EAGLE BANCORP INC
Form 10-K
March 13, 2007

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **Annual report under Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the fiscal year ended December 31, 2006

o **Transition report under Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from to

Commission file number: 0-25923

Eagle Bancorp, Inc.

(Exact Name of Registrant as Specified in its Charter)

Maryland	**52-2061461**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
7815 Woodmont Avenue, Bethesda, Maryland	**20814**
(Address of Principal Executive Offices)	(Zip Code)

Registrant s Telephone Number, including area code: **(301) 986-1800**

Securities registered pursuant to Section 12(b) of the Act: **Common Stock $.01 par value**

Securities registered pursuant to Section 12(g) of the Act: **None**

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

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

Indicate by check mark whether the registrant; (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports; and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark if disclosure of delinquent filers in pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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. o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

The aggregate market value of the outstanding Common Stock held by nonaffiliates as of June 30, 2006 was approximately $152 million.

As of March 7, 2007, the number of outstanding shares of the Common Stock, $.01 par value, of Eagle Bancorp, Inc. was 9,501,172.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company s definitive Proxy Statement for the Annual Meeting of Shareholders to be held on May 15, 2007 are incorporated by reference in part III hereof.

Form 10-K Cross Reference Sheet

The following shows the location in this Annual Report on Form 10-K or the Company s Proxy Statement for the Annual Meeting of Stockholders to be held on May 15, 2007, of the information required to be disclosed by the United States Securities and Exchange Commission Form 10-K. References to pages only are to pages in this report.

PART III **Item 10.** **Directors, Executive Officers and Corporate Governance.** The information required by this Item is incorporated by reference to, the material appearing under the captions Election of Directors ; Executive Officers who are Not Directors ; and Compliance with Section 16(a) of the Securities Exchange Act of 1934 in the Proxy Statement. The Company has adopted a code of ethics that applies to its Chief Executive Officer and Chief Financial Officer. A copy of the code of ethics will be provided to any person, without charge, upon written request directed to Zandra Nichols, Corporate Secretary, Eagle Bancorp, Inc., 7815 Woodmont Avenue, Bethesda, Maryland 20814.

Item 11. **Executive Compensation.** The information required by this Item is incorporated by reference to the material appearing under the captions Election of Directors Director s Compensation ; Executive Compensation and Report of the Compensation Committee in the Proxy Statement.

Item 12. **Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.** The information required by this Item is incorporated by reference to the material appearing under the caption Voting Securities and Principal Shareholders in the Proxy Statement.

Item 13. **Certain Relationships and Related Transactions and Director Independence.** The information required by this Item is incorporated by reference to the material appearing under the caption Election of Directors Certain Relationships and Related Transactions in the Proxy Statement.

Item 14. **Principal Accountant Fees and Services.** The information required by this Item is incorporated by reference to the material appearing under the caption Independent Registered Public Accounting Firm Fees Paid to Independent Accounting Firm in the Proxy Statement.

PART IV **Item 15.** **Exhibits and Financial Statement Schedules.** See Exhibits and Financial Statements at Page 76.

Six Year Summary of Selected Financial Data

The following table shows selected historical consolidated financial data for Eagle Bancorp (the Company). It should be read in conjunction with the Company s audited consolidated financial statements appearing elsewhere in this report.

	Year Ended December 31, 2006	2005	2004	2003	2002	2001	5 Year Compound Growth Rate
	(dollars in thousands except per share data)						
Selected Balances Period End							
Total assets	$ 773,451	$ 672,252	$ 553,453	$ 442,997	$ 347,829	$ 236,833	27 %
Total stockholders equity	72,916	64,964	58,534	53,012	20,028	17,132	34 %
Total loans	625,773	549,212	415,509	317,533	236,860	182,256	28 %
Total deposits	628,515	568,893	462,287	335,514	278,434	195,688	26 %
Selected Balances Averages							
Total assets	$ 712,297	$ 610,245	$ 487,853	$ 375,802	$ 292,921	$ 198,843	29 %
Total stockholders equity	68,973	61,563	55,507	34,028	18,381	16,615	33 %
Total loans	575,854	479,311	353,537	266,811	210,303	149,056	31 %
Total deposits	585,621	512,416	397,788	292,953	237,910	166,118	29 %
Results of Operations							
Interest income	$ 50,318	$ 36,726	$ 24,195	$ 18,403	$ 16,661	$ 14,121	29 %
Interest expense	17,880	8,008	4,328	3,953	5,170	5,998	24 %
Net interest income	32,438	28,718	19,867	14,450	11,491	8,123	32 %
Provision for credit losses	1,745	1,843	675	1,175	843	979	12 %
Net interest income after provision for credit losses	30,693	26,875	19,192	13,275	10,648	7,144	34 %
Noninterest income	3,846	3,998	3,753	2,850	2,107	1,324	24 %
Noninterest expense	21,824	18,960	14,952	11,007	8,530	6,445	28 %
Income before taxes	12,715	11,913	7,993	5,118	4,225	2,023	44 %
Income tax expense	4,690	4,369	2,906	1,903	1,558	269	77 %
Net income	8,025	7,544	5,087	3,215	2,667	1,754	36 %
Dividends declared	2,147	1,994					
Per Share Data(1)							
Net income, basic	$ 0.85	$ 0.82	$ 0.56	$ 0.49	$ 0.54	$ 0.36	19 %
Net income, diluted	0.81	0.77	0.53	0.46	0.51	0.34	19 %
Book value	7.69	6.95	6.38	5.85	4.09	3.50	17 %
Dividends declared per share	0.23	0.22					
Dividend payout ratio(3)	27.06 %	26.83 %					
Financial Ratios							
Return on average assets	1.13 %	1.24 %	1.04 %	0.86 %	0.91 %	0.88 %	
Return on average equity	11.63 %	12.25 %	9.16 %	9.45 %	14.51 %	10.56 %	
Average equity to average assets	9.68 %	10.09 %	11.38 %	9.05 %	6.28 %	8.36 %	
Net interest margin	4.81 %	4.99 %	4.35 %	4.14 %	4.16 %	4.31 %	
Efficiency ratio(2)	60.15 %	57.95 %	63.30 %	63.62 %	62.73 %	68.22 %	

(1) Adjusted for all years presented giving retroactive effect to stock splits in the form of 30% stock dividends paid on July 5, 2006 and February 28, 2005 and a seven for five stock split in the form of a 40% stock dividend paid on June 15, 2001.

(2) Computed by dividing noninterest expense by the sum of net interest income and noninterest income.

(3) Computed by dividing dividends declared per share by net income per share.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of Eagle Bancorp, Inc. (the Company) and its subsidiary, EagleBank (the Bank). This discussion and analysis should be read in conjunction with the audited Consolidated Financial Statements and Notes thereto, appearing elsewhere in this report.

This report contains forward looking statements within the meaning of the Securities Exchange Act of 1934, as amended, including statements of goals, intentions, and expectations as to future trends, plans, events or results of Company operations and policies and regarding general economic conditions. In some cases, forward looking statements can be identified by use of such words as may , will , anticipate , believes , expects , plans , estimates , potential , continue , should , and similar words or phases. These statements are based upon current and anticipate economic conditions, nationally and in the Company s market, interest rates and interest rate policy, competitive factors and other conditions which, by their nature, are not susceptible to accurate forecast, and are subject to significant uncertainty. Because of these uncertainties and the assumptions on which this discussion and the forward looking statements are based, actual future operations and results in the future may differ materially from those indicated herein. Readers are cautioned against placing undue reliance on any such forward looking statements.

GENERAL

The Company is a growth oriented, one-bank holding company headquartered in Bethesda, Maryland. We provide general commercial and consumer banking services through our wholly owned banking subsidiary EagleBank, a Maryland chartered bank which is a member of the Federal Reserve System. We were organized in October 1997, to be the holding company for the Bank. The Bank was organized as an independent, community oriented, and full-service alternative to the super regional financial institutions, which dominate our primary market area. Our philosophy is to provide superior, personalized service to our customers. We focus on relationship banking, providing each customer with a number of services, becoming familiar with and addressing customer needs in a proactive, personalized fashion. The Bank currently has six offices serving Montgomery County and three offices in the District of Columbia. In May 2006, the Bank opened its newest branch in Chevy Chase, Montgomery County, Maryland. In July 2006, the Company formed Eagle Commercial Ventures, LLC as a direct subsidiary to provide subordinate financing for the acquisition, development and construction of real estate projects, where the primary financing would be provided by EagleBank.

The Company offers a broad range of commercial banking services to our business and professional clients as well as full service consumer banking services to individuals living or working in the service area. We emphasize providing commercial banking services to sole proprietors, small and medium-sized businesses, partnerships, corporations, non-profit organizations and associations, and investors living and working in and near our primary service area. A full range of retail banking services are offered to accommodate the individual needs of both business customers as well as the community we serve. These services include the usual deposit functions of commercial banks, including business and personal checking accounts, NOW accounts and money market and savings accounts, business, construction, and commercial loans, equipment leasing, residential mortgages and consumer loans and cash management services. We have developed significant expertise and commitment as an SBA lender, have been designated a Preferred Lender by the Small Business Administration (SBA), and are the largest community bank SBA lender in the Washington metropolitan area. In 2006, the Bank developed and began offering a remote deposit service which allows clients to facilitate and expedite deposit transactions through the use of electronic scanning devices.

CRITICAL ACCOUNTING POLICIES

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the consolidated financial statements; accordingly, as this information changes, the consolidated financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

The allowance for credit losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on two principles of accounting: (a) Statement on Financial Accounting Standards (SFAS) 5, Accounting for Contingencies , which requires that losses be accrued when they are probable of occurring and are estimable and (b) SFAS No. 114, Accounting by Creditors for Impairment of a Loan , which requires that losses be accrued when it is probable that the Company will not collect all principal and interest payments according to the contractual terms of the loan. The loss, if any, can be determined by the difference between the loan balance and the value of collateral, the present value of expected future cash flows, or values observable in the secondary markets.

Three components comprise our allowance for credit losses: a specific allowance, a formula allowance and a nonspecific or environmental factors allowance. Each component is determined based on estimates that can and do change when actual events occur.

The specific allowance allocates an allowance to identified loans. A loan for which reserves are individually allocated may show deficiencies in the borrower s overall financial condition, payment record, support available from financial guarantors and or the fair market value of collateral. When a loan is identified as impaired, a specific reserve 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 substandard, doubtful and loss, which are segregated from non-classified loans. Classified loans are assigned specific reserves based on an impairment analysis. Allowance factors relate to the level of the internal risk rating with non-classified loans exhibiting higher risk ratings receiving a higher allowance factor.

The nonspecific or environmental factors allowance is an estimate of potential loss associated with the remaining loans (those not identified as either requiring specific reserves or having classified risk ratings). The loss estimates are based on more global factors, such as delinquency trends, loss history, trends in the volume and size of individual credits, effects of changes in lending policy, the experience and depth of management, national and local economic trends, any concentrations of credit risk, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The environmental factors allowance captures losses whose impact on the portfolio may have occurred but have yet to be recognized in the other allowance factors.

Management has significant discretion in making the judgments inherent in the determination of the provision and allowance for credit losses, including, in connection with the valuation of collateral, a borrower s prospects of repayment, and in establishing allowance factors on the formula allowance and nonspecific or environmental allowance components of the allowance. The establishment of allowance factors is a continuing evaluation, based on management s ongoing assessment of the global factors discussed above and their impact on the portfolio. The 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 have a direct impact on the amount of the provision, and a related, after tax effect on net income. Errors in management s perception and assessment of the global 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. Alternatively, errors in management s perception and assessment of the global factors and their impact on the portfolio could result in the allowance being in excess of amounts necessary to cover losses in the portfolio, and may result in lower provisioning in the future. For additional information regarding the allowance for credit losses, refer to the discussion under the caption Allowance for Credit Losses below.

Beginning in January 2006, the Company adopted the provisions of SFAS No. 123R, which requires the expense recognition for the fair value of share based compensation awards, such as stock options, restricted stock, performance based shares and the like. This standard allows management to establish modeling assumptions as to expected stock price volatility, option terms, forfeiture rates and dividend rates which directly impact estimated fair value. The accounting standard also allows for the use of alternative option pricing models which may impact fair value as determined. The Company s practice is to utilize reasonable and supportable assumptions, which are reviewed with the appropriate Board Committee(s).

RESULTS OF OPERATIONS

Overview

The Company reported net income of $8.0 million for the year ended December 31, 2006, a 6% increase over net income of $7.5 million for the year ended December 31, 2005, as compared to $5.1 million for the year ended December 31, 2004.

Earnings per basic share were $0.85 for the year ended December 31, 2006, as compared to $0.82 for the year 2005 and $0.56 for the year 2004. Earnings per diluted share was $0.81 for the year ended December 31, 2006, as compared to $0.77 for the year 2005 and $0.53 for the year 2004.

For the three months ended December 31, 2006, the Company reported net income of $2.2 million as compared to $2.1 million for the same period in 2005. Earnings per basic share was $0.23 and $0.22 per diluted share for the three months ended December 31, 2006, as compared to $0.22 per basic share and $0.21 per diluted share for the same period in 2005.

Earnings per share for the three and twelve months ended December 31, 2005 and 2004 have been adjusted to reflect 1.3 for one stock splits in the form of 30% stock dividends effected on July 5, 2006 and February 26, 2005.

The Company had a return on average assets of 1.13% and a return on average equity of 11.63% for the year of 2006, as compared to returns on average assets and average equity of 1.24% and 12.25%, respectively, for the year of 2005 and 1.04% and 9.16% respectively, for the year of 2004.

