appreciation rights is calculated by subtracting the grant price from the fair market value of the common shares on the day prior to the date of exercise, and multiplying the result by the number of stock appreciation rights exercised. The number of common shares to be issued is determined by dividing that appreciation by the closing price of the common shares on the day prior to the date of exercise.

If an executive officer exercises a Stock Incentive as an option by surrendering shares to satisfy the exercise price, the executive officer will receive a reload grant of stock appreciation rights to restore the appreciation lost on the shares that were surrendered to pay the option cost. The number of stock appreciation rights granted is equal to the number of shares surrendered. The reload grant has the same expiration date as the underlying grant. The reload grant price is equal to the closing stock price of our common stock on the date of exercise of the underlying grant. The reload grant vests one year from the date of exercise if the executive officer remains employed with us and retains ownership of the shares received from the exercise for one year, less shares surrendered or sold to pay income taxes. Grants of stock options or stock appreciation rights made prior to the executive officer s appointment as an executive officer do not offer these reload grants.

During fiscal year 2008, certain Named Executive Officers exercised Stock Incentives previously granted under our 2003 Stock Incentive Plan and 1993 Stock Incentive Program, which are included in the Option Awards Number of Shares Acquired on Exercise column of the Option Exercises and Stock Vested for Fiscal Year 2008 table on page 39.

Employee Benefits.

The Named Executive Officers are eligible to participate in various employee benefit plans and programs. These plans and programs reflect experience, expertise, level of responsibility, longevity and advancement. We use these plans to ensure that our executive compensation program remains sufficiently competitive to attract, retain and motivate the executive officers and other employees necessary to advance the goals of the Win Strategy.

Qualified Benefit Plans.

During fiscal year 2008, the Named Executive Officers participated in the following tax-qualified benefit plans and programs:

- The Parker-Hannifin Consolidated Pension Plan, which we refer to as the Pension Plan; and
- The Parker Retirement Savings Plan, which we refer to as the Retirement Savings Plan.

The Pension Plan is a qualified defined benefit pension plan in which most full-time non-union U.S. salaried employees hired prior to April 1, 2004 participate. The Pension Plan offers normal retirement, early retirement and death benefits. The monthly normal retirement benefit is the greater of a minimum benefit and

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an amount based on final average pay. The calculation of the minimum benefit and final average pay amounts can be summarized as follows:

Minimum Benefit:	$21.00 multiplied by years of service, up to a maximum of 40 years.
Final Average Pay Amount:	0.75% of the highest five consecutive year average of monthly base salary, Target Incentive Bonuses and General RONA Bonuses up to the social security wage base, multiplied by years of service up to a maximum of 35 years; plus
	1.36% of the highest five consecutive year average of monthly base salary, Target Incentive Bonuses and General RONA Bonuses in excess of the social security wage base, multiplied by years of service up to a maximum of 35 years; plus
	0.50% of the highest five consecutive year average of monthly base salary, Target Incentive Bonuses and General RONA Bonuses, multiplied by years of service in excess of 35 up to a maximum of 5 years.

The amount of the benefit is reduced by 6% per year for each year prior to age 65 if retirement occurs before age 65 and after age 55. We elected to freeze new participation in the Pension Plan in 2004. All participants as of April 1, 2004 were given the option to either remain in the Pension Plan or terminate in favor of maintaining a retirement income account under the Retirement Savings Plan. Employees hired after April 1, 2004 were not eligible to participate in the Pension Plan and instead maintain a retirement income account under the Retirement Savings Plan. Each of the Named Executive Officers other than Mr. Kashkoush elected to remain in and continue to accrue benefits under the Pension Plan. Mr. Kashkoush elected to terminate his participation in the Pension Plan and maintain a retirement income account under the Retirement Savings Plan. All benefits accrued by Mr. Kashkoush and the other employees who elected to terminate participation in the Pension Plan were frozen as of June 30, 2004. Those employees initiated their retirement income accounts on July 1, 2004. The Committee does not grant extra years of credited service under the Pension Plan, and we do not have any policy that allows us to do so.

The Retirement Savings Plan is a qualified defined contribution pension plan under Section 401(k) of the Internal Revenue Code. Most full-time U.S. employees are eligible to participate in the Retirement Savings Plan. Participants may make pre-tax contributions to the Retirement Savings Plan up to the applicable statutory limit. Converted RONA Bonuses are not eligible for deferral under the Retirement Savings Plan. We provide to each participant a matching contribution of 100% on the first 3% of pay contributed and 50% on the 4th and 5th percent of pay contributed. As described above, certain participants also maintain a retirement income account within the Retirement Savings Plan. We provide to each holder of a retirement income account an annual contribution equal to a percentage of the amount of the participant s annual compensation up to the Internal Revenue Service statutory limit (currently $225,000 per year) determined based on age and length of service. These contributions range from 0.5% to 6% of the participant s compensation which does not exceed that limit. Participants accrue earnings on contributions based on the performance of various investment funds available within the Retirement Savings Plan. The contributions made by us under the Retirement Savings Plan for the Named Executive Officers during fiscal year 2008 are included in the All Other Compensation column of the Summary Compensation Table for Fiscal Year 2008 on page 30.

Non-Qualified Benefit Plans.

During fiscal year 2008, the Named Executive Officers participated in the following non-qualified benefit plans and programs:

- The Parker Hannifin Savings Restoration Plan, which we refer to as the Savings Restoration Plan;
- The Parker Hannifin Executive Deferral Plan, which we refer to as the Executive Deferral Plan;
- The Parker-Hannifin Corporation Pension Restoration Plan, which we refer to as the Pension Restoration Plan; and
- The Parker-Hannifin Corporation Supplemental Executive Retirement Benefits Program, which we refer to as the Supplemental Retirement Program.

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The Savings Restoration Plan is available to employees who earn base salaries in excess of $130,000 per year and who are otherwise eligible to participate in the plan. The Savings Restoration Plan was established to restore deferral opportunities and matching contributions lost because of statutory limits in the Retirement Savings Plan. Specifically, the Savings Restoration Plan allows executive officers to defer a portion of their pre-tax compensation and receive matching contributions from us that would have been available under the Retirement Savings Plan if the Internal Revenue Service statutory limit did not exist. Converted RONA Bonuses are not eligible for deferral under the Savings Restoration Plan. Each Named Executive Officer may annually defer to his or her Savings Restoration Plan account any portion of the compensation that he cannot defer under the Retirement Savings Plan due to the statutory limit, other than Converted RONA Bonuses, up to the greater of 20% of base pay or $25,000. We provide to each participant a matching contribution of common stock equal to 100% on the first 3% of pay contributed and 50% on the 4th and 5th percent of pay contributed, reduced by the maximum matching contribution available to the participant under the Retirement Savings Plan. We also take into account the matching contributions made under the Retirement Savings Plan to ensure that the maximum match under both plans does not exceed $17,000. In addition, certain participants also maintain a separate retirement income account within the Savings Restoration Plan similar to the Retirement Savings Plan. We provide to each holder of a retirement income account an annual contribution equal to a percentage of the amount of the participant s annual compensation in excess of the Internal Revenue Service statutory limit determined based on age and length of service. These contributions range from 0.5% to 6% of the amount of the participant s compensation in excess of that limit. All deferrals and contributions are made under the Savings Restoration Plan by accounting entry rather than any physical exchange of cash or common stock. Participants also accrue earnings, on an accounting-entry basis, on deferrals based on the performance of various investment fund choices and on contributions based on the performance of our common stock. Participants are our unsecured creditors for their respective account balances. Account balances are paid out upon any of the following events as follows:

Retirement:	Balances are distributed to the participant in either a lump sum or in periodic installments, based on a prior election by the participant. The participant can delay the first payment for up to five years following retirement or until age 70, whichever is earlier. Balances continue to accumulate earnings under the various investment funds at all times during the payout period.
Termination Before Retirement:	Balances accruing prior to December 31, 2004 are, at our election, distributed to the participant in either a lump sum upon termination or in periodic installments. Account balances accruing on or after January 1, 2005 are distributed to the participant in a lump sum upon termination.
Disability:	If we determine that a participant is totally disabled, the participant s account balance will be paid upon termination in the same manner as if he or she retired.
Withdrawals During Employment:	Balances can be withdrawn without penalty during employment only if we determine that the participant suffered severe financial hardship. Balances accruing prior to December 31, 2004 can also be withdrawn voluntarily during employment, subject to a 10% forfeiture penalty.
Death:	Balances are distributed to the participant s beneficiary in a lump sum.
Change in Control:	Balances accruing prior to December 31, 2004 are distributed to the participant in a lump sum without penalty if the participant expressly elected a lump sum. If the participant did not expressly elect a lump sum, distributions are treated as unscheduled withdrawals and are subject to a forfeiture penalty of 5% if they are withdrawn within 30 days or 10% if they are withdrawn beyond the 30-day period. Balances accruing on or after January 1, 2005 are distributed to the participant in a lump sum or, at our election, in installment payments made over a three year period.

Our matching contributions made under the Savings Restoration Plan for the Named Executive Officers during fiscal year 2008 are included in the All Other Compensation column of the Summary Compensation Table for Fiscal Year 2008 on page 30. All contributions, earnings, withdrawals, distributions and aggregate balances for the Named Executive Officers participating in the Savings Restoration Plan during fiscal year 2008 are included in the Nonqualified Deferred Compensation for Fiscal Year 2008 table on page 41.

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The Executive Deferral Plan is available to executive officers and certain other key employees. The Executive Deferral Plan provides executive officers with an opportunity to defer a portion of their compensation (in addition to that deferred under the Retirement Savings Plan and the Savings Restoration Plan) on a pre-tax basis, including annual cash incentive compensation and LTI Award payouts, and to accumulate tax-deferred earnings on the deferrals. Converted RONA Bonuses are not eligible for deferral under the Executive Deferral Plan. Each executive may defer to his or her account up to 80% of base salary, 80% of General RONA Bonuses paid in August and Target Incentive Bonuses paid in August and 100% of LTI Award payouts. Similar to the Savings Restoration Plan, all deferrals are made under the Executive Deferral Plan by accounting entry rather than any physical exchange of cash. Participants also accrue earnings on an accounting-entry basis based on the performance of various investment fund choices. Participants are our unsecured creditors for their respective account balances. Account balances are paid out upon the same events and in the same manner as account balances under the Savings Restoration Plan, except for distributions made upon a change in control. In that case, balances are distributed to the participant or the participant s beneficiary in a lump sum. Prior to distribution, the balances are increased to reflect any gross-up amount necessary to offset federal excise taxes and any after-tax value the participant would have received if the account had remained in place and been paid as elected by the participant. All contributions, earnings, withdrawals, distributions and aggregate balances for the Named Executive Officers participating in the Executive Deferral Plan during fiscal year 2008 are included in the Nonqualified Deferred Compensation for Fiscal Year 2008 table on page 41.

The Pension Restoration Plan is available to all individuals who participate in the Pension Plan and Savings Restoration Plan and who are otherwise eligible to participate in the Pension Restoration Plan. The Pension Restoration Plan was established to restore benefits lost because of statutory limits on the Pension Plan. Specifically, the benefits available under the Pension Restoration Plan equal the amount that would be payable to the participant under the Pension Plan in excess of the Internal Revenue Service statutory limit if that limit did not exist. Similar to the Pension Plan, Converted RONA Bonuses are not considered in calculating the benefits available under the Pension Restoration Plan.

The Supplemental Retirement Program was established to provide executive officers with retirement benefits supplemental to the benefits under the Pension Plan. The benefit provided under the Supplemental Retirement Program is intended, at age 65, to provide to participants with at least 10 years of service 55% of the average of the three highest years of base salary plus annual cash incentive compensation. Similar to the Pension Plan and the Pension Restoration Plan, Converted RONA Bonuses are not considered in calculating the benefits available under the Supplemental Retirement Program. Volume Incentive Bonuses, LTI Awards and Stock Incentives are also not considered in calculating the benefits available under the Supplemental Retirement Program. The benefit is subject to reduction for early retirement, less than 15 years of service, benefits under the Pension Plan, the Pension Restoration Plan and any of our non-U.S. pension plans, 50% of primary social security benefits, and contributions to the participant s retirement income accounts under the Retirement Savings Plan and the Savings Restoration Plan. Participants vest at age 60, or at age 55 with the consent of the Committee, and with five years of participation in the Supplemental Retirement Program, or a lesser period established by the Committee at the time they become participants. To receive a benefit under the Supplemental Retirement Program, however, a participant must have at least 10 years of service. During fiscal year 2007, the Finance Committee of the Board of Directors adopted an amendment to the Pension Plan which allows us to shift some of our obligations under the Supplemental Retirement Program to the Pension Plan. Under the amendment, as participants vest under the Supplemental Retirement Program, their Pension Plan formulas will be modified to shift a portion of their benefits from the Supplemental Retirement Program to the Pension Plan (up to the limits established by statute and under the Pension Plan). We incurred no additional cost or liability and participants receive no additional value under the Supplemental Retirement Program as a result of the amendment. We and the participants do, however, receive various tax benefits as a result of the amendment.

As previously disclosed in our Compensation Discussion and Analysis for fiscal year 2007, on August 15, 2007 the Committee approved the vesting of Mr. Myslenski as a participant in the Supplemental Retirement Program effective as of his May 2, 2008 retirement. Mr. Myslenski, who was age 57 at the time of his retirement, was scheduled to vest in the Supplemental Retirement Program at age 60. The Committee approved this early vesting in connection with Mr. Myslenski s service as a senior executive officer because he was identified by the Committee as an essential contributor to our efforts to drive and support the Win Strategy. Mr. Myslenski s benefits under the Supplemental Retirement Program will be adjusted for early retirement in

accordance with the terms of the program. A significant portion of our obligations under the Supplemental Retirement Program resulting from this early vesting was shifted to the Pension Plan at no additional cost to us to ensure that we maximize all available tax benefits.

Health and Welfare Benefits.

The Named Executive Officers participated in various health and welfare programs generally available to all employees during fiscal year 2008. The Named Executive Officers also participated in our Officer Life Insurance Plan and Executive Long-Term Disability Plan.

Under the Officer Life Insurance Plan, we pay all required premiums for life insurance on executive officers who were participants prior to January 1, 2008, which includes the Named Executive Officers, for the longer of 10 years or until the executive officer reaches age 65. The premiums are designed to allow for accumulation of cash surrender values sufficient to fund the policies during retirement up to age 95, assuming that the participant invests only in the policy s fixed income account, and to maintain death benefits equal to:

- five times base salary during employment and two times final base salary after retirement at age 65 for the Chief Executive Officer;
- four times base salary during employment and two times final base salary after retirement at age 65 for the other members of the Office of the Chief Executive; and
- three times base salary during employment and two times final base salary after retirement at age 65 for all other Named Executive Officers and other participants.

We will not make any post-retirement premium payments on behalf of any executive officer who becomes a participant on or after January 1, 2008 and retires prior to reaching age 65 or 10 years of participation in the plan.

If the participant retires between ages 55 and 65, the post-retirement death benefit is reduced by 10% of base salary for each year prior to age 65 that the participant retires. The amount of the death benefit is adjusted each year on January 1st based on the participant s base salary as of the preceding December 1st. The policies underlying the plan are cash value life insurance policies owned by the participants. Cash surrender values accrue earnings prior to distribution based on their investment in various funds offered within the policies. The premiums we paid on behalf of the Named Executive Officers during fiscal year 2008 are included in the All Other Compensation column of the Summary Compensation Table for Fiscal Year 2008 on page 30.

The Executive Long-Term Disability Plan is intended to replace a reasonable amount of an executive officer s income upon disability. The plan provides a total benefit in the event of a qualifying disability of two-thirds of base salary plus Target Incentive Bonuses and General RONA Bonuses paid during the calendar year ending December 31 of the year prior to the disability, up to a maximum benefit of $33,000 per month. Our executive officers are not eligible to receive the long-term disability benefit generally available to other employees.

Change in Control Agreements.

We are not a party to any written employment agreements with our executive officers. We have, however, entered into separate Change in Control Severance Agreements with our executive officers, which we refer to as the Change in Control Agreements. We are not obligated to pay severance to executive officers under any agreement other than the Change in Control Agreements. The executive officers are, however, eligible to receive severance upon termination for reasons other than a change in control in accordance with our general severance policy for salaried employees. The Change in Control Agreements are designed to attract, retain and motivate executive officers, provide for stability and continuity of management in the event of any actual or threatened change in control, encourage executive officers to remain in service after a change in control and ensure that executive officers are able to devote their entire attention to maximizing shareholder value and safeguarding employee interests in event of a change in control. The Committee determined that the amounts payable under the Change in Control Agreements are necessary to achieve those objectives. The Potential Payments upon Termination or Change of Control at June 30, 2008 tables and the related narrative descriptions beginning on page 42 provide additional information on the Change in Control Agreements, including a brief discussion of the material provisions of the Change in Control Agreements beginning on pages 44 and 46 under the captions Payments upon a Change in Control and Payments upon a Qualifying Termination in Connection with a Change in Control .

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Indemnification Agreements.

We enter into separate Indemnification Agreements with each of our executive officers. Each agreement remains in effect during and after employment with respect to any action taken while the individual serves as an executive officer. The agreements are designed to attract, retain and motivate executive officers by encouraging reasonable and measured risk-taking in the interests of our business and our shareholders, and protecting against liabilities incurred in the performance of their duties to the maximum extent permitted by Ohio law.

The agreements provide for indemnification for all expenses, including attorney fees, judgments, fines and settlement amounts, that the executive officer incurs by reason of his or her service:

- in a civil action or proceeding by another party (unless it is proven that the officer s act or failure to act was taken with deliberate intent to cause injury to our business or in reckless disregard for the best interest of our business); or

- in a criminal action or proceeding (unless the officer had reasonable cause to believe his or her conduct was unlawful).

Executive Perquisites.

During fiscal year 2008, we made various executive perquisites available to each of the Named Executive Officers. On January 1, 2008, we eliminated certain executive perquisites available to the Named Executive Officers and provide only the perquisites described below to our executive officers. These perquisites are offered to promote the business objectives for each perquisite as described below and to reward experience, expertise, level of responsibility, seniority, leadership qualities and advancement. We also use these perquisites to ensure that our executive compensation program remains competitive to attract, retain and motivate the individuals necessary to advance the goals of the Win Strategy. Attributed costs of these perquisites for the Named Executive Officers during fiscal year 2008 are included in the All Other Compensation column of the Summary Compensation Table for Fiscal Year 2008 on page 30.

Private Clubs. We pay or reimburse initiation fees for one private club for each executive officer. We offer this perquisite to encourage executive officers to entertain business colleagues and customers, engage in social interaction with peers from other companies, local leadership and the community, and hold business meetings at offsite locations. We also pay or reimburse the initiation fees for additional clubs for members of the Office of the Chief Executive and at the Executive or Senior Vice President level on a business-needs basis and only with appropriate advance approval.

Spousal Travel. In limited circumstances and only with appropriate advance approval, we reimburse our executive officers for transportation, lodging, meals, entertainment and other travel expenses for their spouses or other family members who accompany them on out-of-town business. We offer these perquisites to encourage executive officers to spend an appropriate amount of time with their direct reports in locations away from corporate headquarters, to allow executive officers and their spouses to develop a more personal relationship with the executive officers subordinates and their families, and to encourage spouses to attend retirement parties, funerals, business dinners and other corporate functions at locations away from their homes.

Executive Physicals. We pay for annual physicals, colonoscopies, mammograms and pap smears, and any necessary travel vaccinations, for each of our executive officers and certain other key employees. We offer this perquisite as part of our overall preventive medicine program to

promptly identify and address medical issues and to preserve our investment in our executive officers by encouraging executive officers to maintain healthy lifestyles and be proactive in addressing actual or potential health issues.

Leased Vehicles. We lease an automobile for each of our executive officers and for certain other key employees. We offer this perquisite to provide executive officers with use of a company car for business travel needs, recognizing that the vehicles can also be used for personal purposes. We pay or reimburse each of the executive officers for lease payments on one automobile, typically for a three-year term. All executive officers have a maximum allowance of $1,570 per month. We also reimburse the executive officers for the cost of tires and maintenance and provide insurance on each vehicle during the lease term. We require each executive officer to take title to his or her vehicle at the end of the lease term because we amortize the entire cost of the vehicle over the lease term. The executive officer is responsible for the payment of all taxes assessed on the fair market value of the vehicle at the time of title transfer.

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Company Apartments. We maintain apartments in Cleveland, Ohio, Newport Beach, California and London, England to provide accommodations to employees working off-site at or relocating to our primary facilities. The apartments are also available to the executive officers for personal use with appropriate advance approval if they are not otherwise being used for business purposes.

Entertainment Venues. We maintain loges, boxes and tickets at various entertainment venues to provide civic support to arts, entertainment and other cultural activities at certain significant business locations and to provide a favorable setting for our employees to entertain customers and other business associates. The loges, boxes and tickets are, however, available to executive officers for personal use if they are not otherwise being used for business purposes. We pay all costs of admission, but all costs of food are paid by the executive officer using the venue only for personal use.

Corporate Aircraft. In limited circumstances, we provide our executive officers with use of corporate aircraft for non-business purposes at no cost. The executive officers may only use corporate aircraft for non-business travel if the flight was previously authorized for business purposes, there are available seats that are not being used for those business purposes and the officer s use does not involve a deviation or extension of the planned business-travel itinerary.

Changes to Executive Compensation Program.

The Committee authorized and adopted the following changes to our executive compensation program for fiscal year 2009:

Deferred Compensation Arrangements: On July 21, 2008, the Committee adopted certain amendments to our deferred compensation plans and arrangements as required by Section 409A of the Internal Revenue Code. These amendments affected the Savings Restoration Plan, the Executive Deferral Plan, the Pension Restoration Plan, the Supplemental Retirement Program and the Change in Control Agreements. These amendments were generally technical in nature and did not change or enhance the amount or terms of any benefits available to any executive officers under those plans and arrangements.

