

SHORE BANCSHARES INC  
Form 10-Q  
May 09, 2006

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

**FORM 10-Q**

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

For the Quarterly Period Ended March 31, 2006

**OR**

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-22345

**SHORE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

Maryland  
(State or Other Jurisdiction of  
Incorporation or Organization)

52-1974638  
(I.R.S. Employer  
Identification No.)

18 East Dover Street, Easton,  
Maryland  
(Address of Principal Executive  
Offices)

21601  
(Zip Code)

(410) 822-1400  
Registrant's Telephone Number, Including Area Code

N/A  
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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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Large accelerated filer

Accelerated filer

Non-accelerated filer

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

**APPLICABLE ONLY TO CORPORATE ISSUERS**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 5,577,465 shares of common stock as of April 30, 2006.

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**INDEX**

|  | <b>Page</b> |
|--|-------------|
| Part I. Financial Information  | 2           |
| Item 1. Financial Statements   | 2           |
| Condensed Consolidated Balance Sheets -<br>March 31, 2006 (unaudited) and December 31, 2005  | 2           |
| Condensed Consolidated Statements of Income -<br>For the three months ended March 31, 2006 and 2005<br>(unaudited)                             | 3           |
| Condensed Consolidated Statements of Changes in<br>Stockholders' Equity -<br>For the three months ended March 31, 2006 and 2005<br>(unaudited) | 4           |
| Condensed Consolidated Statements of Cash Flows -<br>For the three months ended March 31, 2006 and 2005<br>(unaudited)                         | 5           |
| Notes to Condensed Consolidated Financial<br>Statements (unaudited)  | 6           |
| Item 2. Management's Discussion and Analysis of<br>Financial Condition and Results of Operations   | 11          |
| Item 3. Quantitative and Qualitative Disclosures about<br>Market Risk  | 16          |
| Item 4. Controls and Procedures  | 16          |
| Part II. Other Information   | 17          |
| Item 1A. Risk Factors  | 17          |
| Item 6. Exhibits   | 17          |
| Signatures   | 18          |
| Exhibit List   | 19          |

**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements.**

SHORE BANCSHARES, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(Dollars in Thousands)

|  | March 31,<br>2006<br>(unaudited) | December<br>31,<br>2005 |
|--|----------------------------------|-------------------------|
| <b><u>ASSETS:</u></b>  |                                  |                         |
| Cash and due from banks  | \$ 27,231                        | \$ 28,990               |
| Interest bearing deposits with other banks   | 5,501                            | 13,068                  |
| Federal funds sold   | 21,908                           | 25,401                  |
| Investment securities:   |                                  |                         |
| Held-to-maturity, at amortized cost (fair value of, \$14,798 and \$14,826, respectively) | 14,879                           | 14,911                  |
| Available for sale, at fair value  | 108,391                          | 106,160                 |
| Loans, less allowance for credit losses (\$5,417, \$5,236, respectively)                 | 636,496                          | 622,227                 |
| Insurance premiums receivable  | 504                              | 1,089                   |
| Premises and equipment, net  | 15,560                           | 15,187                  |
| Accrued interest receivable on loans and investment securities                           | 4,109                            | 3,897                   |
| Investment in unconsolidated subsidiary  | 909                              | 909                     |
| Goodwill   | 11,939                           | 11,939                  |
| Other intangible assets  | 1,821                            | 1,906                   |
| Deferred income taxes  | 2,024                            | 1,991                   |
| Other real estate owned  | 47                               | 302                     |
| Other assets   | 4,103                            | 3,661                   |
| <b>TOTAL ASSETS</b>  | <b>\$ 855,422</b>                | <b>\$ 851,638</b>       |
| <b><u>LIABILITIES:</u></b>   |                                  |                         |
| Deposits:  |                                  |                         |
| Noninterest bearing demand   | \$ 110,748                       | \$ 113,244              |
| NOW and Super NOW  | 104,637                          | 111,799                 |
| Certificates of deposit \$100,000 or more  | 116,601                          | 106,541                 |
| Other time and savings   | 376,737                          | 373,374                 |
| <b>Total Deposits</b>  | <b>708,723</b>                   | <b>704,958</b>          |
| Accrued interest payable   | 1,390                            | 1,214                   |
| Short term borrowings  | 27,281                           | 35,848                  |
| Income taxes payable   | 1,487                            | -                       |
| Long term debt   | 9,000                            | 4,000                   |
| Other liabilities  | 3,416                            | 4,170                   |
| <b>TOTAL LIABILITIES</b>   | <b>751,297</b>                   | <b>750,190</b>          |
| <b><u>STOCKHOLDERS' EQUITY:</u></b>  |                                  |                         |
| Common stock, par value \$.01; authorized 35,000,000 shares; issued and outstanding:     |                                  |                         |
| March 31, 2006   | 5,577,435                        |                         |
| December 31, 2005  | 5,556,985                        | 55                      |
| Additional paid in capital   | 29,411                           | 29,014                  |

|  |                |                |
|--|----------------|----------------|
| Retained earnings                        | 76,025         | 73,642         |
| Accumulated other comprehensive loss     | (1,367)        | (1,263)        |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>        | <b>104,125</b> | <b>101,448</b> |
| TOTAL LIABILITIES & STOCKHOLDERS' EQUITY | \$ 855,422     | \$ 851,638     |

See accompanying notes to Condensed Consolidated Financial Statements.