The increase in net income for the twelve months ended December 31, 2006 as compared to the same period in 2005 can be attributed substantially to an increase of 13% in net interest income, resulting from an increase of 17% in average earning assets and a decline in the net interest margin of 18 basis points. Since June 2004, the Federal Reserve Bank increased the federal funds target rate by 425 basis points to 5.25% in seventeen interest rate increases of 25 basis points each. Through the year ended December 2005, the impact of these interest rate increases was to contribute to gains in the Company s net interest margin as the higher interest rates impacted asset yields more than the higher interest rates impacted funding costs. For the twelve months ended December 31, 2006, the Company has experienced a decline in its net interest margin as the funding mix has shifted to more interest bearing deposits and borrowed funds and as the costs of those funds increased. For the twelve months ended December 31, 2006, average interest bearing liabilities funding average earning assets increased to 73% as compared to 70% for the twelve months of 2005. Additionally, while the average rate on earning assets for the twelve month period ended December 31, 2006 as compared to 2005 has risen by 108 basis points from 6.38% to 7.46%, the cost of interest bearing liabilities has increased by 164 basis points from 1.98% to 3.62%, resulting in a decline in the net interest spread from 4.40% for the twelve months ended December 31, 2005 to 3.84% for the twelve months ended December 31, 2006. The 18 basis point decline in the net interest margin during the same period has been less than the decline in the net interest spread as the Company continues to benefit from a significant amount of average noninterest bearing funding sources. For the twelve months ended December 31, 2006, average noninterest sources funding earning assets was $183 million as compared to $170 million for the same period in 2005. The combination of higher levels of market interest rates and the increase in noninterest funding sources has resulted in an increase in the value of noninterest sources funding earning assets from 59 basis points for the twelve months in 2005 to 98 basis points for the twelve months ended December 31, 2006.

As a result of competitive pressures, rates paid on deposits, which have been increasing to meet funding needs, may continue to have increases in future periods, which may not be offset by further increases in interest rates on earning assets. As a result of such potential margin compression, the Company s earnings could be adversely impacted.

Loans, which generally have higher yields than securities and other earning assets, increased to 85% of average earning assets in the year 2006 from 83% of average earning assets for the year of 2005. Investment securities for the year of 2005 accounted for 12% of average earning assets as compared to 11% for the year of 2006. This decline in the proportion of average investment securities to average earning assets was directly related to average loan growth for the year 2006 exceeding the growth of average deposits and other funding sources.

The provision for credit losses was $1.7 million for the year of 2006 as compared to $1.8 million for the same period in 2005. This decline was largely attributable to a lesser amount of loan growth in the loan portfolio in 2006 as compared to 2005, offset by specific reserves being provided on a significant problem commercial loan relationship identified in August 2006. As discussed in the section on Allowance for Credit Losses, the Company had $357 thousand of net charge-offs in the year of 2006. This compared to net charge-offs of $98 thousand for the year of 2005. At December 31, 2006, the allowance for credit losses was $7.4 million or 1.18% of total loans, as compared to $6.0 million or 1.09% of total loans at December 31, 2005. The provision for credit losses was $327 thousand for the three months ended December 31, 2006 as compared to $532 thousand for the same period in 2005, the decrease being attributable to a lesser amount of loan growth in the fourth quarter of 2006 as compared to 2005. For the fourth quarter of 2006, the Company had no net charge-offs or recoveries as compared to net charge-offs of $45 thousand for the same period in 2005.

Total noninterest income was $3.8 million for the year 2006 as compared to $4.0 million for 2005, a 4% decline. These amounts include net investment gains of $124 thousand for the year of 2006 and $279 thousand in 2005. Excluding gains on the sale of investment securities, noninterest income was $3.7 million in both 2006 and 2005. This result was due primarily to increased revenue on deposit service charges being effectively offset by lesser amounts of gains on the sale of SBA loans and SBA service fees. For the three months ended December 31, 2006, total noninterest income was $945 thousand as compared to $833 thousand for the same period in 2005. These amounts include net investment gains of $39 thousand for the three months ended December 31, 2006 as compared to net investment losses of

$2 thousand for the same quarter in 2005. Excluding gains on the sale of investment securities, noninterest income increased to $906 thousand for the fourth quarter of 2006, versus $835 thousand for the fourth quarter of 2005.

Noninterest expenses increased from $19.0 million for the year of 2005 to $21.8 million for the year of 2006, an increase of 15%. The increase was attributable primarily to increases in personnel and related benefit cost increases, the cost of share based compensation under new accounting rules effective January 1, 2006 ($345 thousand pre-tax), increased premises and equipment expenses, due in part to a new banking office and the relocation of another banking office, and to higher marketing and advertising costs, outside data processing costs and professional fees associated with a larger organization. For the year 2006, the efficiency ratio, which measures the ratio of noninterest expenses to the sum of net interest income and noninterest income (total revenue) was 60.15% as compared to 57.95% for the year of 2005. For the three months ended December 31, 2006, total noninterest expenses were $5.7 million, as compared to $4.9 million for the same period in 2005, an increase of 18%. This increase was due substantially to the same factors mentioned above which affected the increase for the full year 2006 over 2005.

The combination of increases in net interest income attributed to increases in the average volume of earning assets offset partially by a decline in the net interest margin, similar amounts of total noninterest income, lesser amounts of provision for credit losses due to lesser growth, and increases in noninterest expenses, resulted in an improvement in net income for the year of 2006 versus 2005 of 6% and for the three months ended December 31, 2006 versus 2005 of 4%.

Net Interest Income and Net Interest Margin

Net interest income is the difference between interest income on earning assets and the cost of funds supporting those assets. Earning assets are composed primarily of loans and investment securities. The cost of funds represents interest expense on deposits, customer repurchase agreements and other borrowings, which comprise federal funds purchased and advances from the Federal Home Loan Bank of Atlanta (FHLBA). Noninterest bearing deposits and capital are other components representing funding sources. Changes in the volume and mix of assets and funding sources, along with the changes in yields earned and rates paid, determine changes in net interest income. Net interest income in 2006 was $32.4 million compared to $28.7 million in 2005 and $19.9 million in 2004.

The following table labeled Average Balances, Interest Yields and Rates and Net Interest Margin presents the average balances and rates of the various categories of the Company s assets and liabilities. Included in the table is a measurement of interest rate spread and margin. Interest spread is the difference (expressed as a percentage) between the interest rate earned on earning assets less the interest rate paid on interest bearing liabilities. While net interest spread provides a quick comparison of earnings rates versus cost of funds, management believes that the net interest margin provides a better measurement of performance, since the net interest margin includes the effect of noninterest bearing sources in its calculation, which are significant factors in the Company s financial performance. The net interest margin is net interest income (annualized) expressed as a percentage of average earning assets.

Average Balances, Interest Yields and Rates and Net Interest Margin

	Year Ended December 31, 2006			2005			2004		
	Average Balance (dollars in thousands)	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate
ASSETS:									
Interest earning assets:									
Interest bearing deposits with other banks and other short-term investments	$ 3,379	$ 212	6.27 %	$ 12,168	$ 417	3.43 %	$ 6,432	$ 152	2.36 %
Loans(1)(2)	575,854	45,814	7.96 %	479,311	33,478	6.98 %	353,537	21,393	6.05 %
Investment securities available for sale	75,181	3,277	4.36 %	71,438	2,424	3.39 %	70,720	2,195	3.10 %
Federal funds sold	20,271	1,015	5.01 %	12,281	407	3.31 %	25,290	455	1.80 %
Total interest earning assets	674,685	50,318	7.46 %	575,198	36,726	6.38 %	455,979	24,195	5.31 %
Noninterest earning assets	44,090			40,073			35,810		
Less: allowance for credit losses	6,478			5,026			3,936		
Total noninterest earning assets	37,612			35,047			31,874		
TOTAL ASSETS	$ 712,297			$ 610,245			$ 487,853		
LIABILITIES AND STOCKHOLDERS EQUITY									
Interest bearing liabilities:									
Interest bearing transaction	$ 58,675	$ 204	0.35 %	$ 61,230	$ 122	0.20 %	$ 50,599	$ 72	0.14 %
Savings and money market	152,162	5,174	3.40 %	138,844	2,504	1.80 %	121,477	1,185	0.98 %
Time deposits	229,719	10,225	4.45 %	171,827	4,837	2.82 %	122,864	2,498	2.03 %
Total interest bearing deposits	440,556	15,603	3.54 %	371,901	7,463	2.01 %	294,940	3,755	1.27 %
Customer repurchase agreements and federal funds purchased	32,968	1,199	3.64 %	29,341	350	1.19 %	20,258	105	0.52 %
Other short-term borrowings	12,596	639	5.07 %	3,964	195	4.92 %	5,271	171	3.24 %
Long term borrowings	7,888	439	5.57 %				7,210	297	4.12 %
Total interest bearing liabilities	494,008	17,880	3.62 %	405,206	8,008	1.98 %	327,679	4,328	1.32 %
Noninterest bearing liabilities:									
Noninterest bearing demand	145,065			140,515			102,848		
Other liabilities	4,251			2,961			1,819		
Total noninterest bearing liabilities	149,316			143,476			104,667		
Stockholders equity	68,973			61,563			55,507		
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 712,297			$ 610,245			$ 487,853		
Net interest income		$ 32,438			$ 28,718			$ 19,867	
Net interest spread			3.84 %			4.40 %			3.99 %
Net interest margin			4.81 %			4.99 %			4.35 %

(1) Includes loans held for sale.

(2) Loans placed on nonaccrual status are included in average balances. Net loan fees and late charges in interest income on loans totaled $2 million, $1.2 million and $595 thousand for 2006, 2005, and 2004 respectively.

The rate/volume table below presents the composition of the change in net interest income for the periods indicated, as allocated between the change in net interest income due to changes in the volume of average earning assets and interest bearing liabilities, and the changes in net interest income due to changes in interest rates. As the table shows, the increase in net interest income in 2006 as compared to 2005 is due to growth in the volume of earning assets and a decrease in the margin earned on earning assets. For 2005 over 2004, the increase in net interest income was a function of both increased volume of earning assets and increases in the net interest margin.

Rate/Volume Analysis of Net Interest Income

	2006 compared with 2005			2005 compared with 2004		
	Change Due to Volume	Change Due to Rate	Total Increase (Decrease)	Change Due to Volume	Change Due to Rate	Total Increase (Decrease)
	(dollars in thousands)					
Interest earned on:						
Loans	$ 6,743	$ 5,593	$ 12,336	$ 7,611	$ 4,474	$ 12,085
Investment securities	127	726	853	22	207	229
Interest bearing bank deposits	(301)	96	(205)	136	129	265
Federal funds sold	265	343	608	(234)	186	(48)
Total interest income	6,834	6,758	13,592	7,535	4,996	12,531
Interest paid on:						
Interest bearing transaction	(5)	87	82	15	35	50
Savings and money market	240	2,430	2,670	169	1,150	1,319
Time	1,630	3,758	5,388	995	1,344	2,339
Customer repurchase agreements	43	806	849	47	198	245
Other borrowings	864	19	883	(339)	66	(273)
Total interest expense	2,772	7,100	9,872	887	2,793	3,680
Net interest income	$ 4,062	$ (342)	$ 3,720	$ 6,648	$ 2,203	$ 8,851

Provision for Credit Losses

The provision for credit losses represents the amount of expense charged to earnings to fund the allowance for credit losses. The amount of the allowance for credit losses is based on many factors which reflect management s assessment of the risk in the loan portfolio. Those factors include economic conditions and trends, the value and adequacy of collateral, volume and mix of the portfolio, performance of the portfolio, and internal loan processes of the Company and Bank.

During the year of 2006, a provision for credit losses was made in the amount of $1.7 million and the allowance for credit losses increased $1.4 million, including the impact of net charge-offs of $357 thousand during the period. The provision for credit losses of $1.7 million for the year 2006 compared to a provision for credit losses of $1.8 million for the year 2005 and $675 thousand for the year 2004. The lower provision in 2006 is attributable primarily to three factors: a lower amount of net loan growth in 2006 as compared to 2005 offset in part by a specific loan provision in the third quarter of 2006 associated with a large commercial lending relationship, and a slight change in the mix of the loan portfolio toward more real estate commercial and construction credits during the year (70% versus 68%). For the three months ended December 31, 2006, a provision for credit losses was made in the amount of $327 thousand, as compared to $532 thousand for the same period in 2005, the lower provision being due to lesser growth in the portfolio in the three months ended December 31, 2006 as compared to the same period in 2005, and to accommodate a higher level of net-charge offs in the fourth quarter of 2005. For the fourth quarter of 2005, net charge-offs amounted to $45 thousand as compared to no net charge-offs for the same period in 2006.

The provision for credit losses was $1.8 million in 2005 compared to $675 thousand in 2004. The higher provision for 2005, was due substantially to a 32% growth rate in the loan portfolio during the year.

The maintenance of a high quality loan portfolio, with an adequate allowance for credit losses will continue to be a primary objective of the Company.

Non-Interest Income

Noninterest income consists of deposit account service charges, gains on the sale of SBA and residential mortgage loans, investment gains and losses, other noninterest loan fees, income from bank owned life insurance (BOLI) and other service fees. For the year ended December 31, 2006, noninterest income was $3.8 million. This compared to $4.0 million of noninterest income for the year ended December 31, 2005 and $3.8 million for the year ended December 31, 2004.

