

SUMMIT FINANCIAL GROUP INC  
Form 10-Q  
May 09, 2008

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

FORM 10 – Q

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

For the quarterly period ended March 31, 2008.

or

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR  
15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934 For the transition period from

\_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 0-16587

Summit Financial Group, Inc.  
(Exact name of registrant as specified in its charter)

West Virginia  
(State or other jurisdiction of  
incorporation or organization)

55-0672148  
(IRS Employer  
Identification No.)

300 North Main Street  
Moorefield, West Virginia 26836  
(Address of principal executive offices) (Zip Code)  
(304) 530-1000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☒  
Non-accelerated filer ☐ Smaller reporting company ☐

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

Indicate the number of shares outstanding of each of the issuer's classes of Common Stock as of the latest practicable date.

Common Stock, \$2.50 par value  
7,410,741 shares outstanding as of May 7, 2008

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Summit Financial Group, Inc. and Subsidiaries

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	Exhibits	
	Exhibit 11	Statement re: Computation of Earnings per Share – Information contained in Note 5 to the Consolidated Financial Statements on page 14 of this Quarterly Report is incorporated herein by reference.
	Exhibit 31.1	Sarbanes-Oxley Act Section 302 Certification of Chief Executive Officer
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## Summit Financial Group, Inc. and Subsidiaries

## Consolidated Balance Sheet (unaudited)

Dollars in thousands	March 31, 2008 (unaudited)	December 31, 2007 (*)	March 31, 2007 (unaudited)
<b>ASSETS</b>			
Cash and due from banks	\$ 21,912	\$ 21,285	\$ 12,232
Interest bearing deposits with other banks	103	77	106
Federal funds sold	1,514	181	1,412
Securities available for sale	284,082	283,015	244,438
Other Investments	17,947	17,051	13,735
Loan held for sale, net	489	1,377	-
Loans, net	1,079,223	1,052,489	930,769
Property held for sale	2,183	2,058	42
Premises and equipment, net	22,055	22,130	22,178
Accrued interest receivable	6,851	7,191	6,656
Intangible assets	9,968	10,055	3,159
Other assets	18,783	18,413	17,631
Assets related to discontinued operations	-	214	2,170
Total assets	\$ 1,465,110	\$ 1,435,536	\$ 1,254,528
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>Liabilities</b>			
Deposits			
Non interest bearing	\$ 64,111	\$ 65,727	\$ 60,644
Interest bearing	772,833	762,960	816,581
Total deposits	836,944	828,687	877,225
Short-term borrowings	93,950	172,055	79,886
Long-term borrowings	412,329	315,738	183,819
Subordinated debentures owed to unconsolidated subsidiary trusts	19,589	19,589	19,589
Other liabilities	10,343	9,241	10,954
Liabilities related to discontinued operations	-	806	1,105
Total liabilities	1,373,155	1,346,116	1,172,578
<b>Commitments and Contingencies</b>			
<b>Shareholders' Equity</b>			
Common stock and related surplus, \$2.50 par value; authorized 20,000,000 shares, issued and outstanding 2008 - 7,408,941 shares; issued December 2007 - 7,408,941 shares; issued March 2007 - 7,084,980 shares	24,394	24,391	18,029
Retained earnings	68,901	65,077	63,822
Accumulated other comprehensive income	(1,340)	(48)	99
Total shareholders' equity	91,955	89,420	81,950

Total liabilities and shareholders' equity	\$ 1,465,110	\$ 1,435,536	\$ 1,254,528
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(\*) - December 31, 2007 financial information has been extracted from audited consolidated financial statements