SHORE BANCSHARES, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Unaudited)  
(Dollars in thousands, except per share amounts)

|  | Three months ended March 31, |          |
|--|------------------------------|----------|
|  | 2006                         | 2005     |
| <b>INTEREST INCOME</b>                                       |                              |          |
| Loans, including fees  | \$ 11,455                    | \$ 9,599 |
| Interest and dividends on investment securities:             |                              |          |
| Taxable  | 1,020                        | 870      |
| Tax-exempt   | 143                          | 149      |
| Other interest income  | 447                          | 189      |
| Total interest income  | 13,065                       | 10,807   |
| <b>INTEREST EXPENSE</b>                                      |                              |          |
| Certificates of deposit, \$100,000 or more                   | 1,080                        | 725      |
| Other deposits   | 2,238                        | 1,654    |
| Other interest   | 333                          | 151      |
| Total interest expense                                       | 3,651                        | 2,530    |
| <b>NET INTEREST INCOME</b>                                   | 9,414                        | 8,277    |
| <b>PROVISION FOR CREDIT LOSSES</b>                           | 311                          | 180      |
| <b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b> | 9,103                        | 8,097    |
| <b>NONINTEREST INCOME</b>                                    |                              |          |
| Service charges on deposit accounts                          | 744                          | 562      |
| Gain on sale of securities                                   | -                            | 58       |
| Insurance agency commissions                                 | 2,331                        | 2,084    |
| Other noninterest income                                     | 631                          | 458      |
| Total noninterest income                                     | 3,706                        | 3,162    |
| <b>NONINTEREST EXPENSE</b>                                   |                              |          |
| Salaries and employee benefits                               | 4,468                        | 3,979    |
| Premises and equipment expense                               | 732                          | 655      |
| Other noninterest expense                                    | 1,891                        | 1,659    |
| Total noninterest expense                                    | 7,091                        | 6,293    |
| <b>INCOME BEFORE INCOME TAXES</b>                            | 5,718                        | 4,966    |
| Federal and state income tax expense                         | 2,167                        | 1,860    |
| <b>NET INCOME</b>  | \$ 3,551                     | \$ 3,106 |
| Basic earnings per common share                              | \$ .64                       | \$ .56   |
| Diluted earnings per common share                            | \$ .64                       | \$ .56   |

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|                                     |    |     |    |     |
|-------------------------------------|----|-----|----|-----|
| Dividends declared per common share | \$ | .21 | \$ | .19 |
|-------------------------------------|----|-----|----|-----|

See accompanying notes to Condensed Consolidated Financial Statements.

SHORE BANCSHARES, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)  
For the Three Month Periods Ended March 31, 2006 and 2005  
(Dollars in thousands, except per share amounts)

|  | Common<br>Stock | Additional<br>Paid in<br>Capital | Retained<br>Earnings | Accumulated<br>other<br>Comprehensive<br>Loss | Total<br>Stockholders'<br>Equity |
|--|-----------------|----------------------------------|----------------------|---|----------------------------------|
| Balances, January 1, 2006  | \$ 55           | \$ 29,014                        | \$ 73,642            | \$ (1,263)                                    | \$ 101,448                       |
| Comprehensive income:  |                 |                                  |                      |   |                                  |
| Net income   | -               | -                                | 3,551                | -   | 3,551                            |
| Other comprehensive income, net of tax:  |                 |                                  |                      |   |                                  |
| Unrealized loss on available for sale securities, net of reclassification adjustment of \$0  | -               | -                                | -                    | (104)   | (104)                            |
| Total comprehensive income   |                 |                                  |                      |   | 3,447                            |
| Shares issued  | 1               | 385                              | -                    | -   | 386                              |
| Stock-based compensation expense   | -               | 12                               | -                    | -   | 12                               |
| Cash dividends paid \$0.21 per share   | -               | -                                | (1,168)              | -   | (1,168)                          |
| Balances, March 31, 2006   | \$ 56           | \$ 29,411                        | \$ 76,025            | \$ (1,367)                                    | \$ 104,125                       |
| Balances, January 1, 2005  |                 |                                  |                      |   |                                  |
| Balances, January 1, 2005  | \$ 55           | \$ 28,017                        | \$ 65,182            | \$ (278)                                      | \$ 92,976                        |
| Comprehensive income:  |                 |                                  |                      |   |                                  |
| Net income   | -               | -                                | 3,106                | -   | 3,106                            |
| Other comprehensive income, net of tax:  |                 |                                  |                      |   |                                  |
| Unrealized loss on available for sale securities, net of reclassification adjustment of \$56 | -               | -                                | -                    | (803)   | (803)                            |
| Total comprehensive income   |                 |                                  |                      |   | 2,303                            |
| Shares issued  | -               | 409                              | -                    | -   | 409                              |
| Cash dividends paid \$0.19 per share   | -               | -                                | (1,048)              | -   | (1,048)                          |
| Balances, March 31, 2005   | \$ 55           | \$ 28,426                        | \$ 67,240            | \$ (1,081)                                    | \$ 94,640                        |

See accompanying Notes to Condensed Consolidated Financial Statements





SHORE BANCSHARES, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
(Dollars in thousands)

|   | For the Three Months Ended March 31, |                  |
|---|--------------------------------------|------------------|
|   | 2006                                 | 2005             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                      |                  |
| Net Income  | \$ 3,551                             | \$ 3,106         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                      |                  |
| Depreciation and amortization   | 348                                  | 367              |
| Stock based compensation expense  | 12                                   | -                |
| Discount accretion on debt securities   | (27)                                 | (23)             |
| Provision for credit losses   | 311                                  | 180              |
| Gain on sale of securities  | -                                    | (58)             |
| Net changes in:   |                                      |                  |
| Insurance premiums receivable   | 585                                  | (144)            |
| Accrued interest receivable   | (212)                                | (286)            |
| Other assets  | (388)                                | (207)            |
| Accrued interest payable on deposits  | 176                                  | 182              |
| Accrued expenses  | 733                                  | 1,512            |
| Net cash provided by operating activities   | 5,089                                | 4,629            |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                      |                  |
| Proceeds from maturities and principal payments of securities available for sale  | 748                                  | 6,656            |
| Proceeds from sale of investment securities available for sale                    | -                                    | 2,010            |
| Purchase of securities available for sale   | (3,148)                              | (15,002)         |
| Proceeds from maturities and principal payments of securities held to maturity    | 229                                  | 271              |
| Purchase of securities held to maturity   | (203)                                | -                |
| Net increase in loans   | (14,580)                             | (923)            |
| Purchase of premises and equipment  | (625)                                | (757)            |
| Proceeds from sale of other real estate owned                                     | 255                                  | -                |
| Deferred earn out payment, net of stock issued                                    | -                                    | (2,400)          |
| Net cash used in investing activities   | (17,324)                             | (10,145)         |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                      |                  |
| Net (decrease) increase in demand, NOW, money market and savings deposits         | (9,855)                              | 4,811            |
| Net increase in certificates of deposit   | 13,620                               | 15,299           |
| Net (decrease) increase in short term borrowings                                  | (8,567)                              | 1,225            |
| Net increase in long-term borrowings  | 5,000                                | -                |
| Proceeds from issuance of common stock  | 386                                  | 10               |
| Dividends paid  | (1,168)                              | (1,048)          |
| Net cash (used in) provided by financing activities                               | (584)                                | 20,297           |
| <b>NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>                       | <b>(12,819)</b>                      | <b>14,781</b>    |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>67,459</b>                        | <b>43,551</b>    |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                 | <b>\$ 54,640</b>                     | <b>\$ 58,332</b> |