The Company is an active originator of SBA loans and its current practice is to sell the insured portion of those loans at a premium. Income from this source was $813 thousand for the year ended December 31, 2006 compared to $933 thousand and $648 thousand for the years ended December 31, 2005 and 2004, respectively, as the Company continues to emphasize this lending activity. The decline in income in 2006 as compared to 2005 was due substantially to more competitive sales pricing while the increase in 2005 over 2004 primarily reflected an increased volume of loans sold. The Company also originates residential mortgage loans on a pre-sold basis, servicing released. Sales of these mortgage loans yielded gains of $301 thousand in 2006 compared to $312 thousand in 2005 and $304 thousand in 2004.

Net investment gains amounted to $124 thousand for 2006 as compared to $279 thousand for 2005 and $453 thousand for 2004. The Company sells securities in response to asset/liability management objectives.

Income for the year 2006 amounted to $1.4 million from deposit account service charges and $406 thousand from BOLI, versus $1.2 million from deposit account service charges and $401 thousand from BOLI for the year ended December 31, 2005 and $1.3 million from deposit account service charges and $385 thousand from BOLI for the year ended December 31, 2004. The increase in deposit service charges in 2006 over 2005 was due to additional volume and modifications of earnings credit rates. The decline in deposit service charges in 2005 versus 2004 was primarily related to a decline in overdraft fees but was also attributed to lower commercial deposit account service fees as the 2005 level of interest rates increased the earnings credit to commercial bank clients during the year 2005 as compared to 2004.

Other noninterest income which comprises other service charges, SBA service fees, title and settlement fees, and loan prepayment and commitment fees, amounted to $816 thousand for the year of 2006, $920 thousand for the year of 2005, and $708 thousand for the year of 2004, the decrease in 2006 as compared to 2005 due in part to lower amounts of commitment and prepayment fees.

Noninterest income was $945 thousand for the three months ended December 31, 2006 as compared to $833 thousand for the three months ended December 31, 2005 an increase of 13%. These amounts include a net investment gain of $39 thousand for the three months ended December 31, 2006 and a net investment loss of $2 thousand for the three months ended December 31, 2005. Excluding gains on the sale of investment securities, noninterest income was $906 thousand for the fourth quarter of 2006, versus $835 thousand for the fourth quarter of 2005, an increase of 9%, resulting primarily from an increase in deposit service fees for reasons discussed above relating to the year 2006 as compared to 2005.

Non-Interest Expense

Noninterest expense was $21.8 million for 2006, an increase of 15% as compared to $19.0 million for 2005 and $15.0 million for 2004.

Salaries and benefits were $12.2 million for the year of 2006, a 16% increase as compared to $10.5 million for 2005, and $8.2 million for 2004. This increase in 2006 over 2005 was due to additions to staff and related benefit costs, the cost of share based compensation under new accounting rules effective January 1, 2006 ($345 thousand pre-tax), partially offset by lower amounts of incentive based compensation. At December 31, 2006, the Bank had 171 full time equivalent employees as compared to 145 at December 31, 2005 and 119 at December 31, 2004.

Premises and equipment expenses amounted to $3.8 million for the year of 2006 versus $3.5 million for 2005. This increase of 11% was due primarily to a new banking office opened in May 2006, to the relocation of another office, and to ongoing operating expense increases associated with the Company s facilities, all of which are leased, and increased equipment costs. Premises and equipment expense was $2.7 million for 2004.

Marketing and advertising costs increased from $473 thousand in 2005 to $587 thousand in 2006, an increase of 24%. This increase was associated primarily with increased advertising for deposit products and to special marketing efforts, including sponsorships, customer appreciation events and amounts expended to enhance the Bank s web-site. Marketing and advertising cost was $280 thousand in 2004.

Outside data processing costs were $881 thousand for 2006, as compared to $769 thousand in 2005, or an increase of 14%. The higher costs were due primarily to added system capabilities and to higher processing volumes. Outside data processing costs were $652 thousand for 2004.

Legal and consulting expenses were $448 thousand for 2006 as compared to $674 thousand in 2005 and $434 thousand in 2004. The lower cost in 2006 as compared to 2005 related to a significant consulting arrangement in 2005 related to a companywide initiative on relationship management and attendant systems.

Other expenses, increased to $3.8 million in 2006 from $3.1 million for 2005. The major components of costs in this category include ATM expenses, telephone, courier, printing, business development, office supplies, charitable contributions, and dues. Other expenses were $2.7 million for 2004.

Noninterest expenses were $5.7 million for the three months ended December 31, 2006 compared to $4.9 million for the three months ended December 31, 2005, an increase of 18%. The same factors which contributed to increased noninterest expense for the year of 2006 over 2005 mentioned above also contributed substantially to the increase in noninterest expenses for the three months ended December 31, 2006, as compared to the same period in 2005.

Commencing in 2007, the Bank will be required to pay, along with all other depository institutions insured by the FDIC, deposit insurance premiums. The Bank has never paid deposit insurance premiums before. The premium is expected to be in the range of 5-7 basis points on the Bank s assessable deposit base. While the Bank may seek to adjust interest rates paid on deposits to reflect the payment of premiums, competitive pressures may limit its ability to do so. Institutions which are older and larger than the Bank may have substantial premium credits which may temporarily offset all or part of those institutions premium payments, which may enable them to more aggressively price deposits. If the Bank is unable to price the deposit premium into deposit rates, the payment of premiums is likely to have an adverse affect on earnings.

Income Tax Expense

The Company recorded income tax expense of $4.7 million in 2006 compared to $4.4 million in 2005, and $2.9 million in 2004, resulting in an effective tax rate of 36.9%, 36.7% and 36.3% respectively.

BALANCE SHEET ANALYSIS

Overview

At December 31, 2006, the Company s total assets were $773.5 million, loans were $625.8 million, deposits were $628.5 million and stockholders equity was $72.9 million. As compared to December 31, 2005, assets grew in 2006 by $101.2 million (15%), loans by $76.6 million (14%), deposits by $59.6 million (10%) and stockholders equity by $8.0 million (12%).

The Company declared cash dividends of $0.23 per share for the year 2006 and $0.22 per share for the year 2005.

Securities

The investment securities portfolio is comprised primarily of U.S. Agency debt securities (64%) with final maturities to seven years and an average life of 3.1 years. This portfolio includes $4.3 million of structured notes. The remaining debt securities portfolio consists primarily of seasoned mortgage pass-through securities which have average expected lives of 3.4 years with contractual maturities of the underlying mortgages of up to thirty years. The remaining securities portfolio consists of equity investments, some of which are required by regulatory mandates (Federal Reserve and Federal Home Loan Bank stocks) and the remaining equities of a few community based banking companies.

At December 31, 2006, the investment portfolio amounted to $91.1 million as compared to a balance of $68.1 million at December 31, 2005, an increase of 34%. The investment portfolio is managed to achieve goals related to income, liquidity, interest rate risk management and providing collateral for customer repurchase agreements and other borrowing relationships.

The Company also has a portfolio of short-term investments utilized for asset liability management needs which consists of discount notes, money market investments, other bank certificates of deposit and similar instruments. This portfolio amounted to $4.9 million at December 31, 2006 as compared to $11.2 million at December 31, 2005.

The third element of the Company s securities portfolio is federal funds sold which amounted to $9.7 million at December 31, 2006 as compared to $6.1 million at December 31, 2005. These funds represent excess daily liquidity which is invested on an unsecured basis with well capitalized banks, in amounts generally limited both in the aggregate and to any one bank.

The tables below and Note 3 to the Consolidated Financial Statements provide additional information regarding the Company s investment securities. The Company classifies all its investment securities as available-for-sale (AFS). This classification requires that investment securities be recorded at their fair value with any difference between the fair value and amortized cost (the purchase price adjusted by any accretion or amortization) reported as a component of stockholders equity (accumulated other comprehensive income), net of deferred income taxes. At December 31, 2006, the Company had a net unrealized loss in AFS securities of $420 thousand as compared to a net unrealized loss in AFS securities of $1.0 million at December 31, 2005. The deferred income tax benefit of these unrealized gains and losses was $167 thousand and $390 thousand, respectively.

The following table provides information regarding the composition of the Company s investment securities portfolio at the dates indicated. Amounts are reported at estimated fair value.

	December 31, 2006		**2005**		**2004**	
	Balance	**Percent of Total**	**Balance**	**Percent of Total**	**Balance**	**Percent of Total**
	(dollars in thousands)					
U. S. Government agency securities	$ 58,584	64.3 %	$ 46,998	69.1 %	$ 34,184	53.3 %
Mortgage backed securities	27,333	30.0 %	17,240	25.3 %	23,066	36.0 %
Federal Reserve and Federal Home Loan Bank stock	3,829	4.2 %	2,230	3.3 %	1,956	3.1 %
Other equity investments	1,394	1.5 %	1,582	2.3 %	4,892	7.6 %
	$ 91,140	100 %	$ 68,050	100 %	$ 64,098	100 %

The following table provides information, on an amortized cost basis, regarding the contractual maturity and weighted average yield of the investment portfolio at December 31, 2006. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

At December 31, 2006, there were no issuers, other than the U.S. Government and its agencies, whose securities owned by the Company had a book or fair value exceeding ten percent of the Company s stockholders equity.

	One Year or Less		After One Year Through Five Years		After Five Years Through Ten Years		After Ten Years		Total	
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield
	(dollars in thousands)									
U. S. Government agency securities	$ 6,305	4.83 %	$ 33,484	4.82 %	$ 19,014	5.29 %	$ 0		$ 58,803	4.97 %
Mortgage backed securities			6,263	3.91 %	4,981	4.33 %	16,406	5.16 %	27,650	4.72 %
Federal Reserve and Federal Home Loan Bank stock							3,829	5.84 %	3,829	5.84 %
Other equity investments							1,278	5.52 %	1,278	5.52 %
	$ 6,305	4.83 %	$ 39,747	4.68 %	$ 23,995	5.09 %	$ 21,513	3.94 %	$ 91,560	4.62 %

Loan Portfolio

In its lending activities, the Company seeks to develop sound relationships with clients whose businesses and individual banking needs will grow with the Bank. There has been a significant effort to grow the loan portfolio and to be responsive to the lending needs in the markets served, while maintaining sound asset quality.

Loan growth over the past year has been favorable, with loans outstanding reaching $625.8 million at December 31, 2006, an increase of $76.6 million or 14% as compared to $549.2 million at December 31, 2005, and were $415.5 million at December 31, 2004, an increase of $98.0 million or 31% in 2005 over 2004. For the fourth quarter of 2006, the loan portfolio increased $34.6 million over $591.2 million at September 30, 2006

The Bank is primarily business oriented and as can be seen in the chart below, has a large proportion of its loan portfolio related to real estate (70%) consisting of real estate-commercial, real estate-residential mortgage and construction-commercial and residential. Real estate also serves as collateral for loans made for other purposes, resulting in 79% of our loans being secured by real estate.

The following table shows the trends in the composition of the loan portfolio over the past five years.

	December 31, 2006		2005		2004		2003		2002	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
	(dollars in thousands)									
Commercial	$ 132,981	21 %	$ 118,928	22 %	$ 101,911	25 %	$ 93,112	29 %	$ 64,869	27 %
Real estate commercial(1)	349,044	56 %	284,667	52 %	189,708	47 %	142,819	45 %	111,262	47 %
Real estate residential mortgage	1,523		1,130		9,230	2 %	6,964	2 %	3,699	2 %
Construction commercial and residential	86,524	14 %	90,035	16 %	62,745	14 %	35,644	11 %	23,180	10 %
Home equity	50,572	8 %	50,776	9 %	49,632	11 %	34,092	11 %	30,631	13 %
Other consumer	5,129	1 %	3,676	1 %	2,283	1 %	4,902	2 %	3,219	1 %
Total loans	625,773	100 %	549,212	100 %	415,509	100 %	317,533	100 %	236,860	100 %
Less: Allowance for Credit Losses	(7,373)		(5,985)		(4,240)		(3,680)		(2,766)	
Net loans	$ 618,400		$ 543,227		$ 411,269		$ 313,853		$ 234,094	

(1) Includes loans for land acquisition and owner occupied properties.

As discussed under the caption Business and Risk Factors , the Company has directly made and expects to continue making higher risk loans that entail higher risks than loans made following normal underwriting practices (higher risk loan transactions). These higher risk loan transactions may also be made through the Company s newly formed subsidiary, Eagle Commercial Ventures (ECV), which was

formed in July 2006. The transactions are structured to provide the Company or ECV with returns commensurate to the risk through the requirement of additional interest following payoff of all loans:

- At December 31, 2006, the Company and the Bank have continuing additional interest rights in a higher risk loan transaction where the underlying loans are fully paid and substantial additional interest/revenue is currently expected in 2007 from the sale of remaining units. This residual revenue is considered additional interest under the loan agreements and will be recognized as noninterest revenue when realized. Such amounts may be material to 2007 net income.

- At December 31, 2006, ECV has a $2.0 million loan outstanding relating to a higher risk loan transaction on a real estate project located outside the Company s primary market area which is currently in a construction phase. The loan is expected to be outstanding throughout 2007, with sales completed in 2008.

Although the Company carefully underwrites each higher risk loan transaction and expects these transactions to provide additional revenues, there can be no assurance that any higher risk loan transaction, or the related loans made by the Bank, will prove profitable for the Company and Bank, that the Company and Bank will be able to receive any additional interest payments in respect of these loans, that any additional interest payments will be significant, or that the Company and Bank will not incur losses in respect of these transactions.

Loan Maturity

The following table sets forth the term to contractual maturity of the loan portfolio as of December 31, 2006.

