

BAR HARBOR BANKSHARES
Form 10-Q
May 10, 2007

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2007

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

Commission File Number: **841105-D**

BAR HARBOR BANKSHARES

(Exact name of registrant as specified in its charter)

Maine

(State or other jurisdiction of
incorporation or organization)
PO Box 400

82 Main Street, Bar Harbor, ME

(Address of principal executive offices)

01-0393663

(I.R.S. Employer
Identification Number)

04609-0400

(Zip Code)

(207) 288-3314

(Registrant's telephone number, including area code)

-

Inapplicable

(Former name, former address and former fiscal year, if changed since last report)

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

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES X
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.

Large accelerated filer _____ Accelerated filer X Non-accelerated filer _____

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2): YES: _____ NO: X

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

| | |
|------------------------------|--|
| <u>Class of Common Stock</u> | <u>Number of Shares Outstanding</u> <u>May 3, 2007</u> |
| \$2.00 Par Value | 3,043,078 |

TABLE OF CONTENTS

| | Page No. |
|----------------|--|
| PART I | FINANCIAL INFORMATION |
| Item 1. | Financial Statements (<i>unaudited</i>): |
| | Consolidated Balance Sheets at March 31, 2007, and December 31, 2006 |
| | 3 |
| | Consolidated Statements of Income for the three months ended March 31, 2007 and 2006 |
| | 4 |
| | Consolidated Statements of Changes in Shareholders' Equity for the three months ended |
| | March 31, 2007 and 2006 |
| | 5 |
| | Consolidated Statements of Cash Flows for the three months ended March 31, 2007 and 2006 |
| | 6 |
| | Consolidated Statements of Comprehensive Income for the three months ended March 31, 2007 and 2006 |
| | 7 |
| | Notes to Consolidated Interim Financial Statements |
| | 8-16 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations |
| | 16-43 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk |
| | 44-47 |
| Item 4. | Controls and Procedures |
| | 47 |
| PART II | OTHER INFORMATION |
| Item 1. | Legal Proceedings |
| | 47 |
| Item 1A. | Risk Factors |
| | 48 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds |
| | 48 |
| Item 3. | Defaults Upon Senior Securities |
| | 48 |
| Item 4. | Submission of Matters to a Vote of Security Holders |
| | 48 |
| Item 5. | Other Information |
| | 48 |
| Item 6. | Exhibits |
| | 49 |
| Signatures | 49 |

PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

BAR HARBOR BANKSHARES AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
MARCH 31, 2007 AND DECEMBER 31, 2006
(in thousands, except share data)

(unaudited)

| | March 31, 2007 | December 31, 2006 |
|---|-------------------|----------------------|
| Assets | | |
| Cash and due from banks | \$ 9,308 | \$ 11,838 |
| Overnight interest bearing money market funds | 657 | 7,709 |
| Total cash and cash equivalents | 9,965 | 19,547 |
| Securities available for sale, at fair value | 227,473 | 213,252 |
| Investment in Federal Home Loan Bank stock | 12,531 | 11,849 |
| Loans | 552,643 | 555,099 |
| Allowance for loan losses | (4,499) | (4,525) |
| Loans, net of allowance for loan losses | 548,144 | 550,574 |
| Premises and equipment, net | 11,240 | 11,368 |
| Goodwill | 3,158 | 3,158 |
| Bank owned life insurance | 6,173 | 6,116 |
| Other assets | 8,582 | 9,013 |
| TOTAL ASSETS | \$827,266 | \$824,877 |
| Liabilities | | |
| Deposits | | |
| Demand deposits | \$ 47,848 | \$ 53,872 |
| NOW accounts | 62,364 | 63,588 |
| Savings and money market deposits | 147,690 | 164,213 |
| Time deposits | 129,462 | 132,285 |
| Brokered time deposits | 119,468 | 82,361 |
| Total deposits | 506,832 | 496,319 |
| Short-term borrowings | 173,269 | 175,246 |
| Long-term debt | 79,083 | 85,466 |
| Other liabilities | 5,530 | 6,795 |
| TOTAL LIABILITIES | 764,714 | 763,826 |
| Shareholders' equity | | |
| Capital stock, par value \$2.00; authorized 10,000,000 shares; issued 3,643,614 shares at March 31, 2007 and December 31, 2006 | 7,287 | 7,287 |
| Surplus | 4,424 | 4,365 |
| Retained earnings | 59,975 | 59,339 |
| Accumulated other comprehensive (loss) income: | | |
| Prior service cost and unamortized net actuarial gains/losses on employee benefit plans, net of tax of (\$70) and \$80, at March 31, 2007 and December 31, 2006, respectively | (133) | 156 |

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

| | | |
|--|------------------|------------------|
| Net unrealized appreciation (depreciation) on securities available for sale, net of tax of \$223 and (\$351), at March 31, 2007 and December 31, 2006, respectively | 433 | (680) |
| Net unrealized depreciation on derivative instruments, net of tax of \$183 and \$221 at March 31, 2007 and December 31, 2006, respectively | (356) | (429) |
| Total accumulated other comprehensive loss | (56) | (953) |
| Less: cost of 598,944 | | |
| and 596,169 shares of treasury stock at March 31, 2007 and December 31, 2006, respectively | (9,078) | (8,987) |
| TOTAL SHAREHOLDERS' EQUITY | 62,552 | 61,051 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$827,266 | \$824,877 |

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

BAR HARBOR BANKSHARES AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(in thousands, except share data)

(unaudited)

| | Three Months Ended March 31, | |
|---|---------------------------------|----------|
| | 2007 | 2006 |
| Interest and dividend income: | | |
| Interest and fees on loans | \$ 9,188 | \$ 8,263 |
| Interest and dividends on securities and other earning assets | 3,172 | 2,431 |
| Total interest and dividend income | 12,360 | 10,694 |
| Interest expense: | | |
| Deposits | 3,887 | 2,609 |
| Short-term borrowings | 1,917 | 1,319 |
| Long-term borrowings | 1,274 | 1,279 |
| Total interest expense | 7,078 | 5,207 |
| Net interest income | 5,282 | 5,487 |
| Provision for loan losses | --- | 28 |
| Net interest income after provision for loan losses | 5,282 | 5,459 |
| Non-interest income: | | |
| Trust and other financial services | 541 | 504 |
| Service charges on deposit accounts | 370 | 343 |
| Other service charges, commissions and fees | 52 | 53 |
| Credit and debit card service charges and fees | 267 | 230 |
| Net securities (loss) gain | (920) | 310 |
| Other operating income | 68 | 164 |
| Total non-interest income | 378 | 1,604 |

| | | |
|---------------------------------|----------|----------|
| Non-interest expenses: | | |
| Salaries and employee benefits | 2,345 | 2,444 |
| Postretirement plan settlement | (832) | --- |
| Occupancy expense | 373 | 312 |
| Furniture and equipment expense | 449 | 500 |
| Credit and debit card expenses | 188 | 166 |
| Other operating expense | 1,274 | 1,463 |
| Total non-interest expenses | 3,797 | 4,885 |
| Income before income taxes | 1,863 | 2,178 |
| Income taxes | 488 | 615 |
| Net income | \$ 1,375 | \$ 1,563 |
| <u>Earnings Per Share</u> | | |
| : | | |
| Basic earnings per share | \$ 0.45 | \$ 0.51 |
| Diluted earnings per share | \$ 0.44 | \$ 0.50 |

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

BAR HARBOR BANKSHARES AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(in thousands, except share data)

(unaudited)

| | Capital Stock | Surplus | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total Shareholders' Equity |
|--|------------------|---------|----------------------|---|-------------------|----------------------------------|
| Balance December 31, 2005 | \$7,287 | \$4,002 | \$55,181 | \$(1,738) | \$(8,628) | \$56,104 |
| Cumulative adjustment from the adoption of | | | | | | |
| SAB No. 108 | --- | --- | 331 | --- | --- | 331 |
| Adjusted balance December 31, 2005 | 7,287 | 4,002 | 5,512 | (1,738) | (8,628) | 56,435 |
| Net income | --- | --- | 1,563 | --- | --- | 1,563 |
| Total other comprehensive loss | --- | --- | --- | (726) | --- | (726) |
| Cash dividends declared (\$0.22 per share) | --- | --- | (673) | --- | --- | (673) |
| Purchase of treasury stock (18,725 shares) | --- | --- | --- | --- | (535) | (535) |
| Stock options exercised (3,750 shares), and related tax effects | --- | --- | (37) | --- | 101 | 64 |
| Recognition of stock option expense | --- | 35 | --- | --- | --- | 35 |
| Balance March 31, 2006 | \$7,287 | \$4,037 | \$56,365 | \$(2,464) | \$(9,062) | \$56,163 |

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

| | | | | | | |
|--|---------|---------|----------|----------|-----------|----------|
| Balance December 31, 2006 | \$7,287 | \$4,365 | \$59,339 | \$ (953) | \$(8,987) | \$61,051 |
| Net income | --- | --- | 1,375 | --- | --- | 1,375 |
| Total other comprehensive income | --- | --- | --- | 897 | --- | 897 |
| Cash dividends declared (\$0.235 per share) | --- | --- | (716) | --- | --- | (716) |
| Purchase of treasury stock (4,611 shares) | --- | --- | --- | --- | (150) | (150) |
| Stock options exercised (1,836 shares), and related tax effects | --- | 5 | (23) | --- | 59 | 41 |
| Recognition of stock option expense | --- | 54 | --- | --- | --- | 54 |
| Balance March 31, 2007 | \$7,287 | \$4,424 | \$59,975 | \$ (56) | \$(9,078) | \$62,552 |

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

BAR HARBOR BANKSHARES AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(in thousands)
(unaudited)

| | 2007 | 2006 |
|---|----------|----------|
| Cash flows from operating activities: | | |
| Net income | \$ 1,375 | \$ 1,563 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of premises and equipment | 318 | 333 |
| Amortization of core deposit intangible | 17 | 17 |
| Provision for loan losses | --- | 28 |
| Net securities losses (gains) | 920 | (310) |
| Net amortization of bond premiums | 62 | 84 |
| Recognition of stock option expense | 54 | 35 |
| Postretirement plan settlement | (832) | --- |
| Net change in other assets | 11 | (296) |
| Net change in other liabilities | (875) | (193) |
| Net cash provided by operating activities | 1,050 | 1,261 |
| Cash flows from investing activities: | | |
| Purchases of securities available for sale | (28,246) | (28,347) |
| Proceeds from maturities, calls and principal paydowns of securities available for sale | 12,527 | 6,689 |
| Proceeds from sales of securities available for sale | 2,201 | 3,140 |
| Net increase in Federal Home Loan Bank stock | (682) | (720) |
| Net decrease (increase) in loans | 2,430 | (14,455) |
| Capital expenditures | (190) | (297) |
| Net cash used in investing activities | (11,960) | (33,990) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 10,513 | 29,021 |

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

| | | |
|---|----------|----------|
| Net decrease in securities sold under repurchase agreements and fed funds purchased | (1,759) | (1,797) |
| Proceeds from Federal Home Loan Bank advances | 6,399 | 6,400 |
| Repayments of Federal Home Loan Bank advances | (13,000) | (596) |
| Purchases of treasury stock | (150) | (535) |
| Proceeds from stock option exercises, including excess tax benefits | 41 | 64 |
| Payments of dividends | (716) | (673) |
| Net cash provided by financing activities | 1,328 | 31,884 |
| Net decrease in cash and cash equivalents | (9,582) | (845) |
| Cash and cash equivalents at beginning of year | 19,547 | 14,000 |
| Cash and cash equivalents at end of period | \$ 9,965 | \$13,155 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | \$ 6,072 | \$ 4,557 |
| Non-cash investing and financing activities: | | |
| Cumulative effect adjustment from the adoption of SAB No. 108 | \$ --- | \$ 331 |
| Net unrealized appreciation (depreciation) on securities available for sale, net of reclassification adjustment, net of tax of \$574, and (\$311), respectively | 1,113 | (604) |
| Net unrealized appreciation (depreciation) on interest rate derivatives, net of tax of \$39 and (\$63), respectively | 76 | (123) |
| Ineffective portion of unrealized losses on interest rate derivatives, net of tax of (\$2) | (5) | --- |
| Amortization of net deferred loss related to interest rate derivatives, net of tax of \$1 and \$1, respectively | 2 | 1 |
| Elimination of actuarial gain upon post retirement plan settlement, and related tax effect of (\$151) | (291) | --- |
| Amortization of actuarial gain for supplemental executive retirement plan, net of tax of \$1 | 2 | --- |

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

BAR HARBOR BANKSHARES AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(in thousands)

(unaudited)

| | Three Months Ended March 31, | |
|---|---------------------------------|---------|
| | 2007 | 2006 |
| Net income | \$1,375 | \$1,563 |
| Net unrealized appreciation (depreciation) on securities available for sale, net of reclassification adjustment, net of tax of \$574, and (\$311), respectively | 1,113 | (604) |
| Net unrealized appreciation (depreciation) on interest rate derivatives, net of tax of \$39 and (\$63), respectively | 76 | (123) |
| | (5) | --- |

| | | |
|---|---------|--------|
| Ineffective portion of unrealized losses on interest rate derivatives, net of tax of (\$2) | | |
| Amortization of net deferred loss related to interest rate derivatives, net of tax of \$1 and \$1, respectively | 2 | 1 |
| Elimination of actuarial gain upon post retirement plan settlement, and related tax effect of (\$151) | (291) | --- |
| Amortization of actuarial gain for supplemental executive retirement plan, net of tax of \$1 | 2 | --- |
| Total other comprehensive income (loss) | 897 | (726) |
| Total comprehensive income | \$2,272 | \$ 837 |

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

BAR HARBOR BANKSHARES AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
MARCH 31, 2007
(in thousands, except share data)
(unaudited)

Note 1: Basis of Presentation

The accompanying consolidated interim financial statements are unaudited. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All inter-company transactions have been eliminated in consolidation. Amounts in the prior period financial statements are reclassified whenever necessary to conform to current period presentation. The net income reported for the three months ended March 31, 2007 is not necessarily indicative of the results that may be expected for the year ending December 31, 2007, or any other interim periods.

The consolidated balance sheet at December 31, 2006 has been derived from audited consolidated financial statements at that date. The accompanying unaudited interim consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X (17 CFR Part 218). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, and notes thereto.

Note 2: Management's Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, income tax estimates, and the valuation of intangible assets.

Allowance For Loan Losses:

The allowance for loan losses (the "allowance") at the Company's wholly owned banking subsidiary, Bar Harbor Bank & Trust (the "Bank") is a significant accounting estimate used in the preparation of the Company's consolidated financial statements. The allowance is available to absorb losses on loans. The allowance is maintained at a level that, in management's judgment, is appropriate for the amount of risk inherent in the loan portfolio, given past and present conditions. The allowance is increased by provisions charged to operating expense and by recoveries on loans previously charged-off.

Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. The determination of the adequacy of the allowance and provisioning for estimated losses is evaluated regularly based on review of loans, with particular emphasis on non-performing and other loans that management believes warrant special consideration. The ongoing evaluation process includes a formal analysis, which considers among other factors: the character and size of the loan portfolio, business and economic conditions, real estate market conditions, collateral values, changes in product offerings or loan terms, changes in underwriting and/or collection policies, loan growth, previous charge-off experience, delinquency trends, non-performing loan trends, the performance of individual loans in relation to contract terms and estimated fair values of collateral.

Reserves are established for specific loans including impaired loans, a pool of reserves based on historical charge-offs by loan types, and supplemental reserves that adjust historical loss experience to reflect current economic conditions, industry specific risks, and other observable data.

While management uses available information to recognize losses on loans, changing economic conditions and the economic prospects of the borrowers may necessitate future additions or reductions to the allowance. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance, which also may necessitate future additions or reductions to the allowance, based on information available to them at the time of their examination.

Income Taxes:

On January 1, 2007, the Company adopted Financial Accounting Interpretation Number 48 ("FIN 48") to account for uncertain tax positions. FIN 48 prescribes a recognition threshold of more-likely-than-not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those tax positions to be recognized in the financial statements.

The Company estimates its income taxes for each period for which a statement of income is presented. The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. If current available information indicates that it is more likely than not that deferred tax assets will not be realized, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Significant management judgment is required in determining income tax expense, and deferred tax assets and liabilities. As of March 31, 2007 and December 31, 2006, there was no valuation allowance for deferred tax assets. Deferred tax assets are included in other assets on the consolidated balance sheet.

Goodwill and Identifiable Intangible Assets:

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

In connection with acquisitions, the Company generally records as assets on its consolidated financial statements both goodwill and identifiable intangible assets, such as core deposit intangibles.

The Company evaluates whether the carrying value of its goodwill has become impaired, in which case the value is reduced through a charge to its earnings. Goodwill is evaluated for impairment at least annually, or upon a triggering event as defined by Statement of Financial Accounting Standards ("SFAS") No. 142, using certain fair value techniques.

Identifiable intangible assets consist of core deposit intangibles amortized over their estimated useful lives on a straight-line method, which approximates the amount of economic benefits to the Company. These assets are reviewed for impairment at least annually, or whenever management believes events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Furthermore, the determination of which intangible assets have finite lives is subjective, as is the determination of the amortization period for such intangible assets.

Any changes in the estimates used by the Company to determine the carrying value of its goodwill and identifiable intangible assets, or which otherwise adversely affect their value or estimated lives, would adversely affect the Company's consolidated results of operations.

Note 3: Earnings Per Share

Earnings per share have been computed in accordance with SFAS No. 128, "Earnings Per Share." Basic earnings per share excludes dilution and is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company, such as the Company's dilutive stock options.

The following is a reconciliation of basic and diluted earnings per share for the three months ended March 31, 2007 and 2006:

| | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Net income | \$ 1,375 | \$ 1,563 |
| <u>Computation of Earnings Per Share:</u> | | |
| Weighted average number of capital stock shares outstanding | | |
| Basic | 3,046,918 | 3,044,984 |
| Effect of dilutive employee stock options | 92,673 | 81,341 |
| Diluted | 3,139,591 | 3,126,325 |
| EARNINGS PER SHARE: | | |
| Basic | \$ 0.45 | \$ 0.51 |
| Diluted | \$ 0.44 | \$ 0.50 |
| Anti-dilutive options excluded from earnings per share calculation | 16,463 | 81,513 |

Note 4: Retirement Benefit Plans

Prior to the first quarter of 2007, the Company sponsored a limited post-retirement benefit program, which funded medical coverage and life insurance benefits to a closed group of active and retired employees who met minimum age and service requirements. It was the Company's policy to record the cost of post-retirement health care and life insurance plans based on actuarial estimates, which were dependent on claims and premiums paid. The cost of providing these benefits was accrued during the active service period of the employee.

In the first quarter of 2007, the Company settled its limited post-retirement benefit program. The Company voluntarily paid out \$700 to plan participants, representing 64% of the accrued post retirement benefit obligation. This payment fully settled all Company obligations related to this program. In connection with the settlement of the postretirement program, the Company recorded a reduction in non-interest expense of \$832, representing the elimination of the \$390 remaining accrued benefit obligation included in other liabilities on the consolidated balance sheet, and the \$291 actuarial gain related to the program, which was included in accumulated other comprehensive income, net of tax effect of \$151.

The Company has non-qualified supplemental executive retirement plans for certain retired officers. These plans provide supplemental retirement benefits payable in installments over a period of years upon retirement or death. The Company recognized the net present value of payments associated with the agreements over the service periods of the participating officers. Interest costs continue to be recognized on the benefit obligations.

The Company also has supplemental executive retirement plans for certain executive officers. These plans provide a stream of future payments in accordance with individually defined vesting schedules upon retirement, termination, death, or in the event that the executive leaves the Company following a change of control event.

The following table summarizes the net periodic benefit costs for the three months ended March 31, 2007 and 2006:

| Three Months Ended | Supplemental Executive Retirement Plans | |
|--------------------------------|---|------|
| | 2007 | 2006 |
| Service cost | \$50 | \$47 |
| Interest cost | 40 | 38 |
| Amortization of actuarial loss | 3 | --- |
| Net periodic benefit cost | \$93 | \$85 |

The Company is expected to recognize \$359 of expense for the foregoing plans for the year ended December 31, 2007. The Company is expected to contribute \$222 to the foregoing plans in 2007. As of March 31, 2007, the Company had contributed \$58.

Note 5: Commitments and Contingent Liabilities

The Bank is a party to financial instruments in the normal course of business to meet financing needs of its customers. These financial instruments include commitments to extend credit, unused lines of credit, and standby letters of credit.

Commitments to originate loans, including unused lines of credit, are agreements to lend to a customer provided there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank uses the same credit policy to make such commitments as it uses for on-balance-sheet items, such as loans. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the borrower.

The Bank guarantees the obligations or performance of customers by issuing standby letters of credit to third parties. These standby letters of credit are primarily issued in support of third-party debt or obligations. The risk involved in issuing standby letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination, portfolio maintenance and management procedures in effect to monitor other credit and off-balance sheet instruments. Exposure to credit loss in the event of non-performance by the counter-party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments. Typically, these standby letters of credit have terms of five years or less and

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

expire unused; therefore, the total amounts do not necessarily represent future cash requirements.

The following table summarizes the contractual amounts of commitments and contingent liabilities as of March 31, 2007 and December 31, 2006:

| | March 31, 2007 | December 31, 2006 |
|--|-------------------|----------------------|
| Commitments to originate loans | \$37,007 | \$13,340 |
| Unused lines of credit | \$78,928 | \$81,800 |
| Un-advanced portions of construction loans | \$ 4,002 | \$ 7,638 |
| Standby letters of credit | \$ 462 | \$ 442 |

As of March 31, 2007 and December 31, 2006, the fair value of the standby letters of credit were not significant to the Company's consolidated financial statements.

Note 6: Financial Derivative Instruments

As part of its overall asset and liability management strategy, the Bank periodically uses derivative instruments to minimize significant unplanned fluctuations in earnings and cash flows caused by interest rate volatility. The Bank's interest rate risk management strategy involves modifying the re-pricing characteristics of certain assets and liabilities so that changes in interest rates do not have a significant effect on net income.

The Company recognizes all of its derivative instruments on the consolidated balance sheet at fair value. On the date the derivative instrument is entered into, the Bank designates whether the derivative is part of a hedging relationship (i.e., cash flow or fair value hedge). The Bank formally documents relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking hedge transactions. The Bank also assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting the changes in cash flows or fair values of hedged items.

Changes in fair value of derivative instruments that are highly effective and qualify as a cash flow hedge are recorded in other comprehensive income or loss. Any ineffective portion is recorded in earnings. For fair value hedges that are highly effective, the gain or loss on the hedge and the loss or gain on the hedged item attributable to the hedged risk are both recognized in earnings, with the differences (if any) representing hedge ineffectiveness. The Bank discontinues hedge accounting when it is determined that the derivative is no longer highly effective in offsetting changes of the hedged risk on the hedged item, or management determines that the designation of the derivative as a hedging instrument is no longer appropriate.

At March 31, 2007 the Bank had four outstanding derivative instruments with notional principal amounts totaling \$50,000. These derivative instruments were interest rate swap agreements and interest rate floor agreements, with notional principal amounts totaling \$20,000 and \$30,000, respectively. The details are summarized as follows:

Interest Rate Swap Agreements:

| Description | Maturity | Notional Amount | Fixed Interest Rate | Variable Interest Rate |
|---------------------------------------|----------|-----------------|---------------------|------------------------|
| Receive fixed rate, pay variable rate | 09/01/07 | \$10,000 | 6.04% | Prime (8.25%) |
| Receive fixed rate, pay variable rate | 01/24/09 | \$10,000 | 6.25% | Prime (8.25%) |

The Bank is required to pay to a counter-party monthly variable rate payments indexed to Prime, while receiving monthly fixed rate payments based upon interest rates of 6.04% and 6.25%, respectively, over the term of each

agreement.

The interest rate swap agreements were designated as cash flow hedges in accordance with SFAS No. 133 Implementation Issue No. G25, "Cash Flow Hedges: Using the First-Payments Received Technique in Hedging the Variable Interest Payments on a Group of Non-Benchmark-Rate-Based Loans."

At March 31, 2007, the fair market value of the interest rate swap agreements was an unrealized loss of \$364 compared with unrealized losses of \$473 and \$745 at December 31, and March 31, 2006, respectively. The fair market values of the interest rate swap agreements were included in other liabilities on the consolidated balance sheets.

During the three months ended March 31, 2007, the total net cash flows (paid to) received from counter-parties amounted to (\$106), compared with (\$53) during the same period in 2006. The net cash flows (paid to) received from counter-parties were recorded in interest income.

At March 31, 2007, the net unrealized loss on the interest rate swap agreements included in accumulated other comprehensive loss, net of tax, amounted to \$240 compared with \$313 and \$492 at December 31 and March 31, 2006, respectively. Also included in accumulated other comprehensive loss at March 31, 2007, was a net deferred loss, net of tax, of \$4 related to the de-designation and re-designation of these interest rate swap agreements as cash flow hedges in 2004.

Interest Rate Floor Agreements

| Notional Amount | Termination Date | Prime Strike Rate | Premium Paid |
|-----------------|---------------------|----------------------|-----------------|
| \$20,000 | 08/01/10 | 6.00% | \$186 |
| \$10,000 | 11/01/10 | 6.50% | \$ 69 |

During 2005, interest rate floor agreements were purchased to limit the Bank's exposure to falling interest rates on two pools of loans indexed to the Prime interest rate. Under the terms of the agreements, the Bank paid premiums of \$186 and \$69 for the right to receive cash flow payments if the Prime interest rate falls below the floors of 6.00% and 6.50%, thus effectively ensuring interest income on the pools of prime-based loans at minimum rates of 6.00% and 6.50% for the duration of the agreements. The interest rate floor agreements were designated as cash flow hedges in accordance with SFAS 133.

At March 31, 2007, the total fair market value of the interest rate floor agreements was \$38 compared with \$40 at December 31, 2006. The fair market values of the interest rate floor agreements are included in other assets on the Company's consolidated balance sheets. Pursuant to SFAS 133, changes in the fair market value, representing unrealized gains or losses, are recorded in accumulated other comprehensive loss.

The premiums paid on the interest rate floor agreements are included in accumulated other comprehensive income on the consolidated balance sheets and are being recognized in interest income over the duration of the agreements using the floorlet method, in accordance with SFAS 133. During the three months ended March 31, 2007, \$8 of the premium was recognized in interest income. At March 31, 2007, the remaining unamortized premiums, net of tax, totaled \$150, compared with \$154 at December 31, 2006. During the next twelve months, \$47 of the premiums will be recognized in interest income, decreasing the interest income related to the hedged pool of Prime-based loans.

At March 31, 2007, and December 31, 2006, the unamortized premium net of the unrealized gain on the interest rate floor agreement amounted to \$126 and \$129, net of tax, respectively, and was recorded in accumulated other comprehensive income on the consolidated balance sheet.

A summary of the hedging related balances follows:

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

| | March 31, 2007 | | December 31, 2006 | |
|--|----------------|------------|-------------------|------------|
| | Gross | Net of Tax | Gross | Net of Tax |
| Unrealized gain on interest rate floors, including ineffectiveness | | | | |
| of \$21 at March 31, 2007 and \$28 at December 31, 2006 | \$ 59 | \$ 38 | \$ 68 | \$ 44 |
| Unrealized loss on interest rate swaps | (364) | (240) | (473) | (313) |
| Unamortized premium on interest rate floors | (227) | (150) | (235) | (154) |
| Net deferred loss on de-designation of interest rate swaps | (5) | (4) | (8) | (6) |
| Total | \$(537) | \$(356) | \$(648) | \$(429) |

Note 7: Recently Adopted Accounting Standards

The Company recently adopted the following accounting standards:

Accounting for Uncertainty in Income Taxes:

In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109" ("FIN 48"). This statement clarifies the criteria that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in a company's financial statements. FIN 48 prescribes a recognition threshold of more-likely-than-not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those tax positions to be recognized in the financial statements. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, and disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006.

On January 1, 2007 the Company adopted the provisions of FIN 48 and there was no impact on the consolidated financial statements. Upon the adoption of this standard, the Company performed an analysis of its tax positions to determine whether there may be uncertainties that require further analysis under FIN 48 based upon their specific facts and circumstances. The Company did not identify any uncertain tax positions for which tax benefits should not be recognized under FIN 48 upon adoption or as of March 31, 2007. The Company accounts for interest and penalties related to uncertain tax positions as part of its provision for federal and state income taxes.

The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2004 through 2006. The Company's state income tax returns are also open to audit under the statute of limitations for the years ended December 31, 2004 through 2006.

Accounting for Servicing of Financial Assets:

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156 ("SFAS 156"), "Accounting for Servicing of Financial Assets." This statement amends Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," with respect to the accounting for separately recognized servicing assets and servicing liabilities. SFAS 156 requires companies to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. The statement permits a company to choose either the amortized cost method or fair value measurement method for each class of separately recognized servicing assets. This statement is effective as of the beginning of a company's first fiscal year after September 15, 2006 (January 1, 2007 for the Company). The

Company's adoption of SFAS 156 did not have an impact on its financial condition or results of operations.

Prior Year Financial Statement Misstatements:

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. There are two widely recognized methods for quantifying the effects of financial statement misstatements: the "roll-over" and "iron curtain" methods. The roll-over method, the method the Company historically used, focuses primarily on the impact of a misstatement on the income statement, including the reversing effect of prior year misstatements. Because the focus is on the income statement, the roll-over method can lead to the accumulation of misstatements in the balance sheet that may become material to the balance sheet. The iron curtain method focuses primarily on the effect of correcting the accumulated misstatement as of the balance sheet date, with less emphasis on the reversing effects of prior year errors on the income statements. In SAB 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements under both the roll-over and iron curtain methods. This framework is referred to as the "dual approach." SAB 108 permits companies to initially apply its provisions either by restating prior financial statements as if the dual approach had always been used or recording the cumulative effect of initially applying the dual approach as adjustments to the balance sheet as of the first day of the fiscal year with an offsetting adjustment recorded to retained earnings.