See accompanying notes to Condensed Consolidated Financial Statements

Shore Bancshares, Inc.  
Notes to Condensed Consolidated Financial Statements  
For the Three Months Ended March 31, 2006 and 2005  
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. (the "Company") and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the financial position at March 31, 2006, the results of operations for the three-month periods ended March 31, 2006 and 2005, and cash flows for the three-month periods ended March 31, 2006 and 2005, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2005 were derived from audited financial statements. The results of operations for the three-month period ended March 31, 2006 are not necessarily indicative of the results to be expected for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Note 2 - Earnings Per Share

Year to date basic earnings per share is derived by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. The diluted earnings per share calculation is derived by dividing net income by the weighted average number of shares outstanding during the period, adjusted for the dilutive effect of outstanding options and warrants. Information relating to the calculation of earnings per share is summarized as follows:

|  | Three Months Ended March 31,          |          |
|--|---------------------------------------|----------|
|  | 2006                                  | 2005     |
|  | (in thousands, except per share data) |          |
| Net Income                                     | \$ 3,551                              | \$ 3,106 |
| Weighted Average Shares Outstanding - Basic    | 5,563                                 | 5,520    |
| Dilutive securities                            | 24                                    | 50       |
| Weighted Average Shares Outstanding - Dilutive | 5,587                                 | 5,570    |
| Earnings per common share - Basic              | \$ 0.64                               | \$ 0.56  |
| Earnings per common share - Dilutive           | \$ 0.64                               | \$ 0.56  |

There were no antidilutive stock options excluded from the calculation of earnings per share for the three months ended March 31, 2006 and 2005.

Note 3 - Significant Accounting Policy

Under the provisions of Statements of Financial Accounting Standards (SFAS) Nos. 114 and 118, "Accounting by Creditors for Impairment of a Loan," a loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contracted terms. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loans principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received.

Information with respect to impaired loans and the related valuation allowance is shown below:

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| (Dollars in thousands)  | March 31,<br>2006 | December 31,<br>2005 |
|---|-------------------|----------------------|
| Impaired loans with valuation allowance                             | \$ 981            | \$ 604               |
| Impaired loans with no valuation allowance                          | -                 | 242                  |
| <b>Total impaired loans</b>   | <b>\$ 981</b>     | <b>\$ 846</b>        |
| Allowance for credit losses applicable to impaired loans            | \$ 574            | \$ 555               |
| Allowance for credit losses applicable to other than impaired loans | 4,843             | 4,681                |
| <b>Total allowance for credit losses</b>                            | <b>\$ 5,417</b>   | <b>\$ 5,236</b>      |
| Interest income on impaired loans recorded on the cash basis        | \$ -              | \$ -                 |

Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based upon historical loss ratios and are included in the allowance for credit losses.

Note 4 - Commitments

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At March 31, 2006, total commitments to extend credit were approximately \$210,842,000. Outstanding letters of credit were approximately \$16,094,000 at March 31, 2006.

Note 5 - Stock-Based Compensation

At March 31, 2006, the Company had two Stock Option Plans and an Employee Stock Purchase Plan ("ESPP"), which are more fully described in Note 13 to the audited financial statements contained in the Company's 2005 Annual Report on Form 10-K. Stock options are generally time-based, vesting 20% on each anniversary of the grant date over five years and expiring 10 years from the grant date. ESPP grants allow employees to purchase shares of common stock at 85% of the fair market value on the date of grant. ESPP grants are 100% vested at date of grant and have a 27-month exercise period.

On January 1, 2006, the Company implemented Statement of Financial Accounting Standards 123(R), "Share-Based Payments" ("SFAS No. 123R") which replaced SFAS No. 123 and supercedes Opinion No. 25 and the related implementation guidance. SFAS No. 123R addresses accounting for equity-based compensation arrangements, including employee stock options. The Company adopted the "modified prospective method" where stock-based compensation expense is recorded beginning on the adoption date and prior periods are not restated. Under this method, compensation expense is recognized using the fair-value based method for all new awards granted after January 1, 2006. Additionally, compensation expense for unvested stock options that are outstanding at January 1, 2006 is recognized over the requisite period based on the fair value of those options as previously calculated at the grant date under the pro-forma disclosures of SFAS 123. The fair value of each grant is estimated using the Black-Scholes option pricing model.

During the quarter ended March 31, 2006, the Company recognized pre-tax stock-based compensation expense of \$12,000 as a result of adopting SFAS 123R. Such expense includes compensation expense for stock-based compensation awards granted prior but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. Stock based compensation for all stock based compensation awards granted subsequent to January 1, 2006, was based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The Company recognized compensation expense for stock option

awards on a straight-line basis over the requisite service period of the award. Basic and diluted net income per share for the three months ended March 31, 2006, were not affected as a result of adopting SFAS 123R.

Prior to adoption of SFAS 123R, the Company applied SFAS 123, amended by SFAS 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, which allowed companies to apply existing accounting rules under APB 25. In general, as the exercise price of options granted under these plans was equal to the market price of the underlying common stock on the grant date, no stock-based compensation expense was recognized in our net income from periods prior to the adoption of SFAS 123R. As required by SFAS 123 and 148 prior to the adoption of SFAS 123R, the Company provided pro forma net income and pro forma net income per common share disclosures for stock based awards as if the fair-value method defined in SFAS 123 had been applied.