Calculation of Target Incentive Bonuses: The Committee evaluated our fiscal year 2009 annual plan for free cash flow margin and developed the following table to illustrate how final Target Incentive Bonus amounts will be calculated at the end of fiscal year 2009:

	Less than								Greater than or equal
FY09 Free Cash Flow Margin:	4.00%	4.00%	4.83%	5.67%	6.50%	7.13%	7.75%	8.38%	to 9.00%
Payout %	0%	25%	50%	75%	100%	125%	150%	175%	200%

LTI Awards: As described beginning on page 19, LTI Awards are generally paid in restricted shares, but in certain circumstances may be paid as a contribution to the recipient s Executive Deferral Plan account or in cash. On August 13, 2008, the Committee elected to allow for payment under the 2009-10-11 LTI Awards only in restricted shares. The Committee determined that this change would allow us to realize significant savings in accounting expense for the LTI Awards, and that any benefits to the small number of executive officers who elected to have their LTI Awards paid other than in restricted shares did not outweigh the savings.

Pro Rated LTI Awards: The Committee granted Mr. Banks a pro rata adjustment to his LTI Awards for the fiscal year 2007-08-09 and 2008-09-10 performance periods due to his August 14, 2008 promotion from Senior Vice President and Operating Officer to Executive Vice President and Operating Officer. The Committee originally granted to Mr. Banks 10,928 target LTI Award restricted

shares at the beginning of fiscal year 2007 and 10,500 target LTI Award restricted shares at the beginning of fiscal year 2008. Those awards were adjusted to 11,239 and 11,900 target LTI Award restricted shares, respectively.

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COMPENSATION COMMITTEE REPORT

The Committee has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) of Regulation S-K with the Corporation s management and, based on such review and discussions, the Committee recommended to the Board of Directors that the Compensation Discussion and Analysis be included in this Proxy Statement.

Human Resources and Compensation Committee:

Wolfgang R. Schmitt, Chairman

Candy M. Obourn

Joseph M. Scaminace

Markos I. Tambakeras

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COMPENSATION TABLES

SUMMARY COMPENSATION TABLE FOR FISCAL YEAR 2008

The following table sets forth compensation information for our Named Executive Officers for fiscal year 2008 and fiscal year 2007.

Name and Principal Position	Year	Salary ($)	Stock Awards ($)(2)	Option Awards ($)(3)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
Donald E. Washkewicz,	2008	1,155,000(1)	4,882,896	4,836,956	2,230,069(4)	2,795,390(5)	231,758(6)	16,132,069
Chief Executive Officer, President and Chairman of the Board	2007	1,155,000	8,327,900	3,416,592	1,854,009	2,030,036	281,472	17,065,009
Timothy K. Pistell,	2008	646,000(1)	1,570,480	1,736,062	727,143(4)	1,451,974(5)	184,375(6)	6,316,034
Chief Financial Officer and Executive Vice President Finance and Administration	2007	620,000	2,484,349	954,142	582,495	1,101,530	223,044	5,965,560
Lee C. Banks,	2008	502,000(1)	891,259	896,150	514,985(4)	286,869(5)	117,133(6)	3,208,396
Executive Vice President and Operating Officer	2007	467,834	1,834,000	409,369	388,891	207,140	102,148	3,409,382
Robert P. Barker,	2008	472,000(1)	891,259	1,207,508	462,287(4)	793,134(5)	116,244(6)	3,942,432
Executive Vice President, Operating Officer and President Aerospace Group	2007	441,667	1,833,069	497,324	464,190	478,254	103,732	3,818,236
Marwan M. Kashkoush(7),	2008	462,000(1)	955,017(8)	609,198	416,666(4)	238,812(5)	187,180(6)	2,868,873
Executive Vice President Sales, Marketing and Operations Support								
John D. Myslenski(9)	2008	578,625(1)	1,039,252(10)	1,535,975	649,676(4)	4,458,233(5)	124,479(6)	8,386,240
	2007	660,000	3,366,029	1,826,121	651,820	687,641	196,002	7,387,613

(1) Includes the following amounts deferred under the Savings Restoration Plan for fiscal year 2008: Mr. Washkewicz $11,550; Mr. Pistell $6,460; Mr. Banks $18,350; Mr. Barker $23,300; Mr. Kashkoush $23,100; and Mr. Myslenski $13,367. These amounts are also reported in the Executive Contributions in Last Fiscal Year column of the Nonqualified Deferred Compensation for Fiscal Year 2008 table on page 41.

(2) This column represents the dollar amount recognized for financial statement reporting purposes for fiscal year 2008 and fiscal year 2007 in accordance with FAS 123R for the following:

For fiscal year 2008, (i) the final adjustment to the amount reported in our fiscal year 2007 financial statements of restricted shares issued in fiscal year 2007 in payment under our 2005-06-07 Long Term Incentive Plan for all Named Executive Officers; and (ii) our 2006-07-08, 2007-08-09 and 2008-09-10 LTI Awards for all Named Executive Officers; and

For fiscal year 2007, (i) the final adjustment to the amount reported in our fiscal year 2006 financial statements of restricted shares issued in fiscal year 2006 in payment under our 2004-05-06 Long Term Incentive Plan for all Named Executive Officers except Mr. Kashkoush; and (ii) our 2005-06-07, 2006-07-08 and 2007-08-09 LTI Awards for all Named Executive Officers except Mr. Kashkoush.

This column includes amounts granted in and prior to fiscal year 2008. The amounts do not reflect whether a Named Executive Officer has actually realized a financial benefit from the awards. The amounts were calculated as follows:

(a) Since we are unable to calculate the final payout at the end of the performance period under an LTI Award until our financial statements are completed approximately 30 days after the end of the fiscal year, the expense reported in our financial statements is calculated by comparing

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data from the Peer Group s most recent year-end financial statements as included in their Annual Reports on Form 10-K to our rolling forecast for earnings together with data from our year-to-date financial statements at the end of May. From this data, an estimate of the payout percentage is determined. The estimated payout percentage is applied to each Named Executive Officer s target LTI Award and their awards are valued by using the closing price of our common stock on June 30. This is the amount being reported under (i) our 2006-07-08 LTI Awards for fiscal year 2008 and (ii) our 2005-06-07 LTI Awards for fiscal year 2007.

(b) Once our financial statements for the fiscal year are final, we are able to determine our actual performance against the Peer Group. This adjusted amount is then reported in our financial statements for the following fiscal year. This is the amount being reported for the restricted shares issued under (i) our 2005-06-07 Long Term Incentive Plan for fiscal year 2008 and (ii) our 2004-05-06 Long Term Incentive Plan for fiscal year 2007.

(c) Using historical data to track how we performed against the Peer Group for the last three performance periods, we calculated the estimated value of our 2007-08-09 and 2008-09-10 LTI Awards for fiscal year 2008 and our 2006-07-08 and 2007-08-09 LTI Awards for fiscal year 2007 assuming a payout of 150% of the target amount of the LTI Awards and using the closing price of our common stock on June 30.

Dividends are not accrued or paid on the LTI Awards until after the performance period ends and the restricted shares are issued. No restricted shares that were issued in payment of an LTI Award were forfeited by the Named Executive Officers during fiscal year 2008 and fiscal year 2007.

(3) This column represents the dollar amount recognized for financial statement reporting purposes for fiscal year 2008 and fiscal year 2007 in accordance with FAS 123R of stock option and Stock Incentive grants under our 2003 Stock Incentive Plan and may include amounts from stock options and Stock Incentives granted in and prior to fiscal year 2008. The amounts do not reflect whether a Named Executive Officer has actually realized a financial benefit from the awards. The amounts were calculated using the Black-Scholes option pricing model with the following weighted-average assumptions:

Fiscal Year of Grant	Risk-free Interest Rate	Expected Life of Award	Expected Dividend Yield of Stock	Expected Volatility of Stock
2008	4.4%	5.5 years	1.4%	26.4%
2007	4.7%	5.7 years	1.5%	30.2%
2006	4.2%	5.9 years	1.6%	33.1%
2005	3.5%	4.2 years	1.7%	32.7%

During fiscal year 2008, Mr. Pistell forfeited 2,411 stock options. During fiscal year 2007, no stock options or Stock Incentive awards were forfeited by any of the Named Executive Officers.

(4) Amounts consist of the following Target Incentive Bonuses, General RONA Bonuses, and Converted RONA Bonuses for fiscal year 2008, which were paid in one or more installments with the final payment in August 2008:

Target Incentive Bonus for fiscal year 2008: Mr. Washkewicz $1,099,980; Mr. Pistell $384,993; Mr. Banks $219,996; Mr. Barker $183,330; Mr. Kashkoush $164,997; and Mr. Myslenski $343,730.

General RONA Bonus for fiscal year 2008: Mr. Washkewicz $1,080,156; Mr. Pistell $302,070; Mr. Banks $268,269; Mr. Barker $252,237; Mr. Kashkoush $224,949; and Mr. Myslenski $279,226.

Converted RONA Bonus for fiscal year 2008:. Mr. Washkewicz $49,933; Mr. Pistell $40,080; Mr. Banks $26,720; Mr. Barker $26,720; Mr. Kashkoush $26,720; and Mr. Myslenski $26,720.

(5) Amounts consist of the change in annual actuarial present value of pension benefits for each of the Named Executive Officers, as also reported in the Pension Benefits for Fiscal Year 2008 table on page 40. None of the Named Executive Officers received above-market or preferential earnings on deferred compensation.

(6) The following table describes each component of the All Other Compensation column in the Summary Compensation Table for fiscal year 2008:

Name	Company Contributions to Defined Contribution Plans	Life Insurance Premiums Paid	Tax Gross-Ups (a)	Perquisites (b)	Total All Other Compensation
Donald E. Washkewicz	$16,900	$133,462	$27,614	$53,782	$231,758
Timothy K. Pistell	17,243	70,842	33,391	62,899(c)	184,375
Lee C. Banks	14,806	41,643	15,037	45,647	117,133
Robert P. Barker	16,605	50,705	8,623	40,311	116,244
Marwan M. Kashkoush	52,784	45,992	22,384	66,020(c)	187,180
John D. Myslenski	13,569	11,102	23,597	76,211	124,479

(a) Represents the amounts we reimbursed for the payment of taxes with respect to one or more of the following items: (i) private club dues and initiation fees; (ii) spousal travel; and (iii) holiday gift certificate and/or promotional awards.

(b) Reported in this column are amounts reimbursed or incurred by us with respect to one or more of the following executive perquisites: (i) private club dues and initiation fees; (ii) financial planning, tax preparation and estate planning services; (iii) home security system maintenance and monitoring

fees; (iv) leased vehicle; (v) spousal travel; (vi) executive physicals; (vii) executive long term disability insurance premiums; (viii) vacation pay; and (ix) personal use of the corporate aircraft. In fiscal year 2008, the Human Resources and Compensation Committee permitted one flight for personal use by Donald E. Washkewicz where the corporate aircraft was not otherwise being used for business purposes. The calculation of the aggregate incremental cost of personal use of the corporate aircraft includes the variable costs incurred by us. The Named Executive Officers also use our loge, box seats or tickets to various entertainment venues. However, there is no incremental cost to us for their use of these loges, box seats and tickets. Unless otherwise indicated in note (c) to this table, no Named Executive Officer received an executive perquisite in an amount that exceeds the greater of $25,000 or 10% of the total amount of executive perquisites received by the Named Executive Officer.

(c) Amounts include: (i) $28,767 received by Mr. Pistell for spousal travel; and (ii) $29,986 received by Mr. Kashkoush for spousal travel.

(7) Mr. Kashkoush was not a Named Executive Officer for fiscal year 2007.
(8) Mr. Kashkoush elected to defer $551,660 that he earned under the 2006-07-08 LTI Award under the Performance Bonus Plan and receive it as a credit to his Executive Deferral Plan account. This amount is also reported in the Executive Contributions in Last Fiscal Year column of the Nonqualified Deferred Compensation for Fiscal Year 2008 table on page 41.
(9) Mr. Myslenski retired as Executive Vice President of the Company effective May 2, 2008, but still qualifies as a Named Executive Officer based on his fiscal year 2008 compensation.
(10) Pursuant to the terms of his 2006-07-08 LTI Award, Mr. Myslenski s payout of $1,262,007 was paid in cash because he was retired at the time of payment.

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GRANTS OF PLAN-BASED AWARDS FOR FISCAL YEAR 2008

The following table sets forth information with respect to non-equity and equity incentive plan awards granted to the Named Executive Officers during fiscal year 2008. The LTI Awards and Stock Incentives listed below have been granted under the 2003 Stock Incentive Plan. The information set forth in this table has been adjusted to reflect the 3-shares-for-2 stock split completed on October 1, 2007.

		Compen-sation Committee	Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Option Awards: Number of Securities Under-lying Options	Exercise or Base Price of Option Awards	Grant Date Fair Value of Stock and Option Awards
Name	Grant Date	Action Date (If Different than Grant Date)	Threshold ($)	Target ($)	Maximum ($)	Threshold (#)	Target (#)	Maximum (#)	(#)	($/Sh)	($)
Donald E. Washkewicz											
Target Incentive Bonus	9/11/2007		0	600,000	1,200,000						
General RONA Bonus	9/11/2007		0	(1)	(1)						
Converted RONA Bonus	12/7/2007		0	74,750	(1)						
LTI Award (08-09-10)	8/15/2007					0	55,500	111,000			3,381,800
Stock Incentives	8/15/2007								155,250	60.9334	2,725,155
Timothy K. Pistell											
Target Incentive Bonus	8/15/2007		0	210,000	420,000						
General RONA Bonus	8/15/2007		0	(1)	(1)						
Converted RONA Bonus	12/7/2007		0	60,000	(1)						
LTI Award (08-09-10)	8/15/2007					0	16,800	33,600			1,023,680
LTI Award (07-08-09)	8/15/2007					0	15,750(2)	31,500(2)			959,700
LTI Award (06-07-08)	8/15/2007					0	13,575(2)	27,150(2)			827,170
Stock Incentives	8/15/2007								48,450	60.9334	850,459
Stock Incentives(3)	4/28/2008	8/10/2005							13,497	79.2400	282,897
Stock Incentives(3)	4/28/2008	8/16/2006							8,360	79.2400	175,226
Stock Incentives(4)	10/25/2007	8/11/1999							2,829	77.9900	30,044
Stock Incentives(4)	10/25/2007	8/9/2000							2,983	77.9900	45,968

Stock Incentives(4)	10/25/2007	8/8/2001							3,940	77.9900	64,734
Stock Incentives(4)	8/27/2007	8/13/2003							17,740	71.0534	360,724
Stock Incentives(4)	8/27/2007	8/11/2004							23,662	71.0534	481,138
Lee C. Banks											
Target Incentive Bonus	8/15/2007		0	120,000	240,000						
General RONA Bonus	8/15/2007		0	(1)	(1)						
Converted RONA Bonus	12/7/2007		0	40,000	(1)						
LTI Award (08-09-10)	8/15/2007					0	10,500	21,000			639,800
Stock Incentives	8/15/2007								29,700	60.9334	521,334
Stock Incentives(4)	9/20/2007	8/13/2003							7,872	76.6334	172,607
Stock Incentives(4)	9/20/2007	8/11/2004							14,173	76.6334	310,777

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		Compen-sation Committee	Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Option Awards: Number of Securities Under-lying Options	Exercise or Base Price of Option Awards	Grant Date Fair Value of Stock and Option Awards
Name	Grant Date	Action Date (If Different than Grant Date)	Threshold ($)	Target ($)	Maximum ($)	Threshold (#)	Target (#)	Maximum (#)	(#)	($/Sh)	($)
Robert P. Barker											
Target Incentive Bonus	8/15/2007		0	100,000	200,000						
General RONA Bonus	8/15/2007		0	(1)	(1)						
Converted RONA Bonus	12/7/2007		0	40,000	(1)						
LTI Award (08-09-10)	8/15/2007					0	10,500	21,000			639,800
Stock Incentives	8/15/2007								29,700	60.9334	521,334
Marwan M. Kashkoush											
Target Incentive Bonus	8/15/2007		0	90,000(5)	180,000						
General RONA Bonus	8/15/2007		0	(1)	(1)						
Converted RONA Bonus	12/7/2007		0	40,000	(1)						
LTI Award (08-09-10)	12/7/2007					0	10,113(5)	20,226			824,715
LTI Award (07-08-09)	12/7/2007						8,843(5)	17,686			721,147
LTI Award (06-07-08)	12/7/2007						6,792(5)	13,584			553,888
Stock Incentives	8/15/2007								17,400	60.9334	305,428
Stock Incentives(3)	5/15/2008	8/10/2005							5,889	85.1000	133,091
John D. Myslenski											
Target Incentive Bonus	8/15/2007		0	225,000	450,000						
General RONA Bonus	8/15/2007		0	(1)	(1)						
Converted RONA Bonus	12/7/2007		0	60,000	(1)						
LTI Award (08-09-10)	8/15/2007					0	16,800	33,600			1,023,680
Stock Incentives	8/15/2007								48,450	60.9334	850,459

(1) There are no target amounts for General RONA Bonuses and no maximum amounts for General RONA Bonuses or Converted RONA Bonuses. General RONA Bonuses and Converted RONA Bonuses are calculated as described in the Compensation Discussion and Analysis beginning on page 16.

(2) In recognition of Mr. Pistell s increased responsibilities and corresponding increase in base salary, on August 15, 2007 the Human Resources and Compensation Committee increased Mr. Pistell s target amount of restricted shares under his 2006-07-08 LTI Award previously granted on August 29, 2005 and his 2007-08-09 LTI Award previously granted on August 16, 2006. All other terms and conditions under the original awards remain unaffected.

(3)

Represents reload grants of stock appreciation rights which are exercisable on the date following completion of one year of continuous full-time employment after the exercise of the underlying stock option with tandem stock appreciation right, provided, the Named Executive Officer retains ownership for one year of the shares resulting from the underlying option exercise, less shares surrendered or sold to satisfy tax obligations. Reload grants of stock appreciation rights have accelerated vesting in the event of a Change in Control as defined on page 44.

(4) Represents reload grants of stock options which are exercisable on the date following completion of one year of continuous full-time employment after the exercise of the underlying stock option, provided, the Named Executive Officer retains ownership for one year of the shares resulting from the underlying option exercise, less shares surrendered or sold to satisfy tax obligations. Reload grants of stock options have accelerated vesting in the event of a Change in Control as defined on page 44.

(5) In connection with Mr. Kashkoush s promotion to Executive Vice President Sales, Marketing and Operations Support, on December 7, 2007 the Human Resources and Compensation Committee authorized an increase in Mr. Kashkoush s (i) fiscal year 2008 Target Incentive Bonus award target amount previously granted on August 15, 2007; and (ii) the target amount of restricted shares under his 2008-09-10, 2007-08-09 and 2006-07-08 LTI Awards previously granted on August 15, 2007, August 16, 2006 and August 29, 2005, respectively. All other terms and conditions under the original awards remain unaffected.

The elements of executive compensation included in each Named Executive Officer s total compensation as reported in the Summary Compensation Table for Fiscal Year 2008 on page 30 and the compensation programs under which the grants described in the Grants of Plan-Based Awards for Fiscal Year 2008 table above were made are described in the Compensation Discussion and Analysis, beginning on page 13.

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OUTSTANDING EQUITY AWARDS AT JUNE 30, 2008

The following table sets forth information with respect to option awards and stock awards held by the Named Executive Officers as of June 30, 2008. The information set forth in this table has been adjusted to reflect the 3-shares-for-2 stock split completed on October 1, 2007.

Option Awards				Stock Awards			
Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Option Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($)(1)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($)(1)
	155,250(2)	60.9334	8/14/2017				
6,724		64.4400	8/11/2008				
8,716		63.2800	8/10/2009				
33,489		63.2800	2/2/2010				
119,881		63.2800	8/7/2011				
52,251	104,499(3)	49.7534	8/15/2016				
35,881		55.8000	8/8/2010				
10,915		48.9734	8/8/2010				
101,500	50,750(4)	43.7667	8/9/2015				
153,750		36.2600	8/10/2014				
175,200		31.5267	8/12/2013				
188,100		26.5600	8/6/2012				
				57,918(5)	4,130,712		
				89,856(6)	6,408,530		
				85,824(7)	6,120,968		

				56,712(8)	4,044,700			
						116,250(9)	8,290,950	
						111,000(9)	7,916,520	
	13,497(10)	79.2400	8/9/2015					
	8,360(10)	79.2400	8/15/2016					
	2,829(11)	77.9900	8/10/2009					
	2,983(11)	77.9900	8/8/2010					
	3,940(11)	77.9900	8/7/2011					
	17,740(12)	71.0534	8/12/2013					
	23,662(12)	71.0534	8/10/2014					
	48,450 (2)	60.9334	8/14/2017					
	26,700 (3)	49.7534	8/15/2016					
	12,249 (4)	43.7667	8/9/2015					
				13,213(5)	942,351			
				33,279(6)	2,373,458			
				31,660(7)	2,257,991			
				15,459(8)	1,102,536			
						31,500(9)	2,246,580	
						33,600(9)	2,396,352	
	7,872(13)	76.6334	8/12/2013					
	14,173(13)	76.6334	8/10/2014					
	29,700 (2)	60.9334	8/14/2017					
7,246		59.9600	8/7/2011					
9,075	18,150 (3)	49.7534	8/15/2016					
11,295		48.1734	8/6/2012					
17,001	8,499 (4)	43.7667	8/9/2015					
				11,160(5)	795,931		$	
				10,432(8)	744,010			
						21,114(9)		
						21,000(9)		832,752

D STOCKHOLDERS' EQUITY

$	246,035	5,319	2.16%	$ 229,532	2,975	1.30%	$ 230,300	1,568
	62,279	323	0.52%	59,830	248	0.41%	61,144	236
	323,283	12,944	4.00%	271,161	8,496	3.13%	261,564	7,318
	55,389	2,411	4.35%	57,799	1,496	2.59%	55,645	455
	34,063	1,562	4.59%	31,545	1,536	4.87%	27,117	1,484
	3,432	159	4.63%	874	33	3.78%	218	3
	17,367	1,315	7.57%	10,310	643	6.24%	8,704	382
	10,611	679	6.40%	5,711	260	4.55%	7,161	198
	752,459	24,712	3.28%	666,762	15,687	2.35%	651,853	11,644
	105,747			89,593			85,437	
	5,404			4,486			5,312	
	75,174			71,911			68,459	
$	938,784			$ 832,752			$ 811,061	
		$ 30,844			$ 28,893			$ 28,380
			3.05%			3.35%		
			.46%			.35%		
			3.51%			3.70%		

income is not recorded on a tax equivalent basis.
s have been included in the average balances.
eld for sale.

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Changes in net interest income may also be analyzed by segregating the volume and rate components of interest income and interest expense. The following table summarizes the approximate relative contribution of changes in average volume and interest rates to changes in net interest income for the past two years (in thousands):

	2006 Compared to 2005 Increase - (Decrease)			2005 Compared to 2004 Increase - (Decrease)		
	Total Change	Volume (1)	Rate (1)	Total Change	Volume (1)	Rate (1)
Earning Assets:						
Interest-bearing deposits	$ (9)	$ (27)	$ 18	$ (35)	$ 175	$ (210)
Federal funds sold	(9)	(141)	132	182	4	178
Investment securities:						
Taxable	2,177	838	1,339	453	(87)	540
Tax-exempt (2)	(100)	(67)	(33)	(322)	(331)	9
Loans (3)	8,917	5,314	3,603	4,278	2,320	1,958
Total interest income	10,976	5,917	5,059	4,556	2,081	2,475
Interest-Bearing Liabilities:						
Interest-bearing deposits						
Demand deposits	2,344	230	2,114	1,407	(5)	1,412
Savings deposits	75	10	65	12	(9)	21
Time deposits	4,448	1,818	2,630	1,178	280	898
Securities sold under agreements to repurchase	915	(64)	979	1,041	19	1,022
FHLB advances	26	118	(92)	52	159	(107)
Federal funds purchased	126	118	8	30	19	11
Subordinated debentures	672	512	160	261	80	181
Other debt	419	284	135	62	(28)	90
Total interest expense	9,025	3,026	5,999	4,043	515	3,528
Net interest income	$ 1,951	$ 2,891	$ (940)	$ 513	$ 1,566	$ (1,053)

(1) Changes attributable to the combined impact of volume and rate have been allocated proportionately to the change due to volume and the change due to rate.
(2) The tax-exempt income is not recorded on a tax equivalent basis.
(3) Nonaccrual loans are not material and have been included in the average balances.

Net interest income increased $1,951,000, or 6.8% in 2006, compared to an increase of $513,000, or 1.8% in 2005. The increases in net interest income in 2006 and 2005 were primarily due to growth in interest-earning assets primarily composed of loan growth that was offset by an increase in the cost of interest-bearing liabilities.

In 2006, average earning assets increased by $95.4 million, or 12.2%, and average interest-bearing liabilities increased $85.7 million or 12.9% compared with 2005. In 2005, average earning assets increased by $24.9 million, or 3.3%, and average interest-bearing liabilities increased $14.9 million or 2.3% compared with 2004. Changes in average balances are shown below:

- Average loans increased by $80.9 million or 13.3% in 2006 compared to 2005. In 2005, average loans increased by $37.9 million or 6.6% compared to 2004.

- Ø Average securities increased by $18.8 million or 11.7% in 2006 compared to 2005. In 2005, average securities increased by $10 million or 5.9% compared to 2004.

- Ø Average interest-bearing deposits increased by $71.1 million or 12.7% in 2006 compared to 2005. In 2005, average interest-bearing deposits increased by $7.5 million or 1.4% compared to 2004.

- Ø Average securities sold under agreements to repurchase decreased by $2.4 million or 4.2% in 2006 compared to 2005. In 2005, average securities sold under agreements to repurchase increased by $2.2 million or 3.9% compared to 2004.

- Ø Average borrowings and other debt increased by $17 million or 35% in 2006 compared to 2005. In 2005, average borrowings and other debt increased by $5.2 million or 12% compared to 2004.

- Ø The federal funds rate increased to 5.25% at December 31, 2006 from 4.50% at December 31, 2005 and from 2.25% at December 31, 2004.

- Ø Net interest margin decreased to 3.51% compared to 3.70% in 2005 and 3.75% in 2004. Asset yields increased by 63 basis points in 2006, while interest-bearing liabilities increased by 149 basis points.

To compare the tax-exempt yields on interest-earning assets to taxable yields, the Company also computes non-GAAP net interest income on a tax equivalent basis (TE) where the interest earned on tax-exempt securities is adjusted to an amount comparable to interest subject to normal income taxes, assuming a federal tax rate of 34% (referred to as the tax equivalent adjustment). The TE adjustments to net interest income for 2006, 2005 and 2004 were $397,000, $449,000 and $615,000, respectively. The net yield on interest-earning assets (TE) was 3.56% in 2006, 3.75% in 2005 and 3.83% in 2004.

Provision for Loan Losses

The provision for loan losses in 2006 was $760,000 compared to $1,091,000 in 2005 and $588,000 in 2004. Nonperforming loans increased to $3,668,000 at December 31, 2006 from $3,458,000 and $3,106,000 at December 31, 2005 and 2004, respectively. Net charge-offs were $937,000 during 2006, $1,064,000 during 2005, and $393,000 during 2004. For information on loan loss experience and nonperforming loans, see “Nonperforming Loans” and “Loan Quality and Allowance for Loan Losses” herein.

Other Income

An important source of the Company’s revenue is derived from other income. The following table sets forth the major components of other income for the last three years (in thousands):

				$ Change From Prior Year	
	2006	**2005**	**2004**	**2006**	**2005**
Trust	$ 2,489	$ 2,356	$ 2,254	$ 133	$ 102
Brokerage	533	383	428	150	(45)
Insurance commissions	1,689	1,567	1,447	122	120
Service charges	5,308	4,719	4,746	589	(27)
Securities gains	164	373	92	(209)	281
Mortgage banking	394	742	522	(348)	220
Other	2,803	2,378	2,150	425	228
Total other income	$ 13,380	$ 12,518	$ 11,639	$ 862	$ 879

Total non-interest income increased to $13,380,000 in 2006 compared to $12,518,000 in 2005 and $11,639,000 in 2004. The primary reasons for the more significant year-to-year changes in other income components are as follows:

  - Ø Trust revenues increased $133,000 or 5.6% to $2,489,000 in 2006 from $2,356,000 in 2005 and $2,254,000 in 2004. Approximately 50 percent of trust revenue is market value dependent. The increase in trust revenues was the result of new business and an increase in equity prices.

- Ø Revenue from brokerage annuity sales increased $150,000 or 39.2% to $533,000 in 2006 from $383,000 in 2005 and $428,000 in 2004 as a result of a greater commissions received on sales of annuities.

- Ø Insurance commissions increased $122,000 or 7.8% to $1,689,000 in 2006 from $1,567,000 in 2005 and $1,447,000 in 2004 due to an increase in commissions received on sales of business property and casualty insurance.

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Ø Fees from service charges increased $589,000 or 12.5% to $5,308,000 in 2006 from $4,719,000 in 2005 and $4,746,000 in 2004. This was primarily the result of an increase in the number of overdrafts and an increase in the per overdraft fee to $25 from $22.50.

Ø Net securities gains in 2006 were $164,000 compared to net securities gains of $373,000 in 2005, and $92,000 in 2004. Several securities in the investment portfolio were sold to improve the overall portfolio mix and the margin in 2006, 2005 and 2004.

Ø Mortgage banking income decreased $348,000 or 46.9% to $394,000 in 2006 from $742,000 in 2005 and $522,000 in 2004. This decrease was due to the decline in volume of fixed rate loans originated and sold by First Mid Bank. Loans sold balances are as follows:

Ø $34 million (representing 322 loans) in 2006
Ø $63 million (representing 605 loans) in 2005
Ø $42 million (representing 441 loans) in 2004

Ø Other income increased $425,000 or 17.9% to $2,803,000 in 2006 from $2,378,000 in 2005 and $2,150,000 in 2004. The increase was primarily due to increased ATM service fees.

Other Expense

The major categories of other expense include salaries and employee benefits, occupancy and equipment expenses and other operating expenses associated with day-to-day operations. The following table sets forth the major components of other expense for the last three years (in thousands):

				$ Change From Prior Year	
	2006	**2005**	**2004**	**2006**	**2005**
Salaries and benefits	$ 15,418	$ 13,310	$ 13,626	$ 2,108	$ (316)
Occupancy and equipment	4,797	4,401	4,259	396	142
Amortization of other intangibles	761	568	623	193	(55)
Stationery and supplies	583	522	518	61	4
Legal and professional fees	1,324	1,553	1,173	(229)	380
Marketing and promotion	945	728	771	217	(43)
Other	4,595	4,303	4,169	292	134
Total other expense	$ 28,423	$ 25,385	$ 25,139	$ 3,038	$ 246

Total non-interest expense increased to $28,423,000 in 2006 from $25,385,000 in 2005 and $25,139,000 in 2004. The primary reasons for the more significant year-to-year changes in other expense components are as follows:

Ø Salaries and employee benefits, the largest component of other expense, increased $2,108,000 or 15.8% to $15,418,000 in 2006 from $13,310,000 in 2005 and $13,626,000 in 2004. The increase in 2006 was as a result of the acquisition of Mansfield, merit increases for continuing employees and $178,000 of additional compensation expense related to the vesting of stock options recorded in 2006 in accordance with the provisions of SFAS 123R. There were 347 full-time equivalent employees, of which 29 resulted from acquisition of Mansfield, at December 31, 2006 compared to 318 at December 31, 2005 and 317 at December 31, 2004.

Ø Occupancy and equipment expense increased $396,000 or 9.0% to $4,797,000 in 2006 from $4,401,000 in 2005 and $4,259,000 in 2004. These increases were due to an increase in occupancy expenses for Mansfield in 2006, and the new office location of Checkley and the Highland branch facility that were opened in 2005.

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Amortization of other intangibles expense increased $193,000 in 2006. This was a result of additional core deposit intangible amortization expense resulting from the acquisition of Mansfield.

- Other operating expenses increased $292,000 or 6.8% to 4,595,000 in 2006 from $4,303,000 in 2005 and $4,169,000 in 2004. The increase in 2006 resulted from an increase in expenses related to other real estate owned, ATM and debit card fee expense and increased expenses following the acquisition of Mansfield. The increase in 2005 resulted from an increase in expenses related to other real estate owned.

- On a net basis, all other categories of operating expenses increased $49,000 or 1.7% to $2,852,000 in 2006 from $2,803,000 in 2005 and $2,462,000 in 2004. The increase in 2006 was primarily due to increased expenses following the acquisition of Mansfield. The increase in 2005 was primarily due to increases in various professional fees.

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Income Taxes

Income tax expense amounted to $5,032,000 in 2006 compared to $5,128,000 in 2005 and $4,541,000 in 2004. Effective tax rates were 33.5%, 34.3% and 31.8%, respectively, for 2006, 2005 and 2004. The change in the effective tax rate in 2006 is due to a $142,000 reduction in the state tax expense accrual as a result of amending the 2004 state income tax return for a greater deduction in enterprise zone interest filed during the first quarter of 2006. This resulted in a $92,000 net reduction in tax expense. Additional reduction in state tax expense for 2006 resulted from an increase in deductible enterprise zone loans.

Analysis of Balance Sheet

Loans

The loan portfolio (net of unearned discount) is the largest category of the Company's earning assets. The following table summarizes the composition of the loan portfolio for the last five years (in thousands):

	2006	2005	2004	2003	2002
Real estate - mortgage	$ 510,735	$ 450,435	$ 427,154	$ 390,841	$ 340,033
Commercial & agricultural	161,085	150,598	137,733	131,609	127,065
Installment	47,017	34,385	30,587	28,932	31,119
Other	4,731	2,715	2,375	1,442	1,647
Total loans	$ 723,568	$ 638,133	$ 597,849	$ 552,824	$ 499,864

Loan balances have increased over the past few years primarily as a result of increased commercial real estate loans and commercial operating loans. The increase in commercial real estate loans outstanding has been the result of demand for credit for commercial real estate projects in central Illinois and business development efforts. Also, corporate borrowers have required additional capital for inventory and company expansion. The growth has been primarily in the communities of Champaign, Decatur, Effingham, Highland, and Maryville.

Loan balances increased by $85.4 million or 13.4% from December 31, 2005 to December 31, 2006 primarily as a result of the acquisition of Mansfield which resulted in an increase of approximately $55.8 million and also due to an additional increase in commercial real estate loan balances of $18.1 million. In total commercial real estate loan balances increased to $309.9 million at December 31, 2006 from $282.5 million at December 31, 2005. Loans secured by apartment buildings and hotels comprised the largest percentage of the growth in commercial real estate loans. Balances of loans sold into the secondary market were $34 million in 2006, compared to $63 million in 2005. The balance of real estate loans held for sale, included in the balances shown above, amounted to $2,234,000 and $1,778,000 as of December 31, 2006 and 2005, respectively.

At December 31, 2006, the Company had loan concentrations in agricultural industries of $109.7 million, or 15.2%, of outstanding loans and $92.3 million, or 14.5%, at December 31, 2005. In addition, the Company had loan concentrations in the following industries as of December 31, 2006 and 2005 (dollars in thousands):

	2006		2005	
	Principal balance	% Outstanding loans	Principal balance	% Outstanding loans
Operators of non-residential buildings	$ 31,527	4.36%	$ 22,446	3.52%
Apartment building owners	37,933	5.24%	40,843	6.40%

Motels, hotels & tourist courts	28,064	3.88%	28,054	4.40%
Subdividers & developers	34,872	4.82%	26,397	4.14%

The Company had no further industry loan concentrations in excess of 25% of total risk-based capital.
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The following table presents the balance of loans outstanding as of December 31, 2006, by maturities (in thousands):

	Maturity (1)			
	One year or less(2)	Over 1 through 5 years	Over 5 years	Total
Real estate - mortgage	$ 147,860	$ 319,941	$ 42,934	$ 510,735
Commercial & agricultural	113,409	44,114	3,562	161,085
Installment	22,734	24,023	260	47,017
Other	973	2,368	1,390	4,731
Total loans	$ 284,976	$ 390,446	$ 48,146	$ 723,568

(1) Based upon remaining maturity.
(2) Includes demand loans, past due loans and overdrafts.

As of December 31, 2006, loans with maturities over one year consisted of $368 million in fixed rate loans and $71 million in variable rate loans. The loan maturities noted above are based on the contractual provisions of the individual loans. The Company has no general policy regarding rollovers and borrower requests, which are handled on a case-by-case basis.

Nonperforming Loans

Nonperforming loans include: (a) loans accounted for on a nonaccrual basis; (b) accruing loans contractually past due ninety days or more as to interest or principal payments; and (c) loans not included in (a) and (b) above which are defined as “renegotiated loans”.

The following table presents information concerning the aggregate amount of nonperforming loans (in thousands):

	December 31,				
	2006	2005	2004	2003	2002
Nonaccrual loans	$ 3,639	$ 3,458	$ 3,106	$ 3,296	$ 2,961
Renegotiated loans which are performing in accordance with revised terms	29	-	-	35	188
Total nonperforming loans	$ 3,668	$ 3,458	$ 3,106	$ 3,331	$ 3,149

At December 31, 2006, $1,229,000 of the nonperforming loans resulted from collateral-dependent loans to two borrowers. The $181,000 increase in nonaccrual loans during the year resulted from the net of $1,642,000 of loans put on nonaccrual status, offset by $127,000 of loans transferred to other real estate owned, $220,000 of loans charged off and $1,114,000 of loans becoming current or paid-off.

Interest income that would have been reported if nonaccrual and renegotiated loans had been performing totaled $123,000, $99,000 and $169,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

The Company’s policy is to discontinue the accrual of interest income on any loan for which principal or interest is ninety days past due or earlier when, in the opinion of management, there is reasonable doubt as to the timely collection of interest or principal. Nonaccrual loans are returned to accrual status when, in the opinion of management, the financial position of the borrower indicates there is no longer any reasonable doubt as to the timely collection of interest or principal.

Loan Quality and Allowance for Loan Losses

The allowance for loan losses represents management's estimate of the reserve necessary to adequately account for probable losses existing in the current portfolio. The provision for loan losses is the charge against current earnings that is determined by management as the amount needed to maintain an adequate allowance for loan losses. In determining the adequacy of the allowance for loan losses, and therefore the provision to be charged to current earnings, management relies predominantly on a disciplined credit review and approval process that extends to the full range of the Company's credit exposure. The review process is directed by overall lending policy and is intended to identify, at the earliest possible stage, borrowers who might be facing financial difficulty. Once identified, the magnitude of exposure to individual borrowers is quantified in the form of specific allocations of the allowance for loan losses. Management considers collateral values and guarantees in the determination of such specific allocations. Additional factors considered by management in evaluating the overall adequacy of the allowance include historical net loan losses, the level and composition of nonaccrual, past due and renegotiated loans, trends in volumes and terms of loans, effects of changes in risk selection and underwriting standards or lending practices, lending staff changes, concentrations of credit, industry conditions and the current economic conditions in the region where the Company operates. Management considers the allowance for loan losses a critical accounting policy.

Management recognizes there are risk factors that are inherent in the Company's loan portfolio. All financial institutions face risk factors in their loan portfolios because risk exposure is a function of the business. The Company's operations (and therefore its loans) are concentrated in east central Illinois, an area where agriculture is the dominant industry. Accordingly, lending and other business relationships with agriculture-based businesses are critical to the Company's success. At December 31, 2006, the Company's loan portfolio included $109.7 million of loans to borrowers whose businesses are directly related to agriculture. The balance increased $17.4 million from $92.3 million at December 31, 2005. While the Company adheres to sound underwriting practices, including collateralization of loans, any extended period of low commodity prices, significantly reduced yields on crops and/or reduced levels of government assistance to the agricultural industry could result in an increase in the level of problem agriculture loans and potentially result in loan losses within the agricultural portfolio.

In addition, the Company has $28.1 million of loans to motels, hotels and tourist courts. The performance of these loans is dependent on borrower specific issues as well as the general level of business and personal travel within the region. While the Company adheres to sound underwriting standards, a prolonged period of reduced business or personal travel could result in an increase in non-performing loans to this business segment and potentially in loan losses. The Company also has $31.5 million of loans to operators of non-residential buildings, $37.9 million of loans to apartment building owners and $34.9 million of loans to subdividers and developers. A significant widespread decline in real estate values could result in an increase in non-performing loans to this segment and potentially in loan losses.

Loan loss experience for the past five years are summarized as follows (dollars in thousands):

	2006	2005	2004	2003	2002
Average loans outstanding, net of unearned income	$ 691,726	$ 610,781	$ 572,836	$ 525,095	$ 483,764
Allowance-beginning of year	$ 4,648	$ 4,621	$ 4,426	$ 3,723	$ 3,702
Balance added through acquisitions	1,405	-	-	-	-
Charge-offs:					
Commercial, financial and agricultural	595	757	436	589	673
Real estate-mortgage	231	122	23	50	200
Installment	142	278	129	139	255
Other	188	130	-	-	-

Total charge-offs	1,156	1,287	588	778	1,128
Recoveries:					
Commercial, financial and agricultural	30	75	146	427	12
Real estate-mortgage	8	63	-	15	17
Installment	49	42	49	39	45
Other	132	43	-	-	-
Total recoveries	219	223	195	481	74
Net charge-offs	937	1,064	393	297	1,054
Provision for loan losses	760	1,091	588	1,000	1,075
Allowance-end of year	$ 5,876	$ 4,648	$ 4,621	$ 4,426	$ 3,723
Ratio of net charge-offs to average loans	.14%	.17%	.07%	.06%	.22%
Ratio of allowance for loan losses to loans outstanding (at end of year)	.81%	.73%	.77%	.80%	.74%
Ratio of allowance for loan losses to nonperforming loans	160.2%	134.4%	148.8%	132.9%	118.2%

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The Company minimizes credit risk by adhering to sound underwriting and credit review policies. These policies are reviewed at least annually, and the Board of Directors approves all changes. Senior management is actively involved in business development efforts and the maintenance and monitoring of credit underwriting and approval. The loan review system and controls are designed to identify, monitor and address asset quality problems in an accurate and timely manner. On a monthly basis, the Board of Directors reviews the status of problem loans. In addition to internal policies and controls, regulatory authorities periodically review asset quality and the overall adequacy of the allowance for loan losses.

During 2006, the Company had net charge-offs of $937,000 compared to $1,064,000 in 2005 and $393,000 in 2004. During 2006, the Company's significant charge-offs included $565,000 on commercial loans of five borrowers and $168,000 of commercial and real estate mortgage loans of one borrower. During 2005, the Company's significant charge-offs included $408,000 on two commercial loans secured by business assets and one secured by commercial real estate. The Company also recovered $56,000 on a commercial real estate loan that had been charged-off in a prior period. During 2004, significant charge-offs included $118,000 on two commercial loans of a single borrower and $124,000 on two commercial real estate loans of a single borrower. The Company also recovered $85,000 in interest on an agricultural real estate loan that had been charged-off in a prior period and $68,500 on two commercial real estate loans that were previously charged-off.

At December 31, 2006, the allowance for loan losses amounted to $5,876,000, or .81% of total loans, and 160.2% of nonperforming loans. At December 31, 2005, the allowance was $4,648,000, or .73% of total loans, and 134.4% of nonperforming loans. The ratio of the allowance for loan losses to total loans has been consistent over the past five years ranging from .73% to .81%.

The allowance for loan losses, in management's judgment, is allocated as follows to cover probable loan losses (dollars in thousands):

	December 31, 2006			December 31, 2005			December 31, 2004		
		Allowance for loan losses	% of loans to total loans		Allowance for loan losses	% of loans to total loans		Allowance for loan losses	% of loans to total loans
Real estate-mortgage	$	215	70.6%	$	134	70.6%	$	240	71.4%
Commercial, financial and agricultural		4,002	22.3%		3,249	23.6%		3,124	23.1%
Installment		382	6.5%		319	5.4%		150	5.1%
Other		26	.6%		18	.4%		-	.4%
Total allocated		4,625			3,720			3,514	
Unallocated		1,251	N/A		928	N/A		1,107	N/A
Allowance at end of Year	$	5,876	100.0%	$	4,648	100.0%	$	4,621	100.0%

	December 31, 2003			December 31, 2002		
		Allowance for loan losses	% of loans to total loans		Allowance for loan losses	% of loans to total loans
Real estate-mortgage	$	219	70.7%	$	215	68.1%
Commercial, financial and agricultural		2,912	23.8%		2,882	25.4%
Installment		154	5.2%		190	6.2%
Other		-	.3%		-	.3%

Total allocated		3,285			3,287	
Unallocated		1,141	N/A		436	N/A
Allowance at end of year	$	4,426	100.0%	$	3,723	100.0%

The allowance is allocated to the individual loan categories by a specific allocation for all classified loans plus a percentage of loans not classified based on historical losses and other factors. The unallocated allowance represents an estimate of the probable, inherent, but yet undetected, losses in the loan portfolio. It is based on factors that cannot necessarily be associated with a specific credit or loan category and represents management's estimate to ensure that the overall allowance of loan losses appropriately reflects a margin for the imprecision necessarily inherent in the estimates of expected credit losses.

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Securities

The Company's overall investment goal is to maximize earnings while maintaining liquidity in securities having minimal credit risk. The types and maturities of securities purchased are primarily based on the Company's current and projected liquidity and interest rate sensitivity positions.

The following table sets forth the year-end amortized cost of the Company's securities for the last three years (dollars in thousands):

	December 31,					
	2006		2005		2004	
	Amount	Weighted Average Yield	Amount	Weighted Average Yield	Amount	Weighted Average Yield
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 140,924	4.81%	$ 108,506	3.74%	$ 92,369	2.81%
Obligations of states and political subdivisions	16,637	4.17%	16,829	4.54%	25,133	4.54%
Mortgage-backed securities	15,491	4.50%	20,046	4.34%	34,032	3.82%
Other securities	12,505	6.56%	13,083	6.21%	17,817	6.02%
Total securities	$ 185,557	4.85%	$ 158,464	4.10%	$ 169,351	3.61%

At December 31, 2006, the Company's investment portfolio reflected a decrease in mortgage-backed securities and obligations of states and political subdivisions securities and an increase in U.S. Treasury securities and obligations of U.S. government corporations and agencies. There was also a decrease in other securities. This change in the portfolio mix improved the characteristics of the portfolio relating to interest rate risk exposure and portfolio yield.

The following table indicates the expected maturities of investment securities classified as available-for-sale and held-to-maturity, presented at amortized cost, at December 31, 2006 (dollars in thousands) and the weighted average yield for each range of maturities. Mortgage-backed securities are aged according to their weighted average life. All other securities are shown at their contractual maturity.

	One year or less	After 1 through 5 years	After 5 through 10 years	After 10 years	Total
Available-for-sale:					
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 20,841	$ 85,187	$ 33,940	$ 956	$ 140,924
Obligations of state and political subdivisions	1,525	5,899	3,955	3,935	15,314
Mortgage-backed securities	553	14,938	-	-	15,491
Other securities	500	-	2,500	9,505	12,505
Total investments	$ 23,419	$ 106,024	$ 40,395	$ 14,396	$ 184,234
Weighted average yield	4.76%	4.51%	5.63%	5.79%	4.92%
Full tax-equivalent yield	4.87%	4.61%	5.78%	6.29%	5.07%

Held-to-maturity:										
Obligations of state and political subdivisions	$	145	$	510	$	344	$	324	$	1,323
Weighted average yield		5.36%		5.55%		5.29%		5.47%		5.44%
Full tax-equivalent yield		7.89%		8.17%		7.63%		8.05%		7.97%

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The weighted average yields are calculated on the basis of the amortized cost and effective yields weighted for the scheduled maturity of each security. Full tax-equivalent yields have been calculated using a 34% tax rate. With the exception of obligations of the U.S. Treasury and other U.S. government agencies and corporations, there were no investment securities of any single issuer the book value of which exceeded 10% of stockholders' equity at December 31, 2006.

At December 31, 2006, there were five obligations of states and political subdivisions with a fair value of $1,591,000 and unrealized losses of $12,000, six mortgage-backed securities with a fair value of $13,550,000 and unrealized losses of $332,000, and ten obligations of U.S. government agencies with a fair value of $51,637,000 and unrealized losses of $782,000, in a continuous unrealized loss position for twelve months or more. This position is due to short-term and intermediate rates increasing since the purchase of these securities resulting in the market value of the security being lower than book value. Management does not believe any individual unrealized loss as of December 31, 2006 represents an other than temporary impairment.

Investment securities carried at approximately $158,547,000 and $136,787,000 at December 31, 2006 and 2005, respectively, were pledged to secure public deposits and repurchase agreements and for other purposes as permitted or required by law.

Deposits

Funding of the Company's earning assets is substantially provided by a combination of consumer, commercial and public fund deposits. The Company continues to focus its strategies and emphasis on retail core deposits, the major component of funding sources. The following table sets forth the average deposits and weighted average rates for 2006, 2005 and 2004 (dollars in thousands):

	2006		2005		2004	
	Weighted Average Balance	Average Rate	Average Balance	Weighted Average Rate	Average Balance	Weighted Average Rate
Demand deposits:						
Non-interest bearing	$ 105,744	-	$ 89,593	-	$ 85,437	-
Interest bearing	246,035	2.16%	229,532	1.30%	230,300	.68%
Savings	62,279	.52%	59,830	.41%	61,144	.39%
Time deposits	323,283	4.00%	271,161	3.13%	261,564	2.80%
Total average deposits	$ 737,341	2.52%	$ 650,116	1.80%	$ 638,445	1.43%

	December 31,		
(dollars in thousands)	2006	2005	2004
High month-end balances of total deposits	$ 799,002	$ 677,872	$ 668,540
Low month-end balances of total deposits	651,392	627,107	620,200

In 2006, the average balance of deposits increased by $87.2 million from 2005. The increase was primarily attributable to deposits acquired in the acquisition of Mansfield and to a promotion run in the first quarter of 2006. Average non-interest bearing deposits increased by $16.1 million, average money market account balances increased by $16.8 million, and consumer CD balances increased by $52.1 million offset by a decline in brokered CD balances. In 2005, the average balance of deposits increased by $11.7 million from 2004. The increase was primarily attributable to growth in interest-bearing deposits, including money market accounts, Club 50 accounts, and time

deposit balances (“CD”). Average money market account balances increased by $4.4 million, average balances in the Club 50 accounts increased by $3.9 million, and consumer CD balances increased by $13.2 million, partially offset by a decline in brokered CD balances and public time deposits.

In 2006, the Company’s significant deposits included brokered CDs, time deposits with the State of Illinois, and deposit relationships with two public entities. The Company had six brokered CDs at various maturities with a total balance of $22.4 million as of December 31, 2006. State of Illinois time deposits maintained with the Company totaled $3.1 million as of December 31, 2006. These balances are subject to bid annually. In addition, the Company maintains account relationships with various public entities throughout its market areas. Three public entities had total balances of $16.7 million in various checking accounts and time deposits as of December 31, 2006. These balances are subject to change depending upon the cash flow needs of the public entity.

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The following table sets forth the maturity of time deposits of $100,000 or more (in thousands):

	December 31,		
	2006	2005	2004
3 months or less	$ 38,468	$ 15,947	$ 26,916
Over 3 through 6 months	20,004	23,593	17,560
Over 6 through 12 months	45,532	34,944	22,826
Over 12 months	11,896	28,950	48,031
Total	$ 115,900	$ 103,434	$ 115,333

The balance of time deposits of $100,000 or more increased by $12.5 million from December 31, 2005 to December 31, 2006. The increase in balances was primarily attributable to time deposits acquired in the acquisition of Mansfield and to a promotion run in the first quarter of 2006. The balance of time deposits of $100,000 or more decreased by $11.9 million from December 31, 2004 to December 31, 2005. The decrease in balances was primarily attributable to maturing brokered CD and other time deposit balances that were not replaced.

Balances of time deposits of $100,000 or more includes brokered CDs, time deposits maintained for public entities, and consumer time deposits. The balance of brokered CDs was $22.3 million, $38.4 million and $42.1 as of December 31, 2006, 2005 and 2004, respectively. The Company also maintains time deposits for the State of Illinois with balances of $3.1 million, $3.4 million and $4.4 million as of December 31, 2006, 2005 and 2004, respectively. The State of Illinois deposits are subject to bid annually and could increase or decrease in any given year.

Repurchase Agreements and Other Borrowings

Securities sold under agreements to repurchase are short-term obligations of First Mid Bank. First Mid Bank collateralizes these obligations with certain government securities that are direct obligations of the United States or one of its agencies. First Mid Bank offers these retail repurchase agreements as a cash management service to its corporate customers. Other borrowings consist of Federal Home Loan Bank ("FHLB") advances, federal funds purchased, junior subordinated debentures and loans (short-term or long-term debt) that the Company has outstanding.

Information relating to securities sold under agreements to repurchase and other borrowings for the last three years is presented below (dollars in thousands):

	2006	2005	2004
At December 31:			
Federal funds purchased	$ 6,800	$ 4,000	-
Securities sold under agreements to repurchase	66,693	67,380	$ 59,835
Federal Home Loan Bank advances:			
Overnight	-	12,000	-
Fixed term - due in one year or less	7,000	3,000	17,300
Fixed term - due after one year	13,000	20,000	8,000
Junior subordinated debentures	20,620	10,310	10,310
Debt:			
Loans due in one year or less	-	5,500	4,200
Loans due after one year	11,000	-	400
Total	$ 125,113	$ 122,190	$ 100,045
Average interest rate at year end	5.28%	4.27%	2.59%
Maximum Outstanding at Any Month-end			
Federal funds purchased	$ 6,800	$ 4,000	-
Securities sold under agreements to repurchase	71,516	67,380	$ 63,517
Federal Home Loan Bank advances:			

Overnight	19,500	12,014	7,000
Fixed term - due in one year or less	7,000	20,000	17,300
Fixed term - due after one year	30,000	20,000	25,300
Junior subordinated debentures	20,620	10,310	10,310
Debt:			
Loans due in one year or less	4,500	6,200	9,025
Loans due after one year	15,000	200	400
Averages for the Year			
Federal funds purchased	$ 3,432	$ 874	$ 218
Securities sold under agreements to repurchase	55,389	57,799	55,645
Federal Home Loan Bank advances:			
Overnight	6,622	2,447	997
Fixed term - due in one year or less	6,000	13,575	8,200
Fixed term - due after one year	21,441	15,523	17,920
Junior subordinated debentures	17,367	10,310	8,704
Debt:			
Loans due in one year or less	995	5,607	6,746
Loans due after one year	9,616	104	415
Total	$ 120,862	$ 106,239	$ 98,845
Average interest rate during the year	5.07%	3.74%	2.63%

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FHLB advances represent borrowings by First Mid Bank to economically fund loan demand. The fixed term advances consist of $20 million as follows:

- Ø $7 million advance at 4.00% with a 2-year maturity, due April 15, 2007
- Ø $5 million advance at 4.58% with a 5-year maturity, due March 22, 2010
- Ø $3 million advance at 5.98% with a 10-year maturity, due March 1, 2011, callable quarterly
- Ø $5 million advance at 4.58% with a 10-year maturity, due July 14, 2016, one year lockout, callable quarterly beginning July, 2007

At December 31, 2006, outstanding loan balances included $11 million on a revolving credit agreement with The Northern Trust Company. This loan was renegotiated on April 24, 2006 in conjunction with obtaining financing for the acquisition of Mansfield. The revolving credit agreement has a maximum available balance of $22.5 million with a term of three years from the date of closing. The interest rate (6.51% as of December 31, 2006) is floating at 1.25% over the federal funds rate when the ratio of senior debt to Tier 1 capital is equal to or below 35% as of the end of the previous quarter and 1.50% over the federal funds rate when the ratio of senior debt to Tier 1 capital is above 35%. Currently senior debt to Tier 1 capital is below 35%. The loan is secured by the common stock of First Mid Bank and subject to a borrowing agreement containing requirements for the Company and First Mid Bank to maintain various operating and capital ratios and also contains requirements for prior lender approval for certain sales of assets, merger activity, the acquisition or issuance of debt and the acquisition of treasury stock. The Company and First Mid Bank were in compliance with the existing covenants at December 31, 2006 and 2005.

On February 27, 2004, the Company completed the issuance and sale of $10 million of floating rate trust preferred securities through First Mid-Illinois Statutory Trust I (“Trust I”), a statutory business trust and wholly-owned unconsolidated subsidiary of the Company, as part of a pooled offering. The Company established Trust I for the purpose of issuing the trust preferred securities. The $10 million in proceeds from the trust preferred issuance and an additional $310,000 for the Company’s investment in common equity of the Trust, a total of $10,310 000, was invested in junior subordinated debentures of the Company. The underlying junior subordinated debentures issued by the Company to Trust I mature in 2034, bear interest at three-month London Interbank Offered Rate (“LIBOR”) plus 280 basis points, reset quarterly, and are callable, at the option of the Company, at par on or after April 7, 2009. At December 31, 2006 and 2005 the rate was 8.17% and 6.95%, respectively. The Company used the proceeds of the offering for general corporate purposes.

On April 26, 2006, the Company completed the issuance and sale of $10 million of fixed/floating rate trust preferred securities through First Mid-Illinois Statutory Trust II (“Trust II”), a statutory business trust and wholly-owned unconsolidated subsidiary of the Company, as part of a pooled offering. The Company established Trust II for the purpose of issuing the trust preferred securities. The $10 million in proceeds from the trust preferred issuance and an additional $310,000 for the Company’s investment in common equity of Trust II, a total of $10,310 000, was invested in junior subordinated debentures of the Company. The underlying junior subordinated debentures issued by the Company to Trust II mature in 2036, bear interest at a fixed rate of 6.98% (three-month LIBOR plus 160 basis points) paid quarterly and convert to floating rate (LIBOR plus 160 basis points) after June 15, 2011. The net proceeds to the Company were used for general corporate purposes, including the Company’s acquisition of Mansfield.

The trust preferred securities issued by Trust I and Trust II are included as Tier 1 capital of the Company for regulatory capital purposes. On March 1, 2005, the Federal Reserve Board adopted a final rule that allows the continued limited inclusion of trust preferred securities in the calculation of Tier 1 capital for regulatory purposes. The final rule provides a five-year transition period, ending September 30, 2009, for application of the quantitative limits. The Company does not expect the application of the quantitative limits to have a significant impact on its calculation of Tier 1 capital for regulatory purposes or its classification as well-capitalized.

Interest Rate Sensitivity

The Company seeks to maximize its net interest margin while maintaining an acceptable level of interest rate risk. Interest rate risk can be defined as the amount of forecasted net interest income that may be gained or lost due to changes in the interest rate environment, a variable over which management has no control. Interest rate risk, or sensitivity, arises when the maturity or repricing characteristics of assets differ significantly from the maturity or repricing characteristics of liabilities.

The Company monitors its interest rate sensitivity position to maintain a balance between rate-sensitive assets and rate-sensitive liabilities. This balance serves to limit the adverse effects of changes in interest rates. The Company's asset/liability management committee (ALCO) oversees the interest rate sensitivity position and directs the overall allocation of funds.

In the banking industry, a traditional way to measure potential net interest income exposure to changes in interest rates is through a technique known as "static GAP" analysis which measures the cumulative differences between the amounts of assets and liabilities maturing or repricing at various intervals. By comparing the volumes of interest-bearing assets and liabilities that have contractual maturities and repricing points at various times in the future, management can gain insight into the amount of interest rate risk embedded in the balance sheet.

The following table sets forth the Company's interest rate repricing gaps for selected maturity periods at December 31, 2006 (dollars in thousands):

	Rate Sensitive Within							
	1 year	**1-2 years**	**2-3 years**	**3-4 years**	**4-5 years**	**Thereafter**	**Total**	**Fair Value**
Interest-earning assets:								
Federal funds sold and other interest-bearing deposits	$ 1,570	$ -	$ -	$ -	$ -	$ -	$ 1,570	$ 1,570
Taxable investment securities	26,490	29,670	14,363	27,212	8,951	62,124	168,810	168,810
Nontaxable investment securities	1,673	1,631	977	2,337	1,488	8,673	16,779	16,801
Loans	316,619	136,204	144,335	66,498	39,726	20,186	723,568	712,857
Total	$ 346,352	$ 167,505	$ 159,675	$ 96,047	$ 50,165	$ 90,983	$ 910,727	$ 900,038
Interest-bearing liabilities:								
Savings and N.O.W. accounts	$ 54,242	$ 10,005	$ 10,437	$ 15,187	$ 15,696	$ 93,359	$ 198,926	$ 198,926
Money market accounts	92,890	1,341	1,378	1,788	1,825	9,645	108,867	108,867
Other time deposits	296,254	21,841	7,940	10,802	4,481	79	341,397	342,810
Short-term borrowings/debt	80,493	-	-	-	-	-	80,493	80,490

Long-term borrowings/debt	-	-	11,000	5,000	23,620	5,000	44,620	44,850
Total	$ 523,879	$ 33,187	$ 30,755	$ 32,777	$ 45,622	$ 121,743	$ 774,303	$ 775,943
Rate sensitive assets - rate sensitive liabilities	$ (177,527)	$ 134,318	$ 128,920	$ 63,270	$ 4,543	$ (17,100)	$ 136,424	
Cumulative GAP	$ (177,527)	$ (43,209)	$ 85,711	$ 148,981	$ 153,524	$ 136,424		
Cumulative amounts as % of total rate sensitive assets	-19.5%	14.7%	14.2%	6.9%	0.5%	-1.9%		
Cumulative Ratio	-19.5%	-4.7%	9.4%	16.4%	16.9%	15.0%		

The static GAP analysis shows that at December 31, 2006, the Company was liability sensitive, on a cumulative basis, through the twelve-month time horizon. This indicates that future increases in interest rates, if any, could have an adverse effect on net interest income. Conversely, future decreases in interest rates could have a positive effect on net interest income. There are several ways the Company measures and manages the exposure to interest rate sensitivity, static GAP analysis being one. The Company's ALCO also uses other financial models to project interest income under various rate scenarios and prepayment/extension assumptions consistent with First Mid Bank's historical experience and with known industry trends. ALCO meets at least monthly to review the Company's exposure to interest rate changes as indicated by the various techniques and to make necessary changes in the composition terms and/or rates of the assets and liabilities. Based on all information available, management does not believe that changes in interest rates which might reasonably be expected to occur in the next twelve months will have a material, adverse effect on the Company's net interest income.

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Capital Resources

At December 31, 2006, stockholders' equity increased $3,460,000 or 4.8% to $75,786,000 from $72,326,000 as of December 31, 2005. During 2006, net income contributed $10,009,000 to equity before the payment of dividends to common stockholders of $2,251,000. The change in the market value of available-for-sale investment securities increased stockholders' equity by $758,000, net of tax. Additional purchases of treasury stock (172,820 shares at an average cost of $41.38 per share) decreased stockholders' equity by $7,152,000.

Stock Plans

On July 16, 2004, the Company effected a three-for-two stock split in the form of a 50% stock dividend. All share and per share information has been restated to reflect the split.

Deferred Compensation Plan

The Company follows the provisions of the Emerging Issues Task Force Issue No. 97-14, "*Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested*" ("EITF 97-14") for purposes of the First Mid-Illinois Bancshares, Inc. Deferred Compensation Plan ("DCP"). At December 31, 2006, the Company classified the cost basis of its common stock issued and held in trust in connection with the DCP of approximately $2,629,000 as treasury stock. The Company also classified the cost basis of its related deferred compensation obligation of approximately $2,629,000 as an equity instrument (deferred compensation).

The DCP was effective as of June 1984. The purpose of the DCP is to enable directors, advisory directors, and key employees the opportunity to defer a portion of the fees and cash compensation paid by the Company as a means of maximizing the effectiveness and flexibility of compensation arrangements. The Company invests all participants' deferrals in shares of common stock. Dividends paid on the shares are credited to participants' DCP accounts and invested in additional shares. The Company issued, pursuant to DCP:

- Ø 3,601 common shares during 2006
- Ø 3,622 common shares during 2005
- Ø 6,421 common shares during 2004.

First Retirement and Savings Plan

The First Retirement and Savings Plan ("401(k) plan") was effective beginning in 1985. Employees are eligible to participate in the 401(k) plan after six months of service with the Company. The Company offers common stock as an investment option for participants of the 401(k) plan. The Company issued, pursuant to the 401(k) plan:

- Ø 2,724 common shares during 2006
- Ø 8,002 common shares during 2005
- Ø 8,225 common shares during 2004.

Dividend Reinvestment Plan

The Dividend Reinvestment Plan ("DRIP") was effective as of October 1994. The purpose of the DRIP is to provide participating stockholders with a simple and convenient method of investing cash dividends paid by the Company on its common and preferred shares into newly issued common shares of the Company. All holders of record of the Company's common or preferred stock are eligible to voluntarily participate in the DRIP. The DRIP is administered by Computershare Investor Services, LLC and offers a way to increase one's investment in the Company. Of the $2,251,000 in common stock dividends paid during 2006, $757,000 or 33.3% was reinvested into shares of common stock of the Company through the DRIP. Events that resulted in common shares being reinvested in the DRIP:

- Ø During 2006, 18,664 common shares were issued from common stock dividends
- Ø During 2005, 17,105 common shares were issued from common stock dividends
- Ø During 2004, 39,481 common shares were issued from common stock dividends.

Stock Incentive Plan

In December 1997, the Company established a Stock Incentive Plan ("SI Plan"), intended to provide a means whereby directors and certain officers, consultants and advisors can acquire shares of the Company's common stock. This SI Plan is more fully described in Note 15. A maximum of 225,000 shares were originally authorized under the SI Plan. In September 2001, the Board of Directors authorized an additional 225,000 shares to be issued and sold under the SI Plan. Options to acquire shares are awarded at an exercise price equal to the fair market value of the shares on the date of grant and have a 10-year term. Options granted to employees vest over a four-year period and options granted to directors vest at the time they are issued. The Company has awarded the following stock options:

- Ø The Company awarded no options during the years ended December 31, 2006 or 2005
- Ø In December 2004, the Company awarded 74,250 options at an option price of $41.00.

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Prior to 2006, the Company accounted for the SI Plan under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), and related Interpretations. Accordingly, in 2005 and 2004, no stock-based employee compensation cost was recognized in the Statement of Income as all options granted had an exercise price equal to the market value of the underlying common stock on the grant date.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R using the modified prospective application method. Accordingly, after January 1, 2006, the Company began expensing the fair value of stock options granted, modified, repurchased or cancelled. Additionally, compensation cost for a portion of the awards for which requisite services have not yet been rendered that are outstanding as of January 1, 2006 are being recognized as the requisite service is rendered. As a result of this adoption, the Company's income before income taxes and net income for the year ended December 31, 2006 includes stock option compensation cost of $178,000 and $171,000, respectively, which represents $.04 impact on basic and diluted earnings per share for the year.

Stock Repurchase Program

On August 5, 1998, the Company announced a stock repurchase program of up to 3% of its common stock. In March 2000, the Board of Directors approved the repurchase of an additional 5% of the Company's common stock. In September 2001, the Board of Directors authorized the repurchase of $3 million additional shares of the authorized common stock and in August 2002, the Board of Directors authorized the repurchase of $5 million additional shares of the Company's common stock. In September 2003, the Board of Directors approved the repurchase of $10 million additional shares of the Company's stock. On April 27, 2004, the Board approved the repurchase of $5 million additional shares of the Company's common stock, on August 23, 2005 the Board approved the repurchase of $5 million additional shares of the Company's common stock, and on August 22, 2006 the Board approved the repurchase of $5 million additional shares of the Company's common stock, bringing the aggregate total of purchases authorized on December 31, 2006 to 8%, or $6.2 million, of the Company's common stock plus $33 million of additional shares.

Subsequently, on February 27, 2007, the Board of Directors approved the repurchase of $5 million additional shares of the Company's common stock, bringing the aggregate total of purchases authorized to 8%, or $6.2 million, of the Company's common stock plus $38 million of additional shares.

During 2006, the Company repurchased 172,820 shares (4.0% of common shares) at a total price of $7,152,000. During 2005, the Company repurchased 119,813 shares (2.7% of common shares) at a total price of $4,851,000. Treasury stock is further affected by activity in the DCP.

Capital Ratios

Minimum regulatory requirements for highly-rated banks that do not expect significant growth is 8% for the Total Capital to Risk-Weighted Assets ratio and 3% for the Tier 1 Capital to Average Assets ratio. Other institutions, not considered highly-rated, are required to maintain a ratio of Tier 1 Capital to Risk-Weighted Assets of 4% to 5% depending on their particular circumstances and risk profiles. The Company and First Mid Bank have capital ratios above the minimum regulatory capital requirements and, as of December 31, 2006, the Company and First Mid Bank had capital ratios above the levels required for categorization as well-capitalized under the capital adequacy guidelines established by the bank regulatory agencies.

A tabulation of the Company and First Mid Bank's capital ratios as of December 31, 2006 follows:

	Total Capital to Risk-Weighted	Tier One Capital to Risk-Weighted	Tier One Capital to Average

	Assets	Assets	Assets
First Mid-Illinois Bancshares, Inc. (Consolidated)	10.91%	10.10%	7.56%
First Mid-Illinois Bank & Trust, N.A.	11.83%	11.01%	8.21%

Liquidity

Liquidity represents the ability of the Company and its subsidiaries to meet all present and future financial obligations arising in the daily operations of the business. Financial obligations consist of the need for funds to meet extensions of credit, deposit withdrawals and debt servicing. The Company’s liquidity management focuses on the ability to obtain funds economically through assets that may be converted into cash at minimal costs or through other sources. The Company’s other sources for cash include overnight federal fund lines, FHLB advances, deposits of the State of Illinois, the ability to borrow at the Federal Reserve Bank, and the Company’s operating line of credit with The Northern Trust Company. Details for the sources include:

Ø First Mid Bank has $22.5 million available in overnight federal fund lines, including $10 million from Harris Trust and Savings Bank of Chicago and $12.5 million from The Northern Trust Company. Availability of the funds is subject to the First Mid Bank’s meeting minimum regulatory capital requirements for total capital to risk-weighted assets and Tier 1 capital to total assets. As of December 31, 2006, the First Mid Bank’s ratios of total capital to risk-weighted assets of 11.83% and Tier 1 capital to total average assets of 8.21% met regulatory requirements.

- Ø In addition, the Company has a revolving credit agreement in the amount of $22.5 million with The Northern Trust Company. The Company has an outstanding balance of $11 million as of December 31, 2006 and $11.5 million in available funds. This loan was renegotiated on April 24, 2006 in conjunction with obtaining financing for the acquisition of Mansfield. The revolving credit agreement has a term of three years from the date of closing. The interest rate (6.51% as of December 31, 2006) is floating at 1.25% over the federal funds rate when the ratio of senior debt to Tier 1 capital is equal to or below 35% as of the end of the previous quarter and 1.50% over the federal funds rate when the ratio of senior debt to Tier 1 capital is above 35%. Currently senior debt to Tier 1 capital is below 35%. The loan is secured by the common stock of First Mid Bank and subject to a borrowing agreement containing requirements for the Company and First Mid Bank to maintain various operating and capital ratios and also contains requirements for prior lender approval for certain sales of assets, merger activity, the acquisition or issuance of debt and the acquisition of treasury stock.

- Ø First Mid Bank can also borrow from the FHLB as a source of liquidity. Availability of the funds is subject to the pledging of collateral to the FHLB. Collateral that can be pledged includes one-to-four family residential real estate loans and securities. At December 31, 2006, the excess collateral at the FHLB could support approximately $102 million of additional advances.

- Ø First Mid Bank is also a member of the Federal Reserve System and can borrow funds provided sufficient collateral is pledged.

- Ø First Mid Bank also receives deposits from the State of Illinois. The receipt of these funds is subject to competitive bid and requires collateral to be pledged at the time of placement.

Management monitors its expected liquidity requirements carefully, focusing primarily on cash flows from:

- Ø lending activities, including loan commitments, letters of credit and mortgage prepayment assumptions;
- Ø deposit activities, including seasonal demand of private and public funds;
- Ø investing activities, including prepayments of mortgage-backed securities and call assumptions on U.S. Treasuries and agencies; and
- Ø operating activities, including scheduled debt repayments and dividends to stockholders.

The following table summarizes significant contractual obligations and other commitments at December 31, 2006 (in thousands):

	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Time deposits	$ 341,397	$ 296,077	$ 29,958	$ 15,283	$ 79
Debt	31,620	-	11,000	-	20,620
Other borrowings	86,693	73,693	-	8,000	5,000
Operating leases	3,740	378	920	809	1,633
Supplemental retirement liability	796	50	100	100	546
	$ 464,246	$ 370,198	$ 41,978	$ 24,192	$ 27,878

For the year ended December 31, 2006, net cash was provided from both operating activities and financing activities ($10.2 million and $8.7 million, respectively), while investing activities used net cash of $16.6 million. Thus, cash and cash equivalents increased by $2.3 million since year-end 2005. Generally, during 2006, the increase in cash balances was due to an increase in borrowings offset by funds used to fund new loans.

For the year ended December 31, 2005, net cash was provided from both operating activities and financing activities ($11.4 million and $15.6 million, respectively), while investing activities used net cash of $31 million. Thus, cash and cash equivalents decreased by $4 million since year-end 2004. Generally, during 2006, cash balances were reduced by funds used to fund new loans offset by an increase in borrowings, primarily Federal Home Loan Bank advances.

The Company has also issued $10 million of floating rate trust preferred securities through each of Trust I and Trust II. See heading "Repurchase Agreements and Other Borrowings" for a more detailed description.
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Effects of Inflation

Unlike industrial companies, virtually all of the assets and liabilities of the Company are monetary in nature. As a result, interest rates have a more significant impact on the Company's performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or experience the same magnitude of changes as goods and services, since such prices are affected by inflation. In the current economic environment, liquidity and interest rate adjustments are features of the Company's assets and liabilities that are important to the maintenance of acceptable performance levels. The Company attempts to maintain a balance between monetary assets and monetary liabilities, over time, to offset these potential effects.

Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155 (FAS 155), "Accounting for Certain Hybrid Financial Instruments: an amendment of FASB Statements No. 133 and 140." FAS 155 permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends Statement 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. FAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not expect the adoption of FAS 155 to have a material effect on the results of operations or the statement of condition.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156 (FAS 156), "Accounting for Servicing of Financial Assets: an amendment of FASB Statement No. 14*0.*". FAS 140 establishes, among other things, the accounting for all separately recognized servicing assets and servicing liabilities. This Statement amends FAS 140 to require that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. This Statement permits, but does not require, the subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value. Under this Statement, an entity can elect subsequent fair value measurement to account for its separately recognized servicing assets and servicing liabilities. Adoption of this Statement is required as of the beginning of the first fiscal year that begins after September 15, 2006. The Company does not expect the adoption of FAS 156 to have a material effect on the results of operations or the statement of condition.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement 109," which provides guidance on the measurement, recognition, and disclosure of tax positions taken or expected to be taken in a tax return. The Interpretation also provides guidance on derecognition, classification, interest and penalties, and disclosure. FIN 48 prescribes that a tax position should only be recognized if it is more-likely-than-not that the position will be sustained upon examination by the appropriate taxing authority. A tax position that meets this threshold is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. The cumulative effect of applying the provisions of FIN 48 is to be reported as an adjustment to the beginning balance of retained earnings in the period of adoption. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently assessing the impact, if any, that the adoption of this Interpretation will have on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (FAS 157), "Fair Value Measurements," which provides enhanced guidance for using fair value to measure assets and liabilities. FAS 157 establishes a common definition of fair value, provides a framework for measuring fair value under U.S. Generally Accepted Accounting Principles and expands disclosures requirements about fair value measurements. FAS 157 is

effective for financial statements issued in fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact, if any, the adoption of FAS 157 will have on its financial reporting and disclosures.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158 (FAS 158), "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)," which requires recognition of a net liability or asset to report the funded status of defined benefit pension and other postretirement plans on the balance sheet and recognition (as a component of other comprehensive income) of changes in the funded status in the year in which the changes occur. Additionally, FAS 158 requires measurement of a plan's assets and obligations as of the balance sheet date and additional disclosures in the notes to the financial statements. The recognition and disclosure provisions of FAS 158 are effective for fiscal years ending after December 15, 2006, while the requirement to measure a plan's assets and obligations as of the balance sheet date is effective for fiscal years ending after December 15, 2008. There was no material impact in regard to adoption of the recognition and disclosure provisions of FAS 158. The Company is currently evaluating the impact the adoption of the remaining provisions of FAS 158 will have on its financial reporting and disclosures.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's market risk arises primarily from interest rate risk inherent in its lending, investing and deposit taking activities, which are restricted to First Mid Bank. The Company does not currently use derivatives to manage market or interest rate risks. For a discussion of how management of the Company addresses and evaluates interest rate risk see also "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Interest Rate Sensitivity."

Based on the financial analysis performed as of December 31, 2006, which takes into account how the specific interest rate scenario would be expected to impact each interest-earning asset and each interest-bearing liability, the Company estimates that changes in the prime interest rate would impact First Mid Bank's performance as follows:

		Increase (Decrease) In		
December 31, 2006		**Net Interest Income**	**Net Interest Income**	**Return On Average Equity**
Prime rate is 8.25%		**($000)**	**(%)**	**2006=13.89%**
Prime rate increase of:				
200 basis points to 10.25%	$	(709)	(3.1)%	(.73)%
100 basis points to 9.25%		(336)	(1.5)%	(.34)%
Prime rate decrease of:				
200 basis points to 6.25%		78	0.3%	.08%
100 basis points to 7.25%		(389)	(1.7)%	(.40)%

The following table shows the same analysis performed as of December 31, 2005:

		Increase (Decrease) In		
December 31, 2005		**Net Interest Income**	**Net Interest Income**	**Return On Average Equity**
Prime rate is 7.25%		**($000)**	**(%)**	**2005=13.79** (%)
Prime rate increase of:				
200 basis points to 9.25%	$	98	0.5%	.11%
100 basis points to 8.25%		44	0.2%	.05%
Prime rate decrease of:				
200 basis points to 5.25%		(639)	(3.1)%	(.70)%
100 basis points to 6.25%		(41)	(0.2)%	(.05)%

First Mid Bank's Board of Directors has adopted an interest rate risk policy that establishes maximum decreases in the percentage change in net interest margin of 5% in a 100 basis point rate shift and 10% in a 200 basis point rate shift.

No assurance can be given that the actual net interest income would increase or decrease by such amounts in response to a 100 or 200 basis point increase or decrease in the prime rate because it is also affected by many other factors. The results above are based on one-time "shock" moves and do not take into account any management response or mitigating action.

Interest rate sensitivity analysis is also used to measure the Company's interest risk by computing estimated changes in the Economic Value of Equity (EVE) of First Mid Bank under various interest rate shocks. EVE is determined by calculating the net present value of each asset and liability category by rate shock. The net differential between assets

and liabilities is the Economic Value of Equity. EVE is an expression of the long-term interest rate risk in the balance sheet as a whole. The following tables present, in thousands, First Mid Bank's projected change in EVE for the various rate shock levels at December 31, 2006 and December 31, 2005. All market risk sensitive instruments presented in the tables are held-to-maturity or available-for-sale. First Mid Bank has no trading securities.

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	Changes In Interest Rates (basis points)	Change in Economic Value of Equity Amount of Change ($000)	Percent of Change
December 31, 2006	+200 bp	$ (18,814)	(16.4)%
	+100 bp	(9,827)	(8.6)%
	-200 bp	(4,514)	(3.9)%
	-100 bp	2,369	2.1%
December 31, 2005	+200 bp	$ (9,181)	(8.6)%
	+100 bp	(3,785)	(3.5)%
	-200 bp	(6,194)	(5.8)%
	-100 bp	1,439	1.3%

As indicated above, at December 31, 2006, in the event of a sudden and sustained increase in prevailing market interest rates, First Mid Bank's EVE would be expected to decrease, and in the event of a sudden and sustained decrease in prevailing market interest rates, First Mid Bank's EVE would be expected to increase. At December 31, 2006, First Mid Bank's estimated changes in EVE were within the First Mid Bank's policy guidelines that normally allow for a change in capital of +/-10% from the base case scenario under a 100 basis point shock and +/- 20% from the base case scenario under a 200 basis point shock.

Computation of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, loan prepayments and declines in deposit balances, and should not be relied upon as indicative of actual results. Further, the computations do not contemplate any actions First Mid Bank may undertake in response to changes in interest rates.

Certain shortcomings are inherent in the method of analysis presented in the computation of EVE. Actual values may differ from those projections set forth in the table, should market conditions vary from assumptions used in the preparation of the table. Certain assets, such as adjustable-rate loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. In addition, the proportion of adjustable-rate loans in First Mid Bank's portfolio change in future periods as market rates change. Further, in the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in the table. Finally, the ability of many borrowers to repay their adjustable-rate debt may decrease in the event of an interest rate increase.
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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Consolidated Balance Sheets				
December 31, 2006 and 2005				
(In thousands, except share data)		**2006**		**2005**
Assets				
Cash and due from banks:				
Non-interest bearing	$	20,266	$	19,131
Interest bearing		200		426
Federal funds sold		1,370		-
Cash and cash equivalents		21,836		19,557
Investment securities:				
Available-for-sale, at fair value		184,266		155,841
Held-to-maturity, at amortized cost (estimated fair value of $1,346 and $1,442 at December 31, 2006 and 2005, respectively)		1,323		1,412
Loans held for sale		2,234		1,778
Loans		721,334		636,355
Less allowance for loan losses		(5,876)		(4,648)
Net loans		715,458		631,707
Interest receivable		8,417		6,410
Premises and equipment, net		16,293		15,168
Goodwill, net		17,363		9,034
Intangible assets, net		5,148		2,778
Other assets		8,221		6,888
Total assets	$	980,559	$	850,573
Liabilities and Stockholders' Equity				
Deposits:				
Non-interest bearing	$	121,405	$	95,305
Interest bearing		649,190		553,764
Total deposits		770,595		649,069
Securities sold under agreements to repurchase		66,693		67,380
Interest payable		2,445		1,717
Other borrowings		37,800		44,500
Junior subordinated debentures		20,620		10,310
Other liabilities		6,620		5,271
Total liabilities		904,773		778,247
Stockholders' Equity				
Common stock, $4 par value; authorized 18,000,000 shares; issued 5,701,924 shares in 2006 and 5,633,621 shares in 2005		22,808		22,534
Additional paid-in capital		21,261		19,439
Retained earnings		68,625		60,867
Deferred compensation		2,629		2,440
Accumulated other comprehensive income (loss)		19		(739)
Less treasury stock at cost, 1,414,179 shares in 2006 and 1,241,359 shares in 2005		(39,556)		(32,215)
Total stockholders' equity		75,786		72,326
Total liabilities and stockholders' equity	$	980,559	$	850,573

See accompanying notes to consolidated financial statements.

Consolidated Statements of Income						
For the years ended December 31, 2006, 2005 and 2004						
(In thousands, except per share data)		**2006**		**2005**		**2004**
Interest income:						
Interest and fees on loans	$	46,988	$	38,071	$	33,793
Interest on investment securities:						
Taxable		7,490		5,313		4,860
Exempt from federal income tax		771		871		1,193
Interest on federal funds sold		276		285		103
Interest on deposits with other financial institutions		31		40		75
Total interest income		55,556		44,580		40,024
Interest expense:						
Interest on deposits		18,586		11,719		9,122
Interest on securities sold under agreements						
to repurchase		2,411		1,496		455
Interest on FHLB advances		1,562		1,536		1,484
Interest on federal funds purchased		159		33		3
Interest on subordinated debt		1,315		643		382
Interest on other debt		679		260		198
Total interest expense		24,712		15,687		11,644
Net interest income		30,844		28,893		28,380
Provision for loan losses		760		1,091		588
Net interest income after provision for loan losses		30,084		27,802		27,792
Other income:						
Trust revenues		2,489		2,356		2,254
Brokerage commissions		533		383		428
Insurance commissions		1,689		1,567		1,447
Service charges		5,308		4,719		4,746
Gains on sales of securities, net		164		373		92
Mortgage banking revenue, net		394		742		522
Other		2,803		2,378		2,150
Total other income		13,380		12,518		11,639
Other expense:						
Salaries and employee benefits		15,418		13,310		13,626
Net occupancy and equipment expense		4,797		4,401		4,259
Amortization of other intangible assets		761		568		623
Stationery and supplies		583		522		518
Legal and professional		1,324		1,553		1,173
Marketing and promotion		945		728		771
Other		4,595		4,303		4,169
Total other expense		28,423		25,385		25,139
Income before income taxes		15,041		14,935		14,292
Income taxes		5,032		5,128		4,541
Net income	$	10,009	$	9,807	$	9,751
Per common share data:						
Basic earnings per share	$	2.31	$	2.22	$	2.17
Diluted earnings per share		2.27		2.16		2.13

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Stockholders' Equity
For the years ended December 31, 2006, 2005 and 2004
(In thousands, except share and per share data)

	Common Stock	Additional Paid-In-Capital	Retained Earnings	Deferred Compensation	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
December 31, 2003	**$ 14,672**	**$ 15,960**	**$ 52,942**	**$ 1,881**	**$ 1,581**	**$ (16,441)**	**$ 70,595**
Comprehensive income:							
Net income	-	-	9,751	-	-	-	9,751
Net unrealized change in available-for-sale investment securities	-	-	-	-	(958)	-	(958)
Total Comprehensive Income							8,793
Cash dividends on common stock ($.45 per share)	-	-	(2,023)	-	-	-	(2,023)
Issuance of 39,481 common shares pursuant to the Dividend Reinvestment Plan	105	1,143	-	-	-	-	1,248
Issuance of 6,421 common shares pursuant to the Deferred Compensation Plan	20	188	-	-	-	-	208
Issuance of 8,225 common shares pursuant to the First Retirement & Savings Plan	29	240	-	-	-	-	269
Purchase of 319,618 treasury shares	-	-	-	-	-	(10,365)	(10,365)

Deferred compensation	-	-	-	287	-	(287)	-
Tax benefit related to deferred compensation distributions	-	-	-	36	-	-	36
Issuance of 22,937 common shares pursuant to the exercise of stock options	79	246	-	-	-	-	325
Tax benefit related to exercise of incentive stock options	-	58	-	-	-	-	58
Tax benefit related to exercise of non-qualified stock options	-	10	-	-	-	-	10
3-for-2 stock split in the form of 50% stock dividend	7,411	-	(7,411)	-	-	-	-
December 31, 2004	**$ 22,316**	**$ 17,845**	**$ 53,259**	**$ 2,204**	**$ 623**	**$ (27,093)**	**$ 69,154**
Comprehensive income:							
Net income	-	-	9,807	-	-	-	9,807
Net unrealized change in available-for-sale investment securities	-	-	-	-	(1,362)	-	(1,362)
Total Comprehensive Income							8,445
Cash dividends on common stock ($.50 per share)	-	-	(2,199)	-	-	-	(2,199)
Issuance of 17,105 common shares pursuant to the Dividend Reinvestment Plan	68	631	-	-	-	-	699
Issuance of 3,622 common shares pursuant to the Deferred Compensation Plan	14	133	-	-	-	-	147

Issuance of 8,001 common shares pursuant to the First Retirement & Savings Plan	32	292	-	-	-	-	324
Purchase of 119,813 treasury shares	-	-	-	-	-	(4,851)	(4,851)
Deferred compensation	-	-	-	271	-	(271)	-
Tax benefit related to deferred compensation distributions	-	52	-	(35)	-	-	17
Issuance of 25,996 common shares pursuant to the exercise of stock options	104	363	-	-	-	-	467
Tax benefit related to exercise of incentive stock options	-	115	-	-	-	-	115
Tax benefit related to exercise of non-qualified stock options	-	8	-	-	-	-	8
December 31, 2005	**$ 22,534**	**$ 19,439**	**$ 60,867**	**$ 2,440**	**$ (739)**	**$ (32,215)**	**$ 72,326**

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Consolidated Statements of Changes in Stockholders' Equity
For the years ended December 31, 2006, 2005 and 2004
(In thousands, except share and per share data)

	Common Stock	Additional Paid-In-Capital	Retained Earnings	Deferred Compensation	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
December 31, 2005	**$ 22,534**	**$ 19,439**	**$ 60,867**	**$ 2,440**	**$ (739)**	**$ (32,215)**	**$ 72,326**
Comprehensive income:							
Net income	-	-	10,009	-	-	-	10,009
Net unrealized change in available-for-sale investment securities	-	-	-	-	758	-	758
Total Comprehensive Income							10,767
Cash dividends on common stock ($.52 per share)	-	-	(2,251)	-	-	-	(2,251)
Issuance of 18,664 common shares pursuant to the Dividend Reinvestment Plan	75	682	-	-	-	-	757
Issuance of 3,601 common shares pursuant to the Deferred Compensation Plan	15	132	-	-	-	-	147
Issuance of 2,724 common shares pursuant to the First Retirement & Savings Plan	11	102	-	-	-	-	113
Purchase of 172,820 treasury shares	-	-	-	-	-	(7,152)	(7,152)
Deferred compensation	-	-	-	189	-	(189)	-
	-	7	-	-	-	-	7

Tax benefit related to deferred compensation distributions							
Issuance of 43,314 common shares pursuant to the exercise of stock options	173	571	-	-	-	-	744
Tax benefit related to exercise of incentive stock options	-	52	-	-	-	-	52
Tax benefit related to exercise of non-qualified stock options	-	98	-	-	-	-	98
Vested stock options compensation expense	-	178	-	-	-	-	178
December 31, 2006	**$ 22,808**	**$ 21,261**	**$ 68,625**	**$ 2,629**	**$ 19**	**$ (39,556)**	**$ 75,786**

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Cash Flows						
For the years ended December 31, 2006, 2005 and 2004						
(In thousands)		**2006**		**2005**		**2004**
Cash flows from operating activities:						
Net income	$	10,009	$	9,807	$	9,751
Adjustments to reconcile net income to net cash provided by operating activities:						
Provision for loan losses		760		1,091		588
Depreciation, amortization and accretion, net		1,670		1,489		2,450
Compensation expense for vested stock options		178		-		-
Gain on sales of securities, net		(164)		(373)		(92)
Loss on sales of other real property owned, net		32		236		76
Gain on sales of loans held for sale, net		(452)		(845)		(595)
Deferred income taxes		340		238		178
(Increase) decrease in accrued interest receivable		(888)		(1,005)		165
Increase in accrued interest payable		479		211		278
Origination of loans held for sale		(34,519)		(62,278)		(44,019)
Proceeds from sales of loans held for sale		34,515		64,034		42,675
Decrease (increase) in other assets		(2,698)		(612)		794
(Decrease) increase in other liabilities		989		(582)		(1,068)
Net cash provided by operating activities		10,251		11,411		11,181
Cash flows from investing activities:						
Proceeds from sales of securities available-for-sale		21,927		45,819		5,137
Proceeds from maturities of securities available-for-sale		63,875		96,189		96,442
Proceeds from maturities of securities held-to-maturity		176		140		125
Purchases of securities available-for-sale		(59,481)		(130,069)		(95,502)
Purchases of securities held-to-maturity		-		(264)		-
Net increase in loans		(30,146)		(42,259)		(43,479)
Purchases of premises and equipment		(1,272)		(1,416)		(889)
Proceeds from sales of other real property owned		338		822		924
Payment related to acquisition, net of cash and cash equivalents acquired		(12,062)		-		-
Net cash used in investing activities		(16,645)		(31,038)		(37,242)
Cash flows from financing activities:						
Net increase (decrease) in deposits		13,412		(1,171)		35,248
Increase in federal funds purchased		2,800		4,000		-
(Decrease) increase in repurchase agreements		(687)		7,545		(40)
Decrease in short-term FHLB advances		(25,000)		(2,300)		(5,000)
Proceeds from long-term FHLB advances		15,000		12,000		-
Repayment of long-term FHLB advances		(5,000)		-		-
		(5,500)		900		(5,025)

Proceeds from (Repayment of) short-term debt			
Proceeds from long-term debt	15,500	-	-
Repayment of long-term debt	(4,500)	-	-
Issuance of junior subordinated debentures	10,310	-	10,000
Proceeds from issuance of common stock	1,004	938	802
Purchase of treasury stock	(7,152)	(4,851)	(10,365)
Dividends paid on common stock	(1,514)	(1,431)	(954)
Net cash provided by financing activities	8,673	15,630	24,666
Increase (decrease) in cash and cash equivalents	2,279	(3,997)	(1,395)
Cash and cash equivalents at beginning of year	19,557	23,554	24,949
Cash and cash equivalents at end of year	$ 21,836	$ 19,557	$ 23,554
Supplemental disclosures of cash flow information			
Cash paid during the year for:			
Interest	$ 23,984	$ 15,476	$ 11,366
Income taxes	4,851	5,115	4,658
Supplemental disclosure of noncash investing and financing activities:			
Loans transferred to real estate owned	$ 1,342	$ 454	$ 1,250
Dividends reinvested in common shares	757	699	1,248
Net tax benefit related to option and deferred compensation plans	157	140	104

See accompanying notes to consolidated financial statements.

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Notes To Consolidated Financial Statements
December 31, 2006, 2005 and 2004
(Table dollar amounts in thousands, except share data)

Note 1 - Summary of Significant Accounting Policies

Basis of Accounting and Consolidation

The accompanying consolidated financial statements include the accounts of First Mid-Illinois Bancshares, Inc. ("Company") and its wholly-owned subsidiaries: Mid-Illinois Data Services, Inc. ("MIDS"), First Mid-Illinois Bank & Trust, N.A. ("First Mid Bank") and The Checkley Agency, Inc. ("Checkley"). All significant intercompany balances and transactions have been eliminated in consolidation. Certain amounts in the prior years' consolidated financial statements have been reclassified to conform to the 2006 presentation and there was no impact on net income or stockholders' equity from these reclassifications. The Company operates as a one-segment entity for financial reporting purposes. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America. Following is a description of the more significant of these policies.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from these estimates. Material estimates that are particularly susceptible to significant change related to the determination of the allowance for loan losses. In connection with the determination of the allowance for loan losses, management obtains independent appraisals for significant properties.

Cash Equivalents

For purposes of reporting cash flows, cash equivalents include amounts due from banks and federal funds sold. Generally, federal funds are sold for one-day periods.

Investment Securities

The Company classifies its debt securities into one or more of three categories: held-to-maturity, available-for-sale, or trading. Held-to-maturity securities are those which management has the positive intent and ability to hold to maturity. Available-for-sale securities are those securities which management may sell prior to maturity as a result of changes in interest rates, prepayment factors, or as part of the Company's overall asset and liability strategy. Trading securities are those securities bought and held principally for the purpose of selling them in the near term. The Company had no securities designated as trading during 2006, 2005 or 2004.

Held-to-maturity securities are recorded at cost adjusted for amortization of premiums and accretion of discounts to the earlier of the call date or maturity date using the interest method.

Available-for-sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related income tax effect, are excluded from income and reported as a separate component of stockholders' equity. If a decrease in the fair value of a security is expected to be other than temporary, then the security is written down to its fair value through a charge to income and a new cost basis is established for the security.

Realized gains and losses on the sale of investment securities are recorded using the specific identification method.

Loans

Loans are stated at the principal amount outstanding net of unearned discounts, unearned income and the allowance for loan losses. Unearned income includes deferred loan origination fees reduced by loan origination costs and is amortized to interest income over the life of the related loan using methods that approximate the effective interest rate method. Interest on substantially all loans is credited to income based on the principal amount outstanding.

The Company's policy is to discontinue the accrual of interest income on any loan that becomes ninety days past due as to principal or interest or earlier when, in the opinion of management there is reasonable doubt as to the timely collection of principal or interest. Nonaccrual loans are returned to accrual status when, in the opinion of management, the financial position of the borrower indicates there is no longer any reasonable doubt as to the timely collectibility of interest or principal.

Loans expected to be sold are classified as held for sale in the consolidated financial statements and are recorded at the lower of aggregate cost or market value, taking into consideration future commitments to sell the loans.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level deemed appropriate by management to provide for probable losses inherent in the loan portfolio. The allowance is based on a continuing review of the loan portfolio, the underlying value of the collateral securing the loans, current economic conditions and past loan loss experience. Loans that are deemed to be uncollectible are charged off to the allowance. The provision for loan losses and recoveries are credited to the allowance.

Management, considering current information and events regarding the borrowers' ability to repay their obligations, considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the note agreement, including principal and interest. The amount of the impairment is measured based on the fair value of the collateral, if the loan is collateral dependent, or alternatively, at the present value of expected future cash flows discounted at the loan's effective interest rate. Certain homogeneous loans such as residential real estate mortgage and installment loans are excluded from the impaired loan provisions. Interest income on impaired loans is recorded when cash is received and only if principal is considered to be fully collectible.

Premises and Equipment

Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation and amortization is determined principally by the straight-line method over the estimated useful lives of the assets.

Goodwill and Intangible Assets

The Company has goodwill from business combinations, identifiable intangible assets assigned to core deposit relationships and customer lists acquired, and intangible assets arising from the rights to service mortgage loans for others.

Identifiable intangible assets generally arise from branches acquired that the Company accounted for as purchases. Such assets consist of the excess of the purchase price over the fair value of net assets acquired, with specific amounts assigned to core deposit relationships and customer lists primarily related to insurance agency. Intangible assets are amortized by the straight-line method over various periods up to fifteen years. Management reviews intangible assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

The Company recognizes as a separate asset the rights to service mortgage loans for others. Mortgage servicing rights are not subject to SFAS 142, but are amortized in proportion to and over the period of estimated net servicing income and are subject to periodic impairment testing.

Income Taxes

The Company and its subsidiaries file consolidated federal and state income tax returns with each organization computing its taxes on a separate company basis. Amounts provided for income tax expense are based on income reported for financial statement purposes rather than amounts currently payable under tax laws.

Deferred tax assets and liabilities are recognized for future tax consequences attributable to the temporary differences existing between the financial statement carrying amounts of assets and liabilities and their respective tax basis, as well as operating loss and tax credit carry forwards. To the extent that current available evidence about the future raises doubt about the realization of a deferred tax asset, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a

change in tax rates is recognized as an increase or decrease in income tax expense in the period in which such change is enacted.

Trust Department Assets

Assets held in fiduciary or agency capacities are not included in the consolidated balance sheets since such items are not assets of the Company or its subsidiaries. Fees from trust activities are recorded on an cash basis over the period in which the service is provided. Fees are a function of the market value of assets managed and administered, the volume of transactions, and fees for other services rendered, as set forth in the underlying client agreement with the Wealth Management department of First Mid Bank. This revenue recognition involves the use of estimates and assumptions, including components that are calculated based on asset valuations and transaction volumes. Any out of pocket expenses or services not typically covered by the fee schedule for trust activities are charged directly to the trust account on a gross basis as trust revenue is incurred. The Company manages or administers 1,190 accounts with assets totaling approximately $431,640,000.

Stock Split

On July 16, 2004, the Company effected a three-for-two stock split in the form of a 50% stock dividend. Par value remained at $4 per share. The stock split increased the Company's outstanding common shares from 2,981,539 to 4,472,309 shares. All share and per share amounts have been restated for years prior to 2004 to give retroactive recognition to the stock split.

Treasury Stock

Treasury stock is stated at cost. Cost is determined by the first-in, first-out method.

Stock Options

The Company has a stock-based compensation plan, which is described more fully in Note 15. Prior to 2006, the Company accounted for this plan under the recognition and measurement principles of APB Opinion No. 25, “Accounting for Stock Issued to Employees” (“APB No. 25”), and related Interpretations. Accordingly, in 2005 and 2004, no stock-based employee compensation cost was recognized in the Statements of Income as all options granted had an exercise price equal to the market value of the underlying common stock on the grant date.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R using the modified prospective application method. Accordingly, after January 1, 2006, the Company began expensing the fair value of stock options granted, modified, repurchased or cancelled. Additionally, compensation cost for a portion of the awards for which requisite services have not yet been rendered that are outstanding as of January 1, 2006 are being recognized as the requisite service is rendered. As a result of this adoption, the Company’s income before income taxes and net income for the year ended December 31, 2006 includes stock option compensation cost of $178,000 and $171,000, respectively, which represents $.04 impact on basic and diluted earnings per share for the year.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 on stock-based employee compensation for the years ended December 31, 2005 and 2004.

		2005		**2004**
Net income, as reported	$	9,807	$	9,751
Stock-based compensation expense determined under				
fair-value-based method, net of related tax effect		(333)		(347)
Pro forma net income	$	9,474	$	9,404
Basic Earnings Per Share:				
As reported	$	2.22	$	2.17
Pro forma		2.14		2.09
Diluted Earnings Per Share:				
As reported	$	2.16	$	2.13
Pro forma		2.08		2.05

Comprehensive Income

The Company’s comprehensive income for the years ended December 31, 2006, 2005 and 2004 is as follows:

		2006		**2005**		**2004**
Net income	$	10,009	$	9,807	$	9,751
Other comprehensive gain (loss):						
Unrealized gains (losses) during the year		1,407		(1,859)		(1,478)
Reclassification adjustment for net						
gains realized in net income		(164)		(373)		(92)
Tax effect		(485)		870		612
Total other comprehensive gain (loss)		758		(1,362)		(958)
Comprehensive income	$	10,767	$	8,445	$	8,793

Note 2 - Earnings Per Share

Basic Earnings per Share (“EPS”) is based on the weighted average number of common shares outstanding. Diluted EPS is computed by using the weighted average number of common shares outstanding, increased by the assumed conversion of stock options, if not anti-dilutive. The components of basic and diluted earnings per common share for the years ended December 31, 2006, 2005, and 2004 are as follows:

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	2006	2005	2004
Basic Earnings per Share:			
Net income available to common stockholders	$ 10,009,000	$ 9,807,000	$ 9,751,000
Weighted average common shares outstanding	4,340,215	4,423,186	4,499,092
Basic earnings per common share	$ 2.31	$ 2.22	$ 2.17
Diluted Earnings per Share:			
Net income available to common stockholders	$ 10,009,000	$ 9,807,000	$ 9,751,000
Weighted average common shares outstanding	4,340,215	4,423,186	4,499,092
Assumed conversion of stock options	71,304	124,481	88,967
Diluted weighted average common shares outstanding	4,411,519	4,547,667	4,588,059
Diluted earnings per common share	$ 2.27	$ 2.16	$ 2.13

Note 3 - Cash and Due from Banks

Aggregate cash and due from bank balances of $802,000 at December 31, 2005, were maintained in satisfaction of statutory reserve requirements of the Federal Reserve Bank. No cash and due from bank balance was required to be maintained at the Federal Reserve Bank on December 31, 2006 based upon First Mid Bank’s account activity.

Note 4 - Investment Securities

The amortized cost, gross unrealized gains and losses and estimated fair values of available-for-sale and held-to-maturity securities by major security type at December 31, 2006 and 2005 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
2006				
Available-for-sale:				
U.S. Treasury securities and obligations of U.S. government corporations and Agencies	$ 140,924	$ 545	$ (836)	$ 140,633
Obligations of states and political subdivisions	15,314	161	(19)	15,456
Mortgage-backed securities	15,491	23	(331)	15,183
Federal Home Loan Bank stock	3,727	-	-	3,727
Other securities	8,778	489	-	9,267
Total available-for-sale	$ 184,234	$ 1,218	$ (1,186)	$ 184,266
Held-to-maturity:				
Obligations of states and political subdivisions	$ 1,323	$ 23	$ -	$ 1,346
2005				
Available-for-sale:				
U.S. Treasury securities and obligations of U.S. government corporations and Agencies	$ 108,506	$ 31	$ (1,500)	$ 107,037
Obligations of states and political subdivisions	15,417	239	(50)	15,606
Mortgage-backed securities	20,046	25	(442)	19,629
Federal Home Loan Bank stock	5,557	-	-	5,557
Other securities	7,526	486	-	8,012
Total available-for-sale	$ 157,052	$ 781	$ (1,992)	$ 155,841
Held-to-maturity:				
Obligations of states and political subdivisions	$ 1,412	$ 30	$ -	$ 1,442

Proceeds from sales of investment securities, realized gains and losses and income tax expense and benefit were as follows during the years ended December 31, 2006, 2005 and 2004:

	2006	2005	2004
Proceeds from sales	$ 21,927	$ 45,819	$ 5,137
Gross gains	165	402	92
Gross losses	1	29	-
Income tax expense	57	132	32

With the exception of U.S. governmental agencies and corporations, the Company did not hold any securities of a single issuer, payable from and secured by the same source of revenue or taxing authority, the book value of which exceeded 10% of stockholders' equity at December 31, 2006 or 2005.

The following table presents the aging of gross unrealized losses and fair value by investment category as of December 31, 2006 and 2005:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2006:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 25,877	$ (54)	$ 51,637	$ (782)	$ 77,514	$ (836)
Obligations of states and political subdivisions	1,325	(7)	1,591	(12)	2,916	(19)
Mortgage-backed securities	-	-	13,550	(331)	13,550	(331)
Total	$ 27,202	$ (61)	$ 66,778	$ (1,125)	$ 93,980	$ (1,186)
December 31, 2005:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 42,377	$ (390)	$ 53,798	$ (1,110)	$ 96,175	$ (1,500)
Obligations of states and political subdivisions	2,998	(50)	-	-	2,998	(50)
Mortgage-backed securities	10,268	(264)	8,146	(178)	18,414	(442)
Total	$ 55,643	$ (704)	$ 61,944	$ (1,288)	$ 117,587	$ (1,992)

Management does not believe any individual unrealized loss as of December 31, 2006 or 2005 represents an other than temporary impairment.

At December 31, 2006, the unrealized losses reported for U.S. agency securities relate to ten securities issued by Federal Home Loan Bank. These unrealized losses are primarily attributable to changes in interest rates and individually were 2.7% or less of their respective amortized cost basis. The unrealized losses reported for obligations of states and political subdivisions relate primarily to five securities issued by two municipalities. These unrealized losses are also primarily attributable to changes in interest rates and individually were 1.4% or less of their respective

amortized cost basis. The unrealized losses reported for mortgage-backed securities relate primarily to six securities issued by FHLMC and FNMA. These unrealized losses are also primarily attributable to changes in interest rates and individually were 3.6% or less of their respective amortized cost basis.

At December 31, 2005, the unrealized losses reported for U.S. agency securities relate to ten securities issued by Federal Home Loan Bank. These unrealized losses are primarily attributable to changes in interest rates and individually were 3.5% or less of their respective amortized cost basis. The unrealized losses reported for mortgage-backed securities relate primarily to three securities issued by FHLMC and FNMA. These unrealized losses are also primarily attributable to changes in interest rates and individually were 2.5% or less of their respective amortized cost basis.

The Company has both the intent and ability to hold the securities included in the above table for a time necessary to recover the amortized cost.

Maturities of investment securities were as follows at December 31, 2006. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
Available-for-sale:		
Due in one year or less	$ 22,866	$ 22,801
Due after one-five years	91,086	90,694
Due after five-ten years	40,395	40,653
Due after ten years	14,396	14,935
	168,743	169,083
Mortgage-backed securities	15,491	15,183
Total available-for-sale	$ 184,234	$ 184,266
Held-to-maturity:		
Due in one year or less	$ 145	$ 145
Due after one-five years	510	524
Due after five-ten years	344	349
Due after ten-years	324	327
Total held-to-maturity	$ 1,323	$ 1,345
Total investment securities	$ 185,557	$ 185,611

Investment securities of approximately $158,547,000 and $136,787,000 at December 31, 2006 and 2005, respectively, were pledged to secure public deposits and repurchase agreements and for other purposes as permitted or required by law.

Note 5 - Loans

A summary of loans at December 31, 2006 and 2005 follows:

	2006	2005
Commercial, financial and agricultural	$ 161,088	$ 150,596
Real estate mortgage	510,735	450,435
Installment	47,017	34,384
Other	4,731	2,715
Total gross loans	723,571	638,130
Less unearned discount	3	3
Net loans	$ 723,568	$ 638,133

The real estate mortgage loan balance in the above table includes loans held for sale of $2,234,000 and $1,778,000 at December 31, 2006 and 2005, respectively.

The aggregate principal balances of nonaccrual, past due ninety days or more and renegotiated loans were $3,668,000 and $3,458,000 at December 31, 2006 and 2005, respectively. Interest income which would have been recorded under the original terms of such nonaccrual or renegotiated loans totaled $123,000, $99,000 and $169,000 in 2006, 2005 and 2004, respectively.

Impaired loans are defined as those loans where it is probable that amounts due according to contractual terms, including principal and interest, will not be collected. Both nonaccrual and renegotiated loans meet this definition. The Company evaluates all individual loans on nonaccrual or renegotiated with a balance over $100,000 for impairment. Impaired loans are measured by the Company at the present value of expected future cash flows or, alternatively, if the loan is collateral dependant, at the fair value of the collateral. Known losses of principal on these loans have been charged off. Interest income on nonaccrual loans is recognized only at the time cash is received. Interest income on renegotiated loans is recorded according to the most recently agreed upon contractual terms.

The following table presents information on impaired loans at December 31, 2006 and 2005:

	2006	2005
Impaired loans for which a specific allowance has been provided	$ 657	$ 500
Impaired loans for which no specific allowance has been provided	3,011	2,958
Total loans determined to be impaired	$ 3,668	$ 3,458
Allowance on impaired loans	$ 82	$ 110

	For the year ended December 31,	
	2006	2005
Average recorded investment in impaired loans	$ 3,468	$ 3,577
Cash basis interest income recognized from impaired loans	332	212

Most of the Company’s business activities are with customers located within east central Illinois. At December 31, 2006 and 2005, the Company’s loan portfolio included approximately $109,734,000 and $92,381,000, respectively, of loans to borrowers directly related to the agricultural industry.

Mortgage loans serviced for others by First Mid Bank are not included in the accompanying consolidated balance sheets. The unpaid principal balances of these loans at December 31, 2006 and 2005 were approximately $5,984,000 and $7,605,000, respectively.

Note 6 - Allowance for Loan Losses

Changes in the allowance for loan losses were as follows during the three years ended December 31, 2006, 2005 and 2004:

	2006	2005	2004
Balance, beginning of year	$ 4,648	$ 4,621	$ 4,426
Balance added through acquisition	1,405	-	-
Provision for loan losses	760	1,091	588
Recoveries	219	223	195
Charge-offs	(1,156)	(1,287)	(588)
Balance, end of year	$ 5,876	$ 4,648	$ 4,621

Note 7 - Premises and Equipment, Net

Premises and equipment at December 31, 2006 and 2005 consisted of:

	2006	2005
Land	$ 3,524	$ 3,364
Buildings and improvements	16,365	15,037
Furniture and equipment	11,089	10,782
Leasehold improvements	1,323	1,293
Construction in progress	28	84

Subtotal		32,329		30,559
Accumulated depreciation and amortization		16,036		15,392
Total	$	16,293	$	15,168

Depreciation and amortization expense was $1,612,000, $1,475,000 and $1,721,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

Note 8 - Goodwill and Intangible Assets

The Company has goodwill from business combinations, intangible assets from branch acquisitions, identifiable intangible assets assigned to core deposit relationships and customer lists of insurance agencies acquired, and intangible assets arising from the rights to service mortgage loans for others.

The changes in carrying amount of goodwill for the years ended December 31, 2006 and 2005 were:

		2006		2005
Balance as of January 1	$	12,794	$	12,794
Goodwill acquired during the year		8,329		-
Balance as of December 31	$	21,123	$	12,794

The following table presents gross carrying amount and accumulated amortization by major intangible asset class as of December 31, 2006 and 2005:

		2006				2005		
		Gross Carrying Value		Accumulated Amortization		Gross Carrying Value		Accumulated Amortization
Goodwill not subject to amortization	$	21,123	$	3,760	$	12,794	$	3,760
Intangibles from branch acquisition		3,015		1,961		3,015		1,760
Core deposit intangibles		5,936		2,810		2,805		2,440
Customer list intangibles		1,904		936		1,904		746
Mortgage servicing rights		608		608		608		608
	$	32,586	$	10,075	$	21,126	$	9,314

Total amortization expense for the years ended December 31, 2006, 2005 and 2004 was as follows:

		2006		2005		2004
Intangibles from branch acquisitions	$	201	$	201	$	201
Core deposit intangibles		370		161		190
Mortgage servicing rights		-		15		41
Customer list intangibles		190		191		191
	$	761	$	568	$	623

Estimated amortization expense for each of the five succeeding years is shown in the table below:

In accordance with the provisions of SFAS 142, the Company performed testing of goodwill for impairment as of September 30, 2006 and 2005, and determined, as of each of these dates, that goodwill was not impaired. Management also concluded that the remaining amounts and amortization periods were appropriate for all intangible assets.
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Note 9 - Deposits

As of December 31, 2006 and 2005, deposits consisted of the following:

	2006	2005
Demand deposits:		
Non-interest bearing	$ 121,405	$ 95,305
Interest-bearing	140,038	144,597
Savings	58,888	55,545
Money market	108,867	82,838
Time deposits	341,397	270,784
Total deposits	$ 770,595	$ 649,069

Total interest expense on deposits for the years ended December 31, 2006, 2005 and 2004 was as follows:

	2006	2005	2004
Interest-bearing demand	$ 1,786	$ 1,314	$ 759
Savings	270	212	203
Money market	3,534	1,660	809
Time deposits	12,996	8,533	7,351
Total	$ 18,586	$ 11,719	$ 9,122

As of December 31, 2006, 2005 and 2004, the aggregate amount of time deposits in denominations of more than $100,000 and the total interest expense on such deposits was as follows:

	2006	2005	2004
Outstanding	$ 115,900	$ 103,434	$ 115,333
Interest expense for the year	5,259	3,579	2,956

The following table shows the amount of maturities for all time deposits as of December 31, 2006:

Less than 1 year	$ 296,077
1 year to 2 years	21,977
2 years to 3 years	7,981
3 years to 4 years	10,802
4 years to 5 years	4,481
Over 5 years	79
Total	$ 341,397

In 2006, the Company’s significant deposits included brokered CDs, time deposits with the State of Illinois, and deposit relationships with two public entities. The Company had six brokered CDs at various maturities with a total balance of $22.4 million as of December 31, 2006. State of Illinois time deposits maintained with the Company totaled $3.1 million as of December 31, 2006. These balances are subject to bid annually. In addition, the Company maintains account relationships with various public entities throughout its market areas. Three public entities had total balances of $16.7 million in various checking accounts and time deposits as of December 31, 2006. These balances are subject to change depending upon the cash flow needs of the public entity.

Note 10 - Borrowings

As of December 31, 2006 and 2005 borrowings consisted of the following:

	2006	2005
Federal funds purchased	$ 6,800	$ 4,000
Securities sold under agreements to repurchase	66,693	67,380
Federal Home Loan Bank advances:		
Overnight advances	-	12,000
Fixed-term advances	20,000	23,000
Subordinated debentures	20,620	10,310
Other debt:		
Loans due in one year or less	-	5,500
Loans due after one year	11,000	-
Total	$ 125,113	$ 122,190

Aggregate annual maturities of long-term borrowings at December 31, 2006, are:

2007	$ 7,000
2008	-
2009	11,000
2010	5,000
2011	3,000
Thereafter	25,620
	$ 51,620

FHLB advances represent borrowings by First Mid Bank to economically fund loan demand. The fixed term advances consist of $20 million as follows:

- $7 million advance at 4.00% with a 2-year maturity, due April 15, 2007
- $5 million advance at 4.58% with a 5-year maturity, due March 22, 2010
- $3 million advance at 5.98% with a 10-year maturity, due March 1, 2011, callable quarterly.
- $5 million advance at 4.58% with a 10-year maturity, due July 14, 2016, one year lockout, callable quarterly beginning July, 2007

	2006	2005	2004
Securities sold under agreements to repurchase:			
Maximum outstanding at any month-end	$ 71,516	$ 67,380	$ 63,517
Average amount outstanding for the year	55,389	57,799	55,645

First Mid Bank has collateral pledge agreements whereby it has agreed to keep on hand at all times, free of all other pledges, liens, and encumbrances, whole first mortgages on improved residential property with unpaid principal balances aggregating no less than 133% of the outstanding advances and letters of credit ($250,000 on December 31,

2006) from the FHLB. The securities underlying the repurchase agreements are under the Company's control.
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The Company had debt outstanding of $11 million as of December 31, 2006, on a revolving credit agreement with The Northern Trust Company. This loan was renegotiated on April 24, 2006 in conjunction with obtaining financing for the acquisition of Mansfield. The revolving credit agreement has a maximum available balance of $22.5 million with a term of three years from the date of closing. The interest rate (6.51% as of December 31, 2006) is floating at 1.25% over the federal funds rate when the ratio of senior debt to Tier 1 capital is equal to or below 35% as of the end of the previous quarter and 1.50% over the federal funds rate when the ratio of senior debt to Tier 1 capital is above 35%. Currently senior debt to Tier 1 capital is below 35%. The loan is secured by the common stock of First Mid Bank and subject to a borrowing agreement containing requirements for the Company and First Mid Bank to maintain various operating and capital ratios and also contains requirements for prior lender approval for certain sales of assets, merger activity, the acquisition or issuance of debt and the acquisition of treasury stock. The Company and First Mid Bank were in compliance with the existing covenants at December 31, 2006 and 2005.

On February 27, 2004, the Company completed the issuance and sale of $10 million of floating rate trust preferred securities through First Mid-Illinois Statutory Trust I ("Trust I"), a statutory business trust and wholly-owned unconsolidated subsidiary of the Company, as part of a pooled offering. The Company established Trust I for the purpose of issuing the trust preferred securities. The $10 million in proceeds from the trust preferred issuance and an additional $310,000 for the Company's investment in common equity of the Trust, a total of $10,310 000, was invested in junior subordinated debentures of the Company. The underlying junior subordinated debentures issued by the Company to Trust I mature in 2034, bear interest at three-month London Interbank Offered Rate ("LIBOR") plus 280 basis points, reset quarterly, and are callable, at the option of the Company, at par on or after April 7, 2009. At December 31, 2006 and 2005 the rate was 8.17% and 6.95%, respectively. The Company used the proceeds of the offering for general corporate purposes.

On April 26, 2006, the Company completed the issuance and sale of $10 million of fixed/floating rate trust preferred securities through First Mid-Illinois Statutory Trust II ("Trust II"), a statutory business trust and wholly-owned unconsolidated subsidiary of the Company, as part of a pooled offering. The Company established Trust II for the purpose of issuing the trust preferred securities. The $10 million in proceeds from the trust preferred issuance and an additional $310,000 for the Company's investment in common equity of Trust II, a total of $10,310 000, was invested in junior subordinated debentures of the Company. The underlying junior subordinated debentures issued by the Company to Trust II mature in 2036, bear interest at a fixed rate of 6.98% (three-month LIBOR plus 160 basis points) paid quarterly and converts to floating rate (LIBOR plus 160 basis points) after June 15, 2011. The net proceeds to the Company were used for general corporate purposes, including the Company's acquisition of Mansfield.

The trust preferred securities issued by Trust I and Trust II are included as Tier 1 capital of the Company for regulatory capital purposes. On March 1, 2005, the Federal Reserve Board adopted a final rule that allows the continued limited inclusion of trust preferred securities in the calculation of Tier 1 capital for regulatory purposes. The final rule provides a five-year transition period, ending September 30, 2009, for application of the quantitative limits. The Company does not expect the application of the quantitative limits to have a significant impact on its calculation of Tier 1 capital for regulatory purposes or its classification as well-capitalized.

Note 11 - Regulatory Capital

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Bank holding companies follow minimum regulatory requirements established by the Federal Reserve Board. First Mid Bank follows similar minimum regulatory requirements established for national banks by the OCC. Failure to meet minimum capital requirements can result in the initiation of certain mandatory and possibly additional discretionary action by regulators that, if undertaken, could have a direct material effect on the Company's financial statements.

Quantitative measures established by each regulatory agency to ensure capital adequacy require the reporting institutions to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2006 and 2005, that all capital adequacy requirements have been met.

As of December 31, 2006 and 2005, the most recent notification from the primary regulators categorized First Mid Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios must be maintained as set forth in the table. At December 31, 2006, there are no conditions or events since the most recent notification that management believes have changed this categorization.

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	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2006						
Total Capital (to risk-weighted assets)						
Company	$ 79,132	10.91%	$ 58,019	>8.00%	N/A	N/A
First Mid Bank	85,008	11.83	57,492	> 8.00	$ 71,866	>10.00%
Tier 1 Capital (to risk-weighted assets)						
Company	73,256	10.10	29,009	> 4.00	N/A	N/A
First Mid Bank	79,132	11.01	28,746	> 4.00	43,119	> 6.00
Tier 1 Capital (to average assets)						
Company	73,256	7.56	38,754	> 4.00	N/A	N/A
First Mid Bank	79,132	8.21	38,549	> 4.00	48,187	> 5.00
December 31, 2005						
Total Capital (to risk-weighted assets)						
Company	$ 75,901	11.87%	$ 51,163	>8.00%	N/A	N/A
First Mid Bank	73,913	11.66	50,726	> 8.00	$ 63,407	>10.00%
Tier 1 Capital (to risk-weighted assets)						
Company	71,253	11.14	25,581	> 4.00	N/A	N/A
First Mid Bank	69,265	10.92	25,363	> 4.00	38,044	> 6.00
Tier 1 Capital (to average assets)						
Company	71,253	8.55	33,330	> 4.00	N/A	N/A
First Mid Bank	69,265	8.36	33,152	> 4.00	41,440	> 5.00

Note 12 - Disclosure of Fair Values of Financial Instruments

The Company has determined estimated fair values using the best available information and an estimation methodology suitable for each category of financial instrument. The estimation methodology used, the estimated fair values and the carrying amount at December 31, 2006 and 2005 were as follows:

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Financial instruments for which an active secondary market exists have been valued using quoted available market prices.

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	$ 21,863	$ 21,863	$ 19,557	$ 19,557
Investments available-for-sale	184,266	184,266	155,841	155,841
Investments held-to-maturity	1,323	1,346	1,412	1,442

Financial instrument liabilities with stated maturities and other borrowings have been valued at present value, using a discount rate approximating current market rates for similar assets and liabilities.

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Deposits with stated maturities	$ 341,397	$ 342,810	$ 270,784	$ 270,380
Federal funds purchased	6,800	6,800	4,000	4,000
Securities sold under agreements to repurchase	66,693	66,715	67,380	67,393
Federal Home Loan Bank advances	20,000	20,205	35,000	35,186

Financial instrument liabilities without stated maturities and floating rate debt have estimated fair values equal to both the amount payable on demand and the carrying amount.

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Deposits with no stated maturity	$ 429,198	$ 429,198	$ 378,285	$ 378,285
Floating rate debt	11,000	11,000	5,500	5,500
Junior subordinated debentures	20,620	20,620	10,310	10,310

For loans with floating interest rates, it is assumed that the estimated fair values generally approximate the carrying amount balances. Fixed rate loans have been valued using a discounted present value of projected cash flow. The discount rate used in these calculations is the current rate at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Net loan portfolio (including loans held for sale)	$ 717,692	$ 712,857	$ 633,485	$ 623,882

Off-balance sheet items such as loan commitments and stand-by letters of credit generally approximate their estimated fair values.

Note 13—Deferred Compensation Plan

The Company follows the provisions of the Emerging Issues Task Force Issue No. 97-14, "*Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested*" ("EITF 97-14") for purposes of the First Mid-Illinois Bancshares, Inc. Deferred Compensation Plan ("DCP"). At December 31, 2006, the Company classified the cost basis of its common stock issued and held in trust in connection with the DCP of approximately $2,629,000 as treasury stock. The Company also classified the cost basis of its related deferred compensation obligation of approximately $2,629,000 as an equity instrument (deferred compensation).

The DCP was effective as of June 1984. The purpose of the DCP is to enable directors, advisory directors, and key employees the opportunity to defer a portion of the fees and cash compensation paid by the Company as a means of maximizing the effectiveness and flexibility of compensation arrangements. The Company invests all participants' deferrals in shares of common stock. Dividends paid on the shares are credited to participants' DCP accounts and invested in additional shares. During 2006 and 2005 the Company issued 3,601 common shares and 3,622 common shares, respectively, pursuant to the DCP.

Note 14 - Retirement Plans

The Company has a defined contribution retirement plan which covers substantially all employees and which provides for a Company contribution equal to 4% of each participant's compensation and a Company matching contribution of up to 50% of the first 4% of pre-tax contributions made by each participant. Employee contributions are limited to the 402(g) limit of compensation. The total expense for the plan amounted to $637,000, $591,000 and $570,000 in 2006, 2005 and 2004, respectively. The Company also has two agreements in place to pay $50,000 annually for 20 years from the retirement date to one retired senior officer of the Company and to one current senior officer. Total expense under these two agreements amounted to $82,000, $75,000 and $610,000 in 2006, 2005 and 2004, respectively. The current liability recorded for these two agreements was $796,000 and $768,000, as of December 31, 2006 and 2005, respectively. During the fourth quarter of 2004, the Company revised its estimate for supplemental retirement benefits and made a non-recurring entry of $528,000 to reflect the change in the estimate.

Note 15 - Stock Option Plan

The Company maintains a Stock Incentive Plan ("SI Plan") intended to provide a means whereby directors and certain officers, consultants and advisors can acquire shares of the Company's common stock. The Company believes that such awards better align the interest of its employees and directors with its stockholders. A maximum of 450,000 shares have been authorized under the SI Plan. Options to acquire shares are awarded at an exercise price equal to the fair market value of the shares on the date of grant and have a 10-year term. Options granted to employees vest over a four-year period and options granted to directors vest at the time they are issued.

The fair value of options granted is estimated on the grant date using the Black-Scholes option-pricing model. There were no options granted during 2006 or 2005. The following assumptions were used in estimating the fair value for options granted in 2004. Expected volatility is based on historical volatility of the Company's stock and other factors. The Company uses historical data to estimate option exercise and employee termination within the valuation model; separate groups of employees who have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

	2004
Average expected volatility	17.2%

Average expected dividend yield	1.3%
Average expected term	5.2 yrs
Average risk-free interest rate	3.51%

The total compensation cost recognized in the income statement for 2006 was $178,000 with a related tax benefit of $7,000. There was no compensation cost recorded for stock options for 2005 or 2004.

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A summary of option activity under the SI Plan as of December 31, 2006, 2005 and 2004, and changes during the years then ended is presented below:

	2006			
	Weighted-Average Shares	Weighted-Average Exercise Price	Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, beginning of year	325,035	$ 24.21		
Granted	-	-		
Exercised	(43,312)	17.19		
Forfeited or expired	(5,063)	33.86		
Outstanding, end of year	276,660	$ 25.13	5.83	$ 4,348,000
Exercisable, end of year	204,285	$ 22.03	4.11	$ 3,841,000

	2005			
	Weighted-Average Shares	Weighed-Average Exercise Price	Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, beginning of year	356,656	$ 23.86		
Granted	-	-		
Exercised	(25,996)	17.97		
Forfeited or expired	(5,625)	30.93		
Outstanding, end of year	325,035	$ 24.21	6.49	$ 5,343,000
Exercisable, end of year	197,724	$ 19.73	5.53	$ 4,126,000

	2004			
	Weighted-Average Shares	Weighted-Average Exercise Price	Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, beginning of year	305,343	$ 18.97		
Granted	74,250	41.00		
Exercised	(22,937)	16.70		
Forfeited or expired	-	-		
Outstanding, end of year	356,656	$ 23.86	7.45	$ 5,265,179
Exercisable, end of year	176,380	$ 19.33	6.25	$ 3,353,588

The weighted-average grant-date fair value of options granted during the year 2004 was $7.81. There were no options granted during the years 2006 or 2005. The total intrinsic value of options exercised during the years ended December 31, 2006, 2005 and 2004, was $1,042,000, $587,000, and $479,000, respectively.

A summary of the status of the Company's shares subject to unvested options under the SI Plan as of December 31, 2006, 2005 and 2004, and changes during the years then ended, is presented below:

	2006			2005			2004		
	Shares		Weighted-Average Grant-Date Fair Value	Shares		Weighted-Average Grant-Date Fair Value	Shares		Weighted-Average Grant-Date Fair Value
Unvested, beginning of year	127,311	$	2.97	180,276	$	6.00	165,464	$	4.73
Granted	-		-	-		-	74,250		8.57
Vested	(49,873)		5.75	(47,340)		4.58	(59,438)		4.78
Forfeited	(5,063)		6.04	(5,625)		6.91	-		-
Unvested, end of year	72,375	$	5.83	127,311	$	6.49	180,276	$	6.00

As of December 31, 2006, there was $116,000 of total unrecognized compensation cost related to unvested options granted under the SI Plan. That cost is expected to be recognized over a weighted-average period of three years. The total fair value of shares subject to options that vested during the years ended December 31, 2006, 2005, and 2004, was $287,000, $217,000, and $284,000, respectively.

The following table summarizes information about stock options under the SI plan outstanding at December 31, 2006:

	Options Outstanding				Options Exercisable		
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life		Weighted-Average Exercise Price	Number Exercisable		Weighted-Average Exercise Price
Below $16.00	63,002	2.97	$	14.05	63,002	$	14.05
$16.00 to $40.00	146,439	6.09	$	22.62	110,346	$	21.26
Above $40.00	67,219	7.96	$	41.00	30,937	$	41.00
	276,660	5.83	$	25.13	204,285	$	22.03

Note 16 - Income Taxes

The components of federal and state income tax expense (benefit) for the years ended December 31, 2006, 2005 and 2004 were as follows:

		2006		2005		2004
Current						
Federal	$	4,435	$	4,337	$	3,644
State		257		553		719
Total Current		4,692		4,890		4,363
Deferred						
Federal		299		198		156
State		41		40		22
Total Deferred		340		238		178
Total	$	5,032	$	5,128	$	4,541

Recorded income tax expense differs from the expected tax expense (computed by applying the applicable statutory U.S. federal tax rate of 35% to income before income taxes). During 2006, 2005 and 2004, the Company was in a graduated tax rate position. The principal reasons for the difference are as follows:

	2006	2005	2004
Expected income taxes	$ 5,264	$ 5,227	$ 5,002
Effects of:			
Tax-exempt income	(434)	(433)	(530)
Nondeductible interest expense	45	34	32
State taxes, net of federal taxes	194	385	487
Other items	64	14	(350)
Effect of marginal tax rate	(101)	(99)	(100)
Total	$ 5,032	$ 5,128	$ 4,541

The Company reduced its accrual for taxes in 2004 by $355,000 based upon management's best estimate of future tax liability. There was no such reduction to the 2006 or 2005 accruals. Tax returns filed with the Internal Revenue Service and Illinois Department of Revenue are subject to review by law under a three-year statute of limitations.

The tax effects of the temporary differences that gave rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2006 and 2005 are presented below:

	2006	2005
Deferred tax assets:		
Allowance for loan losses	$ 2,226	$ 1,808
Available-for-sale investment securities	-	472
Deferred compensation	833	759
Supplemental retirement	314	299
Depreciation	51	103
Other	136	79
Total gross deferred tax assets	$ 3,560	$ 3,520
Deferred tax liabilities:		
Deferred loan costs	$ 121	$ 140
Goodwill	637	503
Prepaid expenses	106	115
FHLB stock dividend	331	510
Core deposit premium amortization	176	115
Purchase accounting	805	44
Accumulated accretion	193	67
Other	36	59
Available-for-sale investment securities	12	-
Total gross deferred tax liabilities	$ 2,417	$ 1,553
Net deferred tax assets	$ 1,143	$ 1,967

Net deferred tax assets are recorded in other assets on the consolidated balance sheets. No valuation allowance related to deferred tax assets has been recorded at December 31, 2006 and 2005 as management believes it is more likely than not that the deferred tax assets will be fully realized.

Note 17 - Dividend Restrictions

Banking regulations impose restrictions on the ability of First Mid Bank to pay dividends to the Company. At December 31, 2006, regulatory approval would have been required for aggregate dividends from First Mid Bank to the Company in excess of approximately $3.7 million. The amount of such dividends that could be paid is further restricted by the limitations of sound and prudent banking principles.

Note 18 - Commitments and Contingent Liabilities

First Mid Bank enters into financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include lines of credit, letters of credit and other commitments to extend credit. Each of these instruments involves, to varying degrees, elements of credit, and interest rate and liquidity risk in excess of the amounts recognized in the consolidated balance sheets. The Company uses the same credit policies and requires similar collateral in approving lines of credit and commitments and issuing letters of credit as it does in making loans. The exposure to credit losses on financial instruments is represented by the contractual amount of these instruments. However, the Company does not anticipate any losses from these instruments.

The off-balance sheet financial instruments whose contract amounts represent credit risk at December 31, 2006 and 2005 are as follows:

	2006	2005
Unused commitments including lines of credit:		
Commercial real estate	$ 32,197	$ 28,745
Commercial operating	50,453	46,012
Home Equity	17,021	16,160
Other	26,971	23,178
Total	$ 126,642	$ 114,095
Standby letters of credit	$ 5,244	$ 3,694

Commitments to originate credit represent approved commercial, residential real estate and home equity loans that generally are expected to be funded within ninety days. Lines of credit are agreements by which the Company agrees to provide a borrowing accommodation up to a stated amount as long as there is no violation of any condition established in the loan agreement. Both commitments to originate credit and lines of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the liens and some commitments are expected to expire without being drawn upon, the total amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the financial performance of customers to third parties. Standby letters of credit are primarily issued to facilitate trade or support borrowing arrangements and generally expire in one year or less. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending credit facilities to customers. The maximum amount of credit that would be extended under letters of credit is equal to the total off-balance sheet contract amount of such instrument at December 31, 2006 and 2005. The Company's deferred revenue under standby letters of credit agreements was nominal.

Note 19—Related Party Transactions

Certain officers, directors and principal stockholders of the Company and its subsidiaries, their immediate families or their affiliated companies ("related parties") have loans with one or more of the subsidiaries. These loans are made in the ordinary course of business on substantially the same terms, including interest and collateral, as those prevailing for comparable transactions with others. Loans to related parties totaled approximately $16,091,000 and $17,352,000 at December 31, 2006 and 2005, respectively.

Activity during 2006 was as follows:

Balance at December 31, 2005	$	17,352
New loans		808
Loan repayments		(2,069)
Balance at December 31, 2006	$	16,091

Deposits from related parties held by First Mid Bank at December 31, 2006 and 2005 totaled $6,017,000 and $11,687,000, respectively.

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Note 20—Acquisitions

On May 1, 2006, the Company completed the acquisition, for $24 million in cash, of all of the outstanding common stock of Mansfield and its wholly-owned subsidiary, Peoples State Bank of Mansfield, with locations in Mansfield, Mahomet and Weldon, Illinois, in order to expand its market presence in this area. The Company financed the purchase price through a dividend of $5 million from First Mid Bank, an issuance of $10 million of trust preferred securities and a $9.5 million draw on the Company's line of credit with The Northern Trust Company. Following the completion of the acquisition during the third quarter of 2006, Mansfield merged with and into Peoples State Bank and Peoples State Bank merged with and into First Mid Bank. Following the completion of these mergers, Mansfield and Peoples ceased to exist and Peoples' operations were merged into First Mid Bank's.
The transaction has been accounted for as a purchase, and the results of operations of Mansfield and Peoples since the acquisition date have been included in the consolidated financial statements. The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of this transaction:

Cash and cash equivalents	$	12,193
Investment securities		52,740
Loans		55,770
Less allowance for loan losses		(1,405)
Premises and equipment		1,465
Goodwill		8,329
Core deposit intangibles		3,132
Other asset		1,636
Total assets acquired		133,860
Deposits		108,114
Deferred income taxes		869
Other liabilities		622
Total liabilities assumed		109,605
Net assets acquired	$	24,255

Transaction costs related to the completion of the transaction were approximately $255,000. The fair value of deposits acquired in the transaction exceeded the book value, resulting in a core deposit intangible asset of $3,132,000, which is being amortized over 10 years. The total fair value of the assets and liabilities acquired exceeded the book value, resulting in goodwill of $8,329,000, which is not subject to amortization. The core deposit intangibles and goodwill are not deductible for tax purposes.

The following unaudited pro forma condensed combined financial information presents the results of operations of the Company, including the effects of the purchase accounting adjustments, issuance of trust preferred securities and bank loan, had the acquisition taken place at the beginning of each year.

		For the year ended December 31, 2006		For the year ended December 31, 2005
Net interest income	$	31,806	$	31,946
Provision for loan losses		800		1,171
Non-interest income		13,605		13,183
Non-interest expense		29,331		28,374
Income before income taxes		15,280		15,584
Income tax expense		5,233		5,244

Net income	$	10,047	$	10,340
Earnings per share				
Basic	$	2.31	$	2.34
Diluted	$	2.28	$	2.27
Basic weighted average shares outstanding		4,340,215		4,423,186
Diluted weighted average shares outstanding		4,411,519		4,547,667

The unaudited pro forma condensed combined financial statements do not reflect any anticipated cost savings and revenue enhancements. Additionally, the income statement for the year 2006 includes merger-related expenses. Accordingly, the pro forma results of operations of the Company as of and after the merger may not be indicative of the results that actually would have occurred if the merger had been in effect during the periods presented or of the results that may be attained in the future.

Note 21 - Leases

The Company has several noncancellable operating leases, primarily for property rental of banking buildings, that expire over the next eleven years. These leases generally contain renewal options for periods ranging from one to five years. Rental expense for these leases was $458,000, $421,000 and $296,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

Future minimum lease payments under operating leases are:

		Operating Leases
2007	$	378
2008		460
2009		460
2010		404
2011		405
Thereafter		1,633
Total minimum lease payments	$	3,740

Note 22 - FDIC One-time Assessment Credit

Effective November 17, 2006, the FDIC implemented a one-time credit of $4.7 billion to eligible institutions. The purpose of the credit is to recognize contributions made by certain institutions to capitalize the Bank Insurance Fund and Savings Association Insurance Fund, which have now been merged into the Deposit Insurance Fund. First Mid Bank is an eligible institution and has received notice from the FDIC that its share of the credit is $702,000. This amount is not reflected in the accompanying financial statements as it represents contingent future credits against future insurance assessment payments. As such, the timing and ultimate recoverability of the one-time credit may change.

Note 23- Parent Company Only Financial Statements

Presented below are condensed balance sheets, statements of income and cash flows for the Company:

First Mid-Illinois Bancshares, Inc. (Parent Company)		
Balance Sheets		
December 31,	**2006**	**2005**
Assets		
Cash	$ 100	$ 2,772
Premises and equipment, net	649	677
Investment in subsidiaries	105,268	83,330
Other assets	3,766	3,331
Total Assets	$ 109,783	$ 90,110
Liabilities and Stockholders' equity		
Liabilities		
Dividends payable	$ 1,123	$ 1,143
Debt	31,620	15,810
Other liabilities	1,254	831
Total Liabilities	33,997	17,784
Stockholders' equity	75,786	72,326
Total Liabilities and Stockholders' equity	$ 109,783	$ 90,110

First Mid-Illinois Bancshares, Inc. (Parent Company)			
Statements of Income			
Years ended December 31,	**2006**	**2005**	**2004**
Income:			
Dividends from subsidiaries	$ 15,469	$ 8,906	$ 5,156
Other income	75	38	104
	15,544	8,944	5,260
Operating expenses	3,362	2,383	2,212
Income before income taxes and equity in undistributed earnings of subsidiaries	12,182	6,561	3,048
Income tax benefit	1,353	930	1,202
Income before equity in undistributed earnings of subsidiaries	13,535	7,491	4,250
Equity in undistributed earnings of subsidiaries	(3,526)	2,316	5,501
Net income	$ 10,009	$ 9,807	$ 9,751

First Mid-Illinois Bancshares, Inc. (Parent Company)			
Statements of Cash Flows			
Years ended December 31,	**2006**	**2005**	**2004**
Cash flows from operating activities:			
Net income	$ 10,009	$ 9,807	$ 9,751
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation, amortization, accretion, net	46	10	7
Equity in undistributed earnings of subsidiaries	3,526	(2,316)	(5,501)
(Increase) decrease in other assets	(569)	(690)	209
(Decrease) increase in other liabilities	423	370	(631)
Net cash provided by operating activities	13,435	7,181	3,835
Cash flows from investing activities:			
Cash paid in acquisition	(24,255)	-	-
Net cash used in investing activities	(24,255)	-	-
Cash flows from financing activities:			
Repayment of debt	(10,500)	(3,100)	(11,700)
Proceeds from debt	16,000	4,000	6,675
Issuance of subordinated debt	10,310	-	10,000
Proceeds from issuance of common stock	1,004	937	802
Purchase of treasury stock	(7,152)	(4,851)	(10,365)
Dividends paid on common stock	(1,514)	(1,431)	(954)
Net cash provided by (used in) financing activities	8,148	(4,445)	(5,542)
(Decrease) increase in cash	(2,672)	2,736	(1,707)
Cash at beginning of year	2,772	36	1,743
Cash at end of year	$ 100	$ 2,772	$ 36

Note 24 - Quarterly Financial Data - Unaudited

The following table presents summarized quarterly data for each of the two years ended December 31:

	Quarters ended in 2006			
	March 31	June 30	September 30	December 31
Selected operations data:				
Interest income	$ 11,859	$ 13,651	$ 14,804	$ 15,242
Interest expense	4,719	5,886	6,961	7,146
Net interest income	7,140	7,765	7,843	8,096
Provision for loan losses	193	211	171	185
Net interest income after provision for loan losses	6,947	7,554	7,672	7,911
Other income	3,133	3,415	3,368	3,464
Other expense	6,529	7,137	7,373	7,384
Income before income taxes	3,551	3,832	3,667	3,991
Income taxes	1,147	1,310	1,234	1,341
Net income	$ 2,404	$ 2,522	$ 2,433	$ 2,650
Basic earnings per share	$ 0.55	$ 0.58	$ 0.56	$ 0.62
Diluted earnings per share	$ 0.54	$ 0.57	$ 0.55	$ 0.61

	Quarters ended in 2005			
	March 31	June 30	September 30	December 31
Selected operations data:				
Interest income	$ 10,424	$ 10,873	$ 11,433	$ 11,850
Interest expense	3,349	3,651	4,184	4,503
Net interest income	7,075	7,222	7,249	7,347
Provision for loan losses	187	150	213	541
Net interest income after provision for loan losses	6,888	7,072	7,036	6,806
Other income	3,176	3,068	3,137	3,137
Other expense	6,306	6,494	6,393	6,192
Income before income taxes	3,758	3,646	3,780	3,751
Income taxes	1,323	1,284	1,335	1,186
Net income	$ 2,435	$ 2,362	$ 2,445	$ 2,565
Basic earnings per share	$ 0.55	$ 0.53	$ 0.55	$ 0.59
Diluted earnings per share	$ 0.54	$ 0.52	$ 0.54	$ 0.56

Report of Independent Registered Public Accounting Firm

Audit Committee, Board of Directors and Stockholders
First Mid-Illinois Bancshares, Inc.
Mattoon, Illinois

We have audited the accompanying consolidated balance sheets of First Mid-Illinois Bancshares, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Mid-Illinois Bancshares, Inc. as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2006, in conformity with accounting principals generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of First Mid-Illinois Bancshares, Inc.'s internal control over financial reporting as of December 31, 2006 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 7, 2007 expressed unqualified opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting.

/s/ BKD, LLP
Decatur, Illinois
March 7, 2007

Report of Independent Registered Public Accounting Firm

The Board of Directors
First Mid-Illinois Bancshares, Inc.:

We have audited the accompanying consolidated statements of income, changes in stockholders' equity and cash flows of First Mid-Illinois Bancshares, Inc. and subsidiaries (the Company) for the year ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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

In our opinion, the aforementioned consolidated financial statements present fairly, in all material respects, the results of operations and the cash flows of First Mid-Illinois Bancshares, Inc. and subsidiaries for the year ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP
Chicago, Illinois
March 9, 2005

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

The information called for by Item 9 with respect to changes in accountants is incorporated by reference to the Company's Proxy Statement for the 2007 Annual Meeting of the Company's shareholders under the caption "Independent Public Accountants."

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company's management carried out an evaluation, under the supervision and with the participation of the chief executive officer and the chief financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act of 1934) as of December 31, 2006. Based upon that evaluation, the chief executive officer along with the chief financial officer concluded that the Company's disclosure controls and procedures as of December 31, 2006, are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic filings under the Exchange Act.

Management's Annual Report on Internal Control over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. The Company's internal control over financial reporting is a process designed under the supervision of the Company's chief executive officer and chief financial officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2006 based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in "Internal Control—Integrated Framework." Based on the assessment, management determined that, as of December 31, 2006, the Company's internal control over financial reporting is effective, based on those criteria. Management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2006 has been audited by BKD, LLP, an independent registered public accounting firm, as stated in their report following.

March 7, 2007

/s/ William S. Rowland

William S. Rowland
President and Chief Executive Officer

/s/ Michael L. Taylor

Michael L. Taylor
Chief Financial Officer

Report of Independent Registered Public Accounting Firm

Audit Committee, Board of Directors and Stockholders
First Mid-Illinois Bancshares, Inc.
Mattoon, Illinois

We have audited management's assessment, included in the accompanying Management's Report, that First Mid-Illinois Bancshares, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, management's assessment that First Mid-Illinois Bancshares, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, First Mid-Illinois Bancshares, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of First Mid-Illinois Bancshares, Inc. and subsidiaries as of December 31, 2006 and 2005 and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2006, and our report dated March 7, 2007 expressed an unqualified opinion thereon.

/s/ BKD, LLP

Decatur, Illinois
March 7, 2007

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Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the Company's fourth fiscal quarter of 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY

The information called for by Item 10 with respect to directors and director nominees is incorporated by reference to the Company's Proxy Statement for the 2007 Annual Meeting of the Company's shareholders under the captions "Proposal 1 - Election of Directors" and "Section 16 - Beneficial Ownership Reporting Compliance."

The information called for by Item 10 with respect to executive officers is incorporated by reference to Part I hereof under the caption "Supplemental Item - Executive Officers of the Company."

The information called for by Item 10 with respect to audit committee financial expert is incorporated by reference to the Company's Proxy Statement for the 2007 Annual Meeting of the Company's shareholders under the caption "Report of the Audit Committee to the Board of Directors."

The Company has adopted a code of ethics for senior financial management applicable to the Chief Executive Officer and Chief Financial Officer of the Company. This code of ethics is posted on the Company's website. In the event that the Company amends or waives any provisions of this code of ethics, the Company intends to disclose the same on its website at
www.firstmid.com.

ITEM 11. EXECUTIVE COMPENSATION

The information called for by Item 11 is incorporated by reference to the Company's Proxy Statement for the 2007 Annual Meeting of the Company's shareholders under the captions "Executive Compensation," "Non-qualified Deferred Compensation," Potential Payments Upon Termination or Change in Control of the Company," "Directors' Compensation," Corporate Governance Matters-Compensation Committee Interlocks and Insider Participation," and "Compensation Committee Report."

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

The information called for by Item 12 with respect to equity compensation plans is provided in the table below.

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options (a)	Weighted-average exercise price of outstanding options (b)	Number of securities remaining available for future issuance under equity compensation plans (c)
Equity compensation plans approved by security holders:			
(A) Deferred Compensation Plan	-	-	291,537(1)
(B) Stock Incentive Plan	276,660(2)	$ 25.13(3)	47,063(4)
Equity compensation plans not approved by security holders (5)	-	-	-
Total	276,660	$ 25.13	338,600

(1) Consists of shares issuable with respect to participant deferral contributions invested in common stock.
(2) Consists of stock options.
(3) Represents the weighted-average exercise price of outstanding stock options.
(4) Consists of stock option and/or restricted stock.
(5) The Company does not maintain any equity compensation plans not approved by stockholders.

The Company's equity compensation plans approved by security holders consist of the Deferred Compensation Plan and the Stock Incentive Plan. Additional information regarding each plan is available in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Stock Plans" and Note 15 - "Stock Option Plan" herein.

The information called for by Item 12 with respect to security ownership is incorporated by reference to the Company's Proxy Statement for the 2007 Annual Meeting of the Company's shareholders under the caption "Voting Securities and Principal Holders Thereof."

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information called for by Item 13 is incorporated by reference to the Company's Proxy Statement for the 2007 Annual Meeting of the Company's shareholders under the captions "Certain Relationships and Related Transactions" and "Corporate Governance Matters - Board of Directors."

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information called for by Item 14 is incorporated by reference to the Company's Proxy Statement for the 2007 Annual Meeting of the Company's shareholders under the caption "Fees of Independent Auditors."

PART IV

ITEM 15. EXHIBIT AND FINANCIAL STATEMENT SCHEDULES

(a)(1) and (2) -- Financial Statements and Financial Statement Schedules

The following consolidated financial statements and financial statement schedules of the Company are filed as part of this document under Item 8.

Financial Statements and Supplementary Data:

- Ø Consolidated Balance Sheets -- December 31, 2006 and 2005
- Ø Consolidated Statements of Income -- For the Years Ended December 31, 2006, 2005 and 2004
- Ø Consolidated Statements of Changes in Stockholders' Equity -- For the Years Ended December 31, 2006, 2005 and 2004
- Ø Consolidated Statements of Cash Flows -- For the Years Ended December 31, 2006, 2005 and 2004.

(a)(3) - Exhibits

The exhibits required by Item 601 of Regulation S-K and filed herewith are listed in the Exhibit Index that follows the Signature Page and immediately precedes the exhibits filed.

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FIRST MID-ILLINOIS BANCSHARES, INC.
(Company)

Dated: March 7, 2007

By: /s/ William S. Rowland

William S. Rowland
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on the 7th day of March 2007, by the following persons on behalf of the Company and in the capacities listed.

Signature and Title

/s/ William S. Rowland

William S. Rowland, Chairman of the Board,
President and Chief Executive Officer and Director

/s/ Michael L. Taylor
Michael L. Taylor, Vice President and Chief Financial Officer

/s/ Charles A. Adams
Charles A. Adams, Director

/s/ Kenneth R. Diepholz
Kenneth R. Diepholz, Director

/s/ Joseph R. Dively
Joseph R. Dively, Director

/s/ Steven L. Grissom
Steven L. Grissom, Director

/s/ Daniel E. Marvin, Jr.
Daniel E. Marvin, Jr., Director

/s/ Gary W. Melvin
Gary W. Melvin, Director

/s/ Sara Jane Preston

Sara Jane Preston, Director

/s/ Ray A. Sparks
Ray A. Sparks, Director

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Exhibit Number	Exhibit Index to Annual Report on Form 10-K Description and Filing or Incorporation Reference
2.1	***Agreement and Plan of Merger By and Among First Mid-Illinois Bancshares, Inc., First Mid Merger Company and Mansfield Bancorp, Inc.*** Incorporated by reference to Exhibit 2 to First Mid-Illinois Bancshares, Inc.'s Report on Form 8-K filed with the SEC on February 15, 2006.
3.1	***Restated Certificate of Incorporation and Amendment to Restated Certificate of Incorporation of First Mid-Illinois Bancshares, Inc.*** Incorporated by reference to Exhibit 3(a) to First Mid-Illinois Bancshares, Inc.'s Annual Report on Form 10-K for the year ended December 31, 1987 (File No. 0-13368)
3.2	***Restated Bylaws of First Mid-Illinois Bancshares, Inc. and Amendment thereto*** Incorporated by reference to Exhibit 3.2 to First Mid-Illinois Bancshares, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 0-13368)
4.1	***Rights Agreement, dated as of September 21, 1999, between First Mid-Illinois Bancshares, Inc. and Harris Trust and Savings Bank, as Rights Agent*** Incorporated by reference to Exhibit 4.1 to First Mid-Illinois Bancshares, Inc.'s Registration Statement on Form 8-A filed with the SEC on September 22, 1999
10.1	***Employment Agreement between the Company and William S. Rowland*** Incorporated by reference to Exhibit 10.1 to First Mid-Illinois Bancshares, Inc.'s Report on Form 8-K filed with the SEC on December 16, 2004.
10.2	***Employment Agreement between the Company and John W. Hedges*** Incorporated by reference to Exhibit 10.1 to First Mid-Illinois Bancshares, Inc.'s Report on Form 8-K filed with the SEC on November 3, 2005.
10.3	***First Amendment to Employment Agreement between the Company and John W. Hedges*** (Filed herewith)
10.4	***Employment Agreement between the Company and Michael L. Taylor*** (Filed herewith)
10.5	***Employment Agreement between the Company and Laurel G. Allenbaugh*** (Filed herewith)
10.6	***Employment Agreement between the Company and Christie Wright*** (Filed herewith)
10.7	***Employment Agreement between the Company and Kelly A. Downs*** (Filed herewith)
10.8	***Employment Agreement between the Company and Stanley E. Gilliland*** (Filed herewith)
10.9	***Employment Agreement between the Company and Robert Swift*** (Filed herewith)
10.10	***Amended and Restated Deferred Compensation Plan*** Incorporated by reference to Exhibit 10.4 to First Mid-Illinois Bancshares, Inc.'s Annual Report on Form 10-K for the for the year ended December 31, 2005 (File No 0-13368)
10.11	***1997 Stock Incentive Plan*** Incorporated by reference to Exhibit 10.5 to First Mid-Illinois Bancshares, Inc.'s Annual Report on Form 10-K for the for the year ended December 31, 1998 (File No 0-13368)
10.12	***First Amendment to 1997 Stock Incentive Plan*** Incorporated by reference to Exhibit 10.6 to First Mid-Illinois Bancshares, Inc.'s Annual Report on Form 10-K for the for the year ended December 31, 2005 (File No 0-13368)
10.13	***Second Amendment to 1997 Stock Incentive Plan***

Incorporated by reference to Exhibit 10.7 to First Mid-Illinois Bancshares, Inc.'s Annual Report on Form 10-K for the for the year ended
December 31, 2005 (File No 0-13368)

10.14 ***Supplemental Executive Retirement Plan***
Incorporated by reference to Exhibit 10.8 to First Mid-Illinois Bancshares, Inc.'s Annual Report on Form 10-K for the for the year ended
December 31, 2005 (File No 0-13368)

10.15 ***First Amendment to Supplemental Executive Retirement Plan***
Incorporated by reference to Exhibit 10.9 to First Mid-Illinois Bancshares, Inc.'s Annual Report on Form 10-K for the for the year ended
December 31, 2005 (File No 0-13368)

10.16 ***Participation Agreement (as Amended and Restated) to Supplemental Executive Retirement Plan between the Company and William S. Rowland***
Incorporated by reference to Exhibit 10.10 to First Mid-Illinois Bancshares, Inc.'s Annual Report on Form 10-K for the for the year ended
December 31, 2005 (File No 0-13368)

11.1 ***Statement re: Computation of Earnings Per Share*** (Filed herewith)

21.1 ***Subsidiaries of the Company*** (Filed herewith)

23.1 ***Consent of BKD LLP*** (Filed herewith)

23.2 ***Consent of KPMG LLP (prior year)*** (Filed herewith)

31.1 ***Certification of Chief Executive Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002***

31.2 ***Certification of Chief Financial Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002***

32.1 ***Certification of Chief Executive Officer pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002***

32.2 ***Certification of Chief Financial Officer pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002***

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