The Company completed an analysis under the "dual approach" and adopted SAB 108 effective as of January 1, 2006. The Company applied the SAB 108 provisions using the cumulative effect transition method. Upon adoption of SAB 108, the Company reversed \$331 of income taxes payable resulting from cumulative over accruals of income tax expense. These misstatements primarily resulted from the incorrect determination of depreciation and deferred loan origination costs for tax purposes and principally occurred prior to 2004, with certain amounts dating back to the 1990's. After considering all of the quantitative and qualitative factors, the Company determined these misstatements had not previously been material to any of those prior periods when measured using the roll-over method. Given that the effect of correcting these misstatements during 2006 would be material to the Company's 2006 financial statements, the Company concluded that the cumulative effect adjustment method of initially applying the guidance in SAB 108 was appropriate. In accordance with the transition provisions of SAB 108, the Company recorded this cumulative effect adjustment, resulting in a \$331 increase in other assets and a \$331 increase in retained earnings as of January 1, 2006.

Note 8: Recently Issued Accounting Pronouncements

The following information addresses new or proposed accounting pronouncements that could have an impact on the Company's financial condition, results of operations, earnings per share, or cash flows.

Fair Value Measurements for Financial Assets and Liabilities:

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 ("SFAS 159"), "The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115." This standard provides companies with an option to report selected financial assets and liabilities at fair value. The Standard's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. SFAS 159 helps to mitigate this type of accounting-induced volatility by enabling companies to report related assets and liabilities at fair value, which would likely reduce the need for companies to comply with detailed rules for hedge accounting. This new standard also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and

liabilities. SFAS 159 requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. The new Statement does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in FASB Statements No. 157, "Fair Value Measurements," and No. 107, "Disclosures about Fair Value of Financial Instruments." SFAS 159 is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007 (January 1, 2008 for the Company). Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also adopts the provisions of SFAS 157 at the same time. The Company did not adopt SFAS 159 early and is currently evaluating the impact of adopting this statement.

Fair Value Measurements:

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements." This statement establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair value measurements. The statement is effective for fair value measures already required or permitted by other standards for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within that fiscal year (January 1, 2008 for the Company). The Company is currently evaluating the impact of adopting SFAS 157, but does not anticipate that the adoption of this standard will have a material impact on its financial condition or results of operations.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS

OF OPERATIONS

The following discussion and analysis of the financial condition and results of operations of the Company and its subsidiaries should be read in conjunction with the consolidated financial statements and notes thereto, and selected financial and statistical information appearing elsewhere in this report on Form 10-Q. The purpose of this discussion is to highlight significant changes in the financial condition and results of operations of the Company and its subsidiaries, and provide supplemental information and analysis.

Amounts in the prior period financial statements are reclassified whenever necessary to conform to current period presentation.

Unless otherwise noted, all dollars are expressed in thousands, except share data.

Use of Non-GAAP Financial Measures:

Certain information discussed below is presented on a fully taxable equivalent basis. Specifically, included in first quarter 2007 and 2006 net interest income was \$407 and \$477, respectively, of tax-exempt interest income from certain investment securities and loans. An amount equal to the tax benefit derived from this tax-exempt income has been added back to the interest income and net interest income totals discussed in this Management's Discussion and Analysis, resulting in tax-equivalent adjustments of \$149 and \$187 in the first quarter of 2007 and 2006, respectively. The analysis of net interest income tables included in this Form 10-Q provide a reconciliation of tax-equivalent financial information to the Company's consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles.

Management believes the disclosure of tax-equivalent net interest income information improves the clarity of financial analysis, and is particularly useful to investors in understanding and evaluating the changes and trends in the Company's results of operations. Other financial institutions commonly present net interest income on a tax-equivalent

basis. This adjustment is considered helpful in the comparison of one financial institution's net interest income to that of another institution, as each will have a different proportion of tax-exempt interest from their earning asset portfolios. Moreover, net interest income is a component of a second financial measure commonly used by financial institutions, net interest margin, which is the ratio of net interest income to average earning assets. For purposes of this measure as well, other financial institutions generally use tax-equivalent net interest income to provide a better basis of comparison from institution to institution. The Company follows these practices.

FORWARD LOOKING STATEMENTS DISCLAIMER

Certain statements, as well as certain other discussions contained in this report on Form 10-Q, or incorporated herein by reference, contain statements which may be considered to be forward-looking within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. You can identify these forward-looking statements by the use of words like "strategy," "expects," "plans," "believes," "will," "estimates," "intends," "projects," "goals," "targets," and other words of similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts.

Investors are cautioned that forward-looking statements are inherently uncertain. Forward-looking statements include, but are not limited to, those made in connection with estimates with respect to the future results of operation, financial condition, and the business of the Company which are subject to change based on the impact of various factors that could cause actual results to differ materially from those projected or suggested due to certain risks and uncertainties. Those factors include but are not limited to:

- (i) The Company's success is dependent to a significant extent upon general economic conditions in Maine, and Maine's ability to attract new business, as well as factors that affect tourism, a major source of economic activity in the Company's immediate market areas;
- (ii) The Company's earnings depend to a great extent on the level of net interest income (the difference between interest income earned on loans and investments and the interest expense paid on deposits and borrowings) generated by the Bank, and thus the Bank's results of operations may be adversely affected by increases or decreases in interest rates;
- (iii) The banking business is highly competitive and the profitability of the Company depends on the Bank's ability to attract loans and deposits in Maine, where the Bank competes with a variety of traditional banking and non-traditional institutions, such as credit unions and finance companies;
- (iv) A significant portion of the Bank's loan portfolio is comprised of commercial loans and loans secured by real estate, exposing the Company to the risks inherent in financings based upon analysis of credit risk, the value of underlying collateral, and other intangible factors which are considered in making commercial loans and, accordingly, the Company's profitability may be negatively impacted by judgment errors in risk analysis, by loan defaults, and the ability of certain borrowers to repay such loans during a downturn in general economic conditions;
- (v) A significant delay in or inability to execute strategic initiatives designed to increase revenues and or control expenses;
- (vi) The potential need to adapt to changes in information technology systems, on which the Company is highly dependent, could present operational issues or require significant capital spending;
- (vii) Significant changes in the Company's internal controls, or internal control failures;
- (viii) Acts or threats of terrorism and actions taken by the United States or other governments as a result of such threats, including military action, could further adversely affect business and economic conditions in the United States generally and in the Company's markets, which could have an adverse effect on the Company's financial performance and that of borrowers and on the financial markets and the price of the Company's common stock;

- (ix) Significant changes in the extensive laws, regulations, and policies governing bank holding companies and their subsidiaries could alter the Company's business environment or affect its operations; and
- (x) The Company's success in managing the risks involved in all of the foregoing matters.

The forward-looking statements contained herein represent the Company's judgment as of the date of this report on Form 10-Q, and the Company cautions readers not to place undue reliance on such statements. The Company disclaims any obligation to publicly update or revise any forward-looking statement contained in the succeeding discussion, or elsewhere in this report on Form 10-Q, except to the extent required by federal securities laws.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Management's discussion and analysis of the Company's financial condition are based on the Consolidated Financial Statements, which are prepared in accordance with U.S. generally accepted accounting principles. 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. Management evaluates its estimates, including those related to the allowance for loan losses, on an ongoing basis. Management bases its estimates on historical experience and 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.

The Company's significant accounting policies are more fully enumerated in Note 1 to the Consolidated Financial Statements included in Item 8 of its December 31, 2006 report on Form 10-K. The reader of the financial statements should review these policies to gain a greater understanding of how the Company's financial performance is reported. Management believes the following critical accounting policies represent the more significant estimates and assumptions used in the preparation of the Consolidated Financial Statements:

Allowance for Loan Losses:

Management believes the allowance for loan losses ("allowance") is a significant accounting estimate used in the preparation of the Company's consolidated financial statements. The allowance, which is established through a provision for loan loss expense, is based on management's evaluation of the level of allowance required in relation to the estimated inherent risk of loss in the loan portfolio. Management regularly evaluates the allowance for loan losses for adequacy by taking into consideration factors such as previous loss experience, the size and composition of the portfolio, current economic and real estate market conditions and the performance of individual loans in relation to contract terms and estimated fair values of collateral. The use of different estimates or assumptions could produce different provisions for loan losses. A smaller provision for loan losses results in higher net income, and when a greater amount of provision for loan losses is necessary the result is lower net income. Refer to Item 2 below of this Part I, *Allowance for Loan Losses and Provision for Loan Losses* in this report on Form 10-Q, for further discussion and analysis concerning the allowance.

Income Taxes

: On January 1, 2007, the Company adopted Financial Accounting Interpretation Number 48 ("FIN 48") to account for uncertain tax positions. FIN 48 prescribes a recognition threshold of more-likely-than-not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those tax positions to be recognized in the financial statements.

The Company estimates its income taxes for each period for which a statement of income is presented. This involves estimating the Company's actual current tax liability, as well as assessing temporary differences resulting from differing timing of recognition of expenses, income and tax credits, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the Company's consolidated balance sheets. The Company must also assess the likelihood that any deferred tax assets will be recovered from historical taxes paid and future taxable income and, to the extent that the recovery is not likely, a valuation allowance must be established. Significant management judgment is required in determining income tax expense, and deferred tax assets and liabilities. As of March 31, 2007 and December 31, 2006, there was no valuation allowance for deferred tax assets, which are included in other assets on the consolidated balance sheet.

Goodwill and Other Intangible Assets:

The valuation techniques used by the Company to determine the carrying value of tangible and intangible assets acquired in acquisitions and the estimated lives of identifiable intangible assets involve estimates for discount rates, projected future cash flows and time period calculations, all of which are susceptible to change based upon changes in economic conditions and other factors. Any changes in the estimates used by the Company to determine the carrying value of its goodwill and identifiable intangible assets, or which otherwise adversely affect their value or estimated lives, may have an adverse affect on the Company's results of operations.

EXECUTIVE OVERVIEW

Summary Results of Operations

The Company reported consolidated net income of \$1.4 million or fully diluted earnings per share of \$0.44 for the three months ended March 31, 2007, compared with \$1.6 million or fully diluted earnings per share of \$0.50 for the same quarter in 2006, representing declines of \$188 thousand and \$0.06, or 12.0% and 12.4%, respectively. The annualized return on average shareholders' equity ("ROE") and average assets ("ROA") amounted to 9.02% and 0.67%, respectively, compared with 11.16% and 0.84% for the same quarter in 2006. The decline in first quarter earnings was principally attributed to the Company's planned restructuring of a portion of its balance sheet, substantially offset by the settlement of its limited postretirement benefit program.

- ***Balance Sheet Restructuring:***

In April 2007, the Company's Board of Directors approved the restructuring of a portion of the Company's balance sheet through the sale of \$43.3 million of its aggregate \$227.5 million available for sale investment securities portfolio, the proceeds from which were initially used to pay down short-term borrowings. Since the Company no longer had the intent to hold these securities until a recovery of their amortized cost, which may be at maturity, the Company recorded an adjustment to write down these securities to fair value at March 31, 2007, resulting in a pre-tax impairment loss of \$1.2 million included in first quarter 2007 earnings as a reduction of non-interest income. The Company's overall objectives are to improve future period earnings, lower the interest rate risk profile of the Company's balance sheet, and provide a means to more effectively respond to the current and future yield curve environments.

- ***Post Retirement Plan Settlement:***

In the first quarter of 2007, the Company settled its limited postretirement benefit program, which funded medical coverage and life insurance benefits to a closed group of active and retired employees who met minimum age and service requirements. The Company voluntarily paid out \$700 thousand to plan participants, representing 64% of the total benefit obligation. This payment fully settled all Company obligations related to this program. In connection with

the settlement of the postretirement program, the Company recorded a first quarter reduction in non-interest expense of \$832 thousand, representing the remaining accrued benefit obligation and the actuarial gain related to the program.

• ***Net Interest Income:***

For the quarter ended March 31, 2007, net interest income on a tax equivalent basis amounted to \$5.4 million, representing a decline of \$243 thousand, or 4.3%, compared with the same quarter in 2006. The decline in net interest income was principally attributed to a 40 basis point decline in the net interest margin, which in the first quarter of 2007 amounted to 2.77%. As is widely the situation throughout the banking industry, the decline in the net interest margin was largely attributed to the seventeen consecutive increases in short-term interest rates by the Federal Reserve Bank from June 2004 to June 2006 and a flat-to-inverted yield curve over the past fifteen months, the impact of which has caused the Bank's funding costs to increase at a faster pace than the yield on its earning asset portfolios.

• ***Non-interest Income:***

For the quarter ended March 31, 2007, total non-interest income amounted to \$378 thousand, representing a decline of \$1.2 million, or 76.4%, compared with the same quarter in 2006. The decline in non-interest income was principally attributed to a \$1.2 million securities impairment loss in connection with the Company's restructuring of a portion of its balance sheet. Also included in first quarter net securities losses were realized gains on the sale of securities amounting to \$241 thousand, representing a decline of \$69 thousand, or 22.3%, compared with the same quarter last year.

For the quarter ended March 31, 2007, fees from financial services, service charges on deposits and credit and debit card fees posted increases of 7.3%, 7.9% and 16.1%, respectively, compared with the same quarter in 2006. First quarter 2007 other operating income amounted to \$68 thousand, representing a decline of \$96 thousand, or 59%, compared with the same quarter in 2006. The decline in other operating income was attributed to a \$150 thousand gain on the sale of a parcel of Bank owned real estate recorded during the first quarter of 2006.

• ***Non-Interest Expense:***

For the quarter ended March 31, 2007, total non-interest expense amounted to \$3.8 million, representing a decline of \$1.1 million, or 22.3%, compared with the same quarter in 2006. The decline in non-interest expense was principally attributed to the settlement of the Company's limited post retirement program, the financial impact of which reduced first quarter non-interest expense by \$832 thousand. The decline in first quarter non-interest expense was also attributed to lower salaries and employee benefits expense and other miscellaneous operating expenses, which posted declines of \$99 thousand and \$189 thousand, or 4.1% and 12.9%, compared with the first quarter of 2006, respectively.

Summary Financial Condition

The Company's total assets ended the first quarter of 2007 at \$827.3 million, representing increases of \$2.4 million and \$45.7 million, or 0.3% and 5.9%, compared with December 31 and March 31, 2006.

• ***Loans:***

Total loans ended the first quarter at \$552.6 million, representing a decline of \$2.5 million or 0.4% compared with December 31, 2006 and an increase of \$23.5 million or 4.5% compared with March 31, 2006. The small decline in the loan portfolio compared with December 31, 2006 principally reflected anticipated paydowns on certain seasonal borrowings, combined with softening loan demand and intensifying competition in the markets served by the Bank. The increase in the loan portfolio compared with March 31, 2006 was driven by business lending activity, which

accounted for \$16.4 million or 69.5% of the total year-over-year loan growth.

