

SUMMIT BANCSHARES INC /TX/  
Form 10-Q  
November 08, 2006

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

**FORM 10-Q**

(Mark One)

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the quarterly period ended September 30, 2006 or**

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

**For the Transition period from \_\_\_\_\_ to \_\_\_\_\_.**

Commission File Number 0-11986

**SUMMIT BANCSHARES, INC.**

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(Exact name of registrant as specified in its charter)

Texas

75-1694807

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(State of Incorporation)

(I.R.S. Employer Identification No.)

3880 Hulen St., Fort Worth, Texas 76107

---

(Address of principal executive offices)

(817) 336-6817

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(Registrant's telephone number, including area code)

No Change

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

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

YesNo

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

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YesNo

x

The number of shares of common stock, \$1.25 par value, of the issuer outstanding at October 31, 2006 was 12,711,872 shares.

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## SUMMIT BANCSHARES, INC.

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<p>The September 30, 2006 and 2005 financial statements included herein are unaudited; however, such information reflects all adjustments (consisting solely of normal recurring adjustments), which are, in the opinion of management of the registrant, necessary to a fair statement of the results for the interim periods. The financial statements for the year ended December 31, 2005 included herein are headed "unaudited." These financial statements were reported as "audited" in our Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission but are required to be reflected herein as unaudited because of the absence of an independent auditor's report.</p>	
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**PART I - FINANCIAL INFORMATION****Item 1 - Financial Statements**SUMMIT BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

	(Unaudited) September 30,		(Unaudited) December 31, 2005
	2006	2005	
(In Thousands)			
<b>ASSETS</b>			
CASH AND DUE FROM BANKS NOTE 1	\$ 29,837	\$ 34,967	\$ 32,558
INTEREST-BEARING DEPOSITS	1,015	-0-	892
FEDERAL FUNDS SOLD	-0-	15,671	-0-
INVESTMENT SECURITIES NOTE 3			
Securities Available-for-Sale, at fair value	251,153	236,544	256,842
LOANS NOTES 4, 15 AND 21			
Loans, Net of Unearned Income	857,840	754,153	774,886
Allowance for Loan Losses	(10,399)	(11,131)	(11,208)
<b>LOANS, NET</b>	<b>847,441</b>	<b>743,022</b>	<b>763,678</b>
PREMISES AND EQUIPMENT NOTE 5	16,613	15,620	16,515
GOODWILL NOTE 6	9,060	9,060	9,060
OTHER INTANGIBLE ASSETS, NET NOTE 6	1,936	2,276	2,191
ACCRUED INCOME RECEIVABLE	7,264	5,651	6,273
OTHER REAL ESTATE NOTE 7	-0-	-0-	-0-
OTHER ASSETS	12,994	11,450	11,726
<b>TOTAL ASSETS</b>	<b>\$ 1,177,313</b>	<b>\$ 1,074,261</b>	<b>\$ 1,099,735</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>			
DEPOSITS NOTE 8			
Noninterest-Bearing Demand	\$ 270,863	\$ 258,644	\$ 263,027
Interest-Bearing	657,935	607,384	615,749
<b>TOTAL DEPOSITS</b>	<b>928,798</b>	<b>866,028</b>	<b>878,776</b>
SHORT TERM BORROWINGS NOTE 9	141,370	111,370	121,859
NOTE PAYABLE NOTE 10	-0-	150	-0-
JUNIOR SUBORDINATED DEFERRABLE DEBENTURES NOTE 11	12,372	12,372	12,372
ACCRUED INTEREST PAYABLE	1,773	900	1,014
OTHER LIABILITIES	4,233	3,714	4,381
<b>TOTAL LIABILITIES</b>	<b>1,088,546</b>	<b>994,534</b>	<b>1,018,402</b>
COMMITMENTS AND CONTINGENCIES NOTES 16, 18, 20 AND 22			
SHAREHOLDERS EQUITY NOTES 17, 19 AND 23			
Common Stock - \$1.25 Par Value; 20,000,000 shares authorized; 12,600,722, 12,430,116 and 12,443,518 shares issued and outstanding at September 30, 2006 and 2005 and at December 31, 2005, respectively	15,751	15,538	15,554
Capital Surplus	9,628	8,082	8,170
Retained Earnings	66,804	58,362	60,964
	(3,416)	(2,236)	(3,349)