See Notes to Consolidated Financial Statements

## Summit Financial Group, Inc. and Subsidiaries

## Consolidated Statements of Income (unaudited)

Dollars in thousands	Three Months Ended	
	March 31, 2008	March 31, 2007
Interest income		
Interest and fees on loans		
Taxable	\$ 19,948	\$ 18,597
Tax-exempt	121	115
Interest and dividends on securities		
Taxable	3,196	2,579
Tax-exempt	590	545
Interest on interest bearing deposits with other banks	2	3
Interest on Federal funds sold	2	3
Total interest income	23,859	21,842
Interest expense		
Interest on deposits	7,124	9,028
Interest on short-term borrowings	919	958
Interest on long-term borrowings and subordinated debentures	4,877	2,653
Total interest expense	12,920	12,639
Net interest income	10,939	9,203
Provision for loan losses	1,000	390
Net interest income after provision for loan losses	9,939	8,813
Other income		
Insurance commissions	1,327	206
Service fees	743	617
Gain (loss) on sale of assets	-	2
Net cash settlement on derivative instruments	(170)	(184)
Change in fair value of derivative instruments	705	226
Other	243	189
Total other income	2,848	1,056
Other expense		
Salaries and employee benefits	4,395	3,226
Net occupancy expense	476	418
Equipment expense	534	446
Supplies	194	172
Professional fees	118	174
Amortization of intangibles	88	38
Other	1,284	1,175
Total other expense	7,089	5,649

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Income before income taxes	5,698	4,220
Income tax expense	1,874	1,286
Income from continuing operations	\$ 3,824	\$ 2,934
Discontinued Operations		
Reversal of severance in exit costs	-	80
Operating income(loss)	-	(372)
Income from discontinued operations before income tax expense(benefit)	-	(292)
Income tax expense(benefit)	-	(97)
Income from discontinued operations	-	(195)
Net Income	\$ 3,824	\$ 2,739
Basic earnings from continuing operations per common share	\$ 0.52	\$ 0.41
Basic earnings per common share	\$ 0.52	\$ 0.39
Diluted earnings from continuing operations per common share	\$ 0.51	\$ 0.41
Diluted earnings per common share	\$ 0.51	\$ 0.38

See Notes to Consolidated Financial Statements



## Summit Financial Group, Inc. and Subsidiaries

## Consolidated Statements of Shareholders' Equity (unaudited)

Dollars in thousands	Common Stock and Related Surplus	Retained Earnings (Restated)	Accumulated Other Compre- hensive Income	Total Share- holders' Equity (Restated)
Balance, December 31, 2007	\$ 24,391	\$ 65,077	\$ (48)	\$ 89,420
Three Months Ended March 31, 2008				
Comprehensive income:				
Net income	-	3,824	-	3,824
Other comprehensive income, net of deferred tax benefit of \$792:				
Net unrealized loss on securities of (\$1,292), net of reclassification adjustment for gains included in net income of \$0	-	-	(1,292)	(1,292)
Stock compensation expense	3	-	-	3
Total comprehensive income				2,532
Exercise of stock options	-	-	-	-
Balance, March 31, 2008	\$ 24,394	\$ 68,901	\$ (1,340)	\$ 91,955
Balance, December 31, 2006	\$ 18,021	\$ 61,083	\$ (352)	\$ 78,752
Three Months Ended March 31, 2007				
Comprehensive income:				
Net income	-	2,739	-	2,739
Other comprehensive income, net of deferred tax expense of \$276:				
Net unrealized gain on securities of \$451, net of reclassification adjustment for gains included in net income of \$0	-	-	451	451
Total comprehensive income				3,190
Exercise of stock options	8	-	-	8
Balance, March 31, 2007	\$ 18,029	\$ 63,822	\$ 99	\$ 81,950

See Notes to Consolidated Financial Statements

## Summit Financial Group, Inc. and Subsidiaries

## Consolidated Statements of Cash Flows (unaudited)

Dollars in thousands	Three Months Ended	
	March 31, 2008	March 31, 2007
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 3,824	\$ 2,739
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	398	386
Provision for loan losses	1,000	640
Stock compensation expense	3	8
Deferred income tax (benefit)	(26)	113
Loans originated for sale	(1,608)	(8,149)
Proceeds from loans sold	2,523	15,674
(Gain) on sales of loans held for sale	(28)	(286)
Change in fair value of derivative instruments	(705)	(226)
Securities (gains)	-	-
Reversal of exit costs accrual of discontinued operations	-	(80)
(Gain) loss on disposal of other assets	-	(2)
Amortization of securities premiums, net	(104)	(15)
Amortization of goodwill and purchase accounting adjustments, net	91	41
(Decrease) in accrued interest receivable	340	(305)
(Increase) in other assets	(945)	(819)
Increase in other liabilities	2,430	530
Net cash provided by (used in) operating activities	7,193	10,249
<b>Cash Flows from Investing Activities</b>		
Net (increase) decrease in interest bearing deposits		
with other banks	(26)	165
Proceeds from maturities and calls of securities available for sale	13,814	4,484
Proceeds from sales of securities available for sale	-	-
Principal payments received on securities available for sale	7,169	6,817
Purchases of securities available for sale	(24,029)	(19,173)
Purchases of other investments	(3,935)	(3,325)
	3,039	1,624