• ***Credit Quality:***

The Bank's non-performing loans remained at low levels at quarter-end, representing \$422 thousand or 0.08% of total loans, compared with \$628 thousand and \$896 thousand, or 0.11% and 0.17% of total loans at December 31 and March 31, 2006, respectively. The Bank's loan loss experience continued at low levels during the first quarter, with net charge-offs amounting to \$26 thousand, or annualized net charge-offs to average loans outstanding of 0.02%, compared with \$202 thousand or annualized net charge-offs to average loans outstanding of 0.16% during the first quarter of 2006. In the first quarter of 2007 the Bank did not record a provision for loan losses, compared with \$28 thousand in the first quarter of 2006.

• ***Securities:***

Total securities ended the first quarter at \$227.5 million, representing increases of \$14.2 million and \$26.3 million, or 6.7% and 13.1%, compared with December 31 and March 31, 2006, respectively. Market yields showed meaningful improvement early in the first quarter, with the benchmark 10-year U.S. Treasury note climbing to a five-month high, presenting opportunities for increasing the Bank's earning assets and generating higher levels of net interest income.

• ***Deposits:***

Total deposits ended the first quarter at \$506.8 million, representing increases of \$10.5 million and \$32.1 million, or 2.1% and 6.8% compared with December 31 and March 31, 2006, respectively. Deposit growth was largely attributed to certificates of deposit obtained in the national market, which were principally used to fund the Bank's earning asset growth and replace the seasonal deposit outflows experienced in the first quarter of 2007.

At March 31, 2007, retail deposits totaled \$387.4 million, representing declines of \$26.6 million and \$5.0 million, or 6.4% and 1.3%, compared with December 31 and March 31, 2006, respectively. Historically, the banking business in the Bank's market area has been seasonal, with lower deposits in winter and spring, and higher deposits in summer and autumn. During the first quarter of 2007, the Bank's net deposit outflows were moderately higher than historical norms.

• ***Shareholders' Equity:***

The Company continued to exceed regulatory requirements for "well-capitalized" institutions. At March 31, 2007, the Company's Tier 1 Leverage, Tier 1 Risk-based, and Total Risk-based Capital ratios amounted to 7.26%, 11.18% and 12.02%, respectively. Total shareholders' equity ended the quarter at \$62.6 million, representing increases of \$1.5 million and \$6.4 million, or 2.5% and 11.4%, compared with December 31 and March 31, 2006, respectively.

• ***Tangible Book Value:***

At March 31, 2007 the Company's tangible book value per share of common stock outstanding amounted to \$19.44, compared with \$18.93 and \$17.32 at December 31 and March 31, 2006, representing increases of 2.7% and 12.2%, respectively.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income is the principal component of the Company's income stream and represents the difference or spread between interest generated from earning assets and the interest expense paid on deposits and borrowed funds. Net interest income is entirely generated by the Bank. Fluctuations in market interest rates as well as volume and mix changes in earning assets and interest bearing liabilities can materially impact net interest income.

For the three months ended March 31, 2007, net interest income on a fully tax-equivalent basis amounted to \$5,431, compared with \$5,674 in the first quarter of 2006, representing a decline of \$243, or 4.3%. As discussed below, the Bank's first quarter 2007 net interest income was adversely impacted by a 40 basis point decline in the net interest margin compared with the same quarter in 2006.

Factors contributing to the changes in net interest income and the net interest margin are enumerated in the following discussion and analysis.

Net Interest Income Analysis:

The following tables summarize the Company's average balance sheets and components of net interest income, including a reconciliation of tax equivalent adjustments, for the three months ended March 31, 2007 and 2006, respectively:

AVERAGE BALANCE SHEET AND ANALYSIS OF NET INTEREST INCOME THREE MONTHS ENDED MARCH 31, 2007 AND 2006

| | 2007 | | | 2006 | | |
|--|--------------------|---------------|-----------------|--------------------|---------------|-----------------|
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| Interest Earning Assets: | | | | | | |
| Loans (1,3) | \$554,027 | \$ 9,209 | 6.74% | \$520,868 | \$ 8,280 | 6.45% |
| Taxable investment securities | 196,892 | 2,610 | 5.38% | 155,724 | 1,839 | 4.79% |
| Non-taxable investment securities (3) | 29,646 | 473 | 6.47% | 36,120 | 600 | 6.74% |
| Total Investments | 226,538 | 3,083 | 5.52% | 191,844 | 2,439 | 5.16% |
| Investment in Federal Home Loan Bank stock | 12,347 | 199 | 6.54% | 11,791 | 149 | 5.12% |
| Fed funds sold, money market funds, and time deposits with other banks | 1,497 | 18 | 4.88% | 1,547 | 13 | 3.41% |
| Total Earning Assets | 794,409 | 12,509 | 6.39% | 726,050 | 10,881 | 6.08% |
| Non-Interest Earning Assets: | | | | | | |
| Cash and due from banks | 7,103 | | | 7,494 | | |
| Allowance for loan losses | (4,556) | | | (4,654) | | |
| Other assets (2) | 31,077 | | | 27,528 | | |
| Total Assets | \$828,033 | | | \$756,418 | | |

Interest Bearing Liabilities:

| | | | | | | |
|---|-----------|----------|-------|-----------|----------|-------|
| Deposits | \$449,711 | \$ 3,887 | 3.51% | \$404,086 | \$ 2,609 | 2.62% |
| Securities sold under repurchase agreements and fed funds purchased | 13,928 | 104 | 3.03% | 14,701 | 89 | 2.46% |
| Borrowings from Federal Home Loan Bank | 247,640 | 3,087 | 5.06% | 223,939 | 2,509 | 4.54% |
| Total Borrowings | 261,568 | 3,191 | 4.95% | 238,640 | 2,598 | 4.42% |
| Total Interest Bearing Liabilities | 711,279 | 7,078 | 4.04% | 642,726 | 5,207 | 3.29% |
| Rate Spread | | | 2.35% | | | 2.79% |

Non-Interest Bearing Liabilities:

| | | | | | | |
|---|-----------|----------|-------|-----------|----------|-------|
| Demand deposits | 49,863 | | | 50,418 | | |
| Other liabilities | 5,059 | | | 6,150 | | |
| Total Liabilities | 766,201 | | | 699,294 | | |
| Shareholders' equity | 61,832 | | | 57,124 | | |
| Total Liabilities and Shareholders' Equity | \$828,033 | | | \$756,418 | | |
| Net interest income and net interest margin (3) | | 5,431 | 2.77% | | 5,674 | 3.17% |
| Less: Tax Equivalent adjustment | | (149) | | | (187) | |
| Net Interest Income | | \$ 5,282 | 2.70% | | \$ 5,487 | 3.06% |

(1) For purposes of these computations, non-accrual loans are included in average loans.

(2) For purposes of these computations, unrealized gains (losses) on available-for-sale securities are recorded in other assets.

(3) For purposes of these computations, reported on a tax equivalent basis.

Net Interest Margin:

The net interest margin, expressed on a tax-equivalent basis, represents the difference between interest and dividends earned on interest-earning assets and interest paid to depositors and other creditors, expressed as a percentage of average earning assets.

The net interest margin is determined by dividing tax-equivalent net interest income by average interest-earning assets. The interest rate spread represents the difference between the average tax-equivalent yield earned on interest earning-assets and the average rate paid on interest bearing liabilities. The net interest margin is generally higher than the interest rate spread due to the additional income earned on those assets funded by non-interest bearing liabilities, primarily demand deposits and shareholders' equity.

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

For the three months ended March 31, 2007 the net interest margin amounted to 2.77%, compared with 3.17% during the same period in 2006, representing a decline of 40 basis points.

The following table summarizes the net interest margin components, on a quarterly basis, over the past two years. Factors contributing to the changes in the net interest margin are enumerated in the following discussion and analysis.

NET INTEREST MARGIN ANALYSIS
FOR QUARTER ENDED

| | 2007 | | 2006 | | 2005 | | | |
|--|--------------|---------|--------------|---------|--------------|---------|---------|---------|
| | Average Rate | | Average Rate | | Average Rate | | | |
| | 1st Qtr | 4th Qtr | 3rd Qtr | 2nd Qtr | 1st Qtr | 4th Qtr | 3rd Qtr | 2nd Qtr |
| Interest Earning Assets: | | | | | | | | |
| Loans (1,2) | 6.74% | 6.67% | 6.67% | 6.56% | 6.45% | 6.34% | 6.22% | 6.10% |
| Taxable investment securities | 5.38% | 5.03% | 4.91% | 4.97% | 4.79% | 4.47% | 4.09% | 4.11% |
| Non-taxable investment securities (2) | 6.47% | 6.48% | 6.43% | 6.68% | 6.74% | 6.62% | 6.84% | 6.76% |
| Total Investments | 5.52% | 5.25% | 5.16% | 5.26% | 5.16% | 4.89% | 4.57% | 4.62% |
| Investment in Federal Home Loan Bank stock | | | | | | | | |
| | 6.54% | 6.13% | 11.04% | 0.00% | 5.12% | 4.85% | 4.41% | 4.07% |
| Fed Funds sold, money market funds, and | | | | | | | | |
| Time deposits with other banks | 4.88% | 5.20% | 5.27% | 5.01% | 3.41% | 3.92% | 3.46% | 3.20% |
| Total Earning Assets | 6.39% | 6.28% | 6.33% | 6.09% | 6.08% | 5.94% | 5.79% | 5.70% |
| Interest Bearing Liabilities: | | | | | | | | |
| Deposits | 3.51% | 3.37% | 3.22% | 2.92% | 2.62% | 2.27% | 2.02% | 1.76% |
| Securities sold under repurchase agreements | 3.03% | 2.96% | 2.78% | 2.55% | 2.46% | 2.15% | 1.91% | 1.82% |
| Other borrowings | 5.06% | 5.01% | 5.01% | 4.81% | 4.54% | 4.39% | 4.27% | 4.07% |
| Total Borrowings | 4.95% | 4.87% | 4.89% | 4.69% | 4.42% | 4.21% | 4.10% | 3.93% |
| Total Interest Bearing Liabilities | | | | | | | | |
| | 4.04% | 3.89% | 3.81% | 3.58% | 3.29% | 2.96% | 2.76% | 2.56% |
| Rate Spread | 2.35% | 2.39% | 2.52% | 2.51% | 2.79% | 2.98% | 3.03% | 3.14% |
| Net Interest Margin (2) | 2.77% | 2.86% | 2.95% | 2.89% | 3.17% | 3.36% | 3.39% | 3.45% |
| Net Interest Margin without Tax Equivalent Adjustments | | | | | | | | |
| | 2.70% | 2.77% | 2.86% | 2.79% | 3.06% | 3.26% | 3.30% | 3.35% |

(1) For purposes of these computations, non-accrual loans are included in average loans.

(2) For purposes of these computations, reported on a tax equivalent basis.

In June of 2004, following an extended period of historically low interest rates, the Board of Governors of the Federal Reserve System (the "Federal Reserve") began increasing short-term interest rates. Through June of 2006, the Federal Funds targeted rate had increased seventeen times for a total of 425 basis points while the 10-year U.S. Treasury note remained relatively unchanged, causing a dramatic flattening of the U.S. Treasury yield curve. Over the past fifteen months the yield curve has been flat-to-inverted, meaning short-term interest rates have been equal to or greater than long-term interest rates.

In the first quarter of 2005 the Bank's net interest margin began to decline and this decline has steadily continued through the first quarter of 2007, principally reflecting the inherent net interest margin challenges widely associated

with a flat or inverted yield curve. The declining net interest margin was principally attributed to the increases in the Bank's cost of funds outpacing the increases in yields on its interest earning assets, reflecting the re-pricing of a large portion of the Bank's funding base during a period of rapidly rising short-term interest rates. In addition, highly competitive pricing pressures with respect to loans and deposits and a higher utilization of wholesale funding have adversely impacted the Bank's net interest margin.

The yield on average earning assets amounted to 6.39% in the first quarter of 2007, compared with 6.08% in the first quarter of 2006, representing an increase of 31 basis points. However, the cost of interest bearing liabilities amounted to 4.04% in the first quarter of 2007, compared with 3.29% in the first quarter of 2006, representing an increase of 75 basis points. In short, since the first quarter of 2006, the increases in the cost of the Bank's interest bearing liabilities exceeded the increases in yields on its earning asset portfolios by 44 basis points.

Should short-term interest rates continue at current levels with a yield curve that is inverted or flat, Company management anticipates continued pressure on the net interest margin during 2007, but not to the same degree experienced in 2006. Specifically, management does not anticipate further declines of the magnitude experienced in 2006 in an unchanged interest rate environment. Company management also believes that continued balance sheet growth will be needed to meaningfully increase net interest income in 2007, should interest rates remain at current levels and the yield curve remain flat or inverted.

The Bank's interest rate sensitivity position is more fully described below in Part I, Item 3 of this report on Form 10-Q, *Quantitative and Qualitative Disclosures About Market Risk*.

Interest Income:

For the quarter ended March 31, 2007, total interest income, on a fully tax-equivalent basis, amounted to \$12,509 compared with \$10,881 during the same quarter in 2006, representing an increase of \$1,628, or 15.0%.

The increase in interest income was principally attributed to average earning asset growth of \$68,359, or 9.4%, combined with a 31 basis point increase in the weighted average earning asset yield, when comparing the first quarter of 2007 with the same quarter in 2006. The increases in short-term interest rates by the Federal Reserve have favorably impacted the yields on the Bank's variable rate loan portfolios. In addition, cash flows from the Bank's fixed rate earning asset portfolios have generally been reinvested into higher yielding earning assets.

Comparing the three months ended March 31, 2007 with the same period in 2006, the weighted average yield on the Bank's loan portfolio increased 29 basis points to 6.74%, while the weighted average yield on the securities portfolio increased 36 basis points to 5.52%.

As depicted on the rate /volume tables below, the increased volume of average earning assets on the balance sheet during the first quarter of 2007 contributed \$971 to the increase in first quarter 2007 interest income compared with the first quarter of 2006, while the increase attributed to the impact of a higher weighted average earning asset yield amounted to \$657.

Interest Expense:

For the quarter ended March 31, 2007, total interest expense amounted to \$7,078, compared with \$5,207 during the same quarter in 2006, representing an increase of \$1,871, or 35.9%.

The increase in interest expense was principally attributed to an increase in average interest bearing liabilities amounting to \$68,553 or 10.7%, combined with a 75 basis point increase in the weighted average cost of funds, when comparing the first quarter of 2007 with the same quarter in 2006. The increase in the average cost of interest bearing funds was principally attributed to the increases in short-term market interest rates between periods and, to a lesser

extent, aggressive deposit pricing competition and a proportionately higher utilization of wholesale funding.