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Accumulated Other Comprehensive Income	Unrealized Loss on			
Available-for-Sale Investment Securities, Net of Tax Benefit				
Treasury Stock at Cost (988 and 300 shares at September 30, 2005 and December 31, 2005, respectively)		-0-	(19)	(6)
		<u>          </u>	<u>          </u>	<u>          </u>
TOTAL SHAREHOLDERS EQUITY		88,767	79,727	81,333
		<u>          </u>	<u>          </u>	<u>          </u>
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY		\$ 1,177,313	\$ 1,074,261	\$ 1,099,735
		<u>          </u>	<u>          </u>	<u>          </u>

The accompanying Notes should be read with these financial statements.

SUMMIT BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME

	(Unaudited) For the Nine Months Ended September 30,		(Unaudited) Year Ended December 31, 2005
	2006	2005	
(In Thousands, Except Per Share Data)			
<b>INTEREST INCOME</b>			
Interest and Fees on Loans	\$ 48,827	\$ 36,905	\$ 51,064
Interest and Dividends on Investment Securities:			
Taxable	7,084	5,912	8,281
Exempt from Federal Income Taxes	370	228	324
Interest on Federal Funds Sold and Interest-Bearing Deposits	56	182	292
<b>TOTAL INTEREST INCOME</b>	<b>56,337</b>	<b>43,227</b>	<b>59,961</b>
<b>INTEREST EXPENSE</b>			
Interest on Deposits	13,208	8,169	11,663
Interest on Short Term Borrowings	4,860	2,313	3,317
Interest on Note Payable	1	55	57
Interest on Junior Subordinated Deferrable Debentures	701	522	731
<b>TOTAL INTEREST EXPENSE</b>	<b>18,770</b>	<b>11,059</b>	<b>15,768</b>
<b>NET INTEREST INCOME</b>	<b>37,567</b>	<b>32,168</b>	<b>44,193</b>
LESS: PROVISION FOR LOAN LOSSES NOTE 4	3,515	765	1,105
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>34,052</b>	<b>31,403</b>	<b>43,088</b>
<b>NON-INTEREST INCOME</b>			
Service Charges and Fees on Deposits	2,968	2,964	3,938
Other Income	3,202	3,127	4,066
<b>TOTAL NON-INTEREST INCOME</b>	<b>6,170</b>	<b>6,091</b>	<b>8,004</b>
<b>NON-INTEREST EXPENSE</b>			
Salaries and Employee Benefits - NOTE 18	14,731	13,296	18,277
Occupancy Expense - Net	2,456	1,988	2,834
Furniture and Equipment Expense	1,887	1,756	2,341
Other Real Estate Owned Expense - Net	-0-	(11)	(11)
Intangible Asset Amortization	255	246	334
Other Expense NOTE 13	6,048	5,172	6,883
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>25,377</b>	<b>22,447</b>	<b>30,658</b>
<b>INCOME BEFORE INCOME TAXES</b>	<b>14,845</b>	<b>15,047</b>	<b>20,434</b>
APPLICABLE INCOME TAXES NOTE 14	5,306	5,387	7,258
<b>NET INCOME</b>	<b>\$ 9,539</b>	<b>\$ 9,660</b>	<b>\$ 13,176</b>
<b>NET INCOME PER SHARE</b> NOTE 19			

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Basic	\$	0.76	\$	0.78	\$	1.06
Diluted		0.75		0.76		1.04

The accompanying Notes should be read with these financial statements.