SFAS 123R requires the Company to present pro forma information for the comparative period to the adoption as if we had accounted for all employee stock options and ESPP under the fair value method of the original SFAS 123. The following table illustrates the effect on net income after tax and net income per common share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation during the three-month period ending March 31, 2005 (in thousands, except per share amounts).

|  | Three-month period<br>ended March 31,<br>2005 |
|--|---|
| Net income:  |   |
| As reported  | \$ 3,106                                      |
| Less pro forma stock-based compensation<br>expense determined under the fair value<br>method, net of related tax effects | (29)  |
| Pro forma net income   | \$ 3,077                                      |
| Basic net income per share:  |   |
| As reported  | \$ .56  |
| Pro forma  | .56   |
| Diluted earnings per share   |   |
| As reported  | \$ .56  |
| Pro forma  | .55   |

The Company granted options pursuant to its ESPP on January 31, 2006. The fair value of these options was estimated using the Black-Scholes valuation model using the following weighted average assumptions:

|                           | 2006   |
|---------------------------|--------|
| Dividend yield            | 2.40%  |
| Expected volatility       | 23.57% |
| Risk free interest        | 4.53%  |
| Expected lives (in years) | 2.25   |

The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at the time of the ESPP grant date. For valuation of the ESPP, the Company used the risk free interest rate on the date of grant. The expected life of the options represents the period of time that the Company expects the awards will be outstanding based on historical experience with similar awards. The computation of expected volatility for the ESPP awards is based on historical volatility of the underlying securities. The expected dividend yield is calculated by taking the total expected annual dividend payout divided by the average stock price. Stock-based compensation expense recognized in the consolidated statement of operation in the first quarter of 2006 reflects forfeitures as they occur.



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The following is a summary of changes in shares under option for all plans for the three-month period ended March 31, 2006:

|   | Weighted<br>Number<br>of Shares | Aggregate<br>Average<br>Exercise Price | Intrinsic<br>Value |
|---|---------------------------------|--|--------------------|
| Outstanding at beginning of year                                  | 51,600                          | \$ 16.03                               |                    |
| Granted   | 8,051                           | 8.87                                   |                    |
| Exercised   | (20,450)                        | 9.11                                   |                    |
| Expired/Cancelled   | (250)                           | 19.50                                  |                    |
| Outstanding at end of period                                      | 38,951                          | \$ 22.06                               | \$ 511,530         |
| Exercisable at the end of period                                  | 31,526                          | \$ 22.60                               | \$ 414,020         |
| Weighted average fair value of options<br>granted during the year | \$ 8.87                         |  |                    |

The following summarizes information about options outstanding at March 31, 2006:

| Options Outstanding |        | Options Outstanding and Exercisable |  |
|---------------------|--------|-------------------------------------|--|
| Exercise<br>Price   | Number | Number                              | Weighted<br>Average<br>Remaining<br>Contract<br>Life |
| \$ 8.78             | 4,535  | 4,535                               | .70  |
| 32.00               | 4,000  | 4,000                               | 2.80   |
| 21.00               | 3,470  | 3,470                               | 3.80   |
| 19.75               | 14,635 | 7,210                               | 6.17   |
| 24.98               | 4,260  | 4,260                               | .43  |
| 27.70               | 8,051  | 8,051                               | 2.08   |
|                     | 38,951 | 31,526                              |  |

The total intrinsic value of stock options exercised during the first quarter of 2006 and 2005 was approximately \$507,000 and \$6,000, respectively. Cash received upon exercise of options during the first quarter of 2006 and 2005 was approximately \$186,000 and \$10,000, respectively.

Note 6 - Segment Reporting

The Company operates two primary businesses: Community Banking and Insurance Products and Services. Through the Community Banking business, the Company provides services to consumers and small businesses on the Eastern Shore of Maryland and Delaware through its 16-branch network. Community banking activities include small business services, retail brokerage, and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards, accounts receivable financing arrangements, and merchant card services.

Through the Insurance Products and Services business, the Company provides a full range of insurance products and services to businesses and consumers in the Company's market areas. Products include property and casualty, life,

marine, individual health and long-term care insurance. Pension and profit sharing plans and retirement plans for executives and employees are available to suit the needs of individual businesses.

Selected financial information by line of business for the three months ended March 31 is included in the following table:

| (In thousands)                      | Community<br>banking | Insurance<br>products<br>and services | Parent<br>Company(a) | Intersegment<br>Transactions | Consolidated<br>Total |
|-------------------------------------|----------------------|---------------------------------------|----------------------|------------------------------|-----------------------|
| <b>2006</b>                         |                      |                                       |                      |                              |                       |
| Net Interest income                 | \$ 9,413             | \$ -                                  | \$ 1                 | \$ -                         | \$ 9,414              |
| Provision for credit losses         | 311                  | -                                     | -                    | -                            | 311                   |
| Net interest income after provision | 9,102                | -                                     | 1                    | -                            | 9,103                 |
| Noninterest income                  | 1,353                | 2,369                                 | 1,099                | (1,115)                      | 3,706                 |
| Noninterest expense                 | 5,620                | 1,493                                 | 1,093                | (1,115)                      | 7,091                 |
| Income before taxes                 | 4,835                | 876                                   | 7                    | -                            | 5,718                 |
| Income tax expense                  | 1,805                | 359                                   | 3                    | -                            | 2,167                 |
| Net income                          | \$ 3,030             | \$ 517                                | \$ 4                 | \$ -                         | \$ 3,551              |
| Intersegment revenue(expense)       | \$ (985)             | \$ (74)                               | \$ 1,059             | \$ -                         | \$ -                  |
| Average assets                      | \$ 838,922           | \$ 10,143                             | \$ 3,784             | \$ -                         | \$ 852,849            |
| <b>2005</b>                         |                      |                                       |                      |                              |                       |
| Net Interest income                 | \$ 8,276             | \$ -                                  | \$ 1                 | \$ -                         | \$ 8,277              |
| Provision for credit losses         | 180                  | -                                     | -                    | -                            | 180                   |
| Net interest income after provision | 8,096                | -                                     | 1                    | -                            | 8,097                 |
| Noninterest income                  | 1,055                | 2,150                                 | 704                  | (747)                        | 3,162                 |
| Noninterest expense                 | 4,725                | 1,630                                 | 685                  | (747)                        | 6,293                 |
| Income before taxes                 | 4,426                | 520                                   | 20                   | -                            | 4,966                 |
| Income tax expense                  | 1,647                | 206                                   | 7                    | -                            | 1,860                 |
| Net income                          | \$ 2,779             | \$ 314                                | \$ 13                | \$ -                         | \$ 3,106              |
| Intersegment revenue (expense)      | \$ (648)             | \$ (32)                               | \$ 680               | \$ -                         | \$ -                  |
| Average assets                      | \$ 785,264           | \$ 7,713                              | \$ 3,514             | \$ -                         | \$ 796,491            |

(a) Amount included in Parent Company relates to services provided to subsidiaries by the Company and rental income.