For the quarter ended March 31, 2007, the weighted average cost of interest bearing liabilities amounted to 4.04%, compared with 3.29% during the same quarter in 2006. Comparing the first quarter of 2007 with the same quarter in 2006, the weighted average cost of borrowed funds increased 53 basis points to 4.95%, while the weighted average cost of interest bearing deposits increased 89 basis points to 3.51%. Reflecting the longer maturities in the Bank's borrowing base that were not as susceptible to movements in short-term interest rates, combined with a higher utilization of brokered time deposits, the increase in the weighted average cost of interest bearing deposits outpaced the weighted average cost of borrowed funds. In addition, given highly competitive pricing pressures in the markets served by the Bank and the need to strengthen customer relationships, the Bank more closely followed the market with respect to the upward re-pricing of maturity and non-maturity deposits, a trend Bank management believes may continue in the future given the continuation of competitive market pressures.

As depicted on the rate/volume analysis table below, the increased volume of average interest bearing liabilities on the balance sheet during the first quarter of 2007 contributed \$595 to the increase in first quarter 2007 interest expense compared with the first quarter of 2006, while the increase attributed to the impact of a higher weighted average rate paid on interest bearing liabilities amounted to \$1,276.

Rate / Volume Analysis:

The following table sets forth a summary analysis of the relative impact on net interest income of changes in the average volume of interest earning assets and interest bearing liabilities, and changes in average rates on such assets and liabilities. The income from tax-exempt assets has been adjusted to a fully tax equivalent basis, thereby allowing uniform comparisons to be made. Because of the numerous simultaneous volume and rate changes during the periods analyzed, it is not possible to precisely allocate changes to volume or rate. For presentation purposes, changes which are not solely due to volume changes or rate changes have been allocated to these categories in proportion to the relationships of the absolute dollar amounts of the change in each.

ANALYSIS OF VOLUME AND RATE CHANGES ON NET INTEREST INCOME THREE MONTHS ENDED MARCH 31, 2007 VERSUS MARCH 31, 2006 INCREASES (DECREASES) DUE TO:

| | Average Volume | Average Rate | Net Interest Income |
|--|-------------------|-----------------|------------------------|
| Loans (1,2) | \$541 | \$ 388 | \$ 929 |
| Taxable investment securities | 527 | 244 | 771 |
| Non-taxable investment securities (2) | (104) | (23) | (127) |
| Investment in Federal Home Loan Bank stock | 7 | 43 | 50 |
| Fed funds sold, money market funds, and time deposits with other banks | --- | 5 | 5 |
| TOTAL EARNING ASSETS | \$971 | \$ 657 | \$1,628 |
| Interest bearing deposits | 319 | 959 | 1,278 |
| Securities sold under repurchase agreements and fed funds purchased | (4) | 19 | 15 |
| Borrowings from Federal Home Loan Bank | 280 | 298 | 578 |
| TOTAL INTEREST BEARING LIABILITIES | \$595 | \$1,276 | \$1,871 |
| NET CHANGE IN NET INTEREST INCOME | \$376 | \$ (619) | \$ (243) |

(1) For purposes of these computations, non-accrual loans are included in average loans.

(2) For the purposes of these computations, interest income is reported on a tax-equivalent basis.

Provision for Loan Losses

The provision for loan losses reflects the amount necessary to maintain the allowance for loan losses (the "allowance") at a level that, in management's judgment, is appropriate for the amount of inherent risk of loss in the Bank's current loan portfolio.

The Bank's non-performing loans remained at low levels at quarter end, representing \$422 or 0.08% of total loans, compared with \$628 and \$896, or 0.11% and 0.17% of total loans at December 31 and March 31, 2006, respectively. The allowance expressed as a percentage of non-performing loans stood at 1,066% at March 31, 2007, compared with 721% and 499% at December 31 and March 31, 2006, respectively.

The Bank's loan loss experience continued at low levels during the first quarter with net charge-offs amounting to \$26, or annualized net charge-offs to average loans outstanding of 0.02%, compared with \$202 or annualized net charge-offs to average loans outstanding of 0.16% during the first quarter of 2006.

Reflecting the continued stable performance of the loan portfolio, for the quarter ended March 31, 2007, the Bank did not record a provision for loan losses, compared with \$28 in the first quarter of 2006.

Refer below to Item 2 of this Part I, *Allowance for Loan Losses*, in this report on Form 10-Q for further discussion and analysis regarding the allowance.

Non-interest Income

In addition to net interest income, non-interest income is a significant source of revenue for the Company and an important factor in its results of operations.

For the quarter ended March 31, 2007, total non-interest income amounted to \$378, compared with \$1,604 during the same quarter in 2006, representing a decline of \$1,226, or 76.4%.

Factors contributing to the changes in non-interest income are enumerated in the following discussion and analysis:

Trust and Other Financial Services:

Income from trust and financial services is principally derived from fee income based on a percentage of the market value of client assets under management and held in custody and, to a lesser extent, revenue from brokerage services conducted through Bar Harbor Financial Services, an independent third-party broker.

For the quarter ended March 31, 2007, income from trust and other financial services amounted to \$541, compared with \$504 during the same quarter in 2006, representing an increase of \$37 or 7.3%.

The increase in fee income was driven by trust and investment management services, principally reflecting growth in assets under management. At March 31, 2007, total managed assets at Bar Harbor Trust Services ("Trust Services"), a Maine chartered non-depository trust company and second tier subsidiary of the Company, stood at \$257,799 compared with \$252,057 and \$226,945 at December 31 and March 31, 2006, representing increases of \$5,742 and \$30,854, or 2.3% and 13.6%, respectively.

Service Charges on Deposits:

This income is principally derived from monthly deposit account maintenance and activity fees, overdraft fees, and a variety of other deposit account related fees.

Income generated from service charges on deposit accounts totaled \$370 for the quarter ended March 31, 2007, compared with \$343 during the same quarter in 2006, representing an increase of \$27, or 7.9%. The increase in service charges on deposit accounts was principally attributed to the continued growth of the Bank's retail, non-maturity deposit account base.

Credit and Debit Card Service Charges and Fees:

This income is principally derived from the Bank's merchant credit card processing services, its Visa debit card product and, to a lesser extent, fees associated with its Visa credit card portfolio. Historically, the Bank's merchant credit card processing activities have been highly seasonal in nature with transaction and fee income volumes peaking in the summer and autumn, while declining in the winter and spring.

For quarter ended March 31, 2007, credit and debit card service charges and fees amounted to \$267, compared with \$230 during the same quarter in 2006, representing an increase of \$37, or 16.1%. The first quarter increase was principally attributed to an increase in debit card fees, principally reflecting the ongoing growth in the Bank's demand deposits accounts base. Merchant credit card processing fees also posed a small increase, reflecting higher merchant credit card processing volumes, compared with the first quarter of 2006. The increase in credit and debit card processing revenue was offset in part by an increase in credit and debit card processing expense, which is included in non-interest expense in the Company's consolidated statements of income.

Net Securities (Losses) Gains:

For the quarter ended March 31, 2007, net securities losses amounted to \$920, compared with net securities gains of \$310 in the first quarter of 2006, representing a decline of \$1,230, or 396.8%. The amount recorded in the first quarter of 2007 represented a securities impairment loss partially offset by realized gains, while the amount recorded in the first quarter of 2006 represented realized gains.

In April 2007, Company's Board of Directors approved the restructuring of a portion of the Company's balance sheet through the sale of \$43,337 of its aggregate \$227,473 available for sale securities portfolio, the proceeds from which were initially be used to pay down short-term borrowings. Since the Company no longer had the intent to hold these securities until a recovery of their amortized cost, which may be at maturity, the Company recorded an adjustment to write down these securities to fair value at March 31, 2007, resulting in an impairment loss of \$1,162. As of March 31, 2007, the amortized cost of these securities amounted to \$44,499, whereas the then current fair market value amounted to \$43,337. The weighted average yield on the securities sold approximated 4.22%, whereas the weighted average cost of the borrowings paid down approximated 5.31%.

The decision to restructure a portion of the Company's balance sheet was based, in part, on an assessment of the overall current state of the economy and management's belief that the Federal Reserve will be keeping short term interest rates on hold much longer than previously anticipated. Considering the potential adverse impact this would likely have on net interest income, management determined that the restructuring of a portion of the Company's balance sheet was appropriate at this time. The Company's overall objectives are to improve future period earnings, lower the interest rate risk profile of the Company's balance sheet, and provide a means to more effectively respond to the current and future yield curve environments.

In the first quarter of 2007 the Company also recorded \$241 in realized gains on the sale of securities, compared with \$310 in the first quarter of 2006, representing a decline of \$69, or 22.2%.

Other Operating Income:

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

For the quarter ended March 31, 2007, total other operating income amounted to \$68, compared with \$164 during the same quarter in 2006, representing a decline of \$96 or 58.5%. The decline in first quarter other operating income was attributed to a \$150 gain on the sale of a parcel of Bank owned real estate adjacent to the Bank's Southwest Harbor, Maine branch office, recorded during the first quarter of 2006.

Non-interest Expense

For the quarter ended March 31, 2007, total non-interest expenses amounted to \$3,797, compared with \$4,885 during the same quarter in 2006, representing a decline of 1,088 or 22.3%.

Factors contributing to the changes in non-interest expense are enumerated in the following discussion and analysis.

Salaries and Employee Benefit Expenses:

For the quarter ended March 31, 2007, salaries and employee benefit expenses amounted to \$2,345, compared with \$2,444 during the same quarter in 2006, representing a decline of \$99 or 4.1%.

The decline in salaries and employee benefit expenses was attributed to a variety of factors including: changes to certain employee benefit programs; changes in overall staffing levels and mix; and lower levels of incentive compensation.

Occupancy Expenses:

For the quarter ended March 31, 2007, total occupancy expenses amounted to \$373, compared with \$312 during the same quarter in 2006, representing an increase of \$61 or, or 19.6%.

The increase in occupancy expenses principally reflect the opening of a new branch office late in the first quarter of 2006 (a leased facility), and higher fuel and utilities prices combined with relatively harsh weather conditions in downeast and midcoast Maine during the first quarter of 2007 compared with the same quarter last year.

Furniture and Equipment Expenses:

For the quarter ended March 31, 2007, furniture and equipment expenses amounted to \$449, compared with \$500 during the first quarter in 2006, representing a decline of \$51, or 10.2%.

The decline in furniture and equipment expenses was principally attributed to certain expenses associated with the Bank's major renovation and opening of a new branch office in the community of Somesville, Maine during the first quarter of 2006.

Credit and Debit Card Expenses:

Credit and debit card expenses principally relate to the Bank's merchant credit card processing activities, Visa debit card processing expenses and, to a lesser extent, its Visa credit card portfolio. Historically, the Bank's merchant credit card processing activities have been highly seasonal in nature with transaction volumes peaking in the summer and autumn, while declining in the winter and spring.

For the quarter ended March 31, 2007, credit and debit card expenses amounted to \$188, compared with \$166 during the same quarter in 2006, representing an increase of \$22, or 13.3%. The increase in credit and debit card expenses was principally attributed to an increase in debit card fees, reflecting the growth of the Bank's retail checking account base. Merchant credit card processing expenses moderately higher in the first quarter of 2007, principally reflecting higher merchant credit card processing volumes compared with the same quarter in 2006. The increase in credit and

debit card expenses was more than offset by increases in credit and debit card income, which is included in non-interest income in the Company's consolidated statements of income.

Post Retirement Plan Settlement:

In the first quarter of 2007, the Company settled its limited postretirement benefit program, which funded medical coverage and life insurance benefits to a closed group of active and retired employees who met minimum age and service requirements. The Company voluntarily paid out \$700 to plan participants, representing 64% of the total benefit obligation. This payment fully settled all Company obligations related to this program. In connection with the settlement of the postretirement program, the Company recorded a first quarter reduction in non-interest expense of \$832, representing the remaining accrued benefit obligation and the actuarial gain related to the program.

Other Operating Expenses:

For the quarter ended March 31, 2007, other operating expenses amounted to \$1,274, compared with \$1,463 during the same quarter in 2006, representing a decline of \$189, or 12.9%. The decline in other operating expenses was attributed to declines in a variety of expense categories including professional services, marketing, loan collection expenses, and software expense.

Income Taxes

For the quarter ended March 31, 2007, total income taxes amounted to \$488, compared with \$615 for the same quarter in 2006, representing a decline of \$127, or 20.1%.

The Company's effective tax rate for the quarter ended March 31, 2007 amounted to 26.2%, compared with 28.2% for the same quarter in 2006. The income tax provisions for these periods were less than the expense that would result from applying the federal statutory rate of 34% to income before income taxes, principally because of the impact of tax exempt interest income on certain investment securities, loans and bank owned life insurance.

Fluctuations in the Company's effective tax rate can occur due to non-taxable income and non-deductible expense bearing different percentages of income before income taxes, during any given reporting period.

FINANCIAL CONDITION

Total Assets

The Company's assets principally consist of loans and investment securities, which at March 31, 2007 represented 66.3% and 27.5% of total assets, compared with 67.3% and 25.9% at December 31, 2006, respectively.

At March 31, 2007, total assets amounted to \$827,266, compared with \$824,877 and \$781,538 at December 31 and March 31, 2006, representing increases of \$2,389 and \$45,728, or 0.3% and 5.9%, respectively.

Investment Securities

The investment securities portfolio is primarily comprised of mortgage-backed securities issued by U.S. government agencies, U.S. government sponsored enterprises, and other corporate issuers. The portfolio also includes tax-exempt obligations of state and political subdivisions, and obligations of other U.S. government sponsored enterprises.

In the first quarter of 2007, the securities portfolio represented 28.5% of the Company's average earning assets and generated 24.6% of total tax-equivalent interest and dividend income, compared with 26.4% and 22.4% in the first quarter of 2006, respectively.

The overall objectives of the Bank's strategy for the investment securities portfolio include maintaining appropriate liquidity reserves, diversifying earning assets, managing interest rate risk, leveraging the Bank's strong capital position, and generating acceptable levels of net interest income.

Securities available for sale represented 100% of total investment securities at March 31, 2007 and 2006. Securities available for sale are reported at their fair value with unrealized gains or losses, net of taxes, excluded from earnings but shown separately as a component of shareholders' equity.

At March 31, 2007, total securities amounted to \$227,473, compared with \$213,252 and \$201,129 at December 31 and March 31, 2006, representing increases of \$14,221 and \$26,344, or 6.7% and 13.1%, respectively. Market yields showed meaningful improvement early in the first quarter of 2007, with the benchmark 10-year U.S. Treasury note climbing to a five-month high, presenting opportunities for increasing the Bank's earning assets and generating higher levels of net interest income.