SUMMIT BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME

	(Unaudited) For the Three Months Ended September 30,	
	2006	2005
	(In Thousands, Except Per Share Data)	
<b>INTEREST INCOME</b>		
Interest and Fees on Loans	\$ 17,308	\$ 13,203
Interest and Dividends on Investment Securities:		
Taxable	2,389	2,072
Exempt from Federal Income Taxes	138	86
Interest on Federal Funds Sold and Interest-Bearing Deposits	24	115
<b>TOTAL INTEREST INCOME</b>	<b>19,859</b>	<b>15,476</b>
<b>INTEREST EXPENSE</b>		
Interest on Deposits	5,002	3,185
Interest on Short Term Borrowings	1,764	878
Interest on Note Payable	-0-	12
Interest on Junior Subordinated Deferrable Debentures	249	188
<b>TOTAL INTEREST EXPENSE</b>	<b>7,015</b>	<b>4,263</b>
<b>NET INTEREST INCOME</b>	<b>12,844</b>	<b>11,213</b>
LESS: PROVISION FOR LOAN LOSSES NOTE 4	415	315
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>12,429</b>	<b>10,898</b>
<b>NON-INTEREST INCOME</b>		
Service Charges and Fees on Deposits	1,046	992
Other Income	1,055	1,184
<b>TOTAL NON-INTEREST INCOME</b>	<b>2,101</b>	<b>2,176</b>
<b>NON-INTEREST EXPENSE</b>		
Salaries and Employee Benefits - NOTE 18	4,895	4,579
Occupancy Expense - Net	847	724
Furniture and Equipment Expense	648	587
Other Real Estate Owned Expense - Net	-0-	-0-
Intangible Asset Amortization	85	82
Other Expense NOTE 13	2,482	1,665
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>8,957</b>	<b>7,637</b>
<b>INCOME BEFORE INCOME TAXES</b>	<b>5,573</b>	<b>5,437</b>
APPLICABLE INCOME TAXES NOTE 14	1,983	1,981
<b>NET INCOME</b>	<b>\$ 3,590</b>	<b>\$ 3,456</b>
<b>NET INCOME PER SHARE - NOTE 19</b>		



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Basic	\$	0.28	\$	0.28
Diluted		0.28		0.27

The accompanying Notes should be read with these financial statements.

SUMMIT BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005  
AND FOR THE YEAR ENDED DECEMBER 31, 2005  
(Unaudited)

	Common Stock		Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income - Net Unrealized Loss on Investment Securities	Treasury Stock	Total Share-Holders Equity
	Shares	Amount					
(Dollars in Thousands, Except Per Share Data)							
Balance at December 31, 2004	12,359,232	\$ 15,449	\$ 7,705	\$ 51,810	\$ (474)	\$ -0-	\$ 74,490
Stock Options Exercised	100,184	126	377				503
Purchases of Stock Held in Treasury						(561)	(561)
Retirement of Stock Held in Treasury	(29,300)	(37)		(505)		542	-0-
Cash Dividend - \$.21 Per Share				(2,603)			(2,603)
Net Income for the Nine Months Ended September 30, 2005				9,660			9,660
Securities Available- for-Sale Adjustment					(1,762)		(1,762)
<b>Total Comprehensive Income NOTE 26</b>							<b>7,898</b>
Balance at September 30, 2005	12,430,116	15,538	8,082	58,362	(2,236)	(19)	79,727
Stock Options Exercised	15,840	19	88				107
Purchases of Stock Held in Treasury						(33)	(33)
Retirement of Stock Held in Treasury	(2,438)	(3)		(43)		46	-0-
Cash Dividend - \$.07 Per Share				(871)			(871)
Net Income for the Three Months Ended December 31, 2005				3,516			3,516
Securities Available- for-Sale Adjustment					(1,113)		(1,113)
<b>Total Comprehensive Income NOTE 26</b>							<b>2,403</b>
Balance at December 31, 2005	12,443,518	15,554	8,170	60,964	(3,349)	(6)	81,333
Stock Options Exercised	196,704	246	1,330				1,576
Stock-Based Compensation Expense			128				128
Purchases of Stock Held in Treasury						(733)	(733)
Retirement of Stock Held in Treasury	(39,500)	(49)		(690)		739	-0-
Cash Dividend - \$.24 Per Share				(3,009)			(3,009)
Net Income for the Nine Months Ended September 30, 2006				9,539			9,539
					(67)		(67)

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Securities Available- for-Sale  
Adjustment

Total Comprehensive Income NOTE 26									9,472
Balance at September 30, 2006	12,600,722	\$ 15,751	\$ 9,628	\$ 66,804	\$ (3,416)	\$ -0-	\$		88,767

The accompanying Notes should be read with these financial statements.

