

FIRST UNITED CORP/MD/  
Form 10-K  
March 14, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

**FORM 10-K**

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

**For the fiscal year ended December 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 0-14237

**FIRST UNITED CORPORATION**

*(Exact name of registrant as specified in its charter)*

**Maryland**

*(State or other jurisdiction of incorporation or organization)*

**52-1380770**

*(I.R.S. Employer Identification Number)*

**19 South Second Street, Oakland, Maryland**

*(Address of principal executive offices)*

**21550-0009**

*(Zip Code)*

Registrant's telephone number, including area code: **(800) 470-4356**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class:

Name of Each Exchange on Which Registered:

**Common Stock, par value \$.01 per share**

**Nasdaq Stock Market**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes  No

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 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 if disclosures of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

The aggregate market value of the registrant's outstanding voting and non-voting common equity held by non-affiliates as of June 30, 2006:

**\$ 126,572,358.**

The number of shares of the registrant's common stock outstanding as of February 28, 2007: **6,146,443**

### **Documents Incorporated by Reference**

Portions of the registrant's definitive proxy statement for the 2007 Annual Meeting of Shareholders to be filed with the SEC in March 2007 pursuant to Regulation 14A are incorporated by reference into Part III of this Annual Report on Form 10-K.

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## **Forward-Looking Statements**

This Annual Report of First United Corporation (the “Corporation” on a parent only basis and “we”, “our” or “us”, on a consolidated basis) filed on Form 10-K may contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Readers of this report should be aware of the speculative nature of “forward-looking statements.” Statements that are not historical in nature, including those that include the words “anticipate,” “estimate,” “should,” “expect,” “believe,” “intend,” and similar expressions, are based on current expectations, estimates and projections about, among other things, the industry and the markets in which the Corporation operates, and they are not guarantees of future performance. Whether actual results will conform to expectations and predictions is subject to known and unknown risks and uncertainties, including risks and uncertainties discussed in this report; general economic, market, or business conditions; changes in interest rates, deposit flow, the cost of funds, and demand for loan products and financial services; changes in the Corporation’s competitive position or competitive actions by other companies; changes in the quality or composition of loan and investment portfolios; the ability to manage growth; changes in laws or regulations or policies of federal and state regulators and agencies; and other circumstances beyond the Corporation’s control. Consequently, all of the forward-looking statements made in this document are qualified by these cautionary statements, and there can be no assurance that the actual results anticipated will be realized, or if substantially realized, will have the expected consequences on the Corporation’s business or operations. For a more complete discussion of these and other risk factors, see Item 1A of Part I of this report. Except as required by applicable laws, the Corporation does not intend to publish updates or revisions of forward-looking statements it makes to reflect new information, future events or otherwise.

## **PART I**

### **ITEM 1. BUSINESS**

#### **General**

The Corporation is a Maryland corporation chartered in 1985 and a financial holding company registered under the federal Bank Holding Company Act of 1956, as amended (the “BHC Act”). The Corporation’s primary business is serving as the parent company of First United Bank & Trust, a Maryland trust company (the “Bank”), First United Insurance Group, LLC, a Maryland insurance agency (the “Insurance Group”), OakFirst Loan Center, Inc., a West Virginia finance company, and OakFirst Loan Center, LLC, a Maryland finance company, (together with OakFirst Loan Center, Inc. the “OakFirst Loan Centers”). OakFirst Loan Center, Inc. has one subsidiary, First United Insurance Agency, Inc., which is a Maryland insurance agency.

On March 31, 2006, the Bank liquidated its subsidiary First United Investment Trust. This entity was a Maryland real estate investment trust that held and serviced mortgage loans. Its assets were transferred to First United Bank & Trust.

At December 31, 2006, the Corporation had assets of approximately \$1.349 billion, net loans of approximately \$957 million, and deposits of approximately \$971 million. Shareholders’ equity at December 31, 2006 was approximately \$97 million.

The Corporation maintains an Internet site at [www.mybankfirstunited.com](http://www.mybankfirstunited.com) 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 (the “SEC”).

#### **Banking Products and Services**

The Bank operates 25 banking offices, one call center and 34 Automated Teller Machines (“ATM’s”) in the following Maryland Counties: Garrett, Allegany, Washington and Frederick; and in the following West Virginia Counties: Mineral, Berkeley, Hardy and Monongalia. The Bank is an independent community bank providing a complete range of retail and commercial banking services to businesses and individuals in its market areas. Services offered are essentially the same as those offered by the regional institutions that compete with the Bank and include checking, savings, and money market deposit accounts, business loans, personal loans, mortgage loans, lines of credit, and consumer-oriented financial services including IRA and employee benefit accounts. In addition, the Bank provides full brokerage services through a networking arrangement with PrimeVest Financial Services, Inc., a full service broker-dealer. The Bank also provides safe deposit and night depository facilities, and a complete line of insurance products and trust services. The Bank’s deposits are insured by the Federal Deposit Insurance Corporation (the “FDIC”).

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***Lending Activities***--The majority of the Corporation's lending activities are conducted through the Bank.

The Bank's commercial loans are primarily secured by real estate, commercial equipment, vehicles or other assets of the borrower. Repayment is often dependent on the successful operation of the borrower and may be affected by adverse conditions in the local economy or real estate market. The financial condition and cash flow of commercial borrowers is therefore carefully analyzed during the loan approval process, and continues to be monitored by obtaining business financial statements, personal financial statements and income tax returns. The frequency of this ongoing analysis depends upon the size and complexity of the credit and collateral that secures the loan. It is also the Bank's general policy to obtain personal guarantees from the principals of the commercial loan borrowers.

Commercial real estate loans are primarily those secured by land for residential and commercial development, agricultural purpose properties, service industry buildings such as restaurants and motels, retail buildings and general purpose business space. The Bank attempts to mitigate the risks associated with these loans through low loan to value ratio standards, thorough financial analyses, and management's knowledge of the local economy in which the Bank lends.

The risk of loss associated with commercial real estate construction lending is controlled through conservative underwriting procedures such as loan to value ratios of 80% or less, obtaining additional collateral when prudent, and closely monitoring construction projects to control disbursement of funds on loans.

The Bank's residential mortgage portfolio is evenly distributed between variable and fixed rate loans. Many loans are booked at fixed rates in order to meet the Bank's requirements under the Community Reinvestment Act. Other fixed rate residential mortgage loans are originated in a brokering capacity on behalf of other financial institutions, for which the Bank receives a fee. As with any consumer loan, repayment is dependent on the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy. Residential mortgage loans exceeding an internal loan-to-value ratio require private mortgage insurance. Title insurance protecting the Bank's lien priority, as well as fire and casualty insurance, is also required.

Home equity lines of credit, included within the residential mortgage portfolio, are secured by the borrower's home and can be drawn on at the discretion of the borrower. These lines of credit are at variable interest rates.

The Bank also provides residential real estate construction loans to builders and individuals for single family dwellings. Residential construction loans are usually granted based upon "as completed" appraisals and are secured by the property under construction. Site inspections are performed to determine pre-specified stages of completion before loan proceeds are disbursed. These loans typically have maturities of six to 12 months and may have a fixed or variable rate. Permanent financing for individuals offered by the Bank includes fixed and variable rate loans with three, five or seven year adjustable rate mortgages.