Impaired Securities:

In April 2007, Company's Board of Directors approved the restructuring of a portion of the Company's balance sheet through the sale of \$43,337 of its aggregate \$227,473 available for sale securities portfolio, the proceeds from which were initially used to pay down short-term borrowings. Since the Company no longer had the intent to hold these securities until a recovery of their amortized cost, which may be at maturity, the Company recorded an adjustment to write down these securities to fair value at March 31, 2007, resulting in an impairment loss of \$1,162. The weighted average yield on the securities sold approximated 4.22%, whereas the weighted average cost of the borrowings paid down approximated 5.31%. The decision to restructure a portion of the Company's balance sheet was based, in part, on an assessment of the overall current state of the economy and management's belief that the Federal Reserve will be keeping short term interest rates on hold much longer than previously anticipated. Considering the potential adverse impact this would likely have on net interest income, management determined that the restructuring of a portion of the Company's balance sheet was appropriate at this time. The Company's overall objectives are to improve future period earnings, lower the interest rate risk profile of the Company's balance sheet, and provide a means to more effectively respond to the current and future yield curve environments.

The securities portfolio contains certain investments where amortized cost, adjusted for the other-than-temporary impairment write down noted above, exceeds fair market value, which at March 31, 2007 amounted to unrealized losses of \$905, compared with \$2,635 at December 31, 2006. Unrealized losses that are considered other-than-temporary are recorded as a loss on the Company's consolidated statement of income. In evaluating whether impairment is other-than-temporary, management considers a variety of factors including the nature of the investment security, the cause of the impairment, the severity and duration of the impairment, and the Bank's ability and intent to hold the security to maturity. Other data considered by management includes, for example, sector credit ratings, volatility of the security's market price, and any other information considered relevant in determining whether other-than-temporary impairment has occurred.

Management believes the unrealized losses in the securities portfolio at March 31, 2007 were attributed to interest rate increases, and reflected the volatile movements in the U.S. Treasury curve over the past few years. Specifically, certain debt securities were purchased in an interest rate environment lower than where the U.S. Treasury yield curve stood on March 31, 2007. Because the decline in market value was attributable to changes in interest rates and not credit quality, and because the Bank has the ability and intent to hold these investment securities until a recovery of their amortized cost, which may be at maturity, the Company does not consider these investment securities to be other-than-temporarily impaired at March 31, 2007.

Loans

The loan portfolio is primarily secured by real estate in the counties of Hancock, Washington and Knox, Maine. The Bank has not engaged in sub-prime lending activities in the past and this continued to be the case during the quarter ended March 31, 2007.

The following table summarizes the components of the Bank's loan portfolio as of the dates indicated.

LOAN PORTFOLIO SUMMARY

| | March 31, 2007 | December 31, 2006 | March 31, 2006 |
|--|-------------------|----------------------|-------------------|
| Residential real estate mortgages | \$251,734 | \$253,640 | \$240,881 |
| Commercial real estate mortgages | 160,715 | 159,661 | 144,336 |
| Commercial and industrial loans | 58,170 | 61,762 | 58,362 |
| Agricultural and other loans to farmers | 17,847 | 17,743 | 18,215 |
| Consumer loans | 11,436 | 10,912 | 12,033 |
| Home equity loans | 46,196 | 45,156 | 48,605 |
| Tax exempt loans | 6,006 | 6,226 | 6,686 |
| Total loans | 552,643 | 555,099 | 529,119 |
| Allowance for loan losses | (4,499) | (4,525) | (4,473) |
| Total loans net of allowance for loan losses | \$548,144 | \$550,574 | \$524,646 |

Total Loans:

At March 31, 2007, total loans amounted to \$552,643, compared with \$555,099 and \$529,119 at December 31, and March 31, 2006, representing a decline of \$2,456, or 0.4%, and an increase of \$23,524, or 4.4%, respectively.

At March 31, 2007, total commercial loans amounted to \$237,353, compared with \$239,245 and \$220,993 at December 31 and March 31, 2006, representing a decline of \$1,892, or 0.8%, and increase of \$16,360, or 7.4%, respectively.

Commercial loans represented 69.5% of total loan growth when comparing March 31, 2007 with the same date in 2006. Commercial loan growth was almost entirely driven by commercial real estate loans, which posted an increase of \$16,379, or 11.3%, when comparing March 31, 2007 with the same date in 2006. Bank management attributes the overall growth in commercial loans, in part, to an effective business banking team, a variety of new business development initiatives, focused incentive compensation plans, and a relatively stable local economy.

The small decline in commercial loans at March 31, 2007 compared with December 31, 2006 was principally attributed to anticipated paydowns on certain seasonal borrowings, combined with softening loan demand and intensifying competition in the markets served by the Bank.

At March 31, 2007, total consumer loans, which principally consisted of consumer real estate (residential mortgage) loans, amounted to \$309,297, compared with \$309,641 and \$301,452 at December 31 and March 31, 2006, representing a decline of \$344, or 0.1%, and an increase 7,845, or 2.6%, respectively. Comparing March 31, 2007 with the same date last year, consumer real estate mortgage loans contributed \$10,762 to the overall growth in consumer loans, offset in part by a \$2,417 decline in home equity loans. The decline in home equity loans was due, in part, to borrower refinancing activity from higher variable interest rate loans to lower fixed interest rate loans.

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

Reflecting a softening real estate market, consumer real estate loan originations started slowing in 2006 and this trend continued during the three months ended March 31, 2007.

At March 31, 2007, consumer and commercial loans secured by real estate comprised 86.9% of the loan portfolio, compared with 86.5% and 82.0% at December 31 and March 31, 2006, respectively. Over the past few years, the strength in the local real estate markets, both residential and commercial, has led to historically high property values in the Bank's market area. However, in the latter part of 2006 and continuing into the first quarter of 2007, this trend began to soften. Recognizing the impact a softening real estate market may have on the loan portfolio and origination pipeline, the Bank periodically reviews its underwriting standards in an effort to ensure that the quality of the loan portfolio is not jeopardized by excessive loan to value ratios or debt service levels. There was no significant deterioration in the performance or risk characteristics of the real estate loan portfolios through the reporting period.

Credit Risk:

Credit risk is managed through loan officer authorities, loan policies, and oversight from the Bank's Senior Credit Officer, the Bank's Senior Loan Officers Committee, the Director's Loan Committee, and the Bank's Board of Directors. Management follows a policy of continually identifying, analyzing and grading credit risk inherent in the loan portfolio. An ongoing independent review, subsequent to management's review, of individual credits is performed by an independent loan review function, which reports to the Audit Committee of the Board of Directors.

As a result of management's ongoing review of the loan portfolio, loans are placed on non-accrual status, either due to the delinquent status of principal and or interest, or a judgment by management that, although payments of principal and or interest are current, such action is prudent because collection in full of all outstanding principal and interest is in doubt. Loans are generally placed on non-accrual status when principal and or interest is 90 days overdue, or sooner if judged appropriate by management. Consumer loans are generally charged-off when principal and or interest payments are 120 days overdue, or sooner if judged appropriate by management.

Non-performing Loans:

Non-performing loans include loans on non-accrual status, loans that have been treated as troubled debt restructurings and loans past due 90 days or more and still accruing interest. There were no troubled debt restructurings in the loan portfolio during 2006 and this continued to be the case during the three months ended March 31, 2007. The following table sets forth the details of non-performing loans as of the dates indicated:

TOTAL NON-PERFORMING LOANS

| | March 31, 2007 | December 31, 2006 | March 31, 2006 |
|--|-------------------|----------------------|-------------------|
| Loans accounted for on a non-accrual basis: | | | |
| Real estate loans: | | | |
| Residential mortgage | \$114 | \$111 | \$355 |
| Loans to finance agricultural production and other loans to farmers | 41 | 41 | --- |
| Commercial and industrial loans | 253 | 415 | 463 |
| Loans to individuals for household, family, and other personal expenditures | 1 | 3 | 7 |
| Total non-accrual loans | 409 | 570 | 825 |
| Accruing loans contractually past due 90 days or more | 13 | 58 | 71 |
| Total non-performing loans | \$422 | \$628 | \$896 |
| Allowance for loan losses to non-performing loans | 1066% | 721% | 499% |
| Non-performing loans to total loans | 0.08% | 0.11% | 0.17% |

| | | | |
|--------------------------|-------|-------|-------|
| Allowance to total loans | 0.81% | 0.82% | 0.85% |
|--------------------------|-------|-------|-------|

During the quarter ended March 31, 2007, non-performing loans remained at low levels. The Bank attributes this success, in part, to mature credit administration processes and underwriting standards, aided by a relatively stable local economy. The Bank maintains a centralized loan collection and managed asset department, providing timely and effective collection efforts for problem loans.

At March 31, 2007, total non-performing loans amounted to \$422, compared with \$628 and \$896 at December 31 and March 31, 2006, representing declines of \$206 and \$474, or 32.8% and 52.9%, respectively. At March 31, 2007, total non-performing loans represented 0.08% of total loans, compared with 0.11% and 0.17% at December 31 and March 31, 2006, respectively.

While the level of non-performing loan ratios continued to reflect the favorable quality of the loan portfolio at March 31, 2007, Bank management is cognizant of relatively softening economic conditions overall, and believes it is managing credit risk accordingly. Future levels of non-performing loans may be influenced by economic conditions, including the impact of those conditions on the Bank's customers, including higher interest rates and debt service levels, oil and gas prices, tourism activity, and other factors existing at the time. Management believes the economic activity and conditions in the local real estate markets will continue to be significant determinants of the quality of the loan portfolio in future periods and, thus, the Company's results of operations and financial condition.

Other Real Estate Owned:

When the Bank takes ownership of collateral property upon foreclosure of a real estate secured loan, the property is transferred from the loan portfolio to Other Real Estate Owned ("OREO") at its fair value. If the loan balance is higher than the fair value of the property, the difference is charged to the allowance for loan losses at the time of the transfer. OREO is classified on the consolidated balance sheet with other assets. At March 31, 2007, there was no OREO, unchanged from December 31 and March 31, 2006.

Allowance for Loan Losses

: The allowance for loan losses ("allowance") is available to absorb losses on loans. The determination of the adequacy of the allowance and provisioning for estimated losses is evaluated quarterly based on review of loans, with particular emphasis on non-performing and other loans that management believes warrant special consideration.

The allowance is maintained at a level that, in management's judgment, is appropriate for the amount of risk inherent in the current loan portfolio, and adequate to provide for estimated losses.

Specific reserves for impaired loans are determined in accordance with SFAS No. 114, "Accounting by Creditors For Impairment of a Loan," as amended by SFAS No. 118, "Accounting by Creditors For Impairment of a Loan-Income Recognition and Disclosures." The amount of loans considered to be impaired totaled \$294 as of March 31, 2007, compared with \$456 and \$463 as of December 31 and March 31, 2006, respectively. The related allowance for loan losses on these impaired loans amounted to \$106 as of March 31, 2007, compared with \$130 and \$54 at December 31 and March 31, 2006, respectively.

Management recognizes that early and accurate recognition of risk is the best means to reduce credit losses and maximize earnings. The Bank employs a comprehensive risk management structure to identify and manage the risk of loss. For consumer loans, the Bank identifies loan delinquency beginning at 10-day delinquency and provides appropriate follow-up by written correspondence or personal contact. Non-residential mortgage consumer loan losses are recognized no later than the point at which a loan is 120 days past due. Residential mortgage losses are recognized during the foreclosure process, or sooner, when that loss is quantifiable and reasonably assured. For commercial loans, the Bank applies a risk grading system, which stratifies the portfolio and allows management to focus appropriate

efforts on the highest risk components of the portfolio. The risk grades include ratings that correlate with regulatory definitions of "Pass," "Other Assets Especially Mentioned," "Substandard," "Doubtful," and "Loss."

Loan loss provisions are recorded based upon overall aggregate data, and the allowance is increased when, on an aggregate basis, additional estimated losses are identified and deemed by management as being likely. No portion of the allowance is restricted to any loan or group of loans, and the entire allowance is available to absorb realized losses. The amount and timing of realized losses and future allowance allocations could vary from current estimates.

While management uses available information to recognize losses on loans, changing economic conditions and the economic prospects of the borrowers may necessitate future additions or reductions to the allowance. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance, which also may necessitate future additions or reductions to the allowance, based on information available to them at the time of their examination.

The Bank's loan loss experience remained at low levels during three months ended March 31, 2007, with net loan charge-offs amounting to \$26, or annualized net charge-offs to average loans outstanding of 0.02%, compared with \$202 or annualized net charge-offs to average loans outstanding of 0.16% during the first quarter of 2006.

There were no material changes in loan concentrations during the three months ended March 31, 2007.

The following table details changes in the allowance and summarizes loan loss experience by loan type for the three-month periods ended March 31, 2007 and 2006.

| | ALLOWANCE FOR LOAN LOSSES THREE MONTHS ENDED MARCH 31, 2007 AND 2006 | |
|---|--|----------|
| | 2007 | 2006 |
| Balance at beginning of period | \$ 4,525 | \$ 4,647 |
| Charge-offs: | | |
| Commercial, financial, agricultural, other loans to farmers | 24 | --- |
| Real estate: | | |
| Construction and development | --- | --- |
| Mortgage | --- | 193 |
| Installments and other loans to individuals | 22 | 25 |
| Total charge-offs | 46 | 218 |
| Recoveries: | | |
| Commercial, finance agricultural, other loans to farmers | 13 | 1 |
| Real estate: | | |
| Construction and development | --- | --- |
| Mortgage | --- | 8 |
| Installments and other loans to individuals | 7 | 7 |
| Total recoveries | 20 | 16 |
| Net charge-offs | 26 | 202 |
| Provision charged to operations | --- | 28 |

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

| | | |
|---|-----------|-----------|
| Balance at end of period | \$ 4,499 | \$ 4,473 |
| Average loans outstanding during Period | \$554,027 | \$520,868 |
| Annualized net charge-offs to average loans outstanding | 0.02% | 0.16% |

Based upon the process employed and giving recognition to all attendant factors associated with the loan portfolio, management believes the allowance for loan losses at March 31, 2007, to be appropriate for the risks inherent in the loan portfolio and resident in the local and national economy as of that date.

Deposits

During the quarter ended March 31, 2007, the most significant funding source for the Bank's earning assets continued to be retail deposits, gathered through its network of twelve banking offices throughout downeast and midcoast Maine.

Historically, the banking business in the Bank's market area has been seasonal, with lower deposits in the winter and spring and higher deposits in summer and autumn. These seasonal swings have been fairly predictable and have not had a materially adverse impact on the Bank. Seasonal swings in deposits have been typically absorbed by the Bank's strong liquidity position, including borrowing capacity from the Federal Home Loan Bank of Boston, brokered certificates of deposit obtained from the national market and cash flows from the securities portfolio.

At March 31, 2007, total deposits amounted to \$506,832, compared with \$496,319 and \$474,752 at December 31 and March 31, 2006, representing increases of \$10,513 and \$32,080, or 2.1% and 6.7%, respectively.

Deposit growth was largely attributed to certificates of deposit obtained from the national market ("brokered deposits"), which at March 31, 2007, totaled \$119,468, compared with \$82,361 and \$82,372 at December 31 and March 31, 2006, representing increases of \$37,107 and \$37,096, or 45.1% and 45.0%, respectively. The increase in brokered deposits at March 31, 2007, compared with March 31, 2006, was utilized to help fund the Bank's earning asset growth, as retail deposits posted small declines. Comparing March 31, 2007 with December 31, 2006, the increase in brokered deposits was principally utilized to replace the seasonal outflows of retail deposits, while also reducing the level of short term borrowings and strengthening the Bank's overall liquidity position.