#### Note 7 - Subsequent Events

At the Annual Meeting of Stockholders of the Company held on April 26, 2006, the Company's stockholders approved the adoption of the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (the "Plan"). The form of the Plan was approved by the Company's Board of Directors on March 13, 2006, but was not effective unless and until it was also approved by stockholders. The effective date of the Plan is April 26, 2006. The material terms of the Plan were discussed in detail in "Proposal 2", beginning on Page 16, of the Company's 2006 definitive proxy statement filed with the Securities and Exchange Commission on March 24, 2006.

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

Unless the context clearly suggests otherwise, references to "the Company" in this report are to Shore Bancshares, Inc. and its consolidated subsidiaries.

### **Forward-Looking Information**

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities

Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words "anticipate", "estimate", "should", "expect", "believe", "intend", and similar expressions, are expressions about the Company's confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which the Company operates, inflation, fluctuations in interest rates, legislation, and governmental regulation. These risks and uncertainties are described in more detail in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. Actual results may differ materially from such forward-looking statements, and the Company assumes no obligation to update forward-looking statements at any time.

### **Introduction**

The following discussion and analysis is intended as a review of significant factors affecting the financial condition and results of operations of Shore Bancshares, Inc. and its consolidated subsidiaries for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements and related notes presented in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2005.

Shore Bancshares, Inc. is the largest independent financial holding company located on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland ("Talbot Bank"), The Centreville National Bank of Maryland located in Centreville, Maryland ("Centreville National Bank") and The Felton Bank, located in Felton, Delaware ("Felton Bank") (collectively, the "Banks"). The Banks operate 16 full service branches in Kent, Queen Anne's, Talbot, Caroline and Dorchester Counties in Maryland and Kent County, Delaware. The Company offers a full range of insurance products and services to its customers through The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC, and Mubell Finance, LLC (collectively, the "Insurance Agency") and investment advisory services through Wye Financial Services, LLC, all of which are wholly-owned subsidiaries of Shore Bancshares, Inc. The shares of common stock of Shore Bancshares, Inc. are listed on the NASDAQ Capital Market under the symbol "SHBI."

The Company maintains an Internet site at [www.shbi.net](http://www.shbi.net) on which it makes available free of charge its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the Securities and Exchange Commission.

### **Critical Accounting Policies**

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The financial information contained within the financial statements is, to a significant extent, financial information contained that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning of income, recognizing an expense, recovering an asset or relieving a liability.

The Company believes its most critical accounting policy relates to the allowance for credit losses. The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two

basic principles of accounting: (i) SFAS No. 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable, and (ii) SFAS No. 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and internal loan processes of the Company in determining the inherent loss that may be present in the Company's loan portfolio. Actual losses could differ significantly from Management's estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.

Management has significant discretion in making the adjustments inherent in the determination of the provision and allowance for credit losses, including in connection with the valuation of collateral, the borrower's prospects of repayment, and in establishing

allowance factors on the formula allowance and unallocated allowance components of the allowance. The establishment of allowance factors is a continuing exercise, based on Management's continuing assessment of the totality of all factors, including, but not limited to, as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of Management, national and local economic trends, concentrations of credit, quality of loan review system and the effect of external factors such as competition and regulatory requirements, and their impact on the portfolio, and allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based upon the same volume and classification of loans. Changes in allowance factors will have a direct impact on the amount of the provision, and a corresponding effect on net income. Errors in Management's perception and assessment of these factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs.

Three basic components comprise the Company's allowance for credit losses: (i) a specific allowance; (ii) a formula allowance; and (iii) a nonspecific allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance to loans identified as impaired. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. When a loan is identified as impaired, a specific allowance is established based on the Company's assessment of the loss that may be associated with the individual loan. The formula allowance is used to estimate the loss on internally risk rated loans, exclusive of those identified as impaired. Loans identified as special mention, substandard, doubtful and loss, as well as impaired, are segregated from performing loans. Remaining loans are then grouped by type (commercial, commercial real estate, construction, home equity or consumer). Each loan type is assigned an allowance factor based on Management's estimate of the risk, complexity and size of individual loans within a particular category. Classified loans are assigned higher allowance factors than non-rated loans due to Management's concerns regarding collectibility or Management's knowledge of particular elements regarding the borrower. Allowance factors grow with the worsening of the internal risk rating. The nonspecific formula is used to estimate the loss of non-classified loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of Management, national and local economic trends, concentrations of credit, quality of loan review system and the effect of external factors such as competition and regulatory requirements. The nonspecific allowance captures losses whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance.

## **OVERVIEW**

Net income for the quarter ended March 31, 2006 was \$3,551,000, or diluted earnings per share of \$.64, compared to \$3,106,000, or diluted earnings per share of \$.56, for the first quarter of 2005. Annualized return on average assets was 1.67% for the first three months of 2006, compared to 1.56% for the same period in 2005. Annualized return on average stockholders' equity was 13.70% and 13.29% for the three months ended March 31, 2006 and 2005, respectively.

## **RESULTS OF OPERATIONS**

### **Net Interest Income**

Net interest income for the quarter ended March 31, 2006 was \$9,414,000, compared to \$8,277,000 for the same period last year, representing a 13.7% increase. This increase is attributable primarily to increases in earning assets, mostly loans, and increases in yields on earning assets for the period, which resulted in increased interest income. Total interest income increased by \$2,258,000 for the three-month period ended March 31, 2006 when compared to the same period last year.

The Company's net interest margin was 4.80% for the three months ended March 31, 2006, which is 29 basis points higher than one year ago. The Company continued to increase its volume of earning assets, which averaged \$791,701,000 for the three months ended March 31, 2006, compared to \$741,417,000 for the same period in 2005. Average loans totaled \$629,172,000 for the three-month period ended March 31, 2006, a \$36,159,000 increase over the same period in 2005. The yield on earning assets increased 76 basis points from 5.88% to 6.64% for the three-month period ended March 31, 2006 when compared to the same period in 2005.