A variety of other consumer loans are also offered to customers, including indirect and direct auto loans, and other secured and unsecured lines of credit and term loans. Careful analysis of an applicant's creditworthiness is performed before granting credit, and on-going monitoring of loans outstanding is performed in an effort to minimize risk of loss by identifying problem loans early.

An allowance for loan losses is maintained to provide for anticipated losses from the Corporation's lending activities. A complete discussion of the factors considered in determination of the allowance for loan losses is included in Item 7 of Part II of this report.

Additionally, the Corporation meets the lending needs of under-served customer groups within its market areas in part through OakFirst Loan Center, Inc., located in Martinsburg, West Virginia, and OakFirst Loan Center, LLC, located in Hagerstown, Maryland.

***Deposit Activities***—The Bank offers a full array of deposit products including checking, savings and money market accounts, regular and IRA certificates of deposit, Christmas Savings accounts, College Savings accounts, and Health Savings accounts. The Bank also offers the CDARS program to municipalities, providing them up to \$20 million of FDIC insurance. In addition, we offer our commercial customers packages which include Treasury Management, Cash Sweep and various checking opportunities.

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**Trust Services**--The Bank's Trust Department offers a full range of trust services, including personal trust, investment agency accounts, charitable trusts, retirement accounts including IRA roll-overs, 401(k) accounts and defined benefit plans, estate administration and estate planning.

Information about the Corporation's income from and assets related to its banking business may be found in the consolidated statements of financial condition and the consolidated statements of income and the related notes thereto included in Item 8 of Part II of this annual report. At December 31, 2006, 2005 and 2004, the total market value of assets under the supervision of the Bank's Trust Department was approximately \$502 million, \$468 million and \$395 million, respectively. Trust Department revenues for these years may be found in Item 7 of Part II of this annual report under the caption "Other Operating Income".

### Insurance Activities

The Corporation offers a full range of insurance products and services to customers in its market areas through the Insurance Group and First United Insurance Agency, Inc. Information about income from insurance activities for each of the years ended December 31, 2006, 2005 and 2004 may be found in Item 7 of Part II of this annual report under the caption "Other Operating Income".

### COMPETITION

The banking business, in all of its phases, is highly competitive. Within their market areas, the Corporation and its affiliates compete with commercial banks, (including local banks and branches or affiliates of other larger banks), savings and loan associations and credit unions for loans and deposits, with consumer finance companies for loans, with insurance companies and their agents for insurance products, and with other financial institutions for various types of products and services. There is also competition for commercial and retail banking business from banks and financial institutions located outside our market areas.

The primary factors in competing for deposits are interest rates, personalized services, the quality and range of financial services, convenience of office locations and office hours. The primary factors in competing for loans are interest rates, loan origination fees, the quality and range of lending services and personalized services.

To compete with other financial services providers, the Corporation relies principally upon local promotional activities, personal relationships established by officers, directors and employees with its customers, and specialized services tailored to meet its customers' needs. In those instances in which the Corporation is unable to accommodate a customer's needs, it will arrange for those services to be provided by other financial services providers with which it has a relationship.

The following table sets forth deposit data for the Maryland and West Virginia Counties in which the Bank maintains offices as of June 30, 2006, the most recent date for which comparative information is available.

	Offices (in Market)	Deposits (in thousands)	Market Share
<b><i>Allegany County, Maryland:</i></b>			
Susquehanna Bank	6	\$ 222,029	35.45%
Manufacturers & Traders Trust Company	7	192,726	30.77%
<b>First United Bank &amp; Trust</b>	<b>5</b>	<b>121,513</b>	<b>19.40%</b>
Farmers & Mechanics Bank	3	59,648	9.52%



Standard Bank	2	30,459	4.86%
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*Source: FDIC Deposit Market Share Report*

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**Frederick County, Maryland:**

Farmers & Mechanics Bank	19	1,114,657	35.61%
Branch Banking & Trust Co.	12	601,109	19.20%
Bank of America NA	6	272,390	8.70%
Frederick County Bank	2	208,974	6.68%
Manufacturers & Traders Trust Company	6	201,845	6.45%
Woodsboro Bank	7	147,839	4.72%
Chevy Chase Bank FSB	5	133,307	4.26%
SunTrust Bank	3	130,576	4.17%
Middletown Valley Bank	4	115,093	3.68%
<b>First United Bank &amp; Trust</b>	<b>3</b>	<b>92,477</b>	<b>2.95%</b>
Sandy Spring Bank	4	54,046	1.73%
Provident Bank of Maryland	2	32,394	1.03%
Damascus Community Bank	2	15,584	0.50%
Sovereign Bank	2	8,476	0.27%
Columbia Bank	1	1,577	0.05%

Source: FDIC Deposit Market Share Report

**Garrett County, Maryland:**

<b>First United Bank &amp; Trust</b>	<b>5</b>	<b>454,671</b>	<b>69.90%</b>
Manufacturers & Traders Trust Co.	5	112,330	17.27%
Susquehanna Bank	2	59,749	9.19%
Clear Mountain Bank	1	19,600	3.01%
Miners & Merchants Bank	1	4,069	0.63%

Source: FDIC Deposit Market Share Report

**Washington County, Maryland:**

Susquehanna Bank	10	508,014	27.99%
Hagerstown Trust Co.	11	397,816	21.92%
Manufacturers & Traders Trust Company	12	397,183	21.89%
Farmers & Mechanics Bank	6	177,852	9.80%
Sovereign Bank	4	172,991	9.53%
<b>First United Bank &amp; Trust</b>	<b>2</b>	<b>56,927</b>	<b>3.14%</b>
First National Bank of McConnellsburg	1	29,852	1.65%
Chevy Chase Bank FSB	1	26,652	1.47%
Citizens National Bank of Berkeley Springs	1	21,399	1.18%
First National Bank of Greencastle	2	16,700	0.92%
Orrstown Bank	1	9,292	0.51%

Source: FDIC Deposit Market Share Report

**Berkeley County, West Virginia:**

Branch Banking & Trust Co.	5	325,183	32.85%
Centra Bank Inc.	3	166,957	16.87%

<b>First United Bank &amp; Trust</b>	<b>5</b>	<b>123,377</b>	<b>12.46%</b>
Susquehanna Bank	4	112,714	11.39%
City National Bank of West Virginia	4	107,829	10.89%
Jefferson Security Bank	2	61,155	6.18%
Citizens National Bank of Berkeley Springs	3	55,615	5.62%
Bank of Charles Town	2	33,204	3.35%
Shenandoah Valley National Bank	1	3,780	0.38%

*Source: FDIC Deposit Market Share Report*

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**Hardy County, West Virginia:**

Summit Community Bank, Inc.	2	212,963	60.44%
Capon Valley Bank	3	99,037	28.11%
Pendleton Community Bank, Inc.	1	18,317	5.20%
<b>First United Bank &amp; Trust</b>	<b>1</b>	<b>14,277</b>	<b>4.05%</b>
Grant County Bank	1	7,776	2.21%

Source: FDIC Deposit Market Share Report

**Mineral County, West Virginia:**

Branch Banking & Trust Co.	2	75,612	32.06%
<b>First United Bank &amp; Trust</b>	<b>2</b>	<b>74,392</b>	<b>31.54%</b>
Manufacturers & Traders Trust Co.	2	56,523	23.96%
Grant County Bank	1	29,344	12.44%

Source: FDIC Deposit Market Share Report

**Monongalia County, West Virginia:**

Centra Bank, Inc.	4	369,432	25.92%
Huntington National Bank	6	361,466	25.36%
Branch Banking & Trust Co.	5	321,455	22.55%
United Bank	4	169,220	11.87%
Wesbanco Bank, Inc.	5	94,026	6.60%
Clear Mountain Bank	4	58,690	4.12%
Citizens Bank of Morgantown, Inc.	1	21,747	1.53%
First Exchange Bank	2	15,429	1.08%
<b>First United Bank &amp; Trust</b>	<b>2</b>	<b>13,824</b>	<b>0.97%</b>

Source: FDIC Deposit Market Share Report

For further information about competition in our market areas, see the Risk Factor entitled “*We operate in a competitive environment*” in Item 1A of Part I of this annual report.