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SUMMIT BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005  
AND FOR THE YEAR ENDED DECEMBER 31, 2005

	(Unaudited) For the Nine Months Ended September 30,		(Unaudited) Year Ended December 31, 2005
	2006	2005	
(In Thousands)			
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net Income	\$ 9,539	\$ 9,660	\$ 13,176
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Stock-Based Compensation Expense	128	-0-	-0-
Depreciation and Amortization	1,494	1,430	1,946
Net Premium Amortization of Investment Securities	669	1,044	1,309
Amortization of Intangible Assets	255	246	334
Provision for Loan Losses	3,515	765	1,105
Deferred Income Taxes Expense (Benefit)	122	(502)	(533)
Net Gain From Sale of Other Real Estate & Repossessed Assets	(8)	-0-	(19)
Net (Gain) Loss From (Sale) Disposal of Premises and Equipment	11	(247)	(247)
Net Increase in Accrued Income and Other Assets	(1,436)	(1,421)	(1,322)
Net Increase in Accrued Expenses and Other Liabilities	611	345	1,126
Total Adjustments	5,361	1,660	3,699
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>14,900</b>	<b>11,320</b>	<b>16,875</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Net Increase in Interest Bearing Deposits	(123)	-0-	(522)
Net (Increase) Decrease in Federal Funds Sold	-0-	(10,651)	4,650
Proceeds from Matured and Prepaid Investment Securities			
· Available-for-Sale	251,754	356,758	524,266
Proceeds from Sales and Redemptions of Investment Securities	-0-	-0-	700
Purchase of Investment Securities			
· Available-for-Sale	(248,497)	(373,447)	(563,976)
Net Assets Acquired in the Purchase of Dignum Financial	-0-	(976)	(1,043)
Loans Originated and Principal Repayments, Net	(87,544)	(51,534)	(72,857)
Recoveries of Loans Previously Charged-Off	266	435	458
Proceeds from Sale of Premises and Equipment	46	339	338
Proceeds from Sale of Other Real Estate & Repossessed Assets	764	-0-	67
Purchases of Premises and Equipment	(1,654)	(1,397)	(2,808)
<b>NET CASH USED BY INVESTING ACTIVITIES</b>	<b>(84,988)</b>	<b>(80,473)</b>	<b>(110,727)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net Increase in Demand Deposits, Savings Accounts and Interest-Bearing Transaction Accounts	6,122	37,647	48,070
Net Increase in Certificates of Deposit	43,900	36,117	38,442
Net Increase in Short Term Borrowings	19,511	7,398	17,887
Repayment of Note Payable	-0-	(1,600)	(1,750)
Payments of Cash Dividends	(3,009)	(2,603)	(3,474)
Proceeds from Stock Options Exercised	1,576	503	610

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Purchases of Treasury Stock	(733)	(561)	(594)
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>67,367</b>	<b>76,901</b>	<b>99,191</b>
<b>NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS</b>	<b>(2,721)</b>	<b>7,748</b>	<b>5,339</b>
<b>CASH AND DUE FROM BANKS AT BEGINNING OF PERIOD</b>	<b>32,558</b>	<b>27,219</b>	<b>27,219</b>
<b>CASH AND DUE FROM BANKS AT END OF PERIOD</b>	<b>\$ 29,837</b>	<b>\$ 34,967</b>	<b>\$ 32,558</b>
<b>SUPPLEMENTAL SCHEDULE OF OPERATING AND INVESTING ACTIVITIES:</b>			
Interest Paid	\$ 18,011	\$ 10,760	\$ 15,355
Income Taxes Paid	5,283	5,549	7,476
Other Real Estate and Other Assets Acquired in Settlement of Loans	721	-0-	461
The accompanying Notes should be read with these financial statements.			

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SUMMIT BANCSHARES, INC. AND SUBSIDIARIES  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (UNAUDITED)  
AND FOR THE YEAR ENDED DECEMBER 31, 2005 (UNAUDITED)

NOTE 1 - Summary of Significant Accounting and Reporting Policies

The accounting and reporting policies of Summit Bancshares, Inc. are in accordance with accounting principles generally accepted in the United States of America and the prevailing practices within the banking industry. A summary of the more significant policies follows:

Basis of Presentation and Principles of Consolidation

The consolidated financial statements of Summit Bancshares, Inc. (hereinafter, collectively with its subsidiaries, the Corporation ), include its accounts and its direct and indirect wholly-owned subsidiaries, Summit Delaware Financial Corporation, Summit Bank, National Association (the Bank ) and SIA Insurance Agency, Inc. ( SIA ). All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

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

Cash and Due From Banks

The Bank is required to maintain certain noninterest-bearing cash balances at the Federal Reserve Bank based on its level of deposits. During the first nine months of 2006, the average cash balance maintained at the Federal Reserve Bank was \$2,631,000. Compensating balances held at correspondent banks, to minimize service charges, averaged approximately \$24,961,000 during the same period.