The overall yield on loans for the three months ended March 31, 2006 was 7.29%, compared to 6.48% for the same period in 2005. The yield on investment securities for the first quarter of 2006 increased to 4.05% from 3.74% for the same period in 2005, and the average balance of investment securities for the first quarter of 2006 increased by \$4,716,000 to \$121,854,000 when compared to the first quarter of 2005.

Total interest expense for the three months ended March 31, 2006 was \$3,651,000, an increase of \$1,121,000 or 44.3% over the three-month period ended March 31, 2005. An increase in the rate paid for interest bearing deposits is the primary reason for the increased expense. Rates paid for certificates of deposit and short-term borrowings increased as a result of higher short-term interest rates and increased competition for deposits. The average balance of interest bearing deposits increased by \$29,049,000 for the three months ended March 31, 2006 when compared to the same period in 2005. The overall rate paid for interest bearing deposits increased 55

basis points to 2.23% as a result of higher rates paid for certificates of deposit. For the three months ended March 31, 2006, the average balance of certificates of deposits, including those \$100,000 or more, increased by \$16,002,000 when compared to the same period last year, and the average rate paid for those certificates of deposit increased 97 basis points to 3.90%. Other certificates of deposit increased \$19,107,000 when compared to the same period last year, and the average rate paid for those deposits increased 68 basis points to 3.53%. Comparing the first quarter of 2006 to the same period in 2005, interest bearing demand deposits decreased by approximately \$1,408,000 and money management and savings deposits declined by \$4,652,000.

Loans comprised 79.5% and 80% of total average earning assets at March 31, 2006 and 2005, respectively.

#### Analysis of Interest Rates and Interest Differentials.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid through March 31, 2006 and 2005:

| (Dollars in thousands)                     | March 31, 2006  |                |            | March 31, 2005  |                |            |
|--|-----------------|----------------|------------|-----------------|----------------|------------|
|  | Average Balance | Income Expense | Yield Rate | Average Balance | Income Expense | Yield Rate |
| <b>Earning Assets</b>                      |                 |                |            |                 |                |            |
| Investment securities                      | \$ 121,854      | \$ 1,234       | 4.05%      | \$ 117,138      | \$ 1,094       | 3.74%      |
| Loans                                      | 629,172         | 11,466         | 7.29%      | 593,013         | 9,608          | 6.48%      |
| Interest bearing deposits                  | 15,748          | 171            | 4.35%      | 988             | 5              | 2.03%      |
| Federal funds sold                         | 24,927          | 276            | 4.43%      | 30,278          | 184            | 2.43%      |
| Total earning assets                       | 791,701         | 13,147         | 6.64%      | 741,417         | 10,891         | 5.88%      |
| Noninterest earning assets                 | 61,148          |                |            | 55,074          |                |            |
| Total Assets                               | \$ 852,849      |                |            | \$ 796,491      |                |            |
| <b>Interest bearing liabilities</b>        |                 |                |            |                 |                |            |
| Interest bearing deposits                  | \$ 595,135      | 3,318          | 2.23%      | \$ 566,086      | 2,379          | 1.68%      |
| Short term borrowing                       | 33,518          | 264            | 3.16%      | 23,928          | 88             | 1.48%      |
| Long term debt                             | 5,722           | 69             | 4.84%      | 5,000           | 63             | 5.03%      |
| Total interest bearing liabilities         | 634,375         | 3,651          | 2.30%      | 595,014         | 2,530          | 1.70%      |
| Noninterest bearing liabilities            | 114,787         |                |            | 108,013         |                |            |
| Stockholders' equity                       | 103,687         |                |            | 93,464          |                |            |
| Total liabilities and stockholders' equity | \$ 852,849      |                |            | \$ 796,491      |                |            |
| Net interest spread                        |                 | \$ 9,496       | 4.34%      |                 | \$ 8,361       | 4.18%      |
| Net interest margin                        |                 |                | 4.80%      |                 |                | 4.51%      |

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate exclusive of the alternative minimum tax rate of 35% and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, for each loan category and yield calculations are stated to include all.



**Noninterest Income**

Noninterest income for the three months ended March 31, 2006 increased to \$3,706,000, which represents an increase of \$544,000 when compared to the same period last year. Approximately \$247,000 of this increase relates to an increase in insurance agency commissions, with the balance attributable to increases in income from nondeposit product sales and trust services of approximately \$47,000, from the origination and sale of loans on the secondary market of approximately \$38,000, an increase in letter of credit fees of approximately \$29,000 and other service charges and non interest income of the Company. The Company recognized gains on sales of securities of \$58,000 during the first three months of 2005, but there were no gains or losses from sales of securities during the first quarter of 2006.

**Noninterest Expense**

Total noninterest expense for the first quarter of 2006 was \$7,091,000, an increase of \$798,000 when compared to the same period in 2005. For the three months ended March 31, 2006, salaries and benefits expense increased by \$489,000, occupancy expense increased by \$77,000 and other noninterest expense increased by \$232,000, when compared to the same period in 2005. The increases are primarily related to the growth of the Company and costs associated with new and expanded product offerings.

### **Income Taxes**

The effective tax rate for the three months ended March 31, 2006 was 37.9%, compared to 37.5% for the same period last year. Management believes that there have been no changes in tax laws or to the Company's tax structure that are likely to have a future material impact on the Company's effective tax rate.

## **ANALYSIS OF FINANCIAL CONDITION**

### **Loans**

Loans, net of unearned income, totaled \$641,913,000 at March 31, 2006, an increase of \$14,450,000 since December 31, 2005. Average loans, net of unearned income, increased by \$36,159,000 or 6.1% when compared to the same period last year.

### **Allowance for Credit Losses**

The Company has established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts. The allowance is decreased by current period charge-off of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based upon this analysis. The evaluation of the adequacy of the allowance for credit losses is based on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans based on factors such as past credit loss experience, local economic trends, nonperforming and problem loans, and other factors which may impact collectibility. A loan is placed on nonaccrual when it is specifically determined to be impaired and principal and interest is delinquent for 90 days or more. Please refer to the discussion above under the caption "Critical Accounting Policies" for an overview of the underlying methodology Management employs on a quarterly basis to maintain the allowance.