**SUPERVISION AND REGULATION**

The following is a summary of the material regulations and policies applicable to the Corporation and its subsidiaries and is not intended to be a comprehensive discussion. Changes in applicable laws and regulations may have a material effect on our business.

**General**

The Corporation is a financial holding company registered with the Board of Governors of the Federal Reserve System (the “FRB”) under the BHC Act and, as such, is subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the FRB.

The Bank is a Maryland trust company subject to the banking laws of Maryland and to regulation by the Commissioner of Financial Regulation of Maryland, who is required by statute to make at least one examination in

each calendar year (or at 18-month intervals if the Commissioner determines that an examination is unnecessary in a particular calendar year). The Bank also has offices in West Virginia, and the operations of these offices are subject to West Virginia laws and to supervision and examination by the West Virginia Division of Banking. As a member of the FDIC, the Bank is also subject to certain provisions of federal law and regulations regarding deposit insurance and activities of insured state-chartered banks, including those that require examination by the FDIC. In addition to the foregoing, there are myriad other federal and state laws and regulations that affect, impact or govern the business of banking, including consumer lending, deposit-taking, and trust operations.

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All non-bank subsidiaries of the Corporation are subject to examination by the FRB, and, as affiliates of the Bank, are subject to examination by the FDIC and the Commissioner of Financial Regulation of Maryland. In addition, OakFirst Loan Center, Inc. is subject to licensing and regulation by the West Virginia Division of Banking, OakFirst Loan Center, LLC is subject to licensing and regulation by the Commissioner of Financial Regulation of Maryland, and the Insurance Group and First United Insurance Agency, Inc. are each subject to licensing and regulation by various state insurance authorities. Retail sales of insurance products by these insurance affiliates are also subject to the requirements of the Interagency Statement on Retail Sales of Nondeposit Investment Products promulgated in 1994 by the FDIC, the FRB, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

### **Regulation of Financial Holding Companies**

In November 1999, the federal Gramm-Leach-Bliley Act (the “GLBA”) was signed into law. GLBA revises the BHC Act and repeals the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls an FDIC insured financial institution. Under GLBA, a bank holding company can elect, subject to certain qualifications, to become a “financial holding company.” GLBA provides that a financial holding company may engage in a full range of financial activities, including insurance and securities sales and underwriting activities, and real estate development, with new expedited notice procedures. Maryland law generally permits state-chartered banks, including the Bank, to engage in the same activities, directly or through an affiliate, as national banking associations. GLBA permits certain qualified national banking associations to form financial subsidiaries, which have broad authority to engage in all financial activities except insurance underwriting, insurance investments, real estate investment or development, or merchant banking. Thus, GLBA has the effect of broadening the permitted activities of the Corporation and the Bank.

The Corporation and its affiliates are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act. Section 23A limits the amount of loans or extensions of credit to, and investments in, the Corporation and its non-bank affiliates by the Bank. Section 23B requires that transactions between the Bank and the Corporation and its non-bank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates.

Under FRB policy, the Corporation is expected to act as a source of strength to the Bank, and the FRB may charge the Corporation with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”), depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default. Accordingly, in the event that any insured subsidiary of the Corporation causes a loss to the FDIC, other insured subsidiaries of the Corporation could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guaranty liabilities generally are superior in priority to obligations of a financial institution to its shareholders and obligations to other affiliates.

### **Federal Banking Regulation**

Federal banking regulators, such as the FRB and the FDIC, may prohibit the institutions over which they have supervisory authority from engaging in activities or investments that the agencies believe are unsafe or unsound banking practices. Federal banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to be unsafe or unsound practices. Enforcement actions may include the appointment of a conservator or receiver, the issuance of a cease and desist order, the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution-affiliated parties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court

actions.

The Bank is subject to certain restrictions on extensions of credit to executive officers, directors, and principal shareholders or any related interest of such persons, which generally require that such credit extensions be made on substantially the same terms as are available to third parties dealing with the Bank and not involve more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels.

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As part of the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), each federal banking regulator adopted non-capital safety and soundness standards for institutions under its authority. These standards include internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation, fees and benefits. An institution that fails to meet those standards may be required by the agency to develop a plan acceptable to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. The Corporation, on behalf of the Bank, believes that the Bank meets substantially all standards that have been adopted. FDICIA also imposes new capital standards on insured depository institutions.

The Community Reinvestment Act (“CRA”) requires the FDIC, in connection with its examination of financial institutions within its jurisdiction, to evaluate the record of those financial institutions in meeting the credit needs of their communities, including low and moderate income neighborhoods, consistent with principles of safe and sound banking practices. These factors are also considered by all regulatory agencies in evaluating mergers, acquisitions and applications to open a branch or facility. As of the date of its most recent examination report, the Bank has a CRA rating of “Satisfactory”.

The Bank’s deposits are insured to a maximum of \$100,000 per depositor through the Deposit Insurance Fund, which is administered by the FDIC, and the Bank is required to pay semi-annual deposit insurance premium assessments to the FDIC. The Bank paid \$.2 million in FDIC premiums during 2006. The Deposit Insurance Fund was created pursuant to the Federal Deposit Insurance Reform Act of 2005, which was signed into law on February 8, 2006. Under this new law, (i) the current \$100,000 deposit insurance coverage will be indexed for inflation (with adjustments every five years, commencing January 1, 2011), and (ii) deposit insurance coverage for retirement accounts was increased to \$250,000 per participant subject to adjustment for inflation. In addition, the FDIC will be given greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments.

For a discussion of the regulatory capital requirements and related restrictions to which the Corporation and the Bank are subject, see the “Capital Requirements” discussion that immediately follows.

## **Capital Requirements**

FDICIA established a system of prompt corrective action to resolve the problems of undercapitalized institutions. Under this system, the federal banking regulators are required to rate supervised institutions on the basis of five capital categories: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critical undercapitalized;” and to take certain mandatory actions (and are authorized to take other discretionary actions) with respect to institutions in the three undercapitalized categories. The severity of the actions will depend upon the category in which the institution is placed. A depository institution is “well capitalized” if it has a total risk based capital ratio of 10% or greater, a Tier 1 risk based capital ratio of 6% or greater, and a leverage ratio of 5% or greater and is not subject to any order, regulatory agreement, or written directive to meet and maintain a specific capital level for any capital measure. An “adequately capitalized” institution is defined as one that has a total risk based capital ratio of 8% or greater, a Tier 1 risk based capital ratio of 4% or greater and a leverage ratio of 4% or greater (or 3% or greater in the case of a bank with a composite CAMEL rating of 1).

FDICIA generally prohibits a depository institution from making any capital distribution, including the payment of cash dividends, or paying a management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. For a capital restoration plan to be acceptable, the depository institution’s parent holding company must guarantee (subject to certain limitations) that the institution will comply with such capital restoration plan.



Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized and requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized depository institutions are subject to the appointment of a receiver or conservator, generally within 90 days of the date such institution is determined to be critically undercapitalized.

Further information about our capital resources is provided in the “Capital Resources” section of Item 7 of Part II of this annual report. Information about the capital ratios of the Corporation and of the Bank as of December 31, 2006 may be found in Note 2 to the Consolidated Financial Statements, which is included in Item 8 of Part II of this annual report.

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## **USA PATRIOT ACT**

Congress adopted the USA PATRIOT Act (the “Patriot Act”) on October 26, 2001 in response to the terrorist attacks that occurred on September 11, 2001. Under the Patriot Act, certain financial institutions, including banks, are required to maintain and prepare additional records and reports that are designed to assist the government’s efforts to combat terrorism. The Patriot Act includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

## **Federal Securities Law**

The shares of the Corporation’s common stock are registered with the Securities and Exchange Commission (the “SEC”) under Section 12(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and listed on the Nasdaq Stock Market’s Global Market. The Corporation is subject to information reporting requirements, proxy solicitation requirements, insider trading restrictions and other requirements of the Exchange Act, including the requirements imposed under the federal Sarbanes-Oxley Act of 2002. Among other things, loans to and other transactions with insiders are subject to restrictions and heightened disclosure, directors and certain committees of the Board must satisfy certain independence requirements, and the Corporation is generally required to comply with certain corporate governance requirements.

## **Governmental Monetary and Credit Policies and Economic Controls**

The earnings and growth of the banking industry and ultimately of the Bank are affected by the monetary and credit policies of governmental authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Government securities, changes in the federal funds rate, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid on deposits. The monetary policies of the FRB authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the FRB, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or their effect on the business and earnings of the Corporation and its subsidiaries.

## **SEASONALITY**

Management does not believe that our business activities are seasonal in nature. Deposit, loan, and insurance demand may vary depending on local and national economic conditions, but management believes that any variation will not have a material impact on our planning or policy-making strategies.

## **EMPLOYEES**

At December 31, 2006, we employed approximately 463 individuals, of whom 352 were full-time employees.

## **ITEM 1A.**

## **RISK FACTORS**

The following factors should be considered carefully in evaluating an investment in shares of common stock of the Corporation.

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### **Risks Relating to the Corporation and its Affiliates**

#### **The Corporation's future depends on the successful growth of its subsidiaries.**

The Corporation's primary business activity for the foreseeable future will be to act as the holding company of the Bank and its other direct and indirect subsidiaries. Therefore, the Corporation's future profitability will depend on the success and growth of these subsidiaries. In the future, part of the Corporation's growth may come from buying other banks and buying or establishing other companies. Such entities may not be profitable after they are purchased or established, and they may lose money, particularly at first. A new bank or company may bring with it unexpected liabilities, bad loans, or bad employee relations, or the new bank or company may lose customers.

#### **The majority of our business is concentrated in Maryland and West Virginia; a significant amount of our business is concentrated in real estate lending.**

Because most of our loans are made to Western Maryland and Northeastern West Virginia borrowers, a decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose loan portfolios are geographically diverse. Further, we make many real estate secured loans, including construction and land development loans, all of which are in greater demand when interest rates are low and economic conditions are good. There can be no guarantee that good economic conditions or low interest rates will continue to exist. Moreover, the market values of the real estate securing our loans may deteriorate due to a number of unpredictable factors, which could cause us to lose money in the event a borrower failed to repay a loan and we were forced to foreclose on the property. Additionally, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, along with the other federal banking regulators, issued final guidance on December 6, 2006 entitled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" directed at institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. This guidance suggests that institutions whose commercial real estate loans exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk and may be required to maintain higher capital ratios than institutions with lower concentrations in commercial real estate lending. Based on our commercial real estate concentration as of December 31, 2006, we may be subject to further supervisory analysis during future examinations. Although we continuously evaluate our concentration and risk management strategies, we cannot guarantee that any risk management practices we implement will be effective to prevent losses relating to our commercial real estate portfolio. Management cannot predict the extent to which this guidance will impact our operations or capital requirements.

#### **The Bank may experience loan losses in excess of its allowance.**

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. Management of First United Bank & Trust maintains an allowance for credit losses based upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, management makes various assumptions and judgments about the ultimate collectability of the loan portfolio and provides an allowance for loan losses based upon a percentage of the outstanding balances and for specific loans when their ultimate collectability is considered questionable. If management's assumptions and judgments prove to be incorrect and the allowance for loan losses is inadequate to absorb future losses, or if the bank regulatory authorities require us to increase the allowance for loan losses as a part of its examination process, our earnings and capital could be significantly and adversely affected. Although management uses the best information available to make determinations with respect to the allowance for loan losses, future adjustments may be necessary if economic conditions differ substantially from the assumptions used or adverse developments arise with respect to our non-performing or performing loans. Material additions to the allowance for loan losses could result in a material decrease in our net income and capital, and could have a material

adverse effect on our financial condition.

**Interest rates and other economic conditions will impact our results of operations.**

Our results of operations may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our profitability is in part a function of the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (i.e., net interest income), including advances from the Federal Home Loan Bank of Atlanta. Interest rate risk arises from mismatches (i.e., the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities and is measured in terms of the ratio of the interest rate sensitivity gap to total assets. More assets repricing or maturing than liabilities over a given time period is considered asset-sensitive and is reflected as a positive gap, and more liabilities repricing or maturing than assets over a given time period is considered liability-sensitive and is reflected as negative gap. An asset-sensitive position (i.e., a positive gap) could enhance earnings in a rising interest rate environment and could negatively impact earnings in a falling interest rate environment, while a liability-sensitive position (i.e., a negative gap) could enhance earnings in a falling interest rate environment and negatively impact earnings in a rising interest rate environment. Fluctuations in interest rates are not predictable or controllable. We have attempted to structure our asset and liability management strategies to mitigate the impact on net interest income of changes in market interest rates, but there can be no assurance that these attempts will be successful in the event of such changes.

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**The market value of our investments could decline.**

As of December 31, 2006, we had classified 100% of our investment securities as available-for-sale pursuant to Statement of Financial Accounting Standards ("SFAS") No. 115 relating to accounting for investments. SFAS No. 115 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be "marked to market" and reflected as a separate item in shareholders' equity (net of tax) as accumulated other comprehensive income. There can be no assurance that future market performance of our investment portfolio will enable us to realize income from sales of securities. Shareholders' equity will continue to reflect the unrealized gains and losses (net of tax) of these investments. Moreover, there can be no assurance that the market value of our investment portfolio will not decline, causing a corresponding decline in shareholders' equity.

Management believes that several factors will affect the market values of our investment portfolio. These include, but are not limited to, changes in interest rates or expectations of changes, the degree of volatility in the securities markets, inflation rates or expectations of inflation and the slope of the interest rate yield curve (the yield curve refers to the differences between shorter-term and longer-term interest rates; a positively sloped yield curve means shorter-term rates are lower than longer-term rates). Also, the passage of time will affect the market values of our investment securities, in that the closer they are to maturing, the closer the market price should be to par value. These and other factors may impact specific categories of the portfolio differently, and management cannot predict the effect these factors may have on any specific category.