	Due In				
	Total	**One Year or Less**	**Over One to Five Years**	**Over Five to Ten Years**	**Over Ten Years**
	(dollars in thousands)				
Commercial	$ 132,981	$ 51,821	$ 45,362	$ 28,228	$ 7,570
Real estate-commercial	349,044	52,596	100,541	175,946	19,961
Real estate-residential	1,523	514	1,009		
Construction	86,524	56,066	18,277	9,004	3,177
Home equity	50,572	326	459	418	49,369
Other consumer	5,129	1,578	2,410	168	973
Total loans	$ 625,773	$ 162,901	$ 168,058	$ 213,764	$ 81,050
Loans with:					
Predetermined fixed interest rate	$ 198,735	$ 14,220	$ 107,086	$ 65,930	$ 11,499
Floating interest rate	427,038	148,681	60,972	147,834	69,551
Total loans	$ 625,773	$ 162,901	$ 168,058	$ 213,764	$ 81,050

Loans are shown in the period based on final contractual maturity. Demand loans, having no contractual maturity and overdrafts, are reported as due in one year or less.

As noted above, a significant portion of the loan portfolio consists of commercial, construction and commercial real estate loans, primarily made in the Washington, D.C. metropolitan area and secured by real estate or other collateral in that market. Although these loans are made to a diversified pool of unrelated borrowers across numerous businesses, adverse developments in the Washington D.C. metropolitan real estate market could have an adverse impact on this portfolio of loans and the Company s income and financial position. While our basic trading area is the Washington, D.C. metropolitan area, the Bank has made loans outside that market area where the nature and quality of such loans was consistent with the Bank s lending policies.

At December 31, 2006, the Company had no other concentrations of loans in any one industry exceeding 10% of its total loan portfolio. An industry for this purpose is defined as a group of counterparties that are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

Allowance for Credit Losses

Management has developed a comprehensive review process to monitor the adequacy of the allowance for credit losses. The review process and guidelines were developed utilizing guidance from federal banking regulatory agencies. The results of this review process, in combination with conclusions of the Bank s outside loan review consultant, support management s view as to the adequacy of the allowance as of the balance sheet date. During 2006, a provision for credit losses was made in the amount of $1.7 million before net charge-offs of $357 thousand. A full discussion of the accounting for allowance for credit losses is contained in Note 1 to the Consolidated Financial Statements; activity in the allowance for credit losses is contained in Note 4 to the Consolidated Financial Statements. Also, please refer to the discussion under the caption, Critical Accounting Policies within Management s Discussion and Analysis of Financial Condition and Results of Operation for further discussion of the methodology which management employs to maintain an adequate allowance for credit losses, and the discussion under the caption Provision for Credit Losses .

The allowance for loan losses represented 1.19% of total loans at December 31, 2006 as compared to 1.09% at December 31, 2005. This increase in the ratio of the allowance was due to two factors as follows: additional reserves provided in the third quarter of 2006 for a large problem commercial loan relationship identified in August 2006 and to a slight increase in the environmental factors of the non-specific reserve component related to various factors including potential impacts of higher interest rates on debt service capacity and on real estate values.

At December 31, 2006, the Company had $2.0 million of loans classified as nonperforming, and $4.3 million of potential problem loans, as compared to $491 thousand of nonperforming assets and $2.9 million of potential problem loans at December 31, 2005. Please refer to Note 1 to the Consolidated Financial Statements under the caption Loans for a discussion of the Company s policy regarding impairment of loans. Please refer to Nonperforming Assets below for a discussion of problem and potential problem assets.

As the loan portfolio and allowance for credit losses review process continues to evolve, there may be changes to elements of the allowance and this may have an effect on the overall level of the allowance maintained. To date, the Bank has enjoyed a high quality loan portfolio with relatively low levels of net charge-offs and low delinquency rates. The maintenance of a high quality portfolio will continue to be a high priority for both management and the Board of Directors.

Management, being aware of the significant loan growth experienced by the Company and the problems which could develop in an unmonitored environment, is intent on maintaining a strong credit review system and risk rating process. The Company established a Credit Department in 2003 to provide independent analysis of credit requests and to manage problem credits. The Credit Department has developed and implemented additional analytical procedures for evaluating credit requests, has further refined the Company s risk rating system, and has adopted enhanced monitoring of the portfolio. The loan portfolio analysis process is ongoing and proactive in order to maintain a portfolio of quality credits and to quickly identify any weaknesses before they become more severe.

The following table sets forth activity in the allowance for credit losses for the past five years.

	Year Ended December 31, 2006	2005	2004	2003	2002
	(dollars in thousands)				
Balance at beginning of year	$ 5,985	$ 4,240	$ 3,680	$ 2,766	$ 2,111
Charge-offs:					
Commercial	(369)	(122)	(257)	(319)	(192)
Home equity	(15)				
Other consumer	(5)	(17)	(35)	(14)	(40)
Total charge-offs	(389)	(139)	(292)	(333)	(232)
Recoveries:					
Commercial	27	41	175	68	26
Other consumer	5		2	4	18
Total recoveries	32	41	177	72	44
Net charge-offs	(357)	(98)	(115)	(261)	(188)
Additions charged to operations	1,745	1,843	675	1,175	843
Balance at end of year	$ 7,373	$ 5,985	$ 4,240	$ 3,680	$ 2,766
Ratio of net charge-offs during the year to average loans outstanding during the year	0.06 %	0.02 %	0.03 %	0.10 %	0.09 %

The following table presents the allocation of the allowance by loan category and the percent of loans each category bears to total loans. The allocation of the allowance for the Commercial category includes a specific reserve of $678 thousand against impaired loans relating to a single relationship which was identified as impaired during the third quarter of 2006. The allocation of the allowance to each category is not necessarily indicative of future losses or charge-offs and does not restrict the usage of the allowance for any specific loan or category.

	Year Ended December 31, 2006		2005		2004		2003		2002	
	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans
	(dollars in thousands)									
Commercial	$ 3,379	21 %	$ 2,594	22 %	$ 1,963	25 %	$ 1,689	29 %	$ 1,134	27 %
Real estate commercial	2,800	56 %	2,395	52 %	1,426	47 %	850	45 %	835	47 %
Real estate residential mortgage	40		48		105	2 %	38	2 %	27	2 %
Construction commercial and residential	854	14 %	602	16 %	431	14 %	613	11 %	231	10 %
Home equity	176	8 %	176	9 %	223	11 %	171	11 %	253	13 %
Other consumer	124	1 %	84	1 %	58	1 %	72	2 %	83	1 %
Unallocated			86		34		247		203	
Total Loans	$ 7,373	100 %	$ 5,985	100 %	$ 4,240	100 %	$ 3,680	100 %	$ 2,766	100 %

Nonperforming Assets

The Company s nonperforming assets, which are comprised of loans delinquent 90 days or more, nonaccrual loans, restructured loans and other real estate owned, totaled $2.0 million at December 31, 2006 compared to $491 thousand at December 31, 2005. The percentage of nonperforming assets to total assets was 0.26% at December 31, 2006 compared to 0.07% at December 31, 2005.

The following table shows the amounts of nonperforming assets at December 31 for the past five years:

	2006	2005	2004	2003	2002
	(dollars in thousands)				
Nonaccrual Loans:					
Commercial	$ 1,976	$ 362	$ 156	$ 554	$ 147
Consumer		129		100	
Real estate					
Accrual loans-past due 90 days:					
Commercial	37				818
Consumer					
Real estate					
Restructured loans					
Real estate owned					
Total non-performing assets	$ 2,013	$ 491	$ 156	$ 654	$ 965

Non-accrual loans at December 31, 2006 consisted primarily of one large commercial relationship amounting to $1.9 million which has been assigned a specific reserve of $678 thousand as mentioned above.

Significant variation in the amount of nonperforming loans may occur from period to period because the amount of nonperforming loans depends largely on the condition of a small number of individual credits and borrowers relative to the total loan portfolio. The Company had no Other Real Estate Owned (OREO) or restructured loans at either December 31, 2006 or 2005. The balance of impaired loans was $2.0 million (which includes the $1.9 million commercial loan relationship identified above) at December 31, 2006, compared to $491 thousand of impaired loans at December 31, 2005 with specific reserves of $200 thousand.

At December 31, 2006, there were $4.3 million of performing loans considered potential problem loans, defined as loans which are not included in the 90 day past due, nonaccrual or restructured categories, but for which known information about possible credit problems causes management to be uncertain as to the ability of the borrowers to comply with the present loan repayment terms which may in the future result in disclosure in the past due, non-accrual or restructured loan categories.

Other Earning Assets

Residential mortgage loans held for sale decreased to $2.2 million at December 31, 2006 from $2.9 million at December 31, 2005. In spite of lower revenue, origination and sales of these loans during 2006 was emphasized by the Company in order to enhance non-interest income, which emphasis is expected to continue in 2007.

Bank owned life insurance is utilized by the Company in accordance with tax regulations as part of the Company s financing of its benefit programs. At December 31, 2006 this asset amounted to $11.5 million as compared to $11.1 million at December 31, 2005, which reflected an increase in cash surrender values, and not new investments.

Intangible Assets

In 2005, the Company began recognizing a servicing asset for the computed value of servicing fees on the sale of the guaranteed portion of SBA loans, which is in excess of a normal servicing fee. Assumptions related to loan term and amortization are made to arrive at the initial recorded value, which is included in other assets.

For 2006, excess servicing fees of $167 thousand were recorded, and $80 thousand was amortized as a reduction of actual service fees collected, which is a component of other income. At December 31, 2006, the balance of excess servicing fees was $255 thousand. For 2005, excess servicing fees of $187 thousand were recorded, of which $19 thousand was amortized as a reduction of actual service fees collected, which is a component of other income. At December 31, 2005, the balance of excess servicing fees was $168 thousand.

Prior to 2005, this asset was deemed to be not material. This asset is subject to impairment testing annually.

Deposits and Other Borrowings

The principal sources of funds for the Bank are core deposits, consisting of noninterest bearing demand, interest bearing transaction, money market and savings accounts and time deposits from the local market areas surrounding the Bank s offices. The deposit base includes transaction accounts, time and savings accounts and accounts which customers use for cash management and which provide the Bank with a source of fee income and cross-marketing opportunities as well as an attractive source of lower cost funds. Time and savings accounts, including money market deposit accounts, also provide a relatively stable and low-cost source of funding.

For the year ending December 31, 2006 deposits grew $59.6 million, from $568.9 million to $628.5 million or 10%. Approximately 42% of the Bank s deposits at December 31, 2006 are made up of time deposits, which are generally the most expensive form of deposit because of their fixed rate and term as compared to 33% at December 31, 2005. These deposits had significant increases in the year ended December 31, 2006 as the Bank utilized these funding sources due to lesser growth in core non-interest and money market deposit accounts. Time deposits in denominations of $100 thousand or more can be more volatile and more expensive than time deposits of less than $100 thousand. However, because the Bank focuses on relationship banking, and its marketplace demographics are favorable, its historical experience has been that large time deposits have not been more volatile or significantly more expensive than smaller denomination certificates. It has been the practice of the Bank to pay posted rates on its time deposits whether under or over $100 thousand. From time to time, when appropriate in order to fund strong loan demand, the Bank accepts time deposits, generally in denominations of less than $100 thousand from bank and credit union subscribers to a wholesale deposit rate line and may also accept brokered deposits. Wholesale deposits amounted to approximately $18 million or 3% of total deposits at December 31, 2006, as compared to approximately $11 million or 2% of total deposits at December 31, 2005. Through September 30, 2006, the Bank reduced its wholesale deposits; however in the fourth quarter of 2006, additional wholesale funds were raised to support loan funding needs.

At December 31, 2006, the Company had approximately $140.0 million in noninterest bearing demand deposits, representing 22% of total deposits. This compared to approximately $165.1 million of these deposits at December 31, 2005 or 29% of total deposits. A significant factor in this decline during 2006 was due to a decline in escrow type accounts due to a slowdown in real estate related activities during 2006. These deposits are primarily business checking accounts on which the payment of interest is prohibited by regulations of the Federal Reserve. Proposed legislation has been introduced in each of the last several sessions of Congress which would permit banks to pay interest on checking and demand deposit accounts established by businesses. If legislation effectively permitting the payment of interest on business demand deposits is enacted, of which there can be no assurance, it is likely that we may be required to pay interest on some portion of our noninterest bearing deposits in order to compete with other banks. Payment of interest on these deposits could have a significant negative impact on our net interest income and net interest margin, net income, and the return on assets and equity.

As an enhancement to the basic noninterest bearing demand deposit account, the Company offers a sweep account, or customer repurchase agreement , allowing qualifying businesses to earn interest on short-term excess funds which are not suited for either a certificate of deposit or a money market account. The balances in these accounts were $38 million at December 31, 2006 compared to $32 million at December 31, 2005. Customer repurchase agreements are not deposits and are not insured but are collateralized by U.S. government agency securities. These accounts are particularly suitable to businesses with significant fluctuation in the levels of cash flows. Attorney and title company escrow accounts are an example of accounts which can benefit from this product, as are customers who may require collateral for deposits in excess of $100 thousand but do not qualify for other pledging arrangements. This program requires the Company to maintain a sufficient investment securities level to accommodate the fluctuations in balances which may occur in these accounts.

At December 31, 2006 and December 31, 2005, the Company had no outstanding balances under its lines of credit provided by correspondent banks. The Bank had $30 million borrowings outstanding under its credit facility from the Federal Home Loan Bank of Atlanta, as compared to no outstandings at December 31, 2005. Outstanding advances are secured by collateral consisting of a blanket lien on qualifying loans in the Bank s commercial mortgage loan portfolio. Please refer to Note 7 to the Consolidated Financial Statements for additional information regarding the Company s short-term borrowings.

CONTRACTUAL OBLIGATIONS

The Company has various financial obligations, including contractual obligations and commitments that may require future cash payments. Except for its loan commitments, as shown in Note 13 to the Consolidated Financial Statements Financial Instruments with Off-Balance Sheet Risk, the following table shows details on these fixed and determinable obligations in the time period indicated.

	Within One Year (dollars in thousands)	**One to Three Years**	**Three to Five Years**	**Over Five Years**	**Total**
Deposits without a stated maturity(1)	$ 366,291	$	$	$	$ 366,291
Time deposits(1)	253,943	6,699	1,582		262,224
Borrowed funds	46,064	22,000			68,064
Operating lease obligations(2)	2,228	4,710	4,659	7,639	19,236
Leasehold improvements & equipment purchases(3)	469				469
Outside data processing(4)	1,130	1,160	300		2,590
Total	$ 670,125	$ 34,569	$ 6,541	$ 7,639	$ 718,874

(1) Excludes accrued interest payable at December 31, 2006.

(2) In September 2006, the Bank signed a lease for approximately 7,400 square feet in a to be constructed office building adjacent to its headquarters building in Bethesda. The minimum lease commitment is approximately $3.0 million and is subject to various approvals and other conditions. The table amounts include this obligation.

(3) At December 31, 2006, the Company had commitments to vendors for leasehold improvements and equipment purchases associated with a new office lease. The estimated amount of these commitments was $469 thousand.

(4) The Bank has outstanding obligations under its current data processing contract that expires in September 2008. Based on the level of expenses in 2006, the remaining contractual obligation is estimated to be approximately $1.5 million at December 31, 2006. The Company is currently

negotiating contract revisions that will include changes to pricing and term. Other significant contracts relate to data communications and data software, amount to approximately $250 thousand annually and expire at various times through December 2012.

OFF BALANCE SHEET ARRANGEMENTS

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. They involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. See Note 13 to the Consolidated Financial Statements for a summary list of loan commitments at December 31, 2006 and 2005.

Loan commitments represent agreements to lend to a customer as long as there is no violation of any condition established in the contract and which have been accepted in writing by the borrower. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained is based on management s credit evaluation of the borrower. Collateral obtained varies, and may include certificates of deposit, accounts receivable, inventory, property and equipment, residential and commercial real estate.

Standby letters of credit are conditional commitments issued by the Company which guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Company deems necessary. At December 31, 2006, approximately 94% of the dollar amount of standby letters of credit was collateralized.

With the exception of these off-balance sheet arrangements, the Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company s financial condition, changes in financial condition, revenues or expenses, results of operations, capital expenditures or capital resources, that is material to investors.

LIQUIDITY MANAGEMENT

Liquidity is a measure of the Company and Bank s ability to meet loan demand and to satisfy depositor withdrawal requirements in an orderly manner. The Bank s primary sources of liquidity consist of cash and cash balances due from correspondent banks, loan repayments, federal funds sold and other short-term investments, maturities and sales of investment securities and income from operations. The Bank s investment portfolio of debt securities is held in an available-for-sale status, which allows it flexibility, subject to holdings held as collateral for customer repurchase agreements, to generate cash from sales as needed to meet ongoing loan demand. These sources of liquidity are considered primary and are supplemented by the ability of the Company and Bank to borrow funds, which are termed secondary sources. The Company maintains secondary sources of liquidity, which includes a $15 million line of credit with a correspondent bank, secured by the stock of the Bank, against which there were no amounts outstanding at December 31, 2006. Additionally, the Bank can purchase up to $62 million in federal funds on an unsecured basis and $5.5 million on a secured basis from its correspondents, against which there were no borrowings outstanding at December 31, 2006. At December 31, 2006, the Bank was also eligible to take advances from the FHLB up to $69 million based on collateral at the FHLB, of which it had $30 million of advances outstanding at December 31, 2006. Also, the Bank may enter into repurchase agreements as well as obtaining additional borrowing capabilities from the FHLB provided adequate collateral exists to secure these lending relationships.

The loss of deposits, through disintermediation, is one of the greater risks to liquidity. Disintermediation occurs most commonly when rates rise and depositors withdraw deposits seeking higher rates in alternative savings and investment sources than the Bank may offer. The Bank was founded under a philosophy of relationship banking and, therefore, believes that it has less of an exposure to disintermediation and resultant liquidity concerns than do many banks. There is, however, a risk that some deposits would be lost if rates were to increase and the Bank elected not to remain competitive with its deposit rates. Under those conditions, the Bank believes that it is well positioned to use other sources of funds such as FHLB borrowings, repurchase agreements and Bank lines of credit to offset a decline in deposits in the short run. Over the long-term, an adjustment in assets and change in business emphasis could compensate for a potential loss of deposits. The Bank also maintains a marketable investment portfolio to provide flexibility in the event of significant liquidity needs. The Bank Board s Asset Liability Board Committee has adopted policy guidelines which emphasize the importance of core deposits and their continued growth.

At December 31, 2006, under the Bank s liquidity formula, it had $219 million of primary and secondary liquidity sources, which was deemed adequate to meet current and projected funding needs.

INTEREST RATE RISK MANAGEMENT

Asset/Liability Management and Quantitative and Qualitative Disclosure about Market Risk

A fundamental risk in banking is exposure to market risk, or interest rate risk, since a bank s net income is largely dependent on net interest income. The Bank s Asset Liability Committee (ALCO) of the Board of Directors formulates and monitors the management of interest rate risk through policies and guidelines established by it and the full Board of Directors. In its consideration of risk limits, the ALCO considers the impact on earnings and capital, the level and direction of interest rates, liquidity, local economic conditions, outside threats and other factors. Banking is generally a business of managing the maturity and re-pricing mismatch inherent in its asset and liability cash flows and to provide net interest income growth consistent with the Company s profit objectives.

The Company, through its ALCO, monitors the interest rate environment in which it operates and adjusts the rates and maturities of its assets and liabilities to remain competitive and to achieve its overall financial objectives subject to established risk limits. In the current interest rate environment, the Company is managing its assets to be either variably priced or with relatively short maturities, so as to mitigate the risk to earnings and capital should interest rates increase from current levels. At the same time, the Bank seeks to acquire longer-term core deposits to lock in relatively lower cost funds. In the current market, due to competitive factors and customer preferences, the effort to attract longer-term fixed priced liabilities has not been as successful as the Company s best case asset liability mix would prefer. There can be no assurance that the Company will be able to successfully achieve its optimal asset liability mix, as a result of competitive pressures, customer preferences and the inability to perfectly forecast future interest rates.

One of the tools used by the Company to manage its interest rate risk is a static GAP analysis presented below. The Company also uses an earnings simulation model (simulation analysis) on a quarterly basis to monitor its interest rate sensitivity and risk and to model its balance sheet cash flows and its income statement effects in different interest rate scenarios. The model utilizes current balance sheet data and attributes and is adjusted for assumptions as to investment maturities (calls), loan prepayments, interest rates, the level of noninterest income and noninterest expense. The data is then subjected to a shock test , which assumes a simultaneous change in interest rates up 100 and 200 basis points or down 100 and 200 basis points, along the entire yield curve, but not below zero. The results are analyzed as to the impact on net interest income, and net income over the next twelve and twenty-four month periods and to the market value of equity impact. The Company s analysis at December 31, 2006 shows a modest negative effect on income over the next 12 months when interest rates are shocked up 100 and 200 basis points, and a slight positive impact on income if rates are shocked down 100 and 200 basis points due to the relatively balanced position between interest sensitive assets and liabilities over the next 90 days (-1%). Over the next 12 months, as denoted in the table below, the Company has an excess of rate sensitive liabilities over rate sensitive assets of 17%. During the year 2006, the Company has been taking actions to mitigate its exposure to lower interest rates for which probability was increasing throughout 2006. Currently, interest rate increases would likely increase the cost of funds more than the income on earning assets potentially resulting in net interest margin contraction. The Company concluded in mid 2005, based on market factors and its recent experience, that larger increases in its retail deposit rate assumptions would likely occur in a rising interest rate environment and modified its model assumptions to reflect more rate sensitivity within the core deposit base. In order to hedge somewhat the prospect that lower market interest rates might be negative to the Company s net interest income and market value as evidenced by the balance sheet shock analysis at March 31, 2006, the Company has lengthened the duration of its assets (both investments and loans) beginning in the second quarter of 2006. Additionally, changes in the deposit portfolio mix during 2006 toward more time deposits has had the effect of increasing the amount of rate sensitive deposits at December 31, 2006 as compared to December 31, 2005. Also, the Company made new variable rate FHLB advances in the second and fourth quarters of 2006 indexed to the prime lending rate, further increasing the amount of variable rate funding. The overall impact of these actions and deposit mix changes in 2006 has been to increase the negative mismatch within 12 months and reduce the Company s exposure to lower market interest rates over the next 12-24 months at December 31, 2006 as compared to the exposure that existed at December 31, 2005.

The following table reflects the result of simulation analysis on the December 31, 2006 asset and liabilities balances.

Change in interest rates (basis points)	**Percentage change in net interest income**	**Percentage change in net income**	**Percentage change in market value of portfolio equity**
+200	-3.8 %	-10.3 %	-8.3 %
+100	-1.9 %	-5.1 %	-4.2 %
0			
-100	+1.1 %	+2.8 %	+1.4 %
-200	+0.7 %	+1.8 %	-0.6 %

These results of simulation are within the policy limits adopted by the Company. For net interest income, the Company has adopted a policy limit of 15% for a 100 basis point change and 20% for a 200 basis point change. For the market value of equity, the Company has adopted a policy limit of 20% for a 100 basis point change and 25% for a 200 basis point change.

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or re-pricing periods, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the loan. Further, in the event of a change in interest rates, prepayment and early withdrawal levels could deviate significantly from those assumed in calculating the tables. Finally, the ability of many borrowers to service their debt may decrease in the event of a significant interest rate increase.

GAP Analysis

Banks and other financial institutions earnings are significantly dependent upon net interest income, which is the difference between interest earned on earning assets and interest expense on interest bearing liabilities.

In falling interest rate environments, net interest income is maximized with longer term, higher yielding assets being funded by lower yielding short-term funds, or what is referred to as a negative mismatch or GAP. Conversely, in a rising interest rate environment, net interest income is maximized with shorter term, higher yielding assets being funded by longer-term liabilities or what is referred to as a positive mismatch or GAP.

Based on the current economic environment, management has been extending the duration of assets (both investments and loans) and emphasizing the acquisition of variable rate liabilities. This strategy has mitigated the Company s exposure to lower interest rates as measured at December 31, 2006 as compared to the position at December 31, 2005. While management believes that this overall position creates a reasonable balance in managing its interest rate risk and maximizing its net interest margin within plan objectives, there can be no assurance as to actual results.

The GAP position, which is a measure of the difference in maturity and re-pricing volume between assets and liabilities, is a means of monitoring the sensitivity of a financial institution to changes in interest rates. The chart below provides an indication of the sensitivity of the Company to changes in interest rates. A negative GAP indicates the degree to which the volume of repriceable liabilities exceeds repriceable assets in given time periods. At December 31, 2006, the Company had a slight negative cumulative GAP position of approximately 1% of total assets out to three months and a negative cumulative GAP position of 17% out to 12 months, as compared to a three month positive GAP of 9% and a positive cumulative GAP out to 12 months of 3% at December 31, 2005 and a three month positive GAP of 8% and a negative cumulative GAP out to 12 months of 13% at September 30, 2006. The change in the GAP position at December 31, 2006 as compared to both December 31, 2005 and September 30, 2006 relates primarily to increases in the duration of assets, changes in the mix of deposits toward more time deposits with maturities within 12 months and the acquisition of variable rate FHLB advances tied to the prime lending rate. As discussed above, these changes were intended to mitigate the Company s exposure to lower market interest rates, the probability of which began increasing in the second quarter of 2006. The current position is within guideline limits established by ALCO.

If interest rates decline, the Company s net interest income and margin are expected to be relatively stable because of the present slight negative mismatch position out to 90 days combined with a more competitive business environment for both deposits and loans. Because competitive market behavior does not necessarily track the trend of interest rates but at times moves ahead of financial market influences, the change in the cost of liabilities may be different than anticipated by the GAP model. If this were to occur, the benefits of a declining interest rate environment may not be in accordance with management s expectations. If interest rates decline, the Company s interest rate sensitivity position at December 31, 2006 as compared to December 31, 2005 shows reduced exposure, within established policy limits established by ALCO. Management has carefully considered its strategy to maximize interest income by reviewing interest rate levels, economic indicators and call features within its investment portfolio. These factors have been discussed with the ALCO and management believes that current strategies are appropriate to current economic and interest rate trends.

GAP Table

	0-3 mos	4-12 mos	13-36 mos	37-60 mos	over 60 mos	Total Rate Sensitive	Non-sensitive	Total Assets
	(dollars in thousand)							
Repriceable in:								
ASSETS:								
Investments	$ 5,145	$ 12,231	$ 31,909	$ 30,251	$ 11,604	$ 91,140		
Loans(1)	298,511	50,326	139,981	120,942	18,170	627,930		
Fed funds and other short-term investments	14,582					14,582		
Other earning assets		11,529				11,529		
Total	$ 318,238	$ 74,086	$ 171,890	$ 151,193	$ 29,774	$ 745,181	$ 28,270	$ 773,451
LIABILITIES:								
Noninterest bearing demand	$ 5,961	$ 18,936	$ 34,131	$ 28,989	$ 51,900	$ 139,917		
Interest bearing transaction	19,979		13,320	13,319	19,978	66,596		
Savings and money market	156,991		597	397	1,793	159,778		
Time deposits	74,097	183,535	3,005	1,587		262,224		
Customer repurchase agreements	38,064					38,064		
Other borrowings	30,000					30,000		
Total	$ 325,092	$ 202,471	$ 51,053	$ 44,292	$ 73,671	$ 696,579	$ 3,956	$ 700,535
GAP	$ (6,854)	$ (128,385)	$ 120,837	$ 106,901	$ (43,897)	$ 48,602		
Cumulative GAP	$ (6,854)	$ (135,239)	$ (14,402)	$ 92,499	$ 48,602			
Cumulative gap as percent of total assets	-0.89%	-17.49%	-1.86%	11.96 %	6.28 %			

(1) Includes loans held for sale and non-accrual loans.