The provision for credit losses for the three-month period ended March 31, 2006 was \$311,000, compared to \$180,000 for the same period in 2005. Despite a decline in nonaccrual loans, Management did not decrease the specific allowance associated with those loans, based on its evaluation of each borrower's ability to repay and the value of the underlying loan collateral. The increased provision is the result of increases in both the formula allowance and nonspecific allowance components. Growth of the loan portfolio and Management's assessment of factors used in calculating the nonspecific allowance contributed to the increased provision. The Company continues to maintain strong underwriting guidelines, and Management believes that the local economy remains stable and that collateral values have increased as a result of the strength of the local real estate economy. Each of these factors has had a positive effect on the quality of the Company's loan portfolio. The Company's historical charge-off ratios are much lower than those of similarly sized institutions according to the most recent FDIC quarterly banking profile. Net charge-offs were \$130,000 for the three-month period ended March 31, 2006, compared to \$114,000 for the same period last year. Since December 31, 2005, nonaccrual loans have increased \$135,000 to \$981,000. Loans past due 90 days and still accruing decreased by \$368,000 since December 31, 2005, totaling \$450,000 at March 31, 2006. The Company's ratio of nonperforming assets, including other real estate owned, remains low. The allowance for credit losses as a percentage of average loans was .86% at March 31, 2006, compared to .80% at March 31, 2005. Based on Management's quarterly evaluation of the adequacy of the allowance for credit losses, it believes that the allowance for credit losses and the related provision are adequate at March 31, 2006.

The following table presents a summary of the activity in the allowance for credit losses:

| (Dollars in thousands)  | Three months Ended March 31, |            |
|---|------------------------------|------------|
|   | 2006                         | 2005       |
| Allowance balance - beginning of period   | \$ 5,236                     | \$ 4,692   |
| Charge-offs:  |                              |            |
| Commercial and other  | 1                            | 94         |
| Real estate   | 107                          | -          |
| Consumer  | 68                           | 35         |
| Totals  | 176                          | 129        |
| Recoveries:   |                              |            |
| Commercial  | -                            | 6          |
| Real estate   | 29                           | 1          |
| Consumer  | 17                           | 8          |
| Totals  | 46                           | 15         |
| Net charge-offs   | 130                          | 114        |
| Provision for credit losses   | 311                          | 180        |
| Allowance balance-end of period   | \$ 5,417                     | \$ 4,758   |
| Average loans outstanding during period   | \$ 629,172                   | \$ 593,013 |
| Net charge-offs (annualized) as a percentage of average loans outstanding during period | .08%                         | .08%       |
| Allowance for credit losses at period end as a percentage of average loans              | .86%                         | .80%       |

Because the Company's loans are predominately secured by real estate, weaknesses in the local real estate market may have a material adverse effect on collateral values. The Company has a concentration of construction and land development loans. At March 31, 2006, the balance of such loans was \$148,717,000 or 23.2% of total outstanding loans, compared to \$134,380,000 or 21.4% at December 31, 2005. The Company does not engage in foreign lending activities.

### Nonperforming Assets

The following table summarizes past due and nonperforming assets of the Company (in thousands):

| Nonperforming Assets:                  | March 31,<br>2006 | December 31,<br>2005 |
|--|-------------------|----------------------|
| Nonaccrual loans                       | \$ 981            | \$ 846               |
| Other real estate owned                | 47                | 302                  |
|  | 1,028             | 1,148                |
| Past due loans still accruing          | 450               | 818                  |
| Total nonperforming and past due loans | \$ 1,478          | \$ 1,966             |

### Investment Securities

Investment securities increased to \$123,270,000, an increase of \$2,199,000 when compared to investments at December 31, 2005. The yields on bonds purchased during the first quarter of 2006 are much higher than the yields on bonds that either matured or were called during this period. The average balance of investment securities was \$121,854,000 for the three-months ended March 31, 2006, compared to \$117,138,000 for the same period in 2005. The tax equivalent yields on investment securities were 4.05% and 3.74% for the three-month periods ended March 31, 2006 and 2005, respectively.

**Deposits**

Total deposits at March 31, 2006 were \$708,723,000, compared to \$704,958,000 at December 31, 2005. Certificates of deposit of \$100,000 or more increased by \$10,060,000 during the first quarter of 2006. Since December 31, 2005, interest bearing and noninterest bearing demand deposits have declined by \$9,658,000 and other time and savings deposits have increased by \$3,363,000.

**Borrowed Funds**

Short-term borrowings at March 31, 2006 and December 31, 2005 consisted of securities sold under agreements to repurchase and short-term borrowing from the Federal Home Loan Bank. The Company also had a convertible advance from the Federal Home Loan Bank of Atlanta in the amount of \$5,000,000 at December 31, 2005 that matured and was repaid in March 2006.

**Long Term Debt**

At March 31, 2006, the Company had two advances from the Federal Home Loan Bank of Pittsburgh totaling \$9,000,000, which mature in October 2007 (\$4,000,000) and February 2008 (\$5,000,000).

**Liquidity and Capital Resources**

The Company derives liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. Talbot Bank and Centreville National Bank are also members of the Federal Home Loan Bank of Atlanta to which they have pledged collateral sufficient to permit additional borrowing of up to approximately \$74 million at March 31, 2006. Management is not aware of any trends or demands, commitments, events or uncertainties that are likely to materially affect the Company's future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity was \$104.1 million at March 31, 2006, an increase of 3% since December 31, 2005. Accumulated other comprehensive loss, which consists solely of net unrealized losses on investment securities available for sale, increased by \$104,000 during the first quarter of 2006, resulting in accumulated other comprehensive loss of \$1,367,000 at March 31, 2006.

Bank regulatory agencies have adopted various capital standards for financial institutions, including risk-based capital standards. The primary objectives of the risk-based capital framework are to provide a more consistent system for comparing capital positions of financial institutions and to take into account the different risks among financial institutions' assets and off-balance sheet items.

Risk-based capital standards have been supplemented with requirements for a minimum Tier 1 capital to assets ratio (leverage ratio). In addition, regulatory agencies consider the published capital levels as minimum levels and may require a financial institution to maintain capital at higher levels.

A comparison of the Company's capital ratios as of March 31, 2006 to the minimum regulatory requirements is presented below:

|                           | Actual | Minimum Requirements |
|---------------------------|--------|----------------------|
| Tier 1 risk-based capital | 12.96% | 4.00%                |
| Total risk-based capital  | 13.77% | 8.00%                |
| Leverage ratio            | 10.96% | 3.00%                |

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

The Company's primary market risk is to interest rate fluctuation and Management has procedures in place to evaluate and mitigate this risks. This risk and these procedures are discussed in Item 7 of Part II of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2005 under the caption "Market Risk Management". Management believes that there have been no material changes in the Company's market risks, the procedures used to evaluate and mitigate these risks, or the Company's actual and simulated sensitivity positions since December 31, 2005.

**Item 4. Controls and Procedures.**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934 with the SEC, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to Management, including the Chief Executive

Officer (“CEO”) and the Principal Accounting Officer (“PAO”), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of March 31, 2006 was carried out under the supervision and with the participation of Management, including the CEO and the PAO. Based on that evaluation, the Company's management, including the CEO and the PAO, has concluded that the Company's disclosure controls and procedures are effective.

During the first quarter of 2006, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II - OTHER INFORMATION

### Item 1A. Risk Factors.

The risks and uncertainties to which the Company's financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2005. Management does not believe that any material changes in these risk factors have occurred since December 31, 2005.

### Item 6. Exhibits.

|              |   |
|--------------|---|
| Exhibit 3.1  | Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000).   |
| Exhibit 3.2  | Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2 of the Company's Form 8-K filed on November 9, 2005).  |
| Exhibit 10.1 | Form of Employment Agreement with W. Moorhead Vermilye (incorporated by reference to Appendix XIII of Exhibit 2.1 of the Company's Form 8-K filed on July 31, 2000).  |
| Exhibit 10.2 | Form of Employment Agreement with Daniel T. Cannon (incorporated by reference to Appendix XIII of Exhibit 2.1 of the Company's Form 8-K filed on July 31, 2000).  |
| Exhibit 10.3 | Form of Employment Agreement with Thomas H. Evans, as amended on November 3, 2005 (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on November 9, 2005).  |
| Exhibit 10.4 | Separation Agreement and General Release between The Avon-Dixon Agency, LLC and Steven Fulwood (incorporated by reference to exhibit 10.11 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2005).   |
| Exhibit 10.5 | Form of Executive Supplemental Retirement Plan Agreement between The Centreville National Bank of Maryland and Daniel T. Cannon (incorporated by reference to Exhibit 10.4 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2003).              |
| Exhibit 10.6 | Form of Life Insurance Endorsement Method Split Dollar Plan Agreement between The Centreville National Bank of Maryland and Daniel T. Cannon (incorporated by reference to Exhibit 10.5 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2003). |

- Exhibit 10.7 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005).
- Exhibit 10.8 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan Trust Agreement ((incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005).
- Exhibit 10.9 1998 Employee Stock Purchase Plan, as amended (incorporated by reference to Appendix A of the Company's definitive Proxy Statement on Schedule 14A for the 2003 Annual Meeting of Stockholders filed on March 31, 2003).
- Exhibit 10.10 1998 Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed with the SEC on September 25, 1998 (Registration No. 333-64319)).



|               |  |
|---------------|--|
| Exhibit 10.11 | Talbot Bancshares, Inc. Employee Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed May 4, 2001 (Registration No. 333-60214)). |
| Exhibit 10.12 | Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (incorporated by reference to Appendix A of the Company's 2006 definitive proxy statement filed on March 24, 2006).            |
| Exhibit 10.13 | Changes to Director Compensation Arrangements (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on February 6, 2006)  |
| Exhibit 31.1  | Certifications of the CEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).  |
| Exhibit 31.2  | Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).  |
| Exhibit 32.1  | Certification of the CEO pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).   |
| Exhibit 32.2  | Certification of the PAO pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).   |

### SIGNATURES

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

Shore Bancshares, Inc.

Date: May 9, 2006

By: /s/ W. Moorhead Vermilye  
W. Moorhead Vermilye  
President and Chief Executive Officer

Date: May 9, 2006

By: /s/ Susan E. Leaverton  
Susan E. Leaverton, CPA  
Treasurer and Principal Accounting Officer

**EXHIBIT INDEX**

| <u>Exhibit Number</u> | <u>Description</u>  |
|-----------------------|---|
| 3.1                   | Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000).   |
| 3.2                   | Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2 of the Company's Form 8-K filed on November 9, 2005).  |
| 10.1                  | Form of Employment Agreement with W. Moorhead Vermilye (incorporated by reference to Appendix XIII of Exhibit 2.1 of the Company's Form 8-K filed on July 31, 2000).  |
| 10.2                  | Form of Employment Agreement with Daniel T. Cannon (incorporated by reference to Appendix XIII of Exhibit 2.1 of the Company's Form 8-K filed on July 31, 2000).  |
| 10.3                  | Form of Employment Agreement with Thomas H. Evans, as amended on November 3, 2005 (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on November 9, 2005).  |
| 10.4                  | Separation Agreement and General Release between The Avon-Dixon Agency, LLC and Steven Fulwood (incorporated by reference to exhibit 10.11 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2005).   |
| 10.5                  | Form of Executive Supplemental Retirement Plan Agreement between The Centreville National Bank of Maryland and Daniel T. Cannon (incorporated by reference to Exhibit 10.4 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2003).              |
| 10.6                  | Form of Life Insurance Endorsement Method Split Dollar Plan Agreement between The Centreville National Bank of Maryland and Daniel T. Cannon (incorporated by reference to Exhibit 10.5 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2003). |
| 10.7                  | Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005).   |
| 10.8                  | Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan Trust Agreement ((incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005).  |
| 10.9                  | 1998 Employee Stock Purchase Plan, as amended (incorporated by reference to Appendix A of the Company's definitive Proxy Statement on Schedule 14A for the 2003 Annual Meeting of Stockholders filed on March 31, 2003).  |
| 10.10                 | 1998 Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed with the SEC on September 25, 1998 (Registration No. 333-64319)).   |

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