Investment Securities

The Corporation has adopted Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ( SFAS 115 ). At the date of purchase, the Corporation is required to classify debt and equity securities into one of three categories: held-to-maturity, trading or available-for-sale. At each reporting date, the appropriateness of the classification is reassessed. Investments in debt securities are classified as held-to-maturity and measured at amortized cost in the financial statements only if management has the positive intent and ability to hold those securities to maturity. Securities that are bought and held principally for the purpose of selling them in the near term are classified as trading and measured at fair value in the financial statements with unrealized gains and losses included in earnings. Investments not classified as either held-to-maturity or trading are classified as available-for-sale and measured at fair value in the financial statements with unrealized gains and losses reported, net of tax, in a separate component of shareholders' equity until realized.

The Corporation has the ability and intent to hold to maturity its investment securities classified as held-to-maturity; accordingly, no adjustment has been made for the excess, if any, of amortized cost over market. In determining the investment category classifications at the time of purchase of securities, management considers its asset/liability strategy, changes in interest rates and prepayment risk, the need to increase capital and other factors. Under certain circumstances (including the deterioration of the issuer's creditworthiness, a change in tax law, or statutory or regulatory requirements), the Corporation may change the investment security classification. In the periods reported for 2006 and 2005, the Corporation held no securities that would have been classified as trading securities.

All investment securities are adjusted for amortization of premiums and accretion of discounts. Amortization of premiums and accretion of discounts are recorded to income over the contractual maturity or estimated life of the individual investment on the level yield method. Gain or loss on sale of investments is based upon the specific identification method and the gain or loss is recorded in non-interest income. Income earned on the Corporation's investments in securities issued by state and political subdivisions is not taxable.

Loans and Allowance for Loan Losses

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Loans are stated at the principal amount outstanding less unearned discount, deferred fees and the allowance for loan losses. Unearned discount on installment loans is recognized as income over the terms of the loans by a method approximating the interest method. Interest income on all other loans is recognized based upon the principal amounts outstanding, the simple interest method. Loan origination fee income, net of direct loan origination costs, is deferred and amortized over the life of the related loan. The accrual of interest on a loan is discontinued when, in the opinion of management, there is doubt about the ability of the borrower to pay interest or principal. Interest previously earned, but uncollected on such loans, is written off. After loans are placed on non-accrual all payments received are applied to principal and no interest income is recorded until the loan is returned to accrual status or the principal balance has been reduced to zero.

NOTE 1 - Summary of Significant Accounting and Reporting Policies (cont d.)

The Corporation has adopted Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan, as amended by Statement of Financial Accounting Standards No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosure. Under this standard, the allowance for loan losses related to loans that are identified for evaluation in accordance with Statement No. 114 (impaired loans) is based on discounted cash flows using the loan's initial effective rate or the fair value of the collateral for certain collateral dependent loans.

The allowance for loan losses is comprised of amounts charged against income in the form of a provision for loan losses for certain loans when it is probable that all amounts due pursuant to the contractual terms of the loan will not be collected. In these situations, a valuation allowance is recorded when the carrying amount of the loan exceeds the discounted cash flows using the loan's initial effective interest rate or the fair value of the collateral for certain collateral dependent loans. Income on impaired loans is recognized based on the collectibility of the principal amount. Adjustments to the allowance for loan losses will be reported in the period such adjustments become known or are reasonably estimable.

The amount maintained in the allowance reflects management's continuing assessment of the potential losses inherent in its loan portfolio based on its evaluation of a number of factors, including the Bank's loss experience in relation to outstanding loans and the existing level of the allowance, prevailing and prospective economic conditions, and management's continuing review of the discounted cash flow values of impaired loans and its evaluation of the quality of the loan portfolio. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely.