Redemption of Federal Home Loan Bank stock		
Net (increase) decrease in federal funds sold	(1,333)	(895)
Net loans made to customers	(27,881)	(15,361)
Purchases of premises and equipment	(324)	(123)
Proceeds from sales of other assets	-	86
Proceeds from early termination of interest rate swap	212	-
Net cash provided by (used in) investing activities	(33,294)	(25,701)
Cash Flows from Financing Activities		
Net increase in demand deposit, NOW and savings accounts	(10,040)	5,239
Net increase(decrease) in time deposits	18,293	(16,754)
Net increase(decrease) in short-term borrowings	(78,105)	19,458
Proceeds from long-term borrowings	100,000	10,000
Repayment of long-term borrowings	(13,408)	(2,290)
Proceeds from issuance of subordinated debentures	9,988	-
Net cash provided by financing activities	26,728	15,653
Increase (decrease) in cash and due from banks	627	201
Cash and due from banks:		
Beginning	21,285	12,031
Ending	\$ 21,912	\$ 12,232

(Continued)

See Notes to Consolidated Financial Statements

Summit Financial Group, Inc. and Subsidiaries

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Consolidated Statements of Cash Flows (unaudited)

Dollars in thousands	Three Months Ended	
	March 31, 2008	March 31, 2007
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$ 12,561	\$ 12,232
Income taxes	\$ -	\$ -
Supplemental Schedule of Noncash Investing and Financing Activities		
Other assets acquired in settlement of loans	\$ 147	\$ 43

See Notes to Consolidated Financial Statements

Summit Financial Group, Inc. and Subsidiaries

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Notes to Consolidated Financial Statements (unaudited)

Note 1. Basis of Presentation

We, Summit Financial Group, Inc. and subsidiaries, prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for annual year end financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature.

The presentation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us 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 materially from these estimates.

The results of operations for the three months ended March 31, 2008 are not necessarily indicative of the results to be expected for the full year. The consolidated financial statements and notes included herein should be read in conjunction with our 2007 audited financial statements and Annual Report on Form 10-K and Form 10-K/A. Certain accounts in the consolidated financial statements for December 31, 2007 and March 31, 2007, as previously presented, have been reclassified to conform to current year classifications.

Note 2. Significant New Accounting Pronouncements

In September 2006, the FASB issued Statement 157, Fair Value Measurements (SFAS 157). SFAS 157 replaces various definitions of fair value in existing accounting literature with a single definition, establishes a framework for measuring fair value in generally accepted accounting principles, and requires additional disclosures about fair value measurements. SFAS 157 does not expand the use of fair value to any new circumstances. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position (FSP) FAS 157-2, "Effective Date of FASB Statement No. 157." This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. We adopted SFAS 157 on January 1, 2008 and the adoption of this statement did not have a material effect on our financial statements. See Note 3 for a discussion of our fair value measurements.

In February 2007, the FASB issued Statement of Financial Accounting Standard 159 (SFAS 159), The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) is applicable on an instrument by instrument basis, with certain exceptions, (ii) is irrevocable (unless a new election date occurs), and (iii) is applied only to entire instruments and not to portions of instruments. We adopted SFAS 159 on January 1, 2008 and the adoption of this statement did not have a material effect on our financial statements.

In December 2007, the FASB issued Statement 141 (revised 2007) (SFAS 141R), Business Combinations. SFAS 141R will significantly change how the acquisition method will be applied to business combinations. SFAS 141R

requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under SFAS 141 whereby the cost of an acquisition was allocated to the individual assets acquired

## Summit Financial Group, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (unaudited)

and liabilities assumed based on their estimated fair value. SFAS 141R requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under SFAS 141. Under SFAS 141R, the requirements of SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case, nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of SFAS 5, Accounting for Contingencies. Reversals of deferred income tax valuation allowances and income tax contingencies will be recognized in earnings subsequent to the measurement period. The allowance for loan losses of an acquirer will not be permitted to be recognized by the acquirer. Additionally, SFAS 141(R) will require new and modified disclosures surrounding subsequent changes to acquisition-related contingencies, contingent consideration, noncontrolling interests, acquisition-related transaction costs, fair values and cash flows not expected to be collected for acquired loans, and an enhanced goodwill rollforward. We will be required to prospectively apply SFAS 141(R) to all business combinations completed on or after January 1, 2009. Early adoption is not permitted. We are currently evaluating SFAS 141(R) and have not determined the impact it will have on our financial statements.