Although interest bearing transaction accounts and money market accounts (which are administered rates) are subject to re-pricing as a whole category of deposits, the Bank s GAP model has incorporated a re-pricing schedule to account for the historical lag in effecting rate changes and the amount of those rate changes relative to the amount of rate change in assets. However, this measurement of interest rate risk sensitivity represents a static position as of a single day and is not necessarily indicative of the Company s position at any other point in time, does not take into account the differences in sensitivity of yields and costs on specific assets and liabilities to changes in market rates, and it does not take into account the specific timing of when changes to a specific asset or liability will occur.

CAPITAL RESOURCES AND ADEQUACY

The assessment of capital adequacy depends on a number of factors such as asset quality, liquidity, earnings performance, changing competitive conditions and economic forces, as well as the overall level of growth. The adequacy of the Company s current and future capital needs is monitored by management on an ongoing basis. Management seeks to maintain a capital structure that will assure an adequate level of capital to support anticipated asset growth and to absorb potential losses.

The capital position of the Company s wholly-owned subsidiary, the Bank, continues to meet regulatory requirements as a well-capitalized institution. The primary indicators relied on by bank regulators in measuring the capital position are the Tier 1 risk-based capital, total risk-based capital, and leverage ratios. Tier 1 capital consists of common and qualifying preferred stockholders equity less goodwill and other intangibles of which the Bank has none and for the Company certain other restricted core capital elements, such as qualifying trust preferred securities and minority interests in consolidated subsidiaries. Total risk-based capital consists of Tier 1 capital, qualifying subordinated debt, and the qualifying portion of the allowance for credit losses, 100% of which qualifies at December 31, 2006 and 2005 and for the Company to a limited extent excess amounts of restricted core capital elements. Risk-based capital ratios are calculated with reference to risk-weighted assets, which are prescribed by regulation. The Tier 1 capital to average assets ratio is often referred to as the leverage ratio.

The Company s capital ratios were all in excess of guidelines established by the Federal Reserve and the Bank s capital ratios as earlier mentioned were in excess of those required to be classified as a well capitalized institution under the prompt corrective action rule of the Federal Deposit Insurance Act. The Company and Bank s capital ratios at December 31, 2006 and 2005 are shown in Note 15 to the Consolidated Financial Statements.

The ability of the Company to continue to grow is dependent on its earnings and those of the Bank, the ability to obtain additional funds for contribution to the Bank s capital, through additional borrowings, through the sale of additional common stock or preferred stock, or through the issuance of additional qualifying equity equivalents, such as subordinated debt or trust preferred securities.

IMPACT OF INFLATION AND CHANGING PRICES

The Consolidated Financial Statements and Notes thereto have been prepared in accordance with accounting principles generally accepted in the United States of America, which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of operations. Unlike most industrial companies, nearly all of our assets and liabilities are monetary in nature. As a result, interest rates have a greater impact on our performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the price of goods or services.

NEW ACCOUNTING STANDARDS

Refer to Note 1 to the Consolidated Financial Statements for statements on New Accounting Standards.

MARKET FOR COMMON STOCK AND DIVIDENDS

Market for Common Stock. The Company s common stock is listed for trading on the NASDAQ Capital Market under the symbol EGBN . Over the twelve month period ended December 31, 2006, the average daily trading amounted to approximately 4,400 shares. No assurance can be given that a very active trading market will develop in the foreseeable future or can be maintained. The following table sets forth the high and low sale prices for the common stock during each calendar quarter during the last three fiscal years, as adjusted for the stock splits paid in the form of 30% stock dividends on February 28, 2005 and July 5, 2006. As of March 7, 2007, there were 9,501,172 shares of common stock outstanding, held by approximately 1,700 beneficial shareholders, including approximately 775 shareholders of record.

	2006		2005		2004	
Quarter	**High**	**Low**	**High**	**Low**	**High**	**Low**
First	$ 18.58	$ 16.46	$ 16.35	$ 11.72	$ 11.83	$ 10.18
Second	$ 19.92	$ 16.95	$ 16.92	$ 13.62	$ 11.79	$ 9.91
Third	$ 21.19	$ 18.49	$ 19.23	$ 15.40	$ 11.83	$ 10.80
Fourth	$ 19.14	$ 16.78	$ 18.42	$ 17.21	$ 12.59	$ 10.48

Dividends. Through December 31, 2004, the Company had not paid any cash dividends. In January 2005, the Company declared its initial quarterly cash dividend. For the full years 2006 and 2005, the Company declared regular quarterly cash dividends which totaled $0.23 per share and $.22 per share, respectively (as adjusted for stock splits). While the Company has adequate liquidity at present, the payment of future cash dividends may depend upon the ability of the Bank, its principal operating business, to declare and pay dividends to the Company. Future dividends will depend primarily upon the Bank s earnings, financial condition, and need for funds, as well as governmental policies and regulations applicable to the Company and the Bank.

In February 2005 and June 2006, the Company declared 1.3 for 1 stock splits in the form of 30% stock dividend which were paid on February 28, 2005 and July 5, 2006 respectively.

In January 2007, the Company established a Dividend Reinvestment Plan, pursuant to which shareholders may have dividends paid on their common stock automatically reinvested in additional shares of common stock. The price at which shares are reinvested may be at a discount of 5% from the market price, where the shares are newly issued shares purchased directly from the Company.

Regulations of the Federal Reserve Board and Maryland law place limits on the amount of dividends the Bank may pay to the Company without prior approval. Prior regulatory approval is required to pay dividends which exceed the Bank s net profits for the current year plus its retained net profits for the preceding two calendar years, less required transfers to surplus. State and federal bank regulatory agencies also have authority to prohibit a bank from paying dividends if such payment is deemed to be an unsafe or unsound practice, and the Federal Reserve Board has the same authority over bank holding companies.

The Federal Reserve Board has established guidelines with respect to the maintenance of appropriate levels of capital by registered bank holding companies. Compliance with such standards, as presently in effect, or as they may be amended from time to time, could possibly limit the amount of dividends that the Company may pay in the future. In 1985, the Federal Reserve Board issued a policy statement on the payment of cash dividends by bank holding companies. In the statement, the Federal Reserve Board expressed its view that a holding company experiencing earnings weaknesses should not pay cash dividends exceeding its net income, or which could only be funded in ways that weaken the holding company s financial health, such as by borrowing. As a depository institution, the deposits of which are insured by the FDIC, the Bank may not pay dividends or distribute any of its capital assets while it remains in default on any assessment due the FDIC. The Bank currently is not in default under any of its obligations to the FDIC.

Issuer Repurchase of Common Stock. No shares of the Company s Common Stock were repurchased by or on behalf of the Company during 2006.

Internet Access To Company Documents. The Company provides access to its SEC filings through the Bank s web site at www.eaglebankmd.com by linking to the SEC s web site. After accessing the web site, the filings are available upon selecting Investor Relations SEC Filings. Reports available include the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are electronically filed or furnished to the SEC.

Stock Price Performance. The following table compares the cumulative total return on a hypothetical investment of $100 in the Company s common stock on December 31, 2001 through December 31, 2006, with the hypothetical cumulative total return on the Nasdaq Stock Market Index (U.S. Companies) and the Nasdaq Bank Index for the comparable period, including reinvestment of dividends.

	December 31,					
	2001	**2002**	**2003**	**2004**	**2005**	**2006**
Eagle Bancorp, Inc.	$ 100.00	$ 134.58	$ 174.09	$ 201.97	$ 300.21	$ 297.04
Nasdaq Stock Market Index (U.S. Companies)	$ 100.00	$ 68.47	$ 102.72	$ 111.54	$ 113.07	$ 123.84
Nasdaq Bank Index	$ 100.00	$ 104.52	$ 135.80	$ 150.73	$ 144.20	$ 160.07

REPORT OF STEGMAN & COMPANY
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and
Stockholders of Eagle Bancorp, Inc.

We have audited the accompanying consolidated balance sheets of Eagle Bancorp, Inc. (the Company) and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in stockholders equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Eagle Bancorp Inc. as of December 31, 2006 and 2005, and the results of its operations and cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Eagle Bancorp s internal control over financial reporting as of December 31, 2006, based on the criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 12, 2007 expressed an unqualified opinion thereon.

/s/ STEGMAN & COMPANY

Stegman & Company
Baltimore, Maryland
March 12, 2007

EAGLE BANCORP, INC.
Consolidated Balance Sheets
(dollars in thousands)

	December 31, 2006	December 31, 2005
ASSETS		
Cash and due from banks	$ 19,250	$ 16,662
Federal funds sold	9,727	6,103
Interest bearing deposits with banks and other short term investments	4,855	11,231
Investment securities available for sale, at fair value	91,140	68,050
Loans held for sale	2,157	2,924
Loans	625,773	549,212
Less allowance for credit losses	(7,373)	(5,985)
Loans, net	618,400	543,227
Premises and equipment, net	6,954	5,774
Deferred income taxes	3,278	2,854
Accrued interest, taxes and other assets	17,690	15,427
TOTAL ASSETS	$ 773,451	$ 672,252
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Deposits:		
Noninterest bearing demand	$ 139,917	$ 165,103
Interest bearing transaction	66,596	73,666
Savings and money market	159,778	142,879
Time, $100,000 or more	158,495	122,571
Other time	103,729	64,674
Total deposits	628,515	568,893
Customer repurchase agreements and federal funds purchased	38,064	32,139
Other short-term borrowings	8,000	
Long-term borrowings	22,000	
Other liabilities	3,956	6,256
Total liabilities	700,535	607,288
STOCKHOLDERS EQUITY		
Common stock, $.01 par value; shares authorized 20,000,000, shares issued and outstanding 9,478,064 (2006) and 7,184,891 (2005)	95	72
Additional paid in capital	50,278	48,594
Retained earnings	22,796	16,918
Accumulated other comprehensive (loss)	(253)	(620)
Total stockholders equity	72,916	64,964
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 773,451	$ 672,252

See notes to consolidated financial statements.

EAGLE BANCORP, INC.
Consolidated Statements of Operations
Years Ended December 31,
(dollars in thousands, except per share data)

	2006	2005	2004
Interest Income			
Interest and fees on loans	$ 45,814	$ 33,478	$ 21,393
Taxable interest and dividends on investment securities	3,277	2,424	2,195
Interest on balances with other banks and short term investments	212	417	152
Interest on federal funds sold	1,015	407	455
Total interest income	50,318	36,726	24,195
Interest Expense			
Interest on deposits	15,603	7,463	3,755
Interest on customer repurchase agreements and federal funds purchased	1,199	350	105
Interest on short-term borrowings	639	195	171
Interest on long-term borrowings	439		297
Total interest expense	17,880	8,008	4,328
Net Interest Income	32,438	28,718	19,867
Provision for Credit Losses	1,745	1,843	675
Net Interest Income After Provision For Credit Losses	30,693	26,875	19,192
Noninterest Income			
Service charges on deposits	1,386	1,153	1,255
Gain on sale of loans	1,114	1,245	952
Gain on sale of investment securities	124	279	453
Increase in the cash surrender value of bank owned life insurance	406	401	385
Other income	816	920	708
Total noninterest income	3,846	3,998	3,753
Noninterest Expense			
Salaries and employee benefits	12,230	10,503	8,204
Premises and equipment expenses	3,835	3,470	2,655
Marketing and advertising	587	473	280
Outside data processing	881	769	652
Legal and consulting fees	448	674	434
Other expenses	3,843	3,071	2,727
Total noninterest expense	21,824	18,960	14,952
Income Before Income Tax Expense	12,715	11,913	7,993
Income Tax Expense	4,690	4,369	2,906
Net Income	$ 8,025	$ 7,544	$ 5,087
Earnings Per Share			
Basic	$ 0.85	$ 0.82	$ 0.56
Diluted	$ 0.81	$ 0.77	$ 0.53
Dividends Declared Per Share	$ 0.23	$ 0.22	$

See notes to consolidated financial statements.

EAGLE BANCORP, INC.