The evaluation of the adequacy of loan collateral is often based upon estimates and appraisals. Because of changing economic conditions, the valuations determined from such estimates and appraisals may also change. Accordingly, the Corporation may ultimately incur losses which vary materially from management's current estimates.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation expense is computed on the straight-line method based upon the estimated useful lives of the assets ranging from three to forty years. Maintenance and repairs are charged to non-interest expense. Renewals and betterments are added to the asset accounts and depreciated over the periods benefited. Depreciable assets sold or retired are removed from the asset and related accumulated depreciation accounts and any gain or loss is reflected in the income and expense accounts.

Other Real Estate

Other real estate is foreclosed property held pending disposition and is valued at the lower of its fair value or the recorded investment in the related loan. At foreclosure, if the fair value, less estimated costs to sell, of the real estate acquired is less than the Corporation's recorded investment in the related loan, a write-down is recognized through a charge to the allowance for loan losses. Any subsequent reduction in value is recognized by a charge to income. Operating expenses of such properties, net of related income, and gains and losses on their disposition are included in non-interest expense.

Federal Income Taxes

The Corporation joins with its subsidiaries in filing a consolidated federal income tax return. The subsidiaries pay to the parent a charge equivalent to their current federal income tax based on the separate taxable income of the subsidiaries.

The Corporation and the subsidiaries maintain their records for financial reporting and income tax reporting purposes on the accrual basis of accounting. Deferred income taxes are provided in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. Deferred income taxes are provided for accumulated temporary differences due to basic differences for assets and liabilities for financial reporting and income tax purposes.

Realization of net deferred tax assets is dependent on generating sufficient future taxable income. Although realization is not assured, management believes it is more likely than not that all of the net deferred tax assets will be realized. The amount of the net deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced.

Cash and Cash Equivalents



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For the purpose of presentation in the Statements of Cash Flows, cash and cash equivalents include cash on hand, clearings and exchanges, and balances due from correspondent banks.

### Reclassification

Certain reclassifications have been made to the 2005 financial statements to conform to the 2006 presentation.

NOTE 1 - Summary of Significant Accounting Policies (cont d.)

Earnings Per Common and Common Equivalent Shares

Statement of Financial Accounting Standards No. 128 ( SFAS 128 ), Earnings Per Share, requires presentation of basic and diluted earnings per share. Basic earnings per share has been computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the reporting period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Net income per common share for all periods presented has been calculated in accordance with SFAS 128. Outstanding stock options issued by the Corporation represent the only dilutive effect reflected in diluted weighted average shares.

Stock-Based Compensation

On January 1, 2006, the Corporation changed its accounting policy related to stock-based compensation in connection with the adoption of Statement of Financial Accounting Standards (SFAS) No. 123, Share-Based Payment (Revised 2004). See Note 12 Stock-Based Compensation for additional information.

Advertising Costs

Advertising costs are expensed as incurred.

Comprehensive Income

Comprehensive income includes all changes in shareholders' equity during a period, except those resulting from investments by and distributions to owners and treasury stock transactions. Besides net income, the other component of the Corporation's comprehensive income is the after tax effect of changes in the fair value of securities available-for-sale. Comprehensive income for the periods ended September 30, 2006 and 2005 and for the year ended December 31, 2005 is reported in Note 26, Comprehensive Income.

Audited Financial Statements

The consolidated balance sheet as of December 31, 2005, and the consolidated statements of income, changes in shareholders' equity and cash flows for the year ended December 31, 2005 are headed "unaudited" in these financial statements. These statements were reported as "audited" in our Annual Report of Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission but are required to be reflected in these statements as unaudited because of the absence of an independent auditor's report.

NOTE 2 Mergers and Acquisitions

On July 2, 2006, the Corporation and Cullen/Frost Bankers, Inc., a Texas corporation ( Cullen/Frost ), entered into an Agreement and Plan of Merger (the Agreement ) pursuant to which the Corporation will merge with and into Cullen/Frost. Under the terms of the Agreement, the Corporation's shareholders will have the right, subject to pro-rata, to elect to receive cash, shares of Cullen/Frost common stock or a combination thereof having a value equal to \$11.50 plus 0.2933 Cullen/Frost shares. The total consideration consists of approximately \$143.4 million in cash and approximately 3.84 million shares of Cullen/Frost common stock (assuming the treasury stock method of accounting for options before giving effect to any exercises of outstanding options). The transaction is subject to customary closing conditions, including the receipt of regulatory approvals and approval of the shareholders of the Corporation. As of the date this report is filed all regulatory approvals have been received as well as shareholder approval. The merger is currently expected to be completed in the fourth quarter of 2006, although delays could occur.