At March 31, 2007, retail deposits totaled \$387,364 compared with \$413,958 at December 31, 2006, representing a decline of \$26,594, or 6.4%. The decline in retail deposits was principally attributed to an \$18,338 decline in money market deposit accounts offered to clients of Trust Services, principally reflecting a partial reallocation of cash within certain managed asset portfolios. The decline in retail deposits was also attributed to the anticipated outflows of seasonal deposits.

Comparing March 31, 2007 with the same date in 2006, total retail deposits were showing a decline of \$5,016, or 1.3%. This decline was also attributed to the money market deposit accounts offered to clients of Trust Services, which posted a decline of \$9,819.

In general, without considering the declines in money market accounts offered to clients of Trust Services, the Bank's retail deposit growth has moderately lagged historical norms. Management believes that competition from banks and non-banks has intensified, as savers and investors seek higher returns in an atmosphere of rising short-term interest rates, and that financial institutions in particular have been aggressively pricing their deposits in order to fund earning asset growth. Management also believes that investors have been reallocating a portion of their cash positions, believing the equity markets have recently become more attractive from a total return perspective.

Since short-term interest rates began rising, Bank management has exercised restraint with respect to overly aggressive deposit pricing strategies, and has sought to achieve an appropriate balance between retail deposit growth and wholesale funding levels, while considering the associated impacts on the Bank's net interest margin and liquidity

position.

Borrowed Funds

Borrowed funds principally consist of advances from the Federal Home Loan Bank of Boston (the "FHLB") and, to a lesser extent, securities sold under agreements to repurchase. Advances from the FHLB are secured by stock in the FHLB, investment securities, and blanket liens on qualifying mortgage loans and home equity loans.

The Bank utilizes borrowed funds in leveraging its strong capital position and supporting its earning asset portfolios. Borrowed funds are principally utilized to support the Bank's investment securities portfolio and, to a lesser extent, fund loan growth. Borrowed funds also provide a means to help manage balance sheet interest rate risk, given the Bank's ability to select desired amounts, terms and maturities on a daily basis.

At March 31, 2007, total borrowings amounted to \$252,352, compared with \$260,712 and \$243,703 at December 31 and March 31, 2006, representing a decline of \$8,360 or 3.2% and an increase of \$8,649 or 3.6%, respectively.

During 2006 the Bank modified its funding and liquidity strategies, providing more balance between brokered deposits and borrowed funds. The decline in borrowings from December 31, 2006 levels reflects the Bank's utilization of a greater proportion of brokered deposits to replace seasonal deposit outflows, support earning asset growth, and strengthen the Bank's liquidity position.

At March 31, 2007, total borrowings expressed as a percent of total assets amounted to 30.5%, compared with 31.6% and 31.2% at December 31 and March 31, 2006, respectively.

Capital Resources

Consistent with its long-term goal of operating a sound and profitable organization, during the first quarter of 2007 the Company maintained its strong capital position and continued to be a "well capitalized" financial institution according to applicable regulatory standards. Management believes this to be vital in promoting depositor and investor confidence and providing a solid foundation for future growth.

The Company and the Bank are subject to the risk based capital guidelines administered by the Company's and the Bank's principal regulators. The risk based capital guidelines are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. Under these guidelines, assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of risk weighted assets and off-balance sheet items. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk based capital to risk weighted assets of 8%, including a minimum ratio of Tier I capital to total risk weighted assets of 4% and a Tier I capital to average assets of 4% ("Leverage Ratio"). Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on the Company's financial statements.

As of March 31, 2007, the Company and the Bank were considered well capitalized under the regulatory framework for prompt corrective action. Under the capital adequacy guidelines, a well capitalized institution must maintain a minimum total risk based capital to total risk weighted assets ratio of at least 10%, a minimum Tier I capital to total risk weighted assets ratio of at least 6%, and a minimum Tier I leverage ratio of at least 5%.

The following table sets forth the Company's regulatory capital at March 31, 2007 and December 31, 2006, under the rules applicable at that date.

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

| | March 31, 2007 | | December 31, 2006 | |
|--|----------------|--------|-------------------|--------|
| | Amount | Ratio | Amount | Ratio |
| Total Capital to Risk Weighted Assets | \$64,398 | 12.02% | \$63,325 | 11.65% |
| Regulatory Requirement | 42,850 | 8.00% | 43,491 | 8.00% |
| Excess | \$21,548 | 4.02% | \$19,834 | 3.65% |
| Tier 1 Capital to Risk Weighted Assets | \$59,899 | 11.18% | \$58,800 | 10.82% |
| Regulatory Requirement | 21,425 | 4.00% | 21,745 | 4.00% |
| Excess | \$38,474 | 7.18% | \$37,055 | 6.82% |
| Tier 1 Capital to Average Assets | \$59,899 | 7.26% | \$58,800 | 7.34% |
| Regulatory Requirement | 32,988 | 4.00% | 32,040 | 4.00% |
| Excess | \$26,911 | 3.26% | \$26,760 | 3.34% |

The Company's principal source of funds to pay cash dividends and support its commitments is derived from Bank operations. The Company declared dividends in the aggregate amount of \$716 and \$646 during the three months ended March 31, 2007 and 2006, at a rate of \$0.235 and \$0.22 per share, respectively.

In March 2004, the Company announced a second stock repurchase plan. The Board of Directors of the Company authorized open market and privately negotiated purchases of up to 10% of the Company's outstanding shares of common stock, or 310,000 shares. Purchases began on March 4, 2004 and were continued through December 31, 2006. The Company's board of directors subsequently authorized the continuance of this stock repurchase plan through December 31, 2007. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time, or from time-to-time, without prior notice. As of March 31, 2007, the Company had repurchased 148,613 shares of stock under this plan, or 47.9% of the total authorized, at a total cost of \$4,003 and an average price of \$26.94 per share. The Company recorded the repurchased shares as treasury stock.

The Company believes that a stock repurchase plan is a prudent use of capital at this time. Management anticipates the stock repurchase plan will be accretive to the return on average shareholders' equity and earnings per share. Management also believes the stock repurchase plan helps facilitate an orderly market for the disposition of large blocks of stock, and lessens the price volatility associated with the Company's thinly traded stock.

Contractual Obligations

The Company is a party to certain contractual obligations under which it is obligated to make future payments. These principally include borrowings from the FHLB, consisting of short and long-term fixed rate borrowings, and collateralized by all stock in the FHLB, a blanket lien on qualified collateral consisting primarily of loans with first and second mortgages secured by one-to-four family properties, and certain pledged investment securities. The Company has an obligation to repay all borrowings from the FHLB.

The Company is also obligated to make payments on operating leases for its branch office in Somesville and its office in Bangor, Maine.

The following table summarizes the Company's contractual obligations at March 31, 2007. Borrowings are stated at their contractual maturity due dates and do not reflect call features, or principal amortization features, on certain borrowings.

CONTRACTUAL OBLIGATIONS (Dollars in thousands)

| Description | Total Amount of Obligations | Payments Due By Period | | |
|-------------|--------------------------------|------------------------|----------------|--------------------------|
| | | < 1 Year | > 1-3 Years | > 3-5 Years > 5 Years |

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

| | | | | | |
|--|-----------|-----------|----------|----------|---------|
| Operating Leases | \$ 305 | \$ 76 | \$ 137 | \$ 92 | \$ --- |
| Borrowings from Federal Home Loan Bank | 239,184 | 160,101 | 42,211 | 35,840 | 1,032 |
| Securities sold under agreements to repurchase | 13,168 | 13,168 | --- | --- | --- |
| Total | \$252,657 | \$173,345 | \$42,348 | \$35,932 | \$1,032 |

All FHLB advances are fixed-rate instruments. Advances are payable at their call dates or final maturity dates. Advances are stated in the above table at their contractual final maturity dates. At March 31, 2007, the Bank had \$52 in callable advances.

In the normal course of its banking and financial services business, and in connection with providing products and services to its customers, the Company has entered into a variety of traditional third party contracts for support services. Examples of such contractual agreements would include services providing ATM, Visa debit and credit card processing, trust services accounting support, student loan servicing, check printing, statement rendering and the leasing of T-1 telecommunication lines supporting the Company's wide area technology network.

The majority of the Company's core operating systems and software applications are maintained "in-house" with traditional third party maintenance agreements of one year or less.

Off-Balance Sheet Arrangements

The Company is, from time to time, a party to certain off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources, that may be considered material to investors.

Standby Letters of Credit:

The Bank guarantees the obligations or performance of certain customers by issuing standby letters of credit to third parties. These letters of credit are sometimes issued in support of third party debt. The risk involved in issuing standby letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same origination, portfolio maintenance and management procedures in effect to monitor other credit products. The amount of collateral obtained, if deemed necessary by the Bank upon issuance of a standby letter of credit, is based upon management's credit evaluation of the customer.

At March 31, 2007, commitments under existing standby letters of credit totaled \$462, compared with \$442 and \$115 at December 31 and March 31, 2006, respectively. The fair value of the standby letters of credit was not significant as of the foregoing dates.

Off-Balance Sheet Risk

The Bank is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financial needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and certain financial derivative instruments; namely, interest rate swap agreements and interest rate floor agreements.

Commitments to Extend Credit:

Commitments to extend credit represent agreements by the Bank to lend to a customer provided there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other

termination clauses and may require payment of a fee.

Since many of these commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis using the same credit policies as it does for its balance sheet instruments. The amount of collateral obtained, if deemed necessary by the Bank upon the issuance of commitment, is based on management's credit evaluation of the customer.

The following table summarizes the Bank's commitments to extend credit as of the dates shown:

| (in thousands) | March 31, 2007 | December 31, 2006 | March 31, 2006 |
|--|-------------------|----------------------|-------------------|
| Commitments to originate loans | \$ 37,007 | \$ 13,340 | \$ 29,007 |
| Unused lines of credit | 78,928 | 81,800 | 74,483 |
| Un-advanced portions of construction loans | 4,002 | 7,638 | 5,671 |
| Total | \$119,937 | \$102,778 | \$109,161 |

Financial Derivative Instruments:

As part of its overall asset and liability management strategy, the Bank periodically uses derivative instruments to minimize significant unplanned fluctuations in earnings and cash flows caused by interest rate volatility. The Bank's interest rate risk management strategy involves modifying the re-pricing characteristics of certain assets and liabilities so that changes in interest rates do not have a significant adverse effect on net interest income. Derivative instruments that management periodically uses as part of its interest rate risk management strategy include interest rate swap agreements and interest rate floor agreements. A policy statement, approved by the Board of Directors of the Bank, governs use of derivative instruments.

At March 31, 2007, the Bank had four outstanding derivative instruments with notional amounts totaling \$50,000. The notional amounts of the financial derivative instruments do not represent exposure to credit loss. The Bank is exposed to credit loss only to the extent the counter-party defaults in its responsibility to pay interest under the terms of the agreements. Management does not anticipate non-performance by the counter-parties to the agreements, and regularly reviews the credit quality of the counter-parties from which the instruments have been purchased.

The details of the Bank's financial derivative instruments as of March 31, 2007 are summarized below. Also refer to Note 7 of the consolidated financial statements in Part I, Item 1 of this report on Form 10-Q.

INTEREST RATE SWAP AGREEMENTS

| Description | Maturity | Notional Amount (in thousands) | Fixed Interest Rate | Variable Interest Rate |
|---------------------------------------|----------|--------------------------------------|------------------------|---------------------------|
| Receive fixed rate, pay variable rate | 09/01/07 | \$10,000 | 6.04% | Prime (8.25%) |
| Receive fixed rate, pay variable rate | 01/24/09 | \$10,000 | 6.25% | Prime (8.25%) |

The Company is required to pay a counter-party monthly variable rate payments indexed to Prime, while receiving monthly fixed rate payments based upon interest rates of 6.04% and 6.25%, respectively, over the term of each respective agreement.

The interest rate swap agreements were designated as cash flow hedges in accordance with SFAS No. 133 Implementation Issue No. G25, "Cash Flow Hedges: Using the First-Payments Received Technique in Hedging the Variable Interest Payments on a Group of Non-Benchmark-Rate-Based Loans."

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

The following table summarizes the contractual cash flows of the interest rate swap agreements outstanding at March 31, 2007, based upon the then current Prime interest rate of 8.25%.

| | Total | Less Than 1 Year | >1-3 Years |
|--|----------|---------------------|------------|
| Fixed payments due from counter-party | \$1,394 | \$ 882 | \$ 512 |
| Variable payments due to counter-party based on prime rate | 1,852 | 1,176 | 676 |
| Net cash flow | \$ (458) | \$ (294) | \$ (164) |

INTEREST RATE FLOOR AGREEMENTS

| Notional Amount | Termination Date | Prime Strike Rate | Premium Paid |
|-----------------|------------------|-------------------|--------------|
| \$20,000 | 08/01/10 | 6.00% | \$186 |
| \$10,000 | 11/01/10 | 6.50% | \$ 69 |

In 2005, interest rate floor agreements were purchased to limit the Bank's exposure to falling interest rates on two pools of loans indexed to the Prime interest rate. Under the terms of the agreements, the Bank paid premiums of \$186 and \$69 for the right to receive cash flow payments if the Prime interest rate falls below the floors of 6.00% and 6.50%, thus effectively ensuring interest income on the pools of prime-based loans at minimum rates of 6.00% and 6.50% on the \$20,000 and \$10,000 notional amounts for the duration of the agreements, respectively. The interest rate floor agreements were designated as cash flow hedges in accordance with SFAS 133.

Liquidity

Liquidity is measured by the Company's ability to meet short-term cash needs at a reasonable cost or minimal loss. The Company seeks to obtain favorable sources of liabilities and to maintain prudent levels of liquid assets in order to satisfy varied liquidity demands. Besides serving as a funding source for maturing obligations, liquidity provides flexibility in responding to customer-initiated needs. Many factors affect the Company's ability to meet liquidity needs, including variations in the markets served by its network of offices, its mix of assets and liabilities, reputation and credit standing in the marketplace, and general economic conditions.

The Bank actively manages its liquidity position through target ratios established under its Asset Liability Management Policy. Continual monitoring of these ratios, both historical and through forecasts under multiple rate scenarios, allows the Bank to employ strategies necessary to maintain adequate liquidity.

The Bank uses a basic surplus model to measure its liquidity over 30 and 90-day time horizons. The relationship between liquid assets and short-term liabilities that are vulnerable to non-replacement are routinely monitored. The Bank's policy is to maintain its liquidity position at approximately 5% of total assets. At March 31, 2007, liquidity, as measured by the basic surplus/deficit model, was 8.0% over the 30-day horizon and 6.4% over the 90-day horizon.

At March 31, 2007, the Bank had unused lines of credit and net unencumbered qualifying collateral availability to support its credit line with the FHLB approximating \$50 million. The Bank also had capacity to borrow funds on a secured basis utilizing certain un-pledged securities in its investment securities portfolio. The Bank's loan portfolio provides an additional source of contingent liquidity that could be accessed in a reasonable time period through pledging or sales. The Bank also has access to the national brokered deposit market, and has been using this funding source to bolster its liquidity position.

The Bank maintains a liquidity contingency plan approved by the Bank's Board of Directors. This plan addresses the steps that would be taken in the event of a liquidity crisis, and identifies other sources of liquidity available to the Company. The Company believes that the level of liquidity is sufficient to meet current and future funding requirements. However, changes in economic conditions, including consumer savings habits and availability or access to the brokered deposit market could potentially have a significant impact on the Company's liquidity position.

Impact of Inflation and Changing Prices

The Consolidated Financial Statements and the accompanying Notes to the Consolidated Financial Statements presented elsewhere in this report have been prepared in accordance with U.S. generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars without considering changes in the relative purchasing power of money over time due to inflation.

Unlike many industrial companies, substantially all of the assets and virtually all of the liabilities of the Company are monetary in nature. As a result, interest rates have a more significant impact on the Company's performance than the general level of inflation. Over short periods of time, interest rates and the U.S. Treasury yield curve may not necessarily move in the same direction or in the same magnitude as inflation.

While the financial nature of the Company's consolidated balance sheets and statements of income is more clearly affected by changes in interest rates than by inflation, inflation does affect the Company because as prices increase the money supply tends to increase, the size of loans requested tends to increase, total Company assets increase, and interest rates are affected by inflationary expectations. In addition, operating expenses tend to increase without a corresponding increase in productivity. There is no precise method, however, to measure the effects of inflation on the Company's financial statements. Accordingly, any examination or analysis of the financial statements should take into consideration the possible effects of inflation.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates/prices, such as interest rates, foreign currency exchange rates, commodity prices and equity prices. Interest rate risk is the most significant market risk affecting the Company. Other types of market risk do not arise in the normal course of the Company's business activities.

Interest Rate Risk:

Interest rate risk can be defined as an exposure to movement in interest rates that could have an adverse impact on the Bank's net interest income. Interest rate risk arises from the imbalance in the re-pricing, maturity and/or cash flow characteristics of assets and liabilities. Management's objectives are to measure, monitor and develop strategies in response to the interest rate risk profile inherent in the Bank's balance sheet. The objectives in managing the Bank's balance sheet are to preserve the sensitivity of net interest income to actual or potential changes in interest rates, and to enhance profitability through strategies that promote sufficient reward for understood and controlled risk.

The Bank's interest rate risk measurement and management techniques incorporate the re-pricing and cash flow attributes of balance sheet and off balance sheet instruments as they relate to current and potential changes in interest rates. The level of interest rate risk, measured in terms of the potential future effect on net interest income, is determined through the use of modeling and other techniques under multiple interest rate scenarios. Interest rate risk is evaluated in depth on a quarterly basis and reviewed by the Asset/Liability Committee ("ALCO") and the Bank's Board of Directors.

The Bank's Asset Liability Management Policy, approved annually by the Bank's Board of Directors, establishes interest rate risk limits in terms of variability of net interest income under rising, flat, and decreasing rate scenarios. It

is the role of ALCO to evaluate the overall risk profile and to determine actions to maintain and achieve a posture consistent with policy guidelines.

The Bank utilizes an interest rate risk model widely recognized in the financial industry to monitor and measure interest rate risk. The model simulates the behavior of interest income and expense of all balance sheet and off-balance sheet instruments, under different interest rate scenarios together with a dynamic future balance sheet. Interest rate risk is measured in terms of potential changes in net interest income based upon shifts in the yield curve.

The interest rate risk sensitivity model requires that assets and liabilities be broken down into components as to fixed, variable, and adjustable interest rates, as well as other homogeneous groupings, which are segregated as to maturity and type of instrument. The model includes assumptions about how the balance sheet is likely to evolve through time and in different interest rate environments. The model uses contractual re-pricing dates for variable products, contractual maturities for fixed rate products, and product specific assumptions for deposit accounts, such as money market accounts, that are subject to re-pricing based on current market conditions. Re-pricing margins are also determined for adjustable rate assets and incorporated in the model. Investment securities and borrowings with call provisions, are examined on an individual basis in each rate environment to estimate the likelihood of a call. Prepayment assumptions for mortgage loans and mortgage backed securities are developed from industry median estimates of prepayment speeds, based upon similar coupon ranges and seasoning. Cash flows and maturities are then determined, and for certain assets, prepayment assumptions are estimated under different interest rate scenarios. Interest income and interest expense are then simulated under several hypothetical interest rate conditions including:

- A flat interest rate scenario in which current prevailing rates are locked in and the only balance sheet fluctuations that occur are due to cash flows, maturities, new volumes, and re-pricing volumes consistent with this flat rate assumption.
- A 200 basis point rise or decline in interest rates applied against a parallel shift in the yield curve over a twelve-month period together with a dynamic balance sheet anticipated to be consistent with such interest rate changes.
- Various non-parallel shifts in the yield curve, including changes in either short-term or long-term rates over a twelve-month horizon, together with a dynamic balance sheet anticipated to be consistent with such interest rate changes.
- An extension of the foregoing simulations to each of two, three, four and five year horizons to determine the interest rate risk with the level of interest rates stabilizing in years two through five. Even though rates remain stable during this two to five year time period, re-pricing opportunities driven by maturities, cash flow, and adjustable rate products will continue to change the balance sheet profile for each of the rate conditions.

Changes in net interest income based upon the foregoing simulations are measured against the flat interest rate scenario and actions are taken to maintain the balance sheet interest rate risk within established policy guidelines.

The following table summarizes the Bank's net interest income sensitivity analysis as of March 31, 2007, over one and two-year horizons and under different interest rate scenarios.

INTEREST RATE RISK
CHANGE IN NET INTEREST INCOME FROM THE FLAT RATE SCENARIO
MARCH 31, 2007

(Dollars in thousands)

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

| | -200 Basis Points Parallel Yield Curve Shift | +200 Basis Points Parallel Yield Curve Shift | -200 Basis Points Short Term Rates |
|---|--|--|--|
| Year 1 | | | |
| Net interest income change (\$) | \$1,137 | (\$1,972) | \$1,866 |
| Net interest income change (%) | 5.03% | (8.72%) | 8.26% |
| Year 2 | | | |
| Net interest income change vs. year one base (\$) | \$1,469 | (\$3,407) | \$5,018 |
| Net interest income change vs. year one base (%) | 6.50% | (15.07%) | 22.20% |

The foregoing interest rate sensitivity modeling results indicate that the Bank's balance sheet is liability sensitive and is favorably positioned for declining interest rates over the one and two-year horizons. The interest rate sensitivity model also suggests that the Bank is exposed to a parallel increase in short-term and long-term rates over the one and two-year horizons but, as discussed below, management believes that this is a scenario that is less likely to occur.

At March 31, 2007, the U.S. Treasury yield curve ("yield curve") was flat-to-inverted, with the two, five and ten-year U.S. Treasury notes closing at 4.57%, 4.53% and 4.64%, respectively. The overnight Fed Funds rate established by the Board of Governors of the Federal Reserve System was 61 basis points below the benchmark 10-year U.S. Treasury note. Given this historical phenomenon, interest rate risk sensitivity modeling is more challenging than would traditionally be the case. Traditional modeling of parallel movements in the March 31, 2007 yield curve would suggest that it would remain flat-to-inverted in either an increasing or declining interest rate environment, a scenario management believes is not likely and one that has historically not occurred. These challenges are discussed in the following discussion and analysis covering the Bank's interest rate risk sensitivity position.

Assuming interest rates remain at or near their current levels and the Bank's balance sheet structure and size remain at current levels, the interest rate sensitivity simulation model suggests that net interest income will trend upward over the one and two-year horizons and beyond. The upward trend principally results from the re-investment of securities and loan cash flows into higher current interest rate levels, while certain loans will continue to "index up" in response to previous interest rate movements more quickly than funding costs. Although short-term market interest rates have risen with the increases in the Federal Funds rate, the Bank has generally lagged the market with the pricing of deposit rates without a material run-off in balances. Margins could narrow if the Bank is prompted to increase deposit interest rates in response to competitive market pricing pressures. Margins could also narrow if, in response to competitive pricing pressures, loan pricing is lower than projected and asset cash flows are not reinvested as assumed. Management anticipates that continued earning asset growth will be needed to meaningfully increase the Bank's current level of net interest income, should interest rates remain at current levels.

Assuming short-term and long-term interest rates decline from current levels (i.e., a parallel yield curve shift) and the Bank's balance sheet structure and size remain at current levels, management believes net interest income will increase over the one-year horizon and then begin a slow decline over the two-year horizon and beyond. The interest rate sensitivity simulation model suggests that, over the twelve-month horizon, funding cost reductions will significantly outpace falling asset yields, favorably impacting net interest income. While the interest rate sensitivity model suggests that net interest income will begin to decline over the twenty-four month horizon and beyond, driven by accelerated cash flows on earning assets and the re-pricing of the Bank's earning asset base, management believes this is a scenario that is not likely to occur, as the 10-year U.S. Treasury note would need to decline well below its all time low. Should the yield curve steepen as rates fall, the simulation model suggests that pressure on net interest income will be significantly reduced or eliminated entirely. Notwithstanding, management anticipates continued earning asset growth will be needed to meaningfully increase the Bank's current level of net interest income beyond the one-year horizon, should both long-term and short-term interest rates decline in parallel.

The interest rate sensitivity model is used to evaluate the impact on net interest income given certain non-parallel shifts in the yield curve, including changes in either short-term or long-term interest rates. In view of the flat-to-inverted U.S. Treasury yield curve at March 31, 2007, management modeled alternative future interest rate scenarios and the anticipated impact on net interest income. Assuming the Bank's balance sheet structure and size remain at current levels, with the short-term Fed Funds interest rate declining 200 basis points, and with the balance of the yield curve returning to its historical ten-year average, the interest rate sensitivity model suggests that net interest income will meaningfully improve over the twelve-month horizon and continue to strengthen over the twenty-four-month horizon and beyond. The model indicates that funding costs will show meaningful declines while loan and securities cash flows will be reinvested into higher yielding earning assets. Management believes this scenario is more likely than a parallel 200 basis point decline in short and long-term interest rates, given the current shape of the yield curve. Management also believes this scenario will meaningfully increase net interest income without earning asset growth.

Assuming that the Federal Reserve continues increasing short-term interest rates by 200 basis points and the balance of the yield curve shifts in parallel with these increases, management believes net interest income will post significant declines over the twelve-month horizon and then begin a steady recovery over the twenty-four month horizon and beyond. The interest rate sensitivity simulation model suggests that as interest rates rise, the Bank's funding costs will re-price more quickly than its earning asset portfolios over a twelve-month horizon. Thereafter, the interest rate sensitivity model suggests the asset sensitivity of the balance sheet will start to increase asset yields faster than funding cost increases. Management believes that strong earning asset growth will be necessary to increase the current level of net interest income should short and long-term interest rates rise in parallel. Management believes this is a scenario that is unlikely to occur, given that the yield curve would have to remain flat over the one and two-year horizons, a phenomena that has historically not occurred. Management also believes that, based on a variety of current economic indicators, the Federal Reserve is at or near the end of its short-term interest rate tightening cycle.

The preceding 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: the nature and timing of interest rate levels and yield curve shape, prepayment speeds on loans and securities, deposit rates, pricing decisions on loans and deposits, reinvestment or replacement of asset and liability cash flows, and others. 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.

As market conditions vary from those assumed in the sensitivity analysis, actual results may also differ due to: prepayment and refinancing levels deviating from those assumed; the impact of interest rate change caps or floors on adjustable rate assets; the potential effect of changing debt service levels on customers with adjustable rate loans; depositor early withdrawals and product preference changes; and other such variables. The sensitivity analysis also does not reflect additional actions that the Bank's ALCO and board of directors might take in responding to or anticipating changes in interest rates, and the anticipated impact on the Bank's net interest income.

ITEM 4. CONTROLS AND PROCEDURES

Company management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this quarterly report. Based on such evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and regulations and are operating in an effective manner.

Edgar Filing: BAR HARBOR BANKSHARES - Form 10-Q

No change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15(d)-15(f) under the Securities Exchange Act of 1934) occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1: Legal Proceedings

The Company and its subsidiaries are parties to certain ordinary routine litigation incidental to the normal conduct of their respective businesses, which in the opinion of management based upon currently available information will have no material effect on the Company's consolidated financial statements.

Item 1A: Risk Factors

There have been no material changes in the Company's risk factors from those disclosed in Part I, Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

Item 2: Unregistered Sales of Equity Securities and Use of Proceeds

(a) None

(b) None

(c) The following table sets forth information with respect to any purchase made by or on behalf of the Company or any "affiliated purchaser," as defined in Section 240.10b-18(a)(3) under the Exchange Act, of shares of Company's common stock during the periods indicated.

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---------------------|--|--|---|--|
| January 1-31, 2007 | 685 | \$31.42 | 685 | 165,313 |
| February 1-28, 2007 | 640 | \$32.95 | 640 | 164,673 |
| March 1-31, 2007 | 3,286 | \$32.50 | 3,286 | 161,387 |

In March 2004, the Company's Board of Directors approved a program to repurchase up to 10% of the Company's outstanding shares of common stock, or approximately 310,000 shares. Purchases began on March 4, 2004 and were continued through December 31, 2006. The Company's Board of Directors subsequently authorized the continuance of this stock repurchase plan through December 31, 2007. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time, or from time-to-time, without prior notice.

Item 3: Defaults 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

(a) Exhibits

| EXHIBIT NUMBER | | |
|-------------------|---|--|
| 3 | 3.1 Articles of Incorporation | Articles as amended July 11, 1995 are incorporated by reference to Form S-14 filed with the Commission March 26, 1984 (Commission Number 2-90171). |
| | 3.2 Bylaws | Bylaws as amended to date are incorporated by reference to Form 10-K, Item 14 (a)(3) filed with the Commission March 28, 2002. (Commission Number 001-13349) |
| 31.1 | Certification of the Chief Executive Officer under Rule 13a-14(a)/15d-14(a) | Filed herewith. |
| 31.2 | Certification of the Chief Financial Officer under Rule 13a-14(a)/15d-14(a) | Filed herewith. |
| 32.1 | Certification of Chief Executive Officer under 18 U.S.C. Section 1350 | Filed herewith. |
| 32.2 | Certification of Chief Financial Officer under 18 U.S.C. Section 1350 | Filed herewith. |

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.

Date: May 10, 2007

Date: May 10, 2007

BAR HARBOR BANKSHARES
(Registrant)
/s/Joseph M. Murphy
Joseph M. Murphy
Chief Executive Officer
/s/Gerald Shencavitz
Gerald Shencavitz
Chief Financial Officer