## Note 3. Fair Value Measurements

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Accordingly, securities available-for-sale and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record other assets at fair value on a nonrecurring basis, such as loans held for sale, and impaired loans held for investment. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

**Available-for-Sale Securities:** Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss



assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities.

## Summit Financial Group, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (unaudited)

**Loans Held for Sale:** Loans held for sale are carried at the lower of cost or market value. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, we classify loans subject to nonrecurring fair value adjustments as Level 2.

**Loans:** We do not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, "Accounting by Creditors for Impairment of a Loan," (SFAS 114). The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At March 31, 2008, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with SFAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the impaired loan as nonrecurring Level 3.

**Derivative Assets and Liabilities:** Substantially all derivative instruments held or issued by us for risk management or customer-initiated activities are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, we measure fair value using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. We classify derivative instruments held or issued for risk management or customer-initiated activities as Level 2. Examples of Level 2 derivatives are interest rate swaps.

## Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis.

	Total at March 31, 2008	Fair Value Measurements Using:		
Dollars in thousands		Level 1	Level 2	Level 3
Assets:				
Available for sale securities	\$ 284,082	\$ -	\$ 284,082	\$ -
Derivatives	\$ 267		\$ 267	
Liabilities:				
Derivatives	\$ 196		\$ 196	

## Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

We may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis are included in the table below.

## Summit Financial Group, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (unaudited)

Dollars in thousands	Total at March 31, 2008	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3
Loans held for sale	\$ 489	\$ -	\$ 489	\$ -
Impaired loans	11,755	-	-	11,755

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral-dependent loans, had a carrying amount of \$13,853,000, with a valuation allowance of \$2,098,000, resulting in an additional provision for loan losses of \$512,000 for the period.

## Note 4. Discontinued Operations

As of January 1, 2008 we no longer have activity related to discontinued operations. The following table lists the assets and liabilities of Summit Mortgage included in the balance sheet as assets and liabilities related to discontinued operations in 2007.

Dollars in thousands	December 31, 2007	March 31, 2007
Assets:		
Loans held for sale, net	\$ -	\$ 1,190
Loans, net	-	134
Premises and equipment, net	-	-
Property held for sale	-	-
Other assets	214	846
Total assets	\$ 214	\$ 2,170
Liabilities:		
Accrued expenses and other liabilities	\$ 806	\$ 1,015
Total liabilities	\$ 806	\$ 1,015

The results of Summit Mortgage are presented as discontinued operations in a separate category on the income statements following the results from continuing operations. The income (loss) from discontinued operations for the period ended March 31, 2007 is presented below.



## Summit Financial Group, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (unaudited)

## Statements of Income from Discontinued Operations

	For the Quarter Ended
Dollars in thousands	March 31, 2007
Interest income	\$ 112
Interest expense	45
Net interest income	67
Provision for loan losses	250
Net interest income after provision for loan losses	(183)
Noninterest income	
Mortgage origination revenue	803
(Loss) on sale of assets	(51)
Total noninterest income	752
Noninterest expense	
Salaries and employee benefits	442
Net occupancy expense	(4)
Equipment expense	22
Professional fees	97
Postage	-
Advertising	98
Impairment of long-lived assets	-
Exit costs	(80)
Other	286
Total noninterest expense	861
Income (loss) before income tax expense	(292)
Income tax expense (benefit)	(97)
Income (loss) from discontinued operations	\$ (195)

Included in liabilities related to discontinued operations in the accompanying consolidated financial statements is an accrual for exit costs related to the discontinuance of the mortgage banking segment. During fourth quarter 2006, we

accrued \$1,859,000 for exit costs, which was comprised of costs related to operating lease terminations, vendor contract terminations, and severance payments. The changes in that accrual are as follows:

Dollars in thousands