The foregoing summary of the Agreement is not complete and is qualified in its entirety by reference to the complete text of such document, which is filed as Exhibit 2.1 to the Report on Form 8-K filed with the Securities and Exchange Commission on July 3, 2006 and which is incorporated herein by reference.

On March 21, 2005, the Corporation acquired Dignum Financial Services ( DFS ) for a purchase price of approximately \$1.0 million. DFS was a proprietorship engaged in financial planning and management services. Of the purchase price, \$0.5 million is subject to the earnings performance of Summit Financial Partners (formerly DFS), a division of the Bank.

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**NOTE 3 - Investment Securities**

A summary of amortized cost and estimated fair values of investment securities as of September 30, 2006 is as follows (in thousands):

	September 30, 2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Investment Securities - Available-for-Sale</b>				
U.S. Government Agencies and Corporations	\$ 170,969	27	\$ (3,004)	\$ 167,992
U.S. Government Agency Mortgage Backed Securities	64,269	71	(1,918)	62,422
Obligations of States and Political Subdivisions	15,055	7	(258)	14,804
Community Reinvestment Act Investment Fund	3,025	-0-	(101)	2,924
Other Securities	3,011	-0-	-0-	3,011
<b>Total Available-for-Sale Securities</b>	<b>\$ 256,329</b>	<b>\$ 105</b>	<b>\$ (5,281)</b>	<b>\$ 251,153</b>

All investment securities are carried on the consolidated balance sheet as of September 30, 2006 at fair value. The net unrealized loss of \$5,176,000 is included in the Available-for-Sale Investment Securities balance. The unrealized loss, net of tax benefit, is included in Shareholders' Equity.

Included in the Other Securities category at September 30, 2006 is \$2,095,000 of Federal Home Loan Bank Stock and \$800,000 of Federal Reserve Stock which are classified as restricted investment securities, carried at cost, and evaluated for impairment. No impairment losses were recorded as of September 30, 2006. The Bank was required at September 30, 2006 to have stock holdings of Federal Home Loan Bank Stock equal to .08% of the Bank's total assets as of the previous quarter end plus 4.10% of its outstanding advances from the Federal Home Loan Bank (FHLB). The Bank is also required to have stock holdings of Federal Reserve Stock equal to 6% of its Capital Stock and Surplus.

A summary of amortized cost and estimated fair values of investment securities as of September 30, 2005 is as follows (in thousands):

	September 30, 2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Investment Securities - Available-for-Sale</b>				
U.S. Government Agencies and Corporations	\$ 167,840	\$ 19	\$ (2,360)	\$ 165,499
U.S. Government Agency Mortgage Backed Securities	53,068	20	(1,074)	52,014
Obligations of States and Political Subdivisions	10,673	69	(68)	10,674
Community Reinvestment Act Investment Fund	3,025	5	-0-	3,030
Other Securities	5,327	-0-	-0-	5,327
<b>Total Available-for-Sale Securities</b>	<b>\$ 239,933</b>	<b>\$ 113</b>	<b>\$ (3,502)</b>	<b>\$ 236,544</b>

All investment securities were carried on the consolidated balance sheet as of September 30, 2005 at fair value. The net unrealized loss of \$3,389,000 was included in the Available-for-Sale Investment Securities balance. The unrealized loss, net of tax benefit, was included in Shareholders' Equity.

Included in the Other Securities category at September 30, 2005 was \$4,450,000 of Federal Home Loan Bank Stock and \$800,000 of Federal Reserve Stock which were classified as restricted investment securities, carried at cost, and evaluated for impairment. No impairment losses were recorded as of September 30, 2005. The Bank was required at September 30, 2005 to have stock holdings of Federal Home Loan Bank Stock equal to .14% of the Bank's total assets as of the previous year end plus 4.25% of its outstanding advancements from the FHLB. The Bank was also required to have stock holdings of Federal Reