

FIRST NATIONAL LINCOLN CORP /ME/
Form 10-Q
November 08, 2006
UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

X Quarterly Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934

For the quarterly period ended September 30, 2006

Commission File Number 0-26589

FIRST NATIONAL LINCOLN CORPORATION

(Exact name of Registrant as specified in its charter)

MAINE 01-0404322

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

MAIN STREET, DAMARISCOTTA, MAINE 04543

(Address of principal executive offices) (Zip code)

(207) 563-3195

Registrant's telephone number, including area code

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

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to such filing requirements for the past 90 days.

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

Yes No

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of November 3, 2006

Common Stock: 9,768,150 shares

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Part I. Financial Information**Selected Financial Data (Unaudited)**

First National Lincoln Corporation and Subsidiary

| <i>Dollars in thousands, except for per share amounts</i> | For the nine months ended | | For the quarters ended | |
|---|----------------------------------|------------|-------------------------------|------------|
| | <u>September 30</u> | | <u>September 30</u> | |
| | 2006 | 2005 | 2006 | 2005 |
| Summary of Operations | | | | |
| Operating Income | \$ 55,154 | \$ 43,174 | \$ 20,075 | \$ 16,092 |
| Operating Expense | 42,146 | 29,927 | 15,626 | 11,403 |
| Net Interest Income | 22,981 | 23,398 | 7,738 | 7,989 |
| Provision for Loan Losses | 900 | 100 | 300 | - |
| Net Income | 9,325 | 9,477 | 3,177 | 3,347 |
| Per Common Share Data | | | | |
| Basic Earnings per Share | \$ 0.95 | \$ 0.98 | \$ 0.32 | \$ 0.34 |
| Diluted Earnings per Share | 0.94 | 0.96 | 0.32 | 0.34 |
| Cash Dividends Declared | 0.450 | 0.390 | 0.155 | 0.135 |
| Book Value | 10.93 | 10.36 | 10.93 | 10.36 |
| Market Value | 16.92 | 19.25 | 16.92 | 19.25 |
| Financial Ratios | | | | |
| Return on Average Equity ¹ | 11.85% | 12.97% | 11.95% | 13.14% |
| Return on Average Tangible Equity ¹ | 16.07% | 17.79% | 16.21% | 18.16% |
| Return on Average Assets ¹ | 1.16% | 1.37% | 1.17% | 1.37% |
| Average Equity to Average Assets | 9.80% | 10.55% | 9.77% | 10.42% |
| Average Tangible Equity to Average Assets | 7.22% | 7.69% | 7.20% | 7.54% |
| Net Interest Margin Tax-Equivalent ¹ | 3.29% | 3.88% | 3.28% | 3.76% |
| Dividend Payout Ratio | 47.37% | 39.80% | 48.44% | 39.71% |
| Allowance for Loan Losses/Total Loans | 0.75% | 0.88% | 0.75% | 0.88% |
| Non-Performing Loans to Total Loans | 0.46% | 0.40% | 0.46% | 0.40% |
| Non-Performing Assets to Total Assets | 0.34% | 0.30% | 0.34% | 0.30% |
| Efficiency Ratio ² | 51.97% | 53.31% | 54.08% | 54.64% |
| At Period End | | | | |
| Total Assets | \$1,095,440 | \$ 993,321 | \$1,095,440 | \$ 993,321 |
| Total Loans | 828,539 | 739,597 | 828,539 | 739,597 |
| Total Investment Securities | 178,954 | 163,439 | 178,954 | 163,439 |
| Total Deposits | 848,048 | 755,324 | 848,048 | 755,324 |
| Total Shareholders' Equity | 106,664 | 101,844 | 106,664 | 101,844 |

¹Annualized using a 365-day basis²The Company uses the following formula in calculating its efficiency ratio:

Non-Interest Expense - Loss on Securities Sales

Tax-Equivalent Net Interest Income + Non-Interest Income Gains on Securities Sales

Item 1 Financial Statements

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

First National Lincoln Corporation

We have reviewed the accompanying interim consolidated financial information of First National Lincoln Corporation and Subsidiary as of September 30, 2006 and 2005, for the three-month and nine-month periods then ended. These financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is to express an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

/s/ Berry, Dunn, McNeil & Parker

Portland, Maine

November 6, 2006

Consolidated Balance Sheets (Unaudited)

First National Lincoln Corporation and Subsidiary

| <i>In thousands of dollars, except per share amounts</i> | September 30, 2006 | December 31, 2005 | September 30, 2005 |
|---|-------------------------------|----------------------|-----------------------|
| Assets | | | |
| Cash and due from banks | \$ 26,512 | \$ 25,982 | \$ 29,507 |
| Overnight funds sold | - | - | 2,500 |
| Cash and cash equivalents | 26,512 | 25,982 | 32,007 |
| Securities available for sale | 45,190 | 54,743 | 49,171 |
| Securities to be held to maturity (fair value \$133,015 at September 30, 2006, \$128,563 at December 31, 2005, and \$114,098 at September 30, 2005) | 133,764 | 129,238 | 114,268 |
| Loans held for sale (fair value approximates cost) | - | - | 40 |
| Loans | 828,539 | 772,338 | 739,597 |
| Less: allowance for loan losses | 6,221 | 6,086 | 6,474 |
| Net loans | 822,318 | 766,252 | 733,123 |
| Accrued interest receivable | 6,677 | 5,005 | 4,759 |
| Premises and equipment | 15,697 | 16,712 | 16,987 |
| Other real estate owned | 1,413 | - | - |
| Goodwill | 27,684 | 27,684 | 27,960 |
| Other assets | 16,185 | 16,593 | 15,006 |
| Total Assets | \$1,095,440 | \$1,042,209 | \$ 993,321 |
| Liabilities | | | |
| Demand deposits | \$ 68,455 | \$ 62,109 | \$ 66,792 |
| NOW deposits | 106,785 | 109,124 | 127,312 |
| Money market deposits | 143,600 | 127,630 | 119,419 |
| Savings deposits | 103,272 | 109,615 | 116,440 |
| Certificates of deposit | 178,164 | 125,741 | 140,450 |
| Certificates \$100,000 and over | 247,772 | 179,745 | 184,911 |
| Total deposits | 848,048 | 713,964 | 755,324 |
| Borrowed funds | 130,300 | 215,189 | 126,647 |
| Other liabilities | 10,428 | 9,604 | 9,506 |
| Total Liabilities | 988,776 | 938,757 | 891,477 |
| Shareholders' Equity | | | |
| Common stock | 98 | 99 | 99 |
| Additional paid-in capital | 45,958 | 47,718 | 47,806 |
| Retained earnings | 59,859 | 54,901 | 52,798 |
| Net unrealized gains on available-for-sale securities | 749 | 734 | 1,141 |
| Total Shareholders' Equity | 106,664 | 103,452 | 101,844 |
| Total Liabilities & Shareholders' Equity | \$1,095,440 | \$1,042,209 | \$ 993,321 |
| Common Stock | | | |
| Number of shares authorized | 18,000,000 | 18,000,000 | 18,000,000 |
| Number of shares issued and outstanding | 9,762,868 | 9,832,777 | 9,827,356 |
| Book value per share | \$ 10.93 | \$ 10.52 | \$ 10.36 |
| See Report of Independent Registered Public Accounting Firm. | | | |

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

Consolidated Statements of Income (Unaudited)

First National Lincoln Corporation and Subsidiary

| <i>In thousands of dollars, except number of shares and per share data</i> | For the nine months ended September 30, | | For the quarters ended September 30, | |
|--|--|-----------|---|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Interest income | | | | |
| Interest and fees on loans | \$40,164 | \$30,619 | \$14,253 | \$11,157 |
| Interest on deposits with other banks | 61 | 9 | 61 | 5 |
| Interest and dividends on investments | 7,250 | 5,701 | 2,515 | 1,976 |
| Total interest income | 47,475 | 36,329 | 16,829 | 13,138 |
| Interest expense | | | | |
| Interest on deposits | 18,539 | 8,978 | 7,486 | 3,911 |
| Interest on borrowed funds | 5,955 | 3,953 | 1,605 | 1,238 |
| Total interest expense | 24,494 | 12,931 | 9,091 | 5,149 |
| Net interest income | 22,981 | 23,398 | 7,738 | 7,989 |
| Provision for loan losses | 900 | 100 | 300 | - |
| Net interest income after provision for loan losses | 22,081 | 23,298 | 7,438 | 7,989 |
| Non-interest income | | | | |
| Investment management and fiduciary income | 1,447 | 1,245 | 474 | 426 |
| Service charges on deposit accounts | 2,054 | 1,779 | 704 | 628 |
| Mortgage origination and servicing income | 361 | 481 | 109 | 106 |
| Other operating income | 3,817 | 3,340 | 1,959 | 1,794 |
| Total non-interest income | 7,679 | 6,845 | 3,246 | 2,954 |
| Non-interest expense | | | | |
| Salaries and employee benefits | 8,207 | 8,349 | 3,037 | 2,875 |
| Occupancy expense | 1,058 | 1,016 | 301 | 319 |
| Furniture and equipment expense | 1,557 | 1,564 | 560 | 529 |
| Amortization of identified intangibles | 213 | 200 | 71 | 71 |
| Other operating expense | 5,717 | 5,767 | 2,266 | 2,460 |
| Total non-interest expense | 16,752 | 16,896 | 6,235 | 6,254 |
| Income before income taxes | 13,008 | 13,247 | 4,449 | 4,689 |
| Applicable income taxes | 3,683 | 3,770 | 1,272 | 1,342 |
| NET INCOME | \$9,325 | \$9,477 | \$3,177 | \$3,347 |
| Earnings per common share: | | | | |
| Basic earnings per share | \$0.95 | \$0.98 | \$0.32 | \$0.34 |
| Diluted earnings per share | \$0.94 | \$0.96 | \$0.32 | \$0.34 |
| Cash dividends declared per share | \$0.450 | \$0.390 | \$0.155 | \$0.135 |
| Weighted average number of shares outstanding | 9,829,157 | 9,717,011 | 9,793,172 | 9,823,370 |
| Incremental shares | 84,199 | 124,417 | 84,310 | 128,621 |

See Report of Independent Registered Public Accounting Firm.

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

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

First National Lincoln Corporation and Subsidiary

| <i>In thousands of dollars except number of shares</i> | Number of common shares | Common stock | Additional paid-in capital | Retained earnings | Net unrealized gains on securities available for sale | Treasury stock | Total shareholders' equity |
|---|-------------------------------|-----------------|-------------------------------|----------------------|---|-------------------|----------------------------------|
| Balance at December 31, 2004 | 7,356,836 | \$74 | \$3,973 | \$46,809 | \$1,959 | \$ - | \$52,815 |
| Net income | - | - | - | 9,477 | - | - | 9,477 |
| Net unrealized loss on securities available for sale, net of tax benefit of \$421 | - | - | - | - | (818) | - | (818) |
| Comprehensive income | - | - | - | 9,477 | (818) | - | 8,659 |
| Cash dividends declared | - | - | - | (3,835) | - | - | (3,835) |
| Payment to repurchase common stock | (162,199) | (1) | (2,773) | - | - | - | (2,774) |
| Proceeds from sale of common stock | 168,121 | 1 | 1,245 | - | - | - | 1,246 |
| Tax benefit of disqualifying disposition of incentive stock option shares | - | - | - | 347 | - | - | 347 |
| Acquisition of FNB Bankshares | 2,464,598 | 25 | 45,361 | - | - | - | 45,386 |
| Balance at September 30, 2005 | 9,827,356 | \$99 | \$47,806 | \$52,798 | \$1,141 | \$ - | \$101,844 |
| Balance at December 31, 2005 | 9,832,777 | \$99 | \$47,718 | \$54,901 | \$734 | \$ - | \$103,452 |
| Net income | - | - | - | 9,325 | - | - | 9,325 |
| Net unrealized gain on securities available for sale, net of taxes of \$12 | - | - | - | - | 15 | - | 15 |
| Comprehensive income | - | - | - | 9,325 | 15 | - | 9,340 |
| Cash dividends declared | - | - | - | (4,422) | - | - | (4,422) |
| Payment to repurchase common stock | (135,503) | (1) | (2,330) | - | - | - | (2,331) |
| Proceeds from sale of common stock | 65,594 | - | 570 | - | - | - | 570 |
| Tax benefit of disqualifying disposition of incentive stock option shares | - | - | - | 55 | - | - | 55 |
| Balance at September 30, 2006 | 9,762,868 | \$98 | \$45,958 | \$59,859 | \$749 | \$ - | \$106,664 |

See Report of Independent Registered Public Accounting Firm.

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

Consolidated Statements of Cash Flows (Unaudited)

First National Lincoln Corporation and Subsidiary

| <i>In thousands of dollars</i> | For nine months ended Sept 30, | |
|---|--------------------------------|-----------|
| | 2006 | 2005 |
| Cash flows from operating activities | | |
| Net income | \$ 9,325 | \$ 9,477 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Depreciation | 1,044 | 958 |
| Provision for loan losses | 900 | 100 |
| Loans originated for resale | (11,248) | (19,222) |
| Proceeds from sales and transfers of loans | 11,248 | 19,773 |
| Net increase in other assets and accrued interest | (1,477) | (817) |
| Net increase in other liabilities | 723 | 2,001 |
| Net amortization (accretion) of premiums (discounts) on investments | (142) | 95 |
| Net acquisition amortization | 194 | 245 |
| Net cash provided by operating activities | 10,567 | 12,610 |
| Cash flows from investing activities | | |
| Proceeds from maturities, payments and calls of securities available for sale | 9,618 | 4,153 |
| Proceeds from maturities, payments and calls of securities to be held to maturity | 13,320 | 20,234 |
| Proceeds from sales of other real estate owned | 551 | - |
| Purchases of securities available for sale | (8) | (683) |
| Purchases of securities to be held to maturity | (17,734) | (35,087) |
| Net increase in loans | (59,048) | (76,656) |
| Capital expenditures | (384) | (1,117) |
| Proceeds from sale of premises and equipment | 355 | - |
| Cash for acquisition, net of cash acquired | - | 3,493 |
| Net cash used in investing activities | (53,330) | (85,663) |
| Cash flows from financing activities | | |
| Net increase in demand deposits, savings, money market and club accounts | 13,634 | 51,587 |
| Net increase in certificates of deposit | 120,570 | 141,208 |
| Repayment on long-term borrowings | - | (37,118) |
| Net decrease in short-term borrowings | (84,872) | (60,459) |
| Payments to repurchase common stock | (2,331) | (2,774) |
| Proceeds from sale of common stock | 570 | 1,246 |
| Dividends paid | (4,278) | (3,400) |
| Net cash provided by financing activities | 43,293 | 90,290 |
| Net increase in cash and cash equivalents | 530 | 17,237 |
| Cash and cash equivalents at beginning of year | 25,982 | 14,770 |
| Cash and cash equivalents at end of period | \$26,512 | \$ 32,007 |
| Interest paid | \$23,596 | \$ 12,285 |
| Income taxes paid | \$ 3,193 | \$ 3,490 |
| Non-cash transactions | | |
| Change in unrealized gain on available for sale securities, net of tax | \$ 15 | \$ (818) |
| Net transfer from loans to other real estate owned | 1,964 | - |
| Fair value of assets acquired | - | 258,631 |
| Less liabilities assumed | - | 214,266 |

See Report of Independent Registered Public Accounting Firm.

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

Notes to Consolidated Financial Statements

First National Lincoln Corporation and Subsidiary

Note 1 Basis of Presentation

First National Lincoln Corporation (the Company) is a financial holding company that owns all of the common stock of The First, N.A. (the Bank). The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of Management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany transactions and balances are eliminated in consolidation. On January 14, 2005, the Company completed the acquisition of FNB Bankshares (FNB) of Bar Harbor, Maine, and operating results include the effect of the FNB acquisition only after the closing date (see Note 8 Pro-Forma Financial Information).

The income reported for the 2006 period is not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2005.

Note 2 Common Stock

On January 20, 2005, the Company announced that its Board of Directors had authorized the repurchase of up to 250,000 shares of the Company's common stock or approximately 2.5% of the outstanding shares. This program ended in July of 2006, with 248,376 shares repurchased under the program at an average price of \$17.15 and at a total cost of \$4,261,000.

On July 21, 2006, the Company announced that its Board of Directors had authorized a new program for the repurchase of up to 250,000 shares of the Company's common stock or approximately 2.5% of the outstanding shares. The Company expects such repurchases to be effected from time to time, in the open market, in private transactions or otherwise, during a period of up to 24 months. The amount and timing of shares to be purchased will be subject to market conditions and will be based on several factors, including the price of the Company's stock and the level of stock issuances under the Company's employee stock plans. No assurance can be given as to the specific timing of the share repurchases or as to whether and to what extent the share repurchase will be consummated. As of September 30, 2006, the Company had repurchased 63,363 shares under the new repurchase plan at an average price of \$17.44 and at a total cost of \$1,105,000.

Note 3 Stock Options

The Company established a shareholder-approved stock option plan in 1995, under which the Company may grant options to its employees for up to 600,000 shares of common stock. The Company believes that such awards align the interests of its employees with those of its shareholders. Only incentive stock options may be granted under the plan. The option price of each option grant is determined by the Options Committee of the Board of Directors, and in no instance shall be less than the fair market value on the date of the grant. An option's maximum term is ten years from the date of grant, with 50% of the options granted vesting two years from the date of grant and the remaining 50% vesting five years from date of grant. As of January 16, 2005, all options under this plan had been granted.

In addition, options to acquire 40,630 FNB shares were converted into options to acquire an aggregate of 95,479 common shares of the Company at a purchase price of \$3.80 per share as a result of the FNB acquisition. As of September 30, 2006, all options converted as a result of the FNB acquisition had been exercised.

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The Company applies the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), Share-Based Payment, to stock-based employee compensation for fiscal years beginning on or after January 1, 2006. As a result, \$29,000 in compensation cost, net of \$16,000 in taxes, is included in the Company's financial statements for the current year. The unrecognized compensation cost to be amortized over a weighted average remaining vesting period of 3.4 years is \$121,000, net of taxes of \$65,000, which is comprised of \$19,000 for 16,500 options granted in 2002 and \$102,000 for 42,000 options granted in 2005, net of taxes of \$10,000 and \$55,000, respectively.

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The weighted average fair market value per share was \$2.77 for options granted in 2002 and \$4.41 for options granted in 2005. The fair market value was estimated using the Black-Scholes option pricing model and the following assumptions: quarterly dividends of \$0.07 in 2002 and \$0.12 in 2005, risk-free interest rate of 1.58% in 2002 and 4.20% in 2005, volatility of 37.73% in 2002 and 25.81% in 2005, and an expected life of 10 years for both years, the options' maximum term. Volatility is based on the actual volatility of the Company's stock during the quarter in which the options were granted. The risk free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve at the time of the option grant.

The following table summarizes the status of the Company's non-vested options as of September 30, 2006.

| | Number of Shares | Weighted Average Grant Date Fair Value |
|----------------------------------|------------------|--|
| Non-vested at December 31, 2005 | 58,500 | \$3.95 |
| Granted in 2006 | - | - |
| Vested in 2006 | - | - |
| Forfeited in 2006 | - | - |
| Non-vested at September 30, 2006 | 58,500 | \$3.95 |

During 2006, 39,750 options were exercised, with total proceeds paid to the Company of \$124,000. The excess of the fair value of the stock issued upon option exercise over the exercise price was \$559,000. The Company recognized a tax benefit of \$55,000 on disqualifying dispositions related to stock option exercises during 2006. A summary of the status of the Company's Stock Option Plan as of September 30, 2006, and changes during the nine months then ended, is presented below.

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (In thousands) |
|-----------------------------------|------------------|---------------------------------|---|---|
| Outstanding at December 31, 2005 | 205,750 | \$7.61 | | |
| Granted in 2006 | - | - | | |
| Vested in 2006 | - | - | | |
| Exercised in 2006 | (39,750) | 3.13 | | |
| Forfeited in 2006 | - | - | | |
| Outstanding at September 30, 2006 | 166,000 | \$8.69 | 3.8 | \$1,412 |
| Exercisable at September 30, 2006 | 107,500 | \$4.95 | 1.8 | \$1,287 |

In prior years, the Company applied Accounting Principles Board Opinion No. 25 and related interpretations in accounting for the stock option plan(s). Accordingly, no compensation cost was recognized in prior years. 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 in prior years.