Consolidated Statements of Changes in Stockholders Equity
(dollars in thousands)

	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance, January 1, 2004	$ 54	$ 46,406	$ 6,281	$ 271	$ 53,012
Comprehensive Income					
Net Income			5,087		5,087
Other comprehensive income:					
Unrealized gain on securities available for sale (net of taxes)				105	105
Less: reclassification adjustment for gains net of taxes of $175 included in net income				(278)	(278)
Total Comprehensive Income				(173)	5,192
Exercise of options for 81,155 shares of common stock		510			510
Tax benefit on non-qualified options exercise		98			98
Balance, December 31, 2004	54	47,014	11,368	98	58,534
Comprehensive Income					
Net Income			7,544		7,544
Other comprehensive income:					
Unrealized loss on securities available for sale (net of taxes)				(549)	(549)
Less: reclassification adjustment for gains net of taxes of $110 included in net income				(169)	(169)
Total Comprehensive Income				(718)	6,826
Cash Dividend ($.22 per share)			(1,994)		(1,994)
1.3 to one stock split in the form of a 30% stock dividend	17	(17)			
Cash paid in lieu of fractional shares		(4)			(4)
Exercise of options for 136,841 shares of common stock	1	1,133			1,134
Tax benefit on non-qualified options exercise		468			468
Balance, December 31, 2005	72	48,594	16,918	(620)	64,964
Comprehensive Income					
Net Income			8,025		8,025
Other comprehensive income:					
Unrealized gain on securities available for sale (net of taxes)				442	442
Less: reclassification adjustment for gains net of taxes of $49 included in net income				(75)	(75)
Total Comprehensive Income				367	8,392
Cash Dividend ($.23 per share)			(2,147)		(2,147)
Stock based compensation		345			345
1.3 to one stock split in the form of a 30% stock dividend	22	(22)			
Cash paid in lieu of fractional shares		(5)			(5)
Exercise of options for 137,999 shares of common stock	1	935			936
Tax benefit on non-qualified options exercise		431			431
Balance, December 31, 2006	$ 95	$ 50,278	$ 22,796	$ (253)	$ 72,916

See notes to consolidated financial statements.

EAGLE BANCORP, INC.

Consolidated Statements of Cash Flows
Years Ended December 31

(dollars in thousands)

	2006	2005	2004
Cash Flows From Operating Activities:			
Net income	$ 8,025	$ 7,544	$ 5,087
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Decrease in deferred income taxes	(647)	(1,312)	(151)
Provision for credit losses	1,745	1,843	675
Depreciation and amortization	1,196	1,122	984
Gains on sale of loans	(1,114)	(1,245)	(952)
Origination of loans held for sale	(59,966)	(29,083)	(29,592)
Proceeds from sale of loans held for sale	61,847	29,612	31,985
Gain on sale of investment securities	(124)	(279)	(453)
Net increase in surrender value of BOLI	(406)	(402)	(385)
Stock based compensation expense	345		
Excess tax benefit from stock-based compensation	(431)	(468)	(98)
Increase in other assets	(1,857)	(1,700)	(528)
Increase (decrease) in other liabilities	(1,869)	4,408	932
Net cash provided by operating activities	6,744	10,040	7,602
Cash Flows From Investing Activities:			
Increase (decrease) in interest bearing deposits other banks	6,376	(1,637)	(5,262)
Purchases of available for sale investment securities	(48,632)	(48,336)	(204,254)
Proceeds from maturities of available for sale securities	20,979	31,230	166,962
Proceeds from sale / call of available for sale securities	5,277	12,275	55,969
Net increase in loans	(76,918)	(133,801)	(98,091)
Bank premises and equipment acquired	(2,376)	(1,170)	(2,451)
Purchase of BOLI			(4,000)
Net cash used in investing activities	(95,294)	(141,439)	(91,127)
Cash Flows From Financing Activities:			
Increase in deposits	59,622	106,606	126,773
Increase (decrease) in customer repurchase agreements	5,925	8,156	(14,471)
Increase (decrease) in other short-term borrowings	8,000	(6,333)	(4,000)
Increase (decrease) in long-term borrowings	22,000		(4,255)
Issuance of common stock	936	1,130	510
Excess tax benefit from stock-based compensation	431	468	98
Payment of dividends and payment in lieu of fractional shares	(2,152)	(1,998)	
Net cash provided by financing activities	94,762	108,029	104,557
Net increase (decrease) in cash	6,212	(23,370)	21,032
Cash and cash equivalents at beginning of year	22,765	46,135	25,103
Cash and cash equivalents at end of year	$ 28,977	$ 22,765	$ 46,135
Supplemental cash flows information:			
Interest paid	$ 16,906	$ 7,571	$ 3,818
Income taxes paid	$ 4,751	$ 5,083	$ 2,462
Non-cash Financing Activities			
Reclassification of borrowings from long-term to short-term	$	$	$ 6,333
Non-cash Investing Activities			
Transfers from loans to other real estate owned	$ 257	$	$

See notes to consolidated financial statements.

Eagle Bancorp, Inc.

Notes to Consolidated Financial Statements for the Years Ended December 31, 2006, 2005 and 2004:

Note 1 Significant Accounting Policies

The consolidated financial statements include the accounts of Eagle Bancorp, Inc. (the Company) and its subsidiaries, EagleBank (the Bank) and Eagle Commercial Ventures LLC (ECV) with all significant intercompany transactions eliminated. The investment in subsidiaries is recorded on the Company s books (Parent Only) on the basis of its equity in the net assets of the subsidiary. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to general practices in the banking industry. Certain reclassifications have been made to amounts previously reported to conform to the classification made in 2006. The following is a summary of the more significant accounting policies.

Nature of Operations

The Company, through its bank subsidiary, conducts a full service community banking business, primarily in Montgomery County, Maryland and Washington, D.C. The primary financial services include real estate, commercial and consumer lending, as well as traditional deposit and repurchase agreement products. The Bank is also active in the origination and sale of residential mortgage loans and the origination of small business loans. The guaranteed portion of small business loans is typically sold through the Small Business Administration, in a transaction apart from the loan s origination. The Bank offers its products and services through nine banking offices and various electronic capabilities. In July 2006, the Company formed Eagle Commercial Ventures, LLC as a direct subsidiary to provide subordinate financing for the acquisition, development and construction of real estate projects, who s primary financing would be done by EagleBank.

Use of Estimates

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

Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, and federal funds sold (items with an original maturity of three months or less).

Loans Held for Sale

The Company engages in sales of residential mortgage loans and the guaranteed portion of Small Business Administration (SBA) loans originated by the Bank. Loans held for sale are carried at the lower of aggregate cost or fair value. Fair value is derived from secondary market quotations for similar instruments. Gains and losses on sales of these loans are recorded as a component of noninterest income in the Consolidated Statements of Income.

The Company s current practice is to sell residential mortgage loans on a servicing released basis, and, therefore, it has no intangible asset recorded for the value of such servicing as of December 31, 2006 or 2005. The sale of the guaranteed portion of SBA loans on a servicing retained basis gives rise to an Excess Servicing Asset, which is computed on a loan by loan basis and which unamortized amount is included in other assets. This asset is being amortized on a straight line basis (with adjustment for prepayments) as an offset of servicing fees collected and is included in other noninterest income.

The Company enters into commitments to originate residential mortgage loans whereby the interest rate on the loan is determined prior to funding (i.e. rate lock commitments). Such rate lock commitments on mortgage loans to be sold in the secondary market are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 15 to 60 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the Company commits to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan. As a result, the Company is not exposed to losses nor will it realize gains related to its rate lock commitments due to changes in interest rates.

The market values of rate lock commitments and best efforts contracts are not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded. Because of the high correlation between rate lock commitments and best efforts contracts, no gain or loss occurs on the rate lock commitments.

Investment Securities

The Company and Bank have no securities classified as trading nor are any investment securities classified as held-to-maturity. Marketable equity securities and debt securities not classified as held-to-maturity or trading are classified as available-for-sale. Securities available-for-sale are acquired as part of the Company s asset/liability management strategy and may be sold in response to changes in interest rates, loan demand, changes in prepayment risk and other factors. Securities available-for-sale are carried at fair value, with unrealized gains or losses being reported as accumulated other comprehensive income, a separate component of stockholders equity, net of deferred tax. Realized gains and losses, using the specific identification method, are included as a separate component of noninterest income. Declines in the fair value of individual available-for-sale securities below their cost that are other than temporary in nature result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether other-than-temporary impairment has occurred include a downgrading of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a change in management s intent and ability to hold a security for a period of time sufficient to allow for any anticipated recovery in fair value.

Loans

Loans are stated at the principal amount outstanding, net of unamortized deferred costs and fees. Interest income on loans is accrued at the contractual rate on the principal amount outstanding. It is the Company s policy to discontinue the accrual of interest when circumstances indicate that collection is doubtful. Deferred fees and costs on loans originated through October 2005 are being amortized on the straight line method over the term of the loan. Deferred fees and costs on loans originated subsequent to October 2005 are being amortized on the interest method over the term of the loan. The difference between the straight line method and the interest method was considered immaterial.

Management considers loans impaired when, based on current information, it is probable that the Company will not collect all principal and interest payments according to contractual terms. Loans are evaluated for impairment in accordance with the Company s portfolio monitoring and ongoing risk assessment procedures. Management considers the financial condition of the borrower, cash flow of the borrower, payment status of the loan, and the value of the collateral, if any, securing the loan. Generally, impaired loans do not include large groups of smaller balance homogeneous loans such as residential real estate and consumer type loans which loans are evaluated collectively for impairment and are generally placed on non-accrual when the loan becomes 90 days past due as to principal or interest. Loans specifically reviewed for impairment are not considered impaired during periods of minimal delay in payment (ninety days or less) provided eventual collection of all amounts due is expected. The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan s effective interest rate, or the fair value of the collateral if repayment is expected to be provided solely by the collateral. In appropriate circumstances, interest income on impaired loans may be recognized on the cash basis.

Allowance for Credit Losses

The allowance for credit losses represents an amount which, in management s judgment, is adequate to absorb probable losses on existing loans and other extensions of credit that may become uncollectible. The adequacy of the allowance for credit losses is determined through careful and continuous review and evaluation of the loan portfolio and involves the balancing of a number of factors to establish a prudent level of allowance. Among the factors considered in evaluating the adequacy of the allowance for credit losses are lending risks associated with growth and entry into new markets, loss allocations for specific nonperforming credits, the level of the allowance to nonperforming loans, historical loss experience, economic conditions, portfolio trends and credit concentrations, changes in the size and character of the loan portfolio, and management s judgment with respect to current and expected economic conditions and their impact on the existing loan portfolio. Allowances for collateral impaired loans are generally determined based on collateral values. Loans or any portion thereof deemed uncollectible are charged against the allowance, while recoveries are credited to the allowance. Management adjusts the level of the allowance through the provision for credit losses, which is recorded as a current period operating expense. The allowance for credit losses consists of allocated and unallocated components.

The components of the allowance for credit losses represent an estimation done pursuant to either Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*, or SFAS No. 114, *Accounting by Creditors for Impairment of a Loan.* Specific allowances are established in cases where management has identified significant conditions or circumstances related to a specific credit that management believes indicate the probability that a loss may be incurred. For potential problem credits for which specific allowance amounts have not been determined, the Company establishes allowances according to the application of credit risk factors. These factors are set by management to reflect its assessment of the relative level of risk inherent in each risk grade. A third component of the allowance computation, termed a nonspecific or environmental factors allowance, is based upon management s evaluation of various environmental conditions that are not directly measured in the determination of either the specific allowance or formula allowance. Such conditions include general economic and business conditions affecting key lending areas, credit quality trends (including trends in delinquencies and nonperforming loans expected to result from existing conditions), loan volumes and concentrations, specific industry conditions within portfolio categories, recent loss experience in particular loan categories, duration of the current business cycle, bank regulatory examination results, findings of outside review consultants, and management s judgment with respect to various other conditions including credit administration and management and the quality of risk identification systems. Executive management reviews these environmental conditions quarterly, and documents the rationale for all changes.

Management believes that the allowance for credit losses is adequate; however, determination of the allowance is inherently subjective and requires significant estimates. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. Evaluation of the potential effects of these factors on estimated losses involves a high degree of uncertainty, including the strength and timing of economic cycles and concerns over the effects of a prolonged economic downturn in the current cycle. In addition, various regulatory agencies, as an integral part of their examination process, and independent consultants engaged by the

Bank periodically review the Bank s loan portfolio and allowance for credit losses. Such review may result in recognition of additions to the allowance based on their judgments of information available to them at the time of their examination.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization computed using the straight-line method for financial reporting purposes. Premises and equipment are depreciated over the useful lives of the assets, which generally range from seven years for furniture, fixtures and equipment, three to five years for computer software and hardware, and ten to forty years for buildings and building improvements. Leasehold improvements are amortized over the terms of the respective leases, which may include renewal options where management has the positive intent to exercise such options, or the estimated useful lives of the improvements, whichever is shorter. The costs of major renewals and betterments are capitalized, while the costs of ordinary maintenance and repairs are expensed as incurred. These costs are included as a component of premises and equipment expenses on the Consolidated Statement of Income.

Advertising

Advertising costs are generally expensed as incurred.

Income Taxes

Income tax expense on the Statements of Operations is based on the results of operations, adjusted for any permanent differences between items of income and deduction recognized for financial reporting purposes differently than for income tax accounting purposes. The Company has adopted the liability method of accounting for income taxes and has recorded deferred tax assets and liabilities determined based on differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities (i.e., temporary differences). Such temporary differences are measured at the enacted rates that are expected to be in effect when these timing differences reverse.

Transfer of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtain the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. In certain cases, the recourse to the Bank to repurchase assets may exist but be deemed immaterial based on the specific facts and circumstances.

Net Income per Common Share

Basic net income per common share is derived by dividing net income available to common stockholders by the weighted-average number of common shares outstanding during the period measured. Diluted net income per common share is computed by dividing net income available to common stockholders by the weighted-average number of common shares outstanding during the period measured including the potential dilutive effects of stock options. Net income per common share has been adjusted to give retroactive reflect to all stock splits.

Stock-Based Compensation

Effective January 2006, in accordance with a new accounting standard (SFAS 123R), the Company is recording as compensation expense an amount equal to the amortization (over the remaining service period) of the fair value (computed at the date of option grant) of any outstanding stock option grants which vest subsequent to December 31, 2005. Refer to Note 11 for a description of shared based compensation expense for the year ended December 31, 2006.