**We operate in a competitive environment.**

We operate in a competitive environment, competing for loans, deposits, and customers with commercial banks, savings associations and other financial entities. Competition for deposits comes primarily from other commercial banks, savings associations, credit unions, money market and mutual funds and other investment alternatives. Competition for loans comes primarily from other commercial banks, savings associations, mortgage banking firms, credit unions and other financial intermediaries. Competition for other products, such as insurance and securities products, comes from other banks, securities and brokerage companies, insurance companies, insurance agents and brokers, and other non-bank financial service providers in our market area. Many of these competitors are much larger in terms of total assets and capitalization, have greater access to capital markets, and/or offer a broader range of financial services than those that we offer. In addition, banks with a larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the needs of larger customers.

In addition, current banking laws facilitate interstate branching, merger activity among banks, and expanded activities. Since September 1995, certain bank holding companies have been authorized to acquire banks throughout the United States. Since June 1, 1997, certain banks have been permitted to merge with banks organized under the laws of different states. As a result, interstate banking is now an accepted element of competition in the banking industry and the Corporation may be brought into competition with institutions with which it does not presently compete. Moreover, as discussed above, the GLBA revised the BHC Act in 2000 and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls an FDIC insured financial institution. These laws may increase the competition we face in our market areas in the future, although management cannot predict the degree to which such competition will impact our financial conditions or results of operations.

**The loss of key personnel could disrupt our operations and result in reduced earnings.**

Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel. Our current executive officers provide valuable services based on their many years of experience and in-depth knowledge of the banking industry. Due to the intense competition for financial professionals, these key personnel would be difficult to replace and an unexpected loss of their services could result in a disruption to the continuity of operations and a possible reduction in earnings.

**The banking industry is heavily regulated; significant regulatory changes could adversely affect our operations.**

Our operations will be impacted by current and future legislation and by the policies established from time to time by various federal and state regulatory authorities. The Corporation is subject to supervision by the FRB. The Bank is subject to supervision and periodic examination by the Maryland Commissioner of Financial Regulation, the West Virginia Division of Banking, and the FDIC. Banking regulations, designed primarily for the safety of depositors, may limit a financial institution's growth and the return to its investors by restricting such activities as the payment of dividends, mergers with or acquisitions by other institutions, investments, loans and interest rates, interest rates paid on deposits, expansion of branch offices, and the offering of securities or trust services. The Corporation and the Bank are also subject to capitalization guidelines established by federal law and could be subject to enforcement actions to the extent that either is found by regulatory examiners to be undercapitalized. It is not possible to predict what changes, if any, will be made to existing federal and state legislation and regulations or the effect that such changes may have on our future business and earnings prospects. Management also cannot predict the nature or the extent of the effect on our business and earnings of future fiscal or monetary policies, economic controls, or new federal or state legislation. Further, the cost of compliance with regulatory requirements may adversely affect our ability to operate profitably.

**We may be adversely affected by recent legislation.**

As discussed above the GLBA repealed restrictions on banks affiliating with securities firms and it also permitted bank holding companies that become financial holding companies to engage in additional financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities that are currently not permitted for bank holding companies. Although the Corporation is a financial holding company, this law may increase the competition we face from larger banks and other companies. It is not possible to predict the full effect that this law will have on us.

The Sarbanes-Oxley Act of 2002 requires management of publicly traded companies to perform an annual assessment of their internal controls over financial reporting and to report on whether the system is effective as of the end of the Company's fiscal year. Disclosure of significant deficiencies or material weaknesses in internal controls could cause an unfavorable impact to shareholder value by affecting the market value of our stock.

The Patriot Act reinforced the importance of implementing and following procedures required by the Bank Secrecy Act and money laundering issues. Non-compliance with this act or failure to file timely and accurate documentation could expose the company to adverse publicity as well as fines and penalties assessed by regulatory agencies.

**We may be subject to claims and the costs of defensive actions.**

Our customers may sue us for losses due to alleged breaches of fiduciary duties, errors and omissions of employees, officers and agents, incomplete documentation, our failure to comply with applicable laws and regulations, or many other reasons. Also, our employees may knowingly or unknowingly violate laws and regulations. Management may

not be aware of any violations until after their occurrence. This lack of knowledge may not insulate us from liability. Claims and legal actions may result in legal expenses and liabilities that may reduce our profitability and hurt our financial condition.

**We may not be able to keep pace with developments in technology.**

We use various technologies in conducting our businesses, including telecommunication, data processing, computers, automation, internet-based banking, and debit cards. Technology changes rapidly. Our ability to compete successfully with other financial institutions may depend on whether we can exploit technological changes. We may not be able to exploit technological changes, and any investment we do make may not make us more profitable.

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## **Risks Relating to the Corporation's Common Stock**

### **The Corporation's ability to pay dividends is limited.**

The Corporation's ability to pay dividends to shareholders is largely dependent upon the receipt of dividends from the Bank. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. Federal law generally prohibits the payment of a dividend by a troubled institution. Under Maryland law, a state-chartered commercial bank may pay dividends only out of undivided profits or, with the prior approval of the Commissioner, from surplus in excess of 100% of required capital stock. If however, the surplus of a Maryland bank is less than 100% of its required capital stock, cash dividends may not be paid in excess of 90% of net earnings. In addition to these specific restrictions, bank regulatory agencies also have the ability to prohibit proposed dividends by a financial institution which would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice. Because of these limitations, there can be no guarantee that we will declare dividends in any fiscal quarter.

### **Shares of the Corporation's common stock are not insured.**

Shares of the Corporation's common stock do not represent deposits and investments in these shares are not insured against loss by the government.

### **Shares of the Corporation's common stock are not heavily traded.**

The shares of the Corporation's common stock are listed on the Nasdaq Global Market and are not heavily traded. Securities that are not heavily traded can be more volatile than stock trading in an active public market. Factors such as our financial results, the introduction of new products and services by us or our competitors, and various factors affecting the banking industry generally may have a significant impact on the market price of our common stock. Management cannot predict the extent to which an active public market for our securities will develop or be sustained in the future. In recent years, the stock market has experienced a high level of price and volume volatility, and market prices for the securities of many companies have experienced wide price fluctuations that have not necessarily been related to their operating performance. Therefore, our shareholders may not be able to sell their shares at the volumes, prices, or times that they desire.

### **The Corporation's Articles of Incorporation and By-Laws may discourage a corporation takeover.**

The Amended and Restated Articles of Incorporation and By-Laws of the Corporation contain certain provisions designed to enhance the ability of the Board of Directors to deal with attempts to acquire control of the corporation. First, the Board of Directors is classified into three classes. Directors of each class serve for staggered three-year periods, and no director may be removed except for cause, and then only by the affirmative vote of either a majority of the entire Board of Directors or a majority of the outstanding voting stock. Second, the Board has the authority to classify and reclassify unissued shares of stock of any class or series of stock by setting, fixing, eliminating, or altering in any one or more respects the preferences, rights, voting powers, restrictions and qualifications of, dividends on, and redemption, conversion, exchange, and other rights of, such securities. The Board could use this authority, along with its authority to authorize the issuance of securities of any class or series, to issue shares having terms favorable to management to a person or persons affiliated with or otherwise friendly to management. In addition to the foregoing, Maryland law contains anti-takeover provisions, such as restrictions on "control share acquisitions" and "business combinations" with certain interested stockholders, that apply to the Corporation.

Although these provisions do not preclude a takeover, they may have the effect of discouraging a takeover attempt that would not be approved by the Board of Directors, but pursuant to which shareholders might receive a substantial premium for their shares over then-current market prices. As a result, shareholders who might desire to participate in

such a transaction might not have the opportunity to do so. Such provisions will also render the removal of the Board of Directors and of management more difficult and, therefore, may serve to perpetuate current management. Such provisions could potentially adversely affect the market price of our common stock.

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**ITEM 1B.**

**UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2.**

**PROPERTIES**

The headquarters of the Corporation and the Bank occupies approximately 29,000 square feet at 19 South Second Street, Oakland, Maryland. These premises are owned by the Corporation. The Bank owns 19 of its banking offices and leases six. The Corporation also leases three offices of non-bank subsidiaries. A banking office is currently under construction on a leased site in Washington County, Maryland. Total rent expense on the leased offices and properties was \$.42 million in 2006. In December of 2005, the Corporation purchased a 30,000 square foot building in Oakland, Maryland to house its operations center. Management expects that this site will be fully functional in March 2007.

**ITEM 3.**

**LEGAL PROCEEDINGS**

We are at times, in the ordinary course of business, subject to legal actions. Management, upon the advice of counsel, believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition.

**ITEM 4.**

**SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

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**PART II****ITEM MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS  
5. AND ISSUER PURCHASES OF EQUITY SECURITIES**

Shares of the Corporation's common stock are listed on the Nasdaq Stock Market under the symbol "FUNC". As of February 28, 2007, the Corporation had 2,085 shareholders of record. The high and low sales prices for, and the cash dividends declared on, the shares of the Corporation's common stock for each quarterly period of 2006 and 2005 are set forth below.

<b>2006</b>	<b>High</b>	<b>Low</b>	<b>Dividends Declared</b>
1 <sup>st</sup> Quarter	\$ 22.83	\$ 20.29	\$ .190
2 <sup>nd</sup> Quarter	23.35	20.29	.190
3 <sup>rd</sup> Quarter	22.00	20.31	.190
4 <sup>th</sup> Quarter	22.79	21.05	.195

<b>2005</b>	<b>High</b>	<b>Low</b>	<b>Dividends Declared</b>
1 <sup>st</sup> Quarter	\$ 21.70	\$ 19.81	\$ .185
2 <sup>nd</sup> Quarter	20.30	18.94	.185
3 <sup>rd</sup> Quarter	20.85	19.25	.185
4 <sup>th</sup> Quarter	21.66	19.14	.190

Cash dividends are typically declared on a quarterly basis and are at the discretion of the Corporation's Board of Directors. Dividends to shareholders are generally dependent on the ability of the Corporation's subsidiaries, especially the Bank, to declare dividends to the Corporation. The ability of these entities to declare dividends are limited by federal and state banking laws and/or state corporate laws. Further information about these limitations may be found in Note 13 to the Consolidated Financial Statements and in Item 1A of Part I under the caption "*The Corporation's ability to pay dividends is limited*", each of which is incorporated herein by reference. There can be no guarantee that dividends will be declared in any fiscal quarter.

Market makers for the Corporation's common stock are:

**FERRIS BAKER WATTS**

12 North Liberty St.  
Cumberland, MD 21502  
(301)724-7161  
(800)776-0629

**SCOTT AND STRINGFELLOW, INC.**

909 East Main Street  
Richmond, VA 23219  
(804)643-1811  
(800)552-7757

113 S. Potomac St.  
Hagerstown, MD 21740  
(301)733-7111  
(800)344-4413

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### First United Corporation Stock Performance Graph

The following graph compares the yearly percentage change in the cumulative total return for First United Corporation common stock for the five years ended December 31, 2006. This data is compared to the NASDAQ Composite market index and the SNL \$1 billion to \$5 billion Bank Index during the same time period. Total return numbers are calculated as change in stock price for the period indicated with dividends being reinvested.

<i>Index</i>	<i>Period Ending</i>					
	<b>12/31/01</b>	<b>12/31/02</b>	<b>12/31/03</b>	<b>12/31/04</b>	<b>12/31/05</b>	<b>12/31/06</b>
First United Corporation	100.00	106.92	164.12	143.24	153.25	163.71
NASDAQ Composite	100.00	68.76	103.67	113.16	115.57	127.58
SNL \$1B-\$5B Bank Index	100.00	115.44	156.98	193.74	190.43	220.36

### Equity Compensation Plan Information

At December 31, 2006, the Corporation had no equity compensation plan or arrangement in effect under which shares of common stock may be issued to its directors or officers.

### Issuer Purchases of Securities

The Corporation did not purchase any shares of its common stock during the fourth quarter of 2006.

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## ITEM 6.

## SELECTED FINANCIAL DATA

The following table sets forth certain selected financial data for the five years ended December 31, 2006 and is qualified in its entirety by the detailed information and financial statements, including notes thereto, included elsewhere or incorporated by reference in this annual report.

(In thousands, except per share data)

	2006	2005	2004	2003	2002
<b>Balance Sheet Data</b>					
Total Assets	\$ 1,349,317	\$ 1,310,991	\$ 1,233,901	\$ 1,108,241	\$ 954,388
Net Loans	957,126	954,545	904,635	786,051	659,758
Investment Securities	263,272	230,095	210,661	223,615	215,236
Deposits	971,381	955,854	850,661	750,161	610,460
Long-term Borrowings	166,330	128,373	175,415	191,735	198,772
Shareholders' Equity	96,856	92,039	86,356	84,191	79,283
<b>Operating Data</b>					
Interest Income	\$ 80,269	\$ 69,756	\$ 60,682	\$ 57,703	\$ 57,589
Interest Expense	39,335	29,413	24,016	23,601	25,702
Net Interest Income	40,934	40,343	36,666	34,102	31,887
Provision for Loan Losses	1,165	1,078	2,534	833	1,506
Other Operating Income	14,041	14,088	12,971	11,867	9,007
Other Operating Expense	35,490	34,654	35,969	29,821	26,038
Income Before Tax	18,320	18,699	11,134	15,315	13,350
Income Tax	5,743	6,548	3,507	4,566	3,695
Net Income	\$ 12,577	\$ 12,151	\$ 7,627	\$ 10,749	\$ 9,655
<b>Per Share Data</b>					
Net Income	\$ 2.05	\$ 1.99	\$ 1.25	\$ 1.77	\$ 1.59
Dividends Paid	.76	.74	.72	.70	.68
Book Value	15.77	15.04	14.17	13.83	13.04
<b>Significant Ratios</b>					
Return on Average Assets	.96%	.95%	.65%	1.03%	1.13%
Return on Average Equity	13.07%	13.61%	8.91%	13.10%	12.75%
Dividend Payout Ratio	37.07%	37.44%	58.00%	39.65%	42.76%
Average Equity to Average Assets	7.35%	7.00%	7.28%	7.88%	8.84%
Total Risk-based Capital Ratio	12.95%	12.66%	12.24%	11.77%	14.31%
Tier I Capital to Risk Weighted Assets	11.81%	11.45%	10.81%	11.04%	13.76%
Tier I Capital to Average Assets	9.08%	8.64%	8.44%	8.72%	11.72%

## **ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS 7. OF OPERATIONS**

This discussion and analysis should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2006, which appear in Item 8 of Part II of this annual report.

### **Overview**

The Corporation is a financial holding company which, through the Bank and its non-bank subsidiaries, provides an array of financial products and services primarily to customers in four Western Maryland counties and four Northeastern West Virginia counties. Its principal operating subsidiary is the Bank, which consists of a community banking network of 25 branch offices located throughout its market areas. Our primary sources of revenue are interest income earned from our loan and investment securities portfolios and fees earned from financial services provided to customers.