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| <i>In thousands of dollars, except per share data</i> | For the nine months ended September 30, | | For the quarters ended September 30, | |
|---|--|---------|---|---------|
| | 2006 | 2005 | 2006 | 2005 |
| Net income | | | | |
| As reported | \$9,325 | \$9,477 | \$3,177 | \$3,347 |
| Value of option grants, net of tax | - | 136 | - | - |
| Pro forma | \$9,325 | \$9,341 | \$3,177 | \$3,347 |
| Basic earnings per share | | | | |
| As reported | \$ 0.95 | \$0.98 | \$ 0.32 | \$0.34 |
| Value of option grants, net of tax | - | 0.01 | - | - |
| Pro forma | \$ 0.95 | \$0.97 | \$ 0.32 | \$0.34 |
| Diluted earnings per share | | | | |
| As reported | \$ 0.94 | \$0.96 | \$ 0.32 | \$0.34 |
| Value of option grants, net of tax | - | 0.01 | - | - |
| Pro forma | \$ 0.94 | \$0.95 | \$ 0.32 | \$0.34 |

Note 4 Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share (EPS) for the nine months ended September 30, 2006 and 2005:

| <i>In thousands, except number of shares and per share data</i> | Income (Numerator) | Shares (Denominator) | Per-Share Amount |
|---|-----------------------|-------------------------|---------------------|
| For the nine months ended September 30, 2006 | | | |
| Net income as reported | \$9,325 | | |
| Basic EPS: Income available to common shareholders | \$9,325 | 9,829,157 | \$0.95 |
| Effect of dilutive securities: incentive stock options | | 84,199 | |
| Diluted EPS: Income available to common shareholders plus assumed conversions | \$9,325 | 9,913,356 | \$0.94 |
| For the nine months ended September 30, 2005 | | | |
| Net income as reported | \$9,477 | | |
| Basic EPS: Income available to common shareholders | \$9,477 | 9,717,011 | \$0.98 |
| Effect of dilutive securities: incentive stock options | | 124,417 | |
| Diluted EPS: Income available to common shareholders plus assumed conversions | \$9,477 | 9,841,428 | \$0.96 |

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The following table sets forth the computation of basic and diluted earnings per share for the quarters ended September 30, 2006 and 2005:

| <i>In thousands, except number of shares and per share data</i> | Income (Numerator) | Shares (Denominator) | Per-Share Amount |
|---|-----------------------|-------------------------|---------------------|
| For the quarter ended September 30, 2006 | | | |
| Net income as reported | \$3,177 | | |
| Basic EPS: Income available to common shareholders | \$3,177 | 9,793,172 | \$0.32 |
| Effect of dilutive securities: incentive stock options | | 84,310 | |
| Diluted EPS: Income available to common shareholders plus assumed conversions | \$3,177 | 9,877,482 | \$0.32 |
| For the quarter ended September 30, 2005 | | | |
| Net income as reported | \$3,347 | | |
| Basic EPS: Income available to common shareholders | \$3,347 | 9,823,370 | \$0.34 |
| Effect of dilutive securities: incentive stock options | | 128,621 | |
| Diluted EPS: Income available to common shareholders plus assumed conversions | \$3,347 | 9,951,991 | \$0.34 |

All earnings per share calculations have been made using the weighted average number of shares outstanding during the period. All of the dilutive securities are incentive stock options granted to certain key members of Management. The dilutive number of shares has been calculated using the treasury method, assuming that all granted options were exercisable at the end of each period.

Note 5 Postretirement Benefit Plans

The Bank sponsors postretirement benefit plans which provide certain life insurance and health insurance benefits for certain retired employees and health insurance for retired directors. None of these plans are pre-funded. The following table sets forth the accumulated postretirement benefit obligation and funded status:

| <i>In thousands of dollars</i> | At September 30, 2006 | 2005 |
|---|----------------------------------|-----------|
| Change in benefit obligation | | |
| Benefit obligation at beginning of year | \$ 1,705 | \$ 531 |
| Plan assumed in FNB acquisition | - | 1,189 |
| Service cost | 8 | 8 |
| Interest cost | 89 | 89 |
| Benefits paid | (118) | (81) |
| Actuarial gain (loss) | 239 | (18) |
| Benefit obligation at end of period | 1,923 | 1,718 |
| Funded status | | |
| Benefit obligation at end of period | (1,923) | (1,718) |
| Unamortized prior service cost | (11) | (11) |
| Unamortized net actuarial loss | 278 | 42 |
| Unrecognized transition obligation | 186 | 215 |
| Accrued benefit cost | \$(1,470) | \$(1,472) |

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The following table sets forth the net periodic pension cost:

| <i>In thousands of dollars</i> | For nine months ended September 30, | | For the quarters ended September 30, | |
|--|--|-------|---|------|
| | 2006 | 2005 | 2006 | 2005 |
| Components of net periodic benefit cost | | | | |
| Service cost | \$ 8 | \$ 8 | \$ 2 | \$ 1 |
| Interest cost | 89 | 89 | 29 | 27 |
| Amortization of unrecognized transition obligation | 22 | 22 | 7 | (1) |
| Amortization of prior service cost | (2) | (2) | - | (4) |
| Amortization of accumulated losses | 5 | 5 | 2 | 2 |
| Net periodic benefit cost | \$122 | \$122 | \$40 | \$25 |

A weighted average discount rate of 7.0% was used in determining both the accumulated benefit obligation and the net periodic benefit cost. The measurement date for benefit obligations was as of year-end for prior years presented. The estimated amount of benefits to be paid in 2006 is \$157,000. For years ending 2007 through 2010, the estimated amount of benefits to be paid is \$155,000 per year, and the total estimated amount of benefits to be paid for years ended 2011 through 2015 is \$788,000. Plan expense for 2006 is estimated to be \$168,000.

Note 6 Goodwill

As of March 31, 2006, in accordance with SFAS No. 142, the Company completed its annual review of goodwill and determined there has been no impairment.

Note 7 Reclassifications

Certain items from the prior year were reclassified in the financial statements to conform with the current year presentation. These do not have a material impact on the balance sheet or income statement presentations.

Note 8 Pro-Forma Financial Information

On August 25, 2004, the Company entered into an agreement to acquire FNB Bankshares (FNB) of Bar Harbor, Maine, and its subsidiary, The First National Bank of Bar Harbor. This acquisition was completed on January 14, 2005. In its 2004 Strategic Plan, the Company identified certain markets in which it would consider future growth opportunities, including the area served by FNB Bankshares. Management expects that the products and services available in the FNB Bankshares market area will be enhanced as a result of the combination of the two companies, and that this will also provide a larger capacity to lend money and a stronger overall funding base.

As part of the acquisition, the Company issued 2.35 shares of its common stock to the shareholders of FNB in exchange for each of the 1,048,814 shares of the common stock outstanding of FNB. Cash in lieu of fractional shares of the Company's stock was paid at the rate of \$17.87 per share, which was the average high/low price of the Company's stock for the 30-day period ended January 9, 2005, under terms specified in the Merger Agreement. At the time of the acquisition, there were outstanding options to purchase 126,208 shares of FNB common stock under the FNB Bankshares Stock Option Plan. Of these, options to acquire 40,630 FNB shares were converted into options to acquire an aggregate of 95,479 common shares of the Company at a purchase price of \$3.80 per share. Unexercised options not converted were paid cash at the rate of \$42.00 for each share subject to the option, less the option exercise price per share. The total amount paid to retire the remaining options was approximately \$2.6 million.

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The total value of the transaction was \$47,955,000, and all of the voting equity interest of FNB was acquired in the transaction. The Company assumed all outstanding liabilities of FNB, including liabilities under certain Employment Continuity Agreements and Split Dollar Agreements with executive officers of FNB. The acquisition was intended to qualify as a reorganization for federal income tax purposes and provide for a tax-free exchange of shares.

The transaction was accounted for as a purchase and the operations of FNB are included in the Company's consolidated financial statements from the date of acquisition. The purchase price was allocated to assets acquired and

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liabilities assumed at the date of acquisition. The excess of purchase price over the fair value of net tangible assets acquired was recorded as goodwill, none of which is expected to be deductible for tax purposes. The core deposit intangible is being amortized over its expected economic life, and goodwill is evaluated annually for possible impairment under the provisions of SFAS No. 142, Goodwill and Other Intangible Assets.

The pro forma statements of income in the following table show how the Company's results of operations would have been presented if the Company and FNB had operated as one entity for the entire periods presented. Management has made adjustments to incorporate FNB's results for the entire year in 2005.

| | For nine months ended | | For quarters ended | |
|--|------------------------------|----------|---------------------------|----------|
| <i>In thousands of dollars, except share and per share information</i> | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Interest income | \$47,475 | \$36,710 | \$16,829 | \$13,138 |
| Interest expense | 24,494 | 13,040 | 9,091 | 5,149 |
| Net interest income | 22,981 | 23,670 | 7,738 | 7,989 |
| Provision for loan losses | 900 | 100 | 300 | - |
| Net interest income after provision for loan losses | 22,081 | 23,570 | 7,438 | 7,989 |
| Other operating income | 7,679 | 6,990 | 3,246 | 2,954 |
| Other operating expenses | 16,752 | 17,590 | 6,235 | 6,254 |
| Income before income taxes | 13,008 | 12,970 | 4,449 | 4,689 |
| Applicable income taxes | 3,683 | 3,668 | 1,272 | 1,342 |
| Net income | \$ 9,325 | \$ 9,302 | \$ 3,177 | \$ 3,347 |
| Operating Statistics | | | | |
| Basic earnings per share | \$0.95 | \$0.96 | \$0.32 | \$0.34 |
| Diluted earnings per share | \$0.94 | \$0.95 | \$0.32 | \$0.34 |
| Cash dividends declared per share | \$0.450 | \$0.390 | \$0.155 | \$0.135 |
| Dividend payout ratio | 47.37% | 40.63% | 48.44% | 39.71% |
| Return on average assets | 1.16% | 1.34% | 1.17% | 1.37% |
| Return on average equity | 11.85% | 12.74% | 11.95% | 13.14% |
| Return on average tangible equity | 16.07% | 17.46% | 16.21% | 18.16% |
| Efficiency ratio (tax equivalent) | 51.97% | 54.75% | 54.08% | 54.64% |

Note 9 Impact of Recently Issued Accounting Standards

SFAS No. 156, Accounting for Servicing of Financial Assets – an amendment to The Financial Accounting Standards Board (FASB) Statement No. 140, requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. Servicing assets and servicing liabilities will subsequently be reported using the amortization method or the fair value measurement method. An entity should adopt this Statement as of the beginning of its first fiscal year that begins after September 15, 2006 with earlier application permitted with certain restrictions. The initial application of the fair value measurement method would be reported as a cumulative effect adjustment to beginning retained earnings. The Statement requires certain disclosures about the basis for measurement and regarding risks, activity, and fair value of servicing assets and of servicing liabilities. Management does not expect SFAS No.156 to have a material impact on the Company's financial statements.