Through December 31, 2005, the Company adopted the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123R) and SFAS 148 *Accounting for Stock-Based Compensation-Transition and Disclosure* (SFAS No. 148), but applied Accounting Principles Board Opinion No. 25 and related interpretations in accounting for its stock based compensation plans. No compensation expense related to the stock based compensation plans was recorded during the years ended December 31, 2005 and December 31, 2004. If the Company had elected to recognize compensation cost based on fair value at the grant dates for awards under the stock based compensation plans consistent with the method prescribed by SFAS No. 123, net income and earnings per share would have been changed to the pro forma amounts as follows for the years ended December 31.

	2005	**2004**
	(in thousands)	
Net income, as reported	$ 7,544	$ 5,087
Less pro forma stock-based compensation expenses determined under the fair value method, net of related tax effects	(793)	(867)
Pro forma net income	$ 6,751	$ 4,220
Net income per share:		
Basic as reported	$ 0.82	$ 0.55
Basic pro forma	$ 0.73	$ 0.46
Diluted as reported	$ 0.77	$ 0.53
Diluted proforma	$ 0.68	$ 0.44

New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123, *Share-Based Payment (Revised 2004*) (SFAS No. 123R). SFAS No. 123R establishes standards for the accounting for transactions in which an entity (i) exchanges its equity instruments for goods or services, or (ii) incurs liabilities in exchange for goods or services that are based on the fair value of the entity s equity instruments or that may be settled by the issuance of the equity instruments. SFAS No. 123R eliminates the ability to account for stock-based compensation using APB 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the measurement date, which is generally the date of the grant. The Company adopted the provisions of SFAS No. 123R on January 1, 2006. Details related to the adoption of SFAS No. 123R and the impact to the Company s financial statements are more fully discussed above under Stock-Based Compensation and in Note 11 Stock Option Plan.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* , an amendment of SFAS No. 133 and SFAS No. 140. This statement permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. It establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. In addition, SFAS No. 155 clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement No. 133. It also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. SFAS No. 155

amends Statement 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. The Company does not presently have any derivative instruments and believes this new accounting standard will have no impact on its financial condition or results of operation.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* . This Statement amends SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* , and requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable, and permits the entities to elect either fair value measurement with changes in fair value reflected in earnings or the amortization and impairment requirements of SFAS No. 140 for subsequent measurement. The subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value eliminates the necessity for entities that manage the risks inherent in servicing assets and servicing liabilities with derivatives to qualify for hedge accounting treatment and eliminates the characterization of declines in fair value as impairments or direct write-downs. This Statement is effective as of the beginning of an entity s first fiscal year that begins after September 15, 2006. The Company is evaluating the impact, if any, of the adoption of this Statement on its financial results.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies when tax benefits should be recorded in financial statements, requires certain disclosures of uncertain tax matters and indicates how any tax reserves should be classified in a balance sheet. FIN 48 is effective for the Company in the first quarter of fiscal 2007. The Company is evaluating the impact if any of FIN 48 on results of operations and financial condition.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157). This Statement provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except SFAS No. 123R and related interpretations and pronouncements that require or permit measurement similar to fair value but are not intended to measure fair value. This pronouncement is effective for fiscal years beginning after November 15, 2007. The Company is evaluating the impact of this new standard, but currently believes that adoption will not have a material impact on its financial position, results of operations, or cash flows.

In September 2006, the FASB issued SFAS No. 158, *Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans* (an amendment of FASB Statements No. 87, 88, 106, and 123R) (SFAS 158). SFAS No. 158 requires an employer to recognize in its statement of financial position an asset for a plan s over funded status or a liability for a plan s under funded status, measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year (with limited exceptions), and recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in our comprehensive income and as a separate component of stockholders equity. SFAS No. 158 is effective for us in the fourth quarter of fiscal 2007. The Company does not offer any defined benefit retirement plans and therefore believes this new accounting standard will have no impact on its financial condition or results of operation.

In September 2006, the SEC s Office of the Chief Accountant and Divisions of Corporation Finance and Investment Management released SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB No. 108), that provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. This pronouncement is effective for fiscal years ending after November 15, 2006. The Company believes the adoption of SAB No. 108 will have no material impact on its financial position, results of operations, or cash flows.

Note 2 Cash and Due from Banks

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. During 2006, the Bank maintained balances at the Federal Reserve (in addition to vault cash) to meet the reserve requirements as well as balances to partially compensate for services. Additionally, the Bank maintained balances with the Federal Home Loan Bank and five domestic correspondents as compensation for services they provide to the Bank.

Note 3 Investment Securities Available-for-Sale

The amortized cost and estimated fair values of investments available for sale at December 31, 2006 and 2005 are as follows:

December 31, 2006	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
	(dollars in thousands)			
U. S. Government agency securities	$ 58,803	$ 161	$ 380	$ 58,584
Mortgage backed securities	27,650	69	386	27,333
Federal Reserve and Federal Home Loan Bank stock	3,829			3,829
Other equity investments	1,278	116		1,394
	$ 91,560	$ 346	$ 766	$ 91,140

December 31, 2005	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
U. S. Government agency securities	$ 47,652	$	$ 654	$ 46,998
Mortgage backed securities	17,798		558	17,240
Federal Reserve and Federal Home Loan Bank stock	2,230			2,230
Other equity investments	1,380	214	12	1,582
	$ 69,060	$ 214	$ 1,224	$ 68,050

Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position as of December 31, 2006 are as follows:

December 31, 2006 (dollars in thousands)	**Estimated Fair Value**	**Less than 12 months**	**More than 12 months**	**Gross Unrealized Losses**
U. S. Government agency securities	$ 32,919	$ 45	$ 335	$ 380
Mortgage backed securities	17,788	27	359	386
Federal Reserve and Federal Home Loan Bank stock				
Other equity investments				
	$ 50,707	$ 72	$ 694	$ 766

All of the bonds reflected in the above table (the debt instruments) are rated AAA. The debt instruments comprise 100% of the gross unrealized losses at December 31, 2006. The debt instruments have a weighted average duration of just 2.80 years, low credit risk, and modest loss (approximately .9%) when compared to book value. The gross unrealized gain on other equity investments represents two banking company stocks owned in the holding company, one of which is not traded on an exchange. The estimated fair value is determined by broker quotes. The unrealized losses that exist on the debt securities are the result of market changes in interest rates since the original purchase. These factors coupled with the fact that the Company has both the intent and ability to hold these investments for the period of time sufficient to allow for any anticipated recovery in fair value substantiates that the unrealized losses in the available-for-sale portfolio are temporary. In addition, at December 31, 2006, the Company held $3.8 million in equity securities in Federal Reserve Bank (FRB) and Federal Home Loan Bank (FHLB) stocks which are held for regulatory purposes and are not marketable.

The amortized cost and estimated fair values of investments available-for-sale at December 31, 2006 and 2005 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	2006 Amortized Cost (dollars in thousands)	**Estimated Fair Value**	**2005 Amortized Cost**	**Estimated Fair Value**
Amounts maturing:				
One year or less	$ 6,305	$ 6,284	$ 13,989	$ 13,825
After one year through five years	33,484	33,402	28,316	27,908
After five years through ten years	19,014	18,898	5,347	5,265
Mortgage backed securities	27,650	27,333	17,798	17,240
FRB, FHLB and other equity securities	5,107	5,223	3,610	3,812
	$ 91,560	$ 91,140	$ 69,060	$ 68,050

Realized gains on sales of investment securities were $195 thousand and realized losses on sales of investment securities were $71 thousand in 2006. Realized gains on sales of investment securities were $344 thousand and realized losses on sales of investment securities were $65 thousand in 2005. Realized gains on sales of investment securities were $577 thousand and realized losses on sales of investment securities were $124 thousand in 2004.

Proceeds from sales and calls of investment securities in 2006 were $5.3 million, in 2005 were $12.3 million, and in 2004 were $56.0 million.

At December 31, 2006, $40.0 million (fair value) of securities were pledged as collateral for certain government deposits, and securities sold under agreement to repurchase. The outstanding balance of no single issuer, except for U.S. Government and U.S. Government agency securities, exceeded ten percent of stockholders equity at December 31, 2006 or 2005.

Note 4 Loans and Allowance for Credit Losses

The Bank makes loans to customers primarily in the Washington, D.C. metropolitan statistical area and surrounding communities. A substantial portion of the Bank s loan portfolio consists of loans to businesses secured by real estate and other business assets.

Loans, net of unamortized net deferred fees, at December 31, 2006 and 2005 are summarized by type as follows:

	2006	2005
	(dollars in thousands)	
Commercial	$ 132,981	$ 118,928
Real estate commercial(1)	349,044	284,667
Real estate residential mortgage	1,523	1,130
Construction commercial and residential	86,524	90,035
Home equity	50,572	50,776
Other consumer	5,129	3,676
Total loans	625,773	549,212
Less: Allowance for Credit Losses	(7,373)	(5,985)
Loans net	$ 618,400	$ 543,227

(1) Includes loans for land acquisition and owner occupied properties.

Unamortized net deferred fees amounted to $1.1 million and $1.2 million at December 31, 2006 and 2005, respectively, of which $512 thousand and $195 thousand, respectively at December 31, 2006 and 2005 represented net deferred costs on home equity loans.

As of December 31, 2006 and 2005, the Bank serviced $26.9 million and $23.0 million, respectively, of SBA loans participations which are not reflected as loan balances on the on the Consolidated Balance Sheet.

Activity in the allowance for credit losses for the past three years is shown below.

	2006	2005	2004
	(dollars in thousands)		
Balance at beginning of year	$ 5,985	$ 4,240	$ 3,680
Provision for credit losses	1,745	1,843	675
Loan charge-offs	(389)	(139)	(292)
Loan recoveries	32	41	177
Balance at end of year	$ 7,373	$ 5,985	$ 4,240

Information regarding impaired loans at December 31, 2006 and 2005 is as follows:

	2006	2005
	(dollars in thousands)	
Impaired loans with a valuation allowance	$ 1,856	$ 491
Impaired loans without a valuation allowance	120	
Total impaired loans	$ 1,976	$ 491
Allowance for credit losses related to impaired loans	$ 678	$ 200
Allowance for credit losses related to other than impaired loans	6,695	5,785
Total allowance for credit losses	$ 7,373	$ 5,985
Average impaired loans for the year	$ 3,267	$ 171
Interest income on impaired loans recognized on a cash basis	$ 125	$

Note 5 Premises and Equipment

Premises and equipment include the following at December 31:

	2006	2005
	(dollars in thousands)	
Leasehold improvements	$ 5,409	$ 4,167
Furniture and equipment	6,877	5,903
Less accumulated depreciation and amortization	(5,332)	(4,296)
Total premises and equipment, net	$ 6,954	$ 5,774

The Company leases banking and office space in thirteen locations under non-cancelable lease arrangements accounted for as operating leases. The initial lease periods range from 5 to 10 years and provide for one or more 5-year renewal options. The leases in some cases provide for scheduled annual rent escalations and require that the Bank (lessee) pay certain operating expenses applicable to the leased space. Rent expense applicable to operating leases amounted to $1,915 thousand in 2006, $1,654 thousand in 2005, and $1,185 thousand in 2004. At December 31, 2006, future minimum lease payments under non-cancelable operating leases having an initial term in excess of one year are as follows:

Years ending December 31:	(dollars in thousands)
2007	$ 2,228
2008	2,310
2009	2,400
2010	2,484
2011	2,175
Thereafter	7,639
Total minimum lease payments	$ 19,236

Note 6 Deposits

The following table provides information regarding the Bank s deposit composition at the dates indicated and shows the average rate being paid on the interest bearing deposits in December of each year.

	2006		2005		2004	
	Balance	Average Rate	Balance	Average Rate	Balance	Average Rate
	(dollars in thousands)					
Noninterest bearing demand	$ 139,917		$ 165,103		$ 130,309	
Interest bearing transaction	66,596	0.44 %	73,666	0.26 %	57,063	0.17 %
Savings and money market	159,778	3.74 %	142,879	2.88 %	126,299	0.99 %
Time, $100,000 or more	158,495	4.81 %	122,571	3.36 %	99,882	2.05 %
Other time	103,729	5.20 %	64,674	3.38 %	48,734	2.17 %
Total	$ 628,515		$ 568,893		$ 462,287	

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The remaining maturity of time deposit at December 31, 2006 and 2005 are as follows:

	2006	2005
	(dollars in thousands)	
Three months or less	$ 70,408	$ 41,203
More than three months through six months	91,540	46,216
More than six months through twelve months	91,991	73,289
Over twelve months	8,285	26,537
Total	$ 262,224	$ 187,245

Interest expense on deposits for the three years ended December 31, 2006, 2005 and 2004 is as follows:

	2006	2005	2004
	(dollars in thousands)		
Interest bearing transaction	$ 204	$ 122	$ 72
Savings and money market	5,174	2,504	1,185
Time, $100,000 or more	6,469	3,259	1,408
Other time	3,756	1,578	1,090
Total	$ 15,603	$ 7,463	$ 3,755

Note 7 Borrowings

Information relating to short-term and long-term borrowings is as follows for the years ended December 31:

	2006		2005		2004	
	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in thousands)					
Short-term:						
At Year-End:						
Federal funds purchased and securities sold under agreement to repurchase	$ 38,064	4.32 %	$ 32,139	2.43 %	$ 23,983	0.50 %
Federal Home Loan Bank current portion	8,000	5.44 %			6,333	3.73 %
Total	$ 46,064		$ 32,139		$ 30,316	
Average for the Year:						