Our 2006 net income was \$12.6 million, an increase of 4.1% over 2005. The increase in 2006 net income was due to strategic decisions implemented by management over the past few years, the Bank's ability to increase its net interest margin, a focus on controlling our operating costs and a reduction in the effective tax rate. 2006 proved to be a challenging year with an inverted interest rate yield curve, a slowed economy and intense competition for retail and commercial deposits.

Operations in 2006 were impacted by the following factors and strategic initiatives:

***Slow Loan and Deposit Growth/Impact on Net Interest Margin*** -- Loan growth slowed significantly in 2006 as compared to 2005, resulting in a minimal net increase in the loan portfolio of \$3 million. Commercial loan production remained at a consistent level with 2005 but was offset by the increased payback of commercial development loans. Residential mortgage loan growth was tempered by management during 2006 as a result of strong customer preference for fixed rate loans. The Bank utilized the secondary market as an outlet for this type of lending to prevent excessive growth in the fixed rate portfolio. Management's preference for originating adjustable, prime-rate based loans has benefited us in the current rising interest rate environment. Although we experienced minimal increase in loan growth, interest income exceeded interest income generated in prior years due to the upward re-pricing of loans. For 2006, interest income on loans increased \$7.5 million (on a fully taxable equivalent basis) when compared with 2005. Interest income on investment securities in 2006 increased by \$3.7 million (on a fully taxable equivalent basis) due to an increase in the average yield on the portfolio and a \$45 million leverage strategy. (Additional information on the composition of interest income is available in Table 1 below).

Funding costs in 2006 increased as a result of the rising interest rate environment and the intense deposit competition in our market areas. The shift from core non-interest bearing accounts to certificates of deposit and higher yielding money market accounts continued during 2006. A large portion of the new time deposits received in 2006 were in denominations of \$100,000 or more, which typically require higher interest rates than core deposits. This reliance on higher rate time deposits and the general increase in interest rates throughout 2006 increased deposit interest expense by approximately \$8.2 million when compared to 2005. Net borrowings increased by \$15.4 million adding an additional \$1.7 million of interest expense over the prior year. The combination of slow loan and deposit growth, rising interest rates on our assets and liabilities, and the increased level of debt resulted in a minimal increase in net interest income on a tax equivalent basis of \$1.4 million (3%) in 2006 when compared to 2005.

The overall net interest margin increased during the year from 3.49% in 2005 to 3.52% in 2006. However, the 2006 net interest margin was negatively impacted by a \$45 million leverage strategy implemented in the latter half of 2006 in an attempt to produce additional net interest income.



**Early Redemption of Long-Term Borrowings** -- In May 2006, the Bank participated in a contemporaneous exchange of long-term FHLB advances. The Bank exchanged \$25 million of long-term advances having a weighted average rate of 5.01% for \$25 million of long-term advances having a weighted average rate of 4.69%. The exchange resulted in a net gain of \$.2 million which will be amortized over the life of the new borrowing.

**Other Operating Income/Other Operating Expense** -- Other operating income in 2006 decreased slightly when compared to 2005. The Bank experienced increases in service charge and Trust department income of \$.8 million and \$.4 million, respectively. Insurance commissions were down slightly in 2006 compared to 2005 due to lower contingency income from insurance companies and the closing of Oakfirst Life Insurance, Inc. early in 2005. Other income in 2005 included a \$.9 million gain on the prepayment of long-term debt. Operating expenses in 2006 increased by 2.4% when compared to 2005. This minimal increase was due primarily to increases in salaries and benefits, occupancy and other expenses and close monitoring of our operating expenses. 2005 operating expenses included a \$.4 million penalty recognized on the prepayment of long-term debt.

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The Bank continued to invest in its core market areas during 2006. A new branch office was opened during the fourth quarter of 2006 in Morgantown, West Virginia and construction of another branch began on a newly leased site in Washington County, Maryland. This new retail branch is anticipated to open late in the first quarter of 2007. The Corporation purchased a 30,000 square foot building in Oakland, Maryland in December 2005 for \$3 million to house its operations center. This space will relieve congestion in the Corporation's headquarters as well as provide capacity for the Bank's anticipated growth. Management expects that this new facility will be ready for use in the first quarter of 2007.

The Corporation continued its tradition of paying dividends to shareholders during 2006 and, in fact, increased them to \$0.76 per share, a 2.7% increase from \$0.74 per share in 2005. The Corporation has paid quarterly cash dividends consistently since 1985, the year in which it was formed.

We will continue to face risks and challenges in the future, including: changes in local economic conditions in our core geographic markets; potential yield compression on loan and deposit products by existing competitors and potential new entrants in our markets; changes in interest rates; and changes to existing federal and state legislation and regulations over banks and financial holding companies. For a more complete discussion of these risk factors, see Item 1A of Part I of this annual report.

### **Critical Accounting Policies and Estimates**

This discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. (See Note 1 of the Notes to Consolidated Financial Statements included in Item 8 of Part II of this annual report.) On an on-going basis, management evaluates estimates, including those related to loan losses and intangible assets. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Management believes the following critical accounting policies affect our more significant judgments and estimates used in the preparation of the consolidated financial statements.

#### *Allowance for Loan Losses*

One of our most important accounting policies is that related to the monitoring of the loan portfolio. A variety of estimates impact the carrying value of the loan portfolio, including the calculation of the allowance for loan losses, the valuation of underlying collateral, the timing of loan charge-offs and the placement of loans on non-accrual status. The allowance is established and maintained at a level that management believes is adequate to cover losses resulting from the inability of borrowers to make required payment on loans. Estimates for loan losses are arrived at by analyzing risks associated with the specific loans and the loan portfolio, current and historical trends in delinquencies and charge-offs, and changes in the size and composition of the loan portfolio. The analysis also requires consideration of the economic climate and direction, changes in lending rates, political conditions, legislation impacting the banking industry and economic conditions specific to Western Maryland and Northeastern West Virginia. Because the calculation of the allowance for loan losses relies on management's estimates and judgments relating to inherently uncertain events, actual results may differ from management's estimates.

The allowance for loan losses is also discussed below in this Item 7 under the caption "Allowance and Provision for Loan Losses" and in Note 4 to Consolidated Financial Statements contained in Item 8 of Part II of this annual report.

#### *Goodwill and Other Intangible Assets*

Statement of Financial Accounting Standards (SFAS) No. 142, Accounting for Goodwill and Other Intangible Assets, establishes standards for the amortization of acquired intangible assets and the non-amortization and impairment assessment of goodwill. We have \$2.1 million of core deposit intangible assets which are subject to amortization and \$11.9 million in goodwill primarily related to the Huntington National Bank branch acquisition that occurred in 2003, which is not subject to periodic amortization.

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Goodwill arising from business combinations represents the value attributable to unidentifiable intangible elements in the business acquired. Our goodwill relates to value inherent in the banking business and the value is dependent upon our ability to provide quality, cost effective services in a highly competitive local market. This ability relies upon continuing investments in processing systems, the development of value-added service features and the ease of use of our services. As such, goodwill value is supported ultimately by revenue that is driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill, which could adversely impact earnings in future periods. SFAS No. 142 requires an annual evaluation of goodwill for impairment. The determination of whether or not these assets are impaired involves significant judgments. Management has concluded that the recorded value of goodwill was not impaired as a result of the evaluation. However, future changes in strategy and/or market conditions could significantly impact these judgments and require adjustments to recorded asset balances.

#### *Other-Than-Temporary Impairment of Investment Securities*

Management systematically evaluates investment securities for impairment on a quarterly basis. Declines in the fair value of available for sale securities below their cost that are considered other than temporary declines are recognized in earnings as realized losses in the period in which the impairment determination is made. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded using the specific identification method.

#### *Pension Plan Assumptions*

Our pension plan costs are calculated using actuarial concepts, as discussed within the requirements of Statement of Financial Accounting Standards (SFAS) No. 87, Employers Accounting for Pensions SFAS No. 132 (R) and as amended by SFAS No. 158, "Employers' Accounting for Deferred Benefit Pension and Other Post Retirement Plans." Pension expense and the determination of our projected pension liability are based upon two critical assumptions; the discount rate and the expected return on plan assets. We evaluate each of these critical assumptions annually. Other assumptions impact the determination of pension expense and the projected liability including the primary employee demographics, such as retirement patterns, employee turnover, mortality rates, and estimated employer compensation increases. These factors, along with the critical assumptions, are carefully reviewed by management each year in consultation with our pension plan consultants and actuaries. Further information about our pension plan assumptions, the plan's funded status, and other plan information is included in Note 11 to Consolidated Financial Statements, which is included in Item 8 of Part II of this annual report.

#### *Recent Accounting Pronouncements and Developments*

Note 1 to the Consolidated Financial Statements included in Item 8, Part II of this annual report discusses new accounting pronouncements that when adopted, may have an effect on our consolidated financial statements.

## **CONSOLIDATED STATEMENT OF INCOME REVIEW**

### **Net Interest Income**

Net interest income is the largest source of operating revenue. Net interest income is the difference between the interest earned on interest-earning assets and the interest expense paid on interest-bearing liabilities. For analytical and discussion purposes, net interest income is adjusted to a taxable equivalent basis to facilitate performance comparisons between taxable and tax-exempt assets by increasing tax-exempt income by an amount equal to the federal income

taxes that would have been paid if this income were taxable at the statutorily applicable rate. The table below summarizes net interest income (on a taxable equivalent basis) for the years 2004-2006 (dollars in thousands).

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	2006	2005	2004
Interest income	\$ 81,838	\$ 70,533	\$ 61,380
Interest expense	39,335	29,413	24,016
Net interest income	42,503	41,120	37,364
Net interest margin %	3.52%	3.49%	3.43%

Net interest income increased \$1.4 million (3%) in 2006 over the same period in 2005, due to an \$11.3 million (16%) increase in interest income offset by a \$9.9 million (34%) increase in interest expense. The increase in interest income resulted from an increase in average interest-earning assets of \$28.1 million (2%) during 2006 when compared to 2005. This increase is attributable to the growth that we experienced in our investment portfolio late in 2005 and throughout 2006. Emphasis on adjustable rate loan products and the rising interest rate environment contributed to the increase in the average rate on our average earning assets of 80 basis points, from 5.98% in 2005 to 6.78% in 2006 (on a fully tax equivalent basis). Interest expense increased during 2006 when compared to 2005 due to the higher interest rate environment, and an overall increase in average interest-bearing liabilities of \$32.3 million. Deposits have increased in 2006 by approximately \$16 million due to an increase in brokered certificates of deposit and a successful retail promotion of a nine month certificate of deposit. The combined effect of the increasing rate environment and the volume increases in our average interest-bearing liabilities resulted in an 83 basis point increase in the average rate paid on our average interest-bearing liabilities from 2.76% for 2005 to 3.59% for 2006. The net result of the aforementioned factors was a 3 basis point increase in the net interest margin at December 31, 2006 to 3.52% from 3.49% at December 31, 2005.

Comparing 2005 to 2004, net interest income increased \$3.8 million (10.1%) due primarily to the increase in interest income of \$9.2 million, offset by an increase in interest expense of \$5.4 million. Interest income from loans increased by \$8.3 million due to the \$93.5 million increase in the average balance of loans in 2005 and a slight increase of 26 basis points in the average yield on loans. The increase in total interest expense was due to increased interest expense on deposits of \$7.0 million (57.8%) offset by a decrease in interest expense on long-term borrowings of \$3.2 million (29.7%). Interest expense on deposits increased primarily due to a \$38.3 million increase in average balances and a 141 basis point increase in the average yield on time deposits over \$100,000. The decrease in interest expense on long-term borrowings was primarily due to the \$45.4 million decrease in the average balance coupled with the 50 basis point decrease in average yield on these borrowings.

As shown below, the composition of total interest income remained steady from 2004 to 2005. Loan interest income and fees decreased in 2006 when compared to 2005 as a percentage of total interest income due to the limited loan growth and the increase in investment securities as a percentage of interest earning assets during this time.

	% of Total Interest Income		
	2006	2005	2004
Interest and fees on loans	85%	88%	88%
Interest on investment securities	15%	12%	12%

Table 1 sets forth the average balances, net interest income and expense and average yields and rates for our interest-earning assets and interest-bearing liabilities for 2006, 2005 and 2004. Table 2 sets forth an analysis of volume and rate changes in interest income and interest expense of our average interest-earning assets and average interest-bearing liabilities for 2006, 2005 and 2004. Table 2 distinguishes between the changes related to average outstanding balances (changes in volume created by holding the interest rate constant) and the changes related to

average interest rates (changes in interest income or expense attributed to average rates created by holding the outstanding balance constant).

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**Distribution of Assets, Liabilities and Shareholders' Equity**  
**Interest Rates and Interest Differential - Tax Equivalent Basis**  
(Dollars in thousands)

**Table 1**

	For the Years Ended December 31									
	2006			2005			2004			
	AVERAGE BALANCE	INTEREST SHLD	RATE	AVERAGE BALANCE	INTEREST SHLD	RATE	AVERAGE BALANCE	INTEREST SHLD	RATE	
<b>Assets</b>										
Loans	\$ 957,709	\$ 69,049	7.21%	\$ 954,784	\$ 61,601	6.45%	\$ 861,255	\$ 53,313	6.19%	
Investment Securities:										
Taxable	171,720	7,699	4.48	179,018	6,231	3.48	191,135	5,819	3.04	
Non taxable	65,902	4,399	6.67	30,041	2,129	7.09	23,311	1,854	7.95	
Total	237,622	12,098	5.09	209,059	8,360	4.00	214,446	7,673	3.58	
Federal funds sold	463	1	.21	1,876	55	2.93	2,043	35	1.71	
Interest-bearing deposits with other banks	2,811	165	5.88	5,327	162	3.04	3,583	56	1.57	
Other interest earning assets	9,231	525	5.68	8,680	355	4.09	8,439	303	3.59	
<b>Total earning assets</b>	<b>1,207,836</b>	<b>81,838</b>	<b>6.78%</b>	<b>1,179,726</b>	<b>70,533</b>	<b>5.98%</b>	<b>1,089,766</b>	<b>61,380</b>	<b>5.63%</b>	
Allowance for loan losses	(6,245)			(6,975)			(6,150)			
Non-earning assets	110,098			102,500			94,730			
<b>Total Assets</b>	<b>\$ 1,311,689</b>			<b>\$ 1,275,251</b>			<b>\$ 1,178,346</b>			