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

The FASB has issued SFAS No. 123(R), Share-Based Payment. SFAS No. 123(R), with certain exceptions, requires entities that grant stock options and shares to employees to recognize the fair value of those options and shares

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as compensation cost over the service (vesting) period in their financial statements. The measurement of that cost is based on the fair value of the equity or liability instruments issued. The Securities and Exchange Commission (SEC) has issued Staff Accounting Bulletin (SAB) No. 107, which provides guidance regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations. The Company adopted SFAS No. 123(R) effective January 1, 2006 and has applied the guidance in SAB No. 107 in the financial statements for the nine-month period ended September, 2006, the effect of which was limited to disclosure in Note 3 to the Company's financial statements.

FASB Staff Position (FSP) 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, was issued on November 3, 2005. This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. Guidance in the FSP shall be applied to reporting periods beginning after December 15, 2005, with earlier application permitted. Application of this FSP to the first quarter of 2006 did not have a material effect on the consolidated financial condition and results of operations of the Company.

In September 2006, FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and early application is encouraged. This Statement does not require any new fair value measurements and the Company does not expect application of this Statement will change current practice.

In September 2006, FASB issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R). This Statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through comprehensive income of a business entity. The funded status of a plan should be measured as of the date of the Company's year-end statement of financial position, with limited exceptions. As of December 31, 2005, the Company's postretirement benefit plan was underfunded by \$1,705,000, as defined in the statement; accordingly, Management expects the cumulative effect of initially applying this Statement to be a reduction in shareholders' equity, net of tax, of \$57,000. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide required disclosures as of the end of the fiscal year ending after December 15, 2006.

In September 2006, the SEC issued SAB No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 requires registrants to evaluate the materiality of unadjusted financial statement misstatements using both the rollover and iron curtain methods. The rollover method quantifies a misstatement based on the amount of the error originating in the current period statement of income. The iron curtain method quantifies a misstatement based on the effects of correcting the misstatement existing in the statement of financial condition at the end of the current period, irrespective of the misstatement's year(s) of origination. SAB No. 108 is effective for years ending after November 15, 2006. The cumulative effect of the initial application on prior years is required to be reported as an adjustment to retained earnings at the beginning of the year of initial application. Management is studying the effects of SAB No. 108 on the Company's financial statements.

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

First National Lincoln Corporation and Subsidiary

Critical Accounting Policies

Management's discussion and analysis of the Company's financial condition is based on the consolidated financial statements which are prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of such financial statements requires Management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an ongoing basis, Management evaluates its estimates, including those related to the allowance for loan losses, the valuation of mortgage servicing rights, and goodwill. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis in making judgments about the carrying values of assets that are not readily apparent from other sources. Actual results could differ from the amount derived from Management's estimates and assumptions under different assumptions or conditions.

Allowance for Loan Losses. Management believes the allowance for loan losses requires the most significant estimates and assumptions used in the preparation of the consolidated financial statements. The allowance for loan losses is based on Management's evaluation of the level of the allowance required in relation to the estimated loss exposure in the loan portfolio. Management believes the allowance for loan losses is a significant estimate and therefore regularly evaluates it for adequacy by taking into consideration factors such as prior loan loss experience, the character and size of the loan portfolio, business and economic conditions and Management's estimation of potential losses. The use of different estimates or assumptions could produce different provisions for loan losses.

Mortgage Servicing Rights. The valuation of mortgage servicing rights also requires significant estimates and assumptions. The Bank often sells mortgage loans it originates and retains the ongoing servicing of such loans, receiving a fee for these services, generally 0.25% of the outstanding balance of the loan per annum. Mortgage servicing rights are recognized when they are acquired through sale of loans and are reported in other assets. They are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Management uses an independent firm that specializes in the valuation of mortgage servicing rights to determine the fair value, which is recorded on the balance sheet. This includes an evaluation for impairment based upon the fair value of the rights, which can vary depending upon current interest rates and prepayment expectations, as compared to amortized cost. The Company's assumptions are adjusted periodically to reflect current circumstances. Stratifying rights determine impairment by predominant characteristics, such as interest rates and terms. The use of different assumptions could produce a different valuation for both mortgage servicing rights and impairment.

Goodwill. Management utilizes numerous techniques to estimate the value of various assets held by the Company, including methods to determine the appropriate carrying value of goodwill as required under SFAS No. 142. In addition, goodwill from a purchase acquisition is subject to ongoing periodic impairment tests, which include an evaluation of the ongoing assets, liabilities and revenues from the acquisition and an estimation of the impact of business conditions.

Acquired Assets and Liabilities. Different estimates or assumptions are also utilized to determine the appropriate carrying value of other assets including, but not limited to, premises and equipment, overall collectibility of loans and receivables. The use of different estimates or assumptions could produce different estimates of carrying value. Management prepares the valuation analyses, which are then reviewed by the Board of Directors of the Company.

GAAP vs. Pro-Forma Results

Operating results for the Company are prepared using accounting principles generally accepted in the United States of America (GAAP) which, under the purchase method of accounting, exclude FNB Bankshares results prior to the closing date of the acquisition on January 14, 2005. This discussion also includes pro-forma information which shows how the Company's results of operations would have been presented if the Company and FNB had operated as one entity for the entire periods presented (for a presentation of pro-forma results, see Note 8 to the Consolidated Financial Statements - Pro-Forma Financial Information).

Executive Summary

Net income for the nine months ended September 30, 2006 was \$9,325,000, a decrease of 1.6% from net income of \$9,477,000 for the comparable period of 2005. Although the Company had modest growth in earning assets this year, it experienced margin compression due to the flat-to-inverted yield curve. In addition, liability costs have increased more rapidly than yield on assets. The net interest margin on a tax-equivalent basis declined to 3.29% for the first nine months of 2006 from 3.88% for the same period in 2005, which, in turn, has resulted in a modest decline in net interest income.

The Company posted excellent growth in non-interest income, however, as well as a slight reduction in non-interest expense. Investment management and fiduciary revenues from First Advisors were up \$202,000 or 16.2% for the first nine months of 2006 when compared to the same period in 2005, as are fees from deposit accounts, which have increased \$275,000 or 15.5% for the first nine months of 2006 when compared to the same period in 2005. On the expense side, the savings are in employee costs, which are down \$142,000 or 1.7% for the first nine months of 2006 when compared to the same period in 2005.

These increased revenues and expense savings have more than offset the \$900,000 provision to the allowance for loan losses posted in the first nine months of 2006 compared to \$100,000 for the same period in 2005. This increase in the provision is not indicative of a significant decline in loan quality – it was to maintain the allowance for loan losses at an adequate level given continued growth in our loan portfolio and our level of chargeoffs.

Net income for the three months ended September 30, 2006 was \$3,177,000, a decrease of 5.1% from net income of \$3,347,000 for the comparable period of 2005.

On a pro-forma basis, net income for the nine months ended September 30, 2006, was \$9,325,000, an increase of \$23,000 or 0.2% over pro-forma net income of \$9,302,000 for the first nine months of 2005. Pro-forma fully diluted earnings per share for the first nine months of 2006 were \$0.94, a decrease of \$0.01 or 1.1% from the \$0.95 reported for the first nine months of 2005.

On a pro-forma basis, net income for the three months ended September 30, 2006 and 2005 was the same as that reported in the Company's consolidated financial statements.

Net Interest Income

Total interest income of \$47,475,000 for the nine months ended September 30, 2006 is a 30.7% increase from total interest income of \$36,329,000 in the comparable period of 2005. Rising interest rates resulted in significantly higher asset yields in 2006 compared to 2005. Total interest expense of \$24,494,000 for the first nine months of 2006 is a 89.4% increase from total interest expense of \$12,931,000 for the first nine months of 2005. This was a direct result of the rising interest rate climate and increased volume in certificates of deposit. Net interest income decreased 1.8% to \$22,981,000 for the nine months ended September 30, 2006, from \$23,298,000 reported for the same period in 2005.

Total interest income of \$16,829,000 for the three months ended September 30, 2006, is a 28.1% increase from total interest income of \$13,138,000 in the comparable period of 2005. This increase was due to rising interest rates which resulted in higher asset yields in 2006 compared to 2005. Total interest expense of \$9,091,000 for the three months ended September 30, 2006, is a 76.6% increase from total interest expense of \$5,149,000 in the comparable period of 2005. This was a direct result of the rising interest rate climate and increased volume in certificates of deposit. Net interest income decreased 3.1% to \$7,738,000 for the three months ended September 30, 2006, from \$7,989,000 reported for the same period in 2005.

The Company's net interest margin on a tax-equivalent basis decreased from 3.88% in the first nine months of 2005 to 3.29% for the nine months ended September 30, 2006. For the three months ended September 30, 2006, the Company's net interest margin was 3.28%, a decrease from 3.76% in the same period of 2005. This is due to the current flat yield curve and liability costs increasing at a faster rate than the yield on assets. These results are consistent with the Company's expectations for changes in its net interest income in the current rate environment.

Tax-exempt interest income amounted to \$2,722,000 and \$2,485,000 for the nine months ended September 30, 2006 and 2005, respectively. For the three months ended September 30, 2006 and 2005, tax-exempt interest income amounted to \$948,000 and \$869,000, respectively. Tax equivalency is calculated using a 35.0% effective tax rate. The following table presents the effect of tax-exempt income on the calculation of the net interest margin, using a 35.0% tax rate in 2006 and 2005:

| | For the nine months ended September 30, | | For the quarter ended September 30, | |
|-------------------------------------|--|----------|--|---------|
| | 2006 | 2005 | 2006 | 2005 |
| Net interest income as presented | \$22,981 | \$23,398 | \$7,738 | \$7,989 |
| Effect of tax-exempt income | 1,465 | 1,338 | 510 | 467 |
| Net interest income, tax equivalent | \$24,446 | \$24,736 | \$8,248 | \$8,456 |

The following table presents the amount of interest earned or paid, as well as the average yield or rate on an annualized basis, for each major category of assets or liabilities for the nine months ended September 30, 2006 and 2005. Tax-exempt income is calculated on a tax-equivalent basis, using a 35.0% tax rate in 2006 and 2005.

| Nine months ended September 30, | 2006 | | 2005 | |
|-------------------------------------|-----------------------|-----------------------|--------------------|--------------------|
| | Amount of interest | Average yield/rate | Amount of interest | Average yield/rate |
| <i>Dollars in thousands</i> | | | | |
| Interest on earning assets | | | | |
| Interest-bearing deposits | \$ 61 | 5.33% | \$ 9 | 2.62% |
| Investments | 8,328 | 5.97% | 6,684 | 5.64% |
| Loans held for sale | 2 | 5.36% | 24 | 7.64% |
| Loans | 40,549 | 6.74% | 30,950 | 5.97% |
| Total interest-earning assets | 48,940 | 6.59% | 37,667 | 5.91% |
| Interest-bearing liabilities | | | | |
| Deposits | 18,539 | 3.45% | 8,978 | 2.08% |
| Other borrowings | 5,955 | 4.44% | 3,953 | 2.82% |
| Total interest-bearing liabilities | 24,494 | 3.64% | 12,931 | 2.26% |
| Net interest income | \$24,446 | | \$24,736 | |
| Interest rate spread | | 2.95% | | 3.65% |
| Net interest margin | | 3.29% | | 3.88% |

The following table presents changes in interest income and expense attributable to changes in interest rates and volume for interest-earning assets and interest-bearing liabilities for the nine months ended September 30, 2006 compared to 2005. Tax-exempt income is calculated on a tax-equivalent basis, using a 35.0% tax rate in both years.

| Nine months ended September 30, 2006 compared to 2005 | | | | |
|---|---------|-----------|--------------------------|---------|
| <i>Dollars in thousands</i> | Volume | Rate | Rate/Volume ¹ | Total |
| Interest on earning assets | | | | |
| Interest-bearing deposits | \$ 21 | \$ 9 | \$ 22 | \$ 52 |
| Investment securities | 1,180 | 394 | 70 | 1,644 |
| Loans held for sale | (21) | (7) | 6 | (22) |
| Loans | 4,992 | 3,967 | 640 | 9,599 |
| Total interest income | 6,172 | 4,363 | 738 | 11,273 |
| Interest expense | | | | |
| Deposits | 2,232 | 5,869 | 1,459 | 9,561 |
| Other borrowings ² | (172) | 2,273 | (99) | 2,002 |
| Total interest expense | 2,060 | 8,142 | 1,360 | 11,563 |
| Change in net interest income | \$4,112 | \$(3,779) | \$(622) | \$(290) |

¹ Represents the change attributable to a combination of change in rate and change in volume.

² Includes federal funds purchased.

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The following table presents the amount of interest earned or paid, as well as the average yield or rate on an annualized basis, for each major category of assets or liabilities for the quarter ended September 30, 2006 and 2005. Tax-exempt income is calculated on a tax-equivalent basis, using a 35.0% tax rate in 2006 and 2005.

| Quarters ended September 30, | 2006 | | 2005 | |
|-------------------------------------|--------------------|--------------------|--------------------|--------------------|
| | Amount of interest | Average yield/rate | Amount of interest | Average yield/rate |
| <i>Dollars in thousands</i> | | | | |
| Interest on earning assets | | | | |
| Interest-bearing deposits | \$61 | 10.55% | \$5 | 3.02% |
| Investments | 2,885 | 6.16% | 2,324 | 5.64% |
| Loans held for sale | 1 | 6.24% | 7 | 5.71% |
| Loans | 14,392 | 7.05% | 11,269 | 6.15% |
| Total interest-earning assets | 17,339 | 6.89% | 13,605 | 6.05% |
| Interest-bearing liabilities | | | | |
| Deposits | 7,486 | 4.05% | 3,911 | 2.39% |
| Other borrowings | 1,605 | 3.78% | 1,238 | 3.25% |
| Total interest-bearing liabilities | 9,091 | 4.00% | 5,149 | 2.55% |
| Net interest income | \$8,248 | | \$8,456 | |
| Interest rate spread | | 2.90% | | 3.50% |
| Net interest margin | | 3.28% | | 3.76% |

The following table presents changes in interest income and expense attributable to changes in interest rates and volume for interest-earning assets and interest-bearing liabilities for the quarter ended September 30, 2006 compared to 2005. Tax-exempt income is calculated on a tax-equivalent basis, using a 35.0% tax rate in 2006 and 2005.

Quarter ended September 30, 2006 compared to 2005

| <i>Dollars in thousands</i> | Volume | Rate | Rate/Volume ¹ | Total |
|-----------------------------------|--------|-----------|--------------------------|---------|
| Interest on earning assets | | | | |
| Interest-bearing deposits | \$12 | \$12 | \$31 | \$56 |
| Investment securities | 317 | 215 | 29 | 561 |
| Loans held for sale | (6) | 1 | (1) | (6) |
| Loans | 1,280 | 1,654 | 190 | 3,123 |
| Total interest income | 1,603 | 1,882 | 249 | 3,734 |
| Interest expense | | | | |
| Deposits | 509 | 2,713 | 353 | 3,575 |
| Other borrowings ² | 141 | 203 | 23 | 367 |
| Total interest expense | 650 | 2,916 | 376 | 3,942 |
| Change in net interest income | \$953 | \$(1,034) | \$(127) | \$(208) |

¹ Represents the change attributable to a combination of change in rate and change in volume.

² Includes federal funds purchased.

On a pro-forma basis, net interest income for the first nine months of 2006 was \$22,981,000, a decrease of \$690,000 or 2.9% compared to net interest income of \$23,670,000 for the first nine months of 2005. The growth in earning assets was offset by margin compression as a result of the flat yield curve. On a pro-forma basis, net interest income for the three months ended September 30, 2006 and 2005 was the same as that reported in the Company's consolidated financial statements.

Provision for Loan Losses

A \$900,000 provision to the allowance for loan losses was made during the first nine months of 2006, compared to a \$100,000 provision made for the same period of 2005. This additional provision is not indicative of a significant decline in loan quality – it was to maintain the allowance for loan losses at an adequate level given continued growth in our loan portfolio and our level of chargeoffs.

Non-Interest Income

Non-interest income was \$7,679,000 for the nine months ended September 30, 2006, an increase of 12.2% from \$6,845,000 reported for the first nine months of 2005. This rise in non-interest income was primarily due to increases in investment management and fiduciary income as well as increased levels of revenue on deposit accounts. There was also a posting of \$285,000 to other income due to amendments to certain employment continuity agreements. On a pro-forma basis, non-interest income increased by \$689,000 or 9.9% from \$6,990,000 in 2005 to \$7,679,000 in 2006.

Non-interest income was \$3,246,000 for the three months ended September 30, 2006, an increase of 9.9% from \$2,954,000 reported in the same period for 2005. While investment management income increased 11.3% and deposit accounts revenues increased by 12.1%, mortgage origination income declined due to higher interest rates and lower levels of loans sold to the secondary market. There was also a posting of \$285,000 to other income due to amendments to certain employment continuity agreements. On a pro-forma basis, non-interest income for the three months ended September 30, 2006 and 2005 was the same as that reported in the Company's consolidated financial statements.

Non-Interest Expense

Non-interest expense of \$16,752,000 for the nine months ended September 30, 2006, is a decrease of 0.9% compared to non-interest expense of \$16,896,000 for the same period in 2005. This decline was attributable to lower employee costs through attrition as well as a reduction in the accrual for the Company's Stakeholder bonus program and lower health insurance costs. In addition, savings were realized from outsourced services that were absorbed into existing in-house operations. On a pro-forma basis, non-interest expense decreased by \$838,000 or 4.8% during the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005, with the largest decrease in salaries and employee benefits, which were down by 4.9%.

Non-interest expense of \$6,235,000 for the three months ended September 30, 2006, is a decrease of 0.3% compared to non-interest expense of \$6,254,000 for the three months ended September 30, 2005. This level of decrease in non-interest expense for the quarter was for the same reasons cited above as well as a decrease in other operating expenses. On a pro-forma basis, non-interest expense for the three months ended September 30, 2006 and 2005 was the same as that reported in the Company's consolidated financial statements.

Income Taxes

Income taxes on operating earnings were \$3,683,000 for the nine months ended September 30, 2006, down from \$3,770,000 in the same period a year ago. This is in line with the Company's level of income before taxes.

Investments

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The Company's investment portfolio decreased by \$5.0 million or 2.7% to \$179.0 million between December 31, 2005, and September 30, 2006. At September 30, 2006, the Company's available-for-sale portfolio had an unrealized gain, net of taxes, of \$0.7 million. Between September 30, 2005, and September 30, 2006, the Company's investment portfolio increased by \$15.5 million or 9.5%. This was due to increased investing activities.

Loans

Loans grew by \$56.2 million or 7.3% during the first nine months of 2006. The growth in commercial loans was \$18.9 million or 6.0% and municipal loans increased \$2.5 million or 12.5%. The residential mortgage portfolio increased by \$27.7 million or 8.8%, and home equity lines of credit decreased \$8.1 million or 9.7% year-to-date. Between September 30, 2005 and September 30, 2006, the loan portfolio increased \$88.9 million or 12.0%, as a result of strong customer demand.

Allowance for Loan Losses

The allowance for loan losses represents the amount available for credit losses inherent in the Company's loan portfolio. Loans are charged off when deemed uncollectible, after giving consideration to factors such as the customer's financial condition, underlying collateral and guarantees, as well as general and industry economic conditions.

Adequacy of the allowance for loan losses is determined using a consistent, systematic methodology, which analyzes the risk inherent in the loan portfolio. In addition to evaluating the collectibility of specific loans when determining the adequacy of the allowance for loan losses, Management also takes into consideration other factors such as changes in the mix and size of the loan portfolio, historic loss experience, the amount of delinquencies and loans adversely classified, and economic trends. The adequacy of the allowance for loan losses is assessed by an allocation process whereby specific loss allocations are made against certain adversely classified loans, and general loss allocations are made against segments of the loan portfolio that have similar attributes. The Company's historical loss experience, industry trends, and the impact of the local and regional economy on the Company's borrowers, are considered by Management in determining the adequacy of the allowance for loan losses.

The allowance for loan losses is increased by provisions charged against current earnings. Loan losses are charged against the allowance when Management believes that the collectibility of the loan principal is unlikely. Recoveries on loans previously charged off are credited to the allowance. While Management uses available information to assess possible losses on loans, future additions to the allowance may be necessary based on increases in non-performing loans, changes in economic conditions, growth in loan portfolios, or for other reasons. Any future additions to the allowance would be recognized in the period in which they were determined to be necessary. In addition, various regulatory agencies periodically review the Company's allowance for loan losses as an integral part of their examination process. Such agencies may require the Company to record additions to the allowance based on judgments different from those of Management.

Credit quality of the commercial portfolios is quantified by a credit rating system designed to parallel regulatory criteria and categories of loan risk. Individual loan officers monitor their loans to ensure appropriate rating assignments are made on a timely basis. Risk ratings and quality of the commercial loan portfolio are also assessed on a regular basis by an independent loan review consulting firm. Ongoing portfolio trend analyses and individual credit reviews to evaluate loan risk and compliance with corporate lending policies are also performed. The level of allowance allocable to each group of risk-rated loans is then determined by applying a loss factor that estimates the amount of probable loss in each category. The assigned loss factor for each risk rating is based upon Management's assessment of historical loss data, portfolio characteristics, economic trends, overall market conditions and past experience.

Consumer loans, which include residential mortgages, home equity loans/lines, and direct/indirect loans, are generally evaluated as a group based on product type and on the basis of delinquency data and other credit data available due to the large number of such loans and the relatively small size of individual credits. Allocations for these loan categories are principally determined by applying loss factors that represent Management's estimate of inherent losses. In each category, inherent losses are estimated based upon Management's assessment of historical loss data, portfolio characteristics, economic trends, overall market conditions and past experience. In addition, certain loans in these categories may be individually risk-rated if considered necessary by Management.

The other method used to allocate the allowance for loan losses entails the assignment of reserve amounts to individual loans on the basis of loan impairment. Certain loans are evaluated individually and are judged to be impaired when Management believes it is probable that the Company will not collect all of the contractual interest and principal payments as scheduled in the loan agreement. Under this method, loans are selected for evaluation based on internal risk ratings or non-accrual status. A specific reserve is allocated to an individual loan when that loan has been deemed impaired and when the amount of a probable loss is estimable on the basis of its collateral value, the present value of anticipated future cash flows, or its net realizable value. At September 30, 2006, impaired loans with specific reserves totaled \$1,011,000 (all of these loans were on non-accrual status) and the amount of such reserves were \$260,000.

All of these analyses are reviewed and discussed by the Directors' Loan Committee, and recommendations from these processes provide Management and the Board of Directors with independent information on loan portfolio condition. As a result of these analyses, the Company has concluded that the level of the allowance for loan losses was adequate as of September 30, 2006. As of that date, the balance of \$6,221,000 was 0.75% of total loans, compared to 0.79% at December 31, 2005 and 0.88% at September 30, 2005. Loans considered to be impaired according to SFAS 114/118 totaled \$3,775,000 at September 30, 2006 compared to \$3,081,000 at December 31, 2005. The portion of the allowance for loan losses allocated to impaired loans at September 30, 2006, was \$260,000 compared to \$392,000 at December 31, 2005.

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In Management's opinion, the level of the Company's allowance for loan losses is adequate. Although the allowance is lower as a percentage of loans than many peers, the Bank's loan portfolio has a higher percentage of residential mortgage loans than peers, which typically reflects a much lower level of credit risk. The Company's actual historical experience supports this by the overall credit quality of the portfolio and historically low level of chargeoffs.

Non-Performing Assets

At September 30, 2006, loans on non-accrual status totaled \$3.8 million, which compares to non-accrual loans of \$3.1 million as of December 31, 2005. In addition to loans on non-accrual status at September 2006, loans past due 90 days or more and accruing (calculated on a constant 30-day month basis) totaled \$756,000 which compares to \$325,000 as of December 31, 2005. The Company continues to accrue interest on these loans because it believes collection of the interest is reasonably assured.

Goodwill

On January 14, 2005, the Company completed the acquisition of FNB Bankshares (FNB) of Bar Harbor, Maine, and its subsidiary, The First National Bank of Bar Harbor, which was merged into the Bank. Management believes that the products and services offered in FNB's market have been enhanced by the combination of the two companies, providing a larger capacity to lend money and a stronger overall funding base. In 2005, the combined entity realized approximately \$1.0 million in initial cost savings from redundant expenses, such as regulatory fees, audit costs, legal costs, and outsourced costs.

The total value of the transaction was \$47,955,000, and all of the voting equity interest of FNB was acquired in the transaction. As required under GAAP, the purchase price was allocated to assets acquired and liabilities assumed at the date of acquisition. The excess of purchase price over the fair value of net tangible and identified intangible assets acquired was recorded as goodwill, which totaled \$27,559,000 and included \$972,000 in direct expenses.

The following table shows the adjusted fair value of assets and liabilities recorded on the Company's balance sheet from the FNB acquisition, including the associated goodwill in the transaction:

In thousands of dollars

| | |
|---|-------------------|
| Assets | |
| Cash and due from banks | \$ 6,963 |
| Investments | 26,562 |
| Loans held for sale (fair value approximates cost) | 591 |
| Loans | 185,357 |
| Less: allowance for loan losses | (2,164) |
| Net loans | 183,193 |
| Bank premises and equipment | 7,767 |
| Goodwill | 27,559 |
| Other assets | 9,311 |
| Total Assets | \$ 261,946 |
| Liabilities & Shareholders' Equity | |
| Deposits | \$ 192,860 |
| Borrowed funds | 17,044 |
| Other liabilities | 4,086 |
| Total liabilities | 213,990 |
| Shareholders' equity | 47,956 |
| Total Liabilities & Shareholders' Equity | \$ 261,946 |

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The majority of the \$1,830,000 difference between actual goodwill booked and the \$26,005,000 of goodwill estimated in the Company's December 31, 2004 financial statements was due to deferred income taxes. During the fourth quarter of 2005, goodwill and other liabilities were reduced by \$276,000, net of tax, as a result of changes in employment continuity agreements with FNB employees who became employees of the Bank, which resulted in lower reserves for these agreements.

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Deposits

During the first nine months of 2006, total deposits increased by \$134.1 million or 18.8% over December 31, 2005. Core deposits (demand, NOW, savings and money market accounts) increased by \$13.6 million or 3.3% in the first nine months of 2006, and during the same period, certificates of deposit increased \$120.5 million or 39.4%. Between September 30, 2005, and September 30, 2006, deposits grew by 12.3%, or \$92.7 million. Demand deposits grew \$1.6 million, money market accounts also grew by \$24.2 million and certificates of deposit grew by \$100.6 million, while NOW accounts decreased by \$20.5 million, and savings decreased by \$13.2 million. The majority of the growth in certificates of deposit, both year-to-date and year-over-year, was from wholesale and brokered sources. The Company saw a decline in core deposits year-over-year due to transfers to higher-yielding certificates of deposit due to higher interest rates.

Borrowed Funds

The Company's funding includes borrowings from the Federal Home Loan Bank of Boston, the Federal Reserve System, and repurchase agreements, enabling it to grow its balance sheet and its revenues. They may also be used to carry out interest rate risk management strategies, and are increased to replace or supplement other sources of funding, including core deposits and certificates of deposit. During the nine months ended September 30, 2006, borrowed funds decreased \$84.9 million or 39.4% from December 31, 2005, as a result of the deposit growth previously noted. Between September 30, 2005 and September 30, 2006, borrowed funds increased \$3.7 million or 2.9%.

Shareholders' Equity

Shareholders' equity as of September 30, 2006 was \$106.7 million, compared to \$103.4 million as of December 31, 2005. The Company's earnings in the first nine months of 2006, net of dividends paid, added to shareholders' equity. The net unrealized loss on available-for-sale securities, presented in accordance with SFAS 115, remained relatively the same at \$749,000 for quarter ended September 30, 2006 compared to \$734,000 at December 31, 2005.

In 2006, a cash dividend of 15.5 cents per share was declared in the third quarter compared to 13.5 cents in the third quarter of 2005. The dividend payout ratio was 47.37% in the third quarter of 2006 compared to 39.8% in the third quarter of 2005. In determining future dividend payout levels, the Board of Directors carefully analyzes capital requirements and earnings retention, as set forth in the Company's Dividend Policy. The ability of the Company to pay cash dividends to its shareholders depends on receipt of dividends from its subsidiary, the Bank. The subsidiary may pay dividends to its parent out of so much of its net profits as the Bank's directors deem appropriate, subject to the limitation that the total of all dividends declared by the Bank in any calendar year may not exceed the total of its net profits of that year combined with its retained net profits of the preceding two years. The amount available for dividends in 2006 is this year's net income plus \$9.8 million.

Regulatory leverage capital ratios for the Company were 7.21% and 7.66% at September 30, 2006 and December 31, 2005, respectively. The Company had a tier one risk-based capital ratio of 10.30% and tier two risk-based capital ratio of 11.14% at September 30, 2006, compared to 10.74% and 11.61%, respectively, at December 31, 2005. These are comfortably above the standards to be rated "well-capitalized" by regulatory authorities qualifying the Company for lower deposit-insurance premiums.

On January 20, 2005, the Company announced that its Board of Directors had authorized the repurchase of up to 250,000 shares of the Company's common stock or approximately 2.5% of the outstanding shares. This program ended in July of 2006, with 248,376 shares repurchased under the program at an average price of \$17.15 and at a total cost of \$4,261,000.

On July 21, 2006, the Company announced that its Board of Directors had authorized a new program for the repurchase of up to 250,000 shares of the Company's common stock or approximately 2.5% of the outstanding shares. The Company expects such repurchases to be effected from time to time, in the open market, in private transactions or otherwise, during a period of up to 24 months. The amount and timing of shares to be purchased will be subject to market conditions and will be based on several factors, including the price of the Company's stock and the level of stock issuances under the Company's employee stock plans. No assurance can be given as to the specific timing of the share repurchases or as to whether and to what extent the share repurchase will be consummated. As of September 30, 2006, the Company had repurchased 63,363 shares under the new repurchase plan at an average price of \$17.44 and at a total cost of \$1,105,000.

Average Daily Balance Sheets

The following table shows the Company's average daily balance sheets for the nine month and three month periods ended September 30, 2006 and 2005.

| <i>In thousands of dollars</i> | For the nine months ended September 30, | | For quarters ended September 30, | |
|---|--|-----------|---|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Assets | | | | |
| Cash and due from banks | \$ 21,066 | \$ 20,904 | \$ 21,465 | \$ 25,586 |
| Overnight funds sold | 1,530 | 459 | 2,295 | 656 |
| Investments | | | | |
| U.S. Treasury securities & government agency securities | 89,947 | 64,771 | 89,369 | 66,390 |
| Obligations of states and political subdivisions | 56,830 | 51,254 | 57,298 | 55,004 |
| Other securities | 39,598 | 42,376 | 39,089 | 42,073 |
| Total investments | 186,375 | 158,401 | 185,755 | 163,467 |
| Loans held for sale | 51 | 420 | 60 | 520 |
| Loans | | | | |
| Commercial | 327,932 | 280,383 | 329,353 | 297,901 |
| Consumer | 45,307 | 34,745 | 46,829 | 35,432 |
| State and municipal | 21,816 | 22,226 | 22,122 | 21,508 |
| Real estate | 409,364 | 355,336 | 411,430 | 372,307 |
| Total loans | 804,419 | 692,690 | 809,733 | 727,148 |
| Allowance for loan losses | (6,131) | (6,525) | (6,129) | (6,529) |
| Net loans | 798,288 | 686,165 | 803,605 | 720,619 |
| Premises and equipment | 16,413 | 16,501 | 16,357 | 16,849 |
| Goodwill | 22,719 | 18,397 | 22,703 | 19,662 |
| Other assets | 27,684 | 26,430 | 27,684 | 27,961 |
| Total assets | \$1,074,126 | \$927,677 | \$1,079,916 | \$975,320 |
| Liabilities and shareholders' equity | | | | |
| Deposits | | | | |
| Demand | \$ 61,377 | \$ 57,802 | \$ 63,020 | \$ 64,869 |
| NOW | 101,131 | 105,713 | 101,668 | 113,018 |
| Money market | 121,885 | 112,502 | 123,071 | 115,752 |
| Savings | 102,698 | 111,832 | 102,441 | 117,229 |
| Certificates of deposit | 161,175 | 115,686 | 166,768 | 131,687 |
| Certificates of deposit over \$100,000 | 232,366 | 130,297 | 239,950 | 171,654 |
| Total deposits | 780,632 | 633,832 | 796,918 | 714,209 |
| Borrowed funds | 179,192 | 187,342 | 168,301 | 151,067 |
| Other liabilities | 9,058 | 8,848 | 9,239 | 8,966 |
| Total liabilities | 968,882 | 830,022 | 974,457 | 874,242 |
| Common stock | 99 | 98 | 99 | 98 |
| Additional paid-in capital | 47,126 | 46,208 | 46,965 | 47,912 |
| Retained earnings | 57,457 | 49,687 | 57,872 | 51,588 |
| Unrealized gain on available-for-sale securities | 562 | 1,662 | 524 | 1,480 |
| Total shareholders' equity | 105,244 | 97,655 | 105,459 | 101,078 |
| Total liabilities and shareholders' equity | \$1,074,126 | \$927,677 | \$1,079,916 | \$975,320 |

Off-Balance Sheet Financial Instruments

No material off-balance sheet risk exists that requires a separate liability presentation.

Sale of Loans

No recourse obligations have been incurred in connection with the sale of loans.

Contractual Obligations

The following table sets forth the contractual obligations of the Company as of September 30, 2006:

| <i>In thousands of dollars</i> | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
|--|------------------|-----------------------------|------------------|------------------|------------------------------|
| Borrowed funds | \$130,300 | 113,100 | 2,000 | 15,000 | 200 |
| Operating leases | 576 | 205 | 232 | 102 | 37 |
| Certificates of deposit | 425,936 | 113,073 | 300,274 | 12,589 | - |
| Total | \$556,812 | 226,378 | 302,506 | 27,691 | 237 |
| Unused line, collateralized by residential real estate | \$ 78,083 | 78,083 | - | - | - |
| Other unused commitments | \$ 50,126 | 50,126 | - | - | - |
| Standby letters of credit | \$ 1,466 | 1,466 | - | - | - |
| Commitments to extend credit | \$ 20,869 | 20,869 | - | - | - |
| Total loan commitments and unused lines of credit | \$150,544 | 150,544 | - | - | - |

Liquidity Management

As of September 30, 2006 the Bank had primary sources of liquidity of \$268.8 million. It is Management's opinion this is adequate. In its Asset/Liability policy, the Bank has guidelines for liquidity. The Company is not aware of any recommendations by the regulatory authorities which, if they were to be implemented, would have a material effect on the Company's liquidity, capital resources or results of operations.

Forward-Looking Statements

Certain disclosures in Management's Discussion and Analysis of Financial Condition and Results of Operations contain certain forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995). In preparing these disclosures, Management must make assumptions, including, but not limited to, the level of future interest rates, prepayments on loans and investment securities, required levels of

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capital, needs for liquidity, and the adequacy of the allowance for loan losses. These forward-looking statements may be subject to significant known and unknown risks uncertainties, and other factors, including, but not limited to, those matters referred to in the preceding sentence.

Although First National Lincoln Corporation believes that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from the results discussed in these forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Readers are also urged to carefully review and consider the various disclosures made by the Company, which attempt to advise interested parties of the facts that affect the Company's business.

Item 3 Quantitative and Qualitative Disclosures About Market Risk**Market-Risk Management**

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates. First National Lincoln Corporation's market risk is composed primarily of interest rate risk. The Bank's Asset/Liability Committee (ALCO) is responsible for reviewing the interest rate sensitivity position of the Company and establishing policies to monitor and limit exposure to interest rate risk. All guidelines and policies established by ALCO have been approved by the Board of Directors.

Asset/Liability Management

The primary goal of asset/liability management is to maximize net interest income within the interest rate risk limits set by ALCO. Interest rate risk is monitored through the use of two complementary measures: static gap analysis and earnings simulation modeling. While each measurement has limitations, taken together they represent a reasonably comprehensive view of the magnitude of interest rate risk in the Company, the level of risk through time, and the amount of exposure to changes in certain interest rate relationships.

Static gap analysis measures the amount of repricing risk embedded in the balance sheet at a point in time. It does so by comparing the differences in the repricing characteristics of assets and liabilities. A gap is defined as the difference between the principal amount of assets and liabilities that reprice within a specified time period. The Bank's cumulative one-year gap, at September 30, 2006, was -14.35% of total assets. Core deposits with non-contractual maturities are presented based upon historical patterns of balance attrition and pricing behavior, which are reviewed at least annually.

The gap repricing distributions include principal cash flows from residential mortgage loans and mortgage-backed securities in the time frames in which they are expected to be received. Mortgage prepayments are estimated by applying industry median projections of prepayment speeds to portfolio segments based on coupon range and loan age.

A summary of the Bank's static gap, as of September 30, 2006 is presented in the following table:

| | 0-90 Days | 90-365 Days | 1-5 Years | 5+ Years |
|---|----------------------|------------------------|----------------------|---------------------|
| Investment securities at amortized cost | \$16,718 | \$30,451 | \$76,238 | \$53,657 |
| Loans held for sale | - | - | - | - |
| Loans | 296,786 | 112,629 | 334,215 | 85,909 |
| Other interest-earning assets | - | 8,413 | - | - |
| Non-rate-sensitive assets | 72 | 216 | 1,140 | 50,147 |
| Total assets | 313,576 | 151,709 | 411,593 | 189,713 |
| Interest-bearing deposits | 257,847 | 242,244 | 69,968 | 209,534 |
| Borrowed funds | 50,823 | 62,255 | 17,082 | 140 |
| Non-rate-sensitive liabilities and equity | 1,281 | 3,843 | 20,496 | 131,078 |
| Total liabilities and equity | 309,951 | 308,342 | 107,546 | 340,752 |
| Period gap | \$3,625 | \$(156,633) | \$304,047 | \$(151,039) |
| Percent of total assets | 0.34% | -14.69% | 28.51% | -14.16% |
| Cumulative gap (current) | 3,625 | (153,008) | 151,039 | - |
| Percent of total assets | 0.34% | -14.35% | 14.16% | 0.00% |

The earnings simulation model forecasts capture the impact of changing interest rates on one-year and two-year net interest income. The modeling process calculates changes in interest income received and interest expense paid on all interest-earning assets and interest-bearing liabilities reflected on the Company's balance sheet. None of the assets used in the simulation are held for trading purposes. The modeling is

done for a variety of scenarios that incorporate changes in the absolute level of interest rates as well as basis risk, as represented by changes in the shape of the yield curve and changes in interest rate relationships. Management evaluates the effects on income of alternative interest rate scenarios

against earnings in a stable interest rate environment. This analysis is also most useful in determining the short-run earnings exposures to changes in customer behavior involving loan payments and deposit additions and withdrawals.

The Bank's most recent simulation model projects net interest income would increase by approximately 4.47% of stable-rate net interest income if short-term rates affected by Federal Open Market Committee actions fall gradually by two percentage points over the next year, and decrease by approximately 6.59% if rates rise gradually by two percentage points. Both scenarios are well within ALCO's policy limit of a decrease in net interest income of no more than 10.0% given a 2.0% move in interest rates, up or down. Management believes this reflects a reasonable interest rate risk position. In year two, and assuming no additional movement in rates, the model forecasts that net interest income would be higher than that earned in a stable rate environment by 19.11% in a falling-rate scenario, and lower than that earned in a stable rate environment by 15.83% in a rising rate scenario, when compared to the year-one base scenario. A summary of the Bank's interest rate risk simulation modeling, as of September 30, 2006 is presented in the following table:

| Changes in Net Interest Income | 2006 |
|--|-------------|
| Year 1 | |
| Projected change if rates decrease by 2.0% | +4.47% |
| Projected change if rates increase by 2.0% | -6.59% |
| Year 2 | |
| Projected change if rates decrease by 2.0% | +19.11% |
| Projected change if rates increase by 2.0% | -15.83% |

This dynamic simulation model includes assumptions about how the balance sheet is likely to evolve through time and in different interest rate environments. Loans and deposits are projected to maintain stable balances. All maturities, calls and prepayments in the securities portfolio are assumed to be reinvested in similar assets. Mortgage loan prepayment assumptions are developed from industry median estimates of prepayment speeds for portfolios with similar coupon ranges and seasoning. Non-contractual deposit volatility and pricing are assumed to follow historical patterns. The sensitivities of key assumptions are analyzed annually and reviewed by ALCO.

The information for static gap and changes in net interest income presented in this section pertains to the Bank only and does not include goodwill and a small volume of assets and liabilities owned by the Company and included in its consolidated financial statements as of September 30, 2006. This sensitivity analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These hypothetical estimates are based upon numerous assumptions including, among others, the nature and timing of interest rate levels, yield curve shape, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, and reinvestment/ replacement of asset and liability cash flows. While assumptions are developed based upon current economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions, including how customer preferences or competitor influences might change.

Interest Rate Risk Management

A variety of financial instruments can be used to manage interest rate sensitivity. These may include investment securities, interest rate swaps, and interest rate caps and floors. Frequently called interest rate derivatives, interest rate swaps, caps and floors have characteristics similar to securities but possess the advantages of customization of the risk-reward profile of the instrument, minimization of balance sheet leverage and improvement of liquidity. As of September 30, 2006, the Company was not using any derivative instruments for interest rate risk management.

The Company engages an independent consultant to periodically review its interest rate risk position, as well as the effectiveness of simulation modeling and reasonableness of assumptions used. As of September 30, 2006, there were no significant differences between the views of the independent consultant and Management regarding the Company's interest rate risk exposure. Management expects interest rates will continue to rise in the near term and believes that the current level of interest rate risk is acceptable.

Item 4: Controls and Procedures

As required by Rule 13a-15 under the Securities Exchange Act of 1934, as of September 30, 2006, the end of the quarter covered by this report, the Company carried out an evaluation under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. In designing and evaluating the Company's disclosure controls and procedures, the Company and its management recognize that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and the Company's management necessarily was required to apply its judgment in evaluating and implementing possible controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. There was no change in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. The Company reviews its disclosure controls and procedures, which may include its internal controls over financial reporting on an ongoing basis, and may from time to time make changes aimed at enhancing their effectiveness and to ensure that the Company's systems evolve with its business.

Part II Other Information**Item 1 Legal Proceedings**

The Company was not involved in any legal proceedings requiring disclosure under Item 103 of Regulation S-K during the reporting period.

Item 1A Risk Factors

There have been no material changes to the Risk Factors previously disclosed in Item 1A of the Company's Annual Report on Form 10-K for the period ended December 31, 2005.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

a. The Company issues shares to the Bank's 401k Investment and Savings Plan pursuant to an exemption from registration under the Securities Act of 1933, as amended (the "Securities Act"), contained in Section 3(a)(11) thereof and Rule 147 promulgated thereunder, as presented in the following table:

| Month | Shares | Average Price | Proceeds |
|----------------|---------------|----------------------|------------------|
| January 2006 | 599 | \$17.41 | \$10,000 |
| February 2006 | 2,275 | 17.51 | 40,000 |
| March 2006 | 454 | 17.55 | 8,000 |
| April 2006 | 633 | 17.21 | 11,000 |
| May 2006 | 451 | 16.84 | 8,000 |
| June 2006 | 456 | 17.25 | 8,000 |
| July 2006 | 467 | 17.04 | 8,000 |
| August 2006 | 878 | 17.40 | 15,000 |
| September 2006 | 387 | 17.21 | 7,000 |
| Total | 6,600 | \$17.35 | \$115,000 |

b. None

c. On January 20, 2005, the Company announced that its Board of Directors had authorized the repurchase of up to 250,000 shares of the Company's common stock or approximately 2.5% of the outstanding shares. This program ended in July of 2006, with 248,376 shares repurchased under the program at an average price of \$17.15 and at a total cost of \$4,261,000.

On July 21, 2006, the Company announced that its Board of Directors had authorized a new program for the repurchase of up to 250,000 shares of the Company's common stock or approximately 2.5% of the outstanding shares. The Company expects such repurchases to be effected from time to time, in the open market, in private transactions or otherwise, during a period of up to 24 months. The amount and timing of shares to be purchased will be subject to market conditions and will be based on several factors, including the price of the Company's stock and the level of stock issuances under the Company's employee stock plans. No assurance can be given as to the specific timing of the share repurchases or as to whether and to what extent the share repurchase will be consummated. As of September 30, 2006, the Company had repurchased 63,363 shares

under the new repurchase plan at an average price of \$17.44 and at a total cost of \$1,105,000.

The following table details repurchases under both programs during the nine months ended September 30, 2006:

Total

Number of

| Month | Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of a Publicly Announced Plan or Pro |
|----------------|-------------------------|-------------------------------------|---|
| January 2006 | 26 | \$16.89 | 26 |
| February 2006 | 21,025 | 17.77 | 21,025 |
| March 2006 | 11,836 | 17.58 | 11,836 |
| April 2006 | - | - | - |
| May 2006 | 39,033 | 16.53 | 39,033 |
| June 2006 | 219 | 17.06 | 219 |
| July 2006 | - | - | - |
| August 2006 | 57,064 | 17.45 | 57,064 |
| September 2006 | 6,299 | 17.31 | 6,299 |
| Total | 135,502 | \$17.24 | 135,502 |

Item 3 Default Upon Senior Securities

None.

Item 4 Submission of Matters to a Vote of Security Holders

None

Item 5 Other Information

A. None.

B. None.

Item 6 Exhibits

Exhibit 2.1 Agreement and Plan of Merger With FNB Bankshares Dated August 25, 2004, incorporated by reference to Exhibit 2.1 to the Registrant's Form 8-K dated August 25, 2004, filed under item 1.01 on August 27, 2004.

Exhibit 3.1 Conformed Copy of the Registrants Articles of Incorporation, incorporated by reference to Exhibit 3.1 to the Company's Form 8-K filed under item 5.03 on October 7, 2004.

Exhibit 3.2 Conformed Copy of the Registrant's Bylaws, incorporated by reference to Exhibit 3.2 to the Company's Form 8-K filed under item 5.03 on October 7, 2004.

Exhibit 10.1(a) FNB Bankshares' Stock Option Plan. incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed under item 5.03 on October 7, 2004.

Exhibit 10.1(b) Specimen FNB Bankshares Non-Qualified Stock Option Agreement entered into with Messrs. Rosborough, McKim, Wrobel, Dalrymple and Lay, whose FNB Bankshares options have been converted into options to purchase 5,287, 34,086, 15,275, 11,750 and 21,150 shares of the Registrant's stock, respectively, all at \$3.80 per share, incorporated by reference to Exhibit 10.1(b) to the Company's Form 8-K filed under item 1.01 on January 14, 2005.

Exhibit 10.2(a) Specimen Employment Continuity Agreement entered into with Messrs. McKim, Wrobel, Dalrymple and Lay, incorporated by reference to Exhibit 10.2(a) to the Company's Form 8-K filed under item 1.01 on January 14, 2005.

Exhibit 10.2(b) Specimen Amendment to Employment Continuity Agreement entered into with Messrs. McKim, Wrobel, Dalrymple and Lay, incorporated by reference to Exhibit 10.2(b) to the Company's Form 8-K filed under item 1.01 on January 14, 2005.

Exhibit 10.3(a) Specimen Split Dollar Agreement entered into with Messrs. McKim, Wrobel, Dalrymple and Lay. For Mr. McKim, the amount of the death benefit is \$250,000; for Messrs. Lay, Dalrymple and Wrobel, the death benefit is \$150,000. Incorporated by reference to Exhibit 10.3(a) to the Company's Form 8-K filed under item 1.01 on January 14, 2005.

Exhibit 10.3(b) Specimen Amendment to Split Dollar Agreement entered into with Messrs. McKim, Wrobel, Dalrymple and Lay, incorporated by reference to Exhibit 10.3(b) to the Company's Form 8-K filed under item 1.01 on January 14, 2005.

Exhibit 10.4 Specimen Amendment to Employment Continuity Agreement entered into with Messrs. McKim and Wrobel, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed under item 1.01 on January 31, 2005.

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Exhibit 10.4 Specimen Amendment to Employment Continuity Agreement entered into with Mr. Dalrymple, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed under item 1.01 on September 27, 2005.

Exhibit 31.1 Certification of Chief Executive Officer Pursuant to Rule 13A-14(A) of The Securities Exchange Act of 1934

Exhibit 31.2 Certification of Chief Financial Officer Pursuant to Rule 13A-14(A) of The Securities Exchange Act of 1934

Exhibit 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

Exhibit 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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Signatures

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

FIRST NATIONAL LINCOLN CORPORATION

/s/ Daniel R. Daigneault

Daniel R. Daigneault

President & Chief Executive Officer

Date: November 8, 2006

/s/ F. Stephen Ward

F. Stephen Ward

Executive Vice President & Chief Financial Officer

Date: November 8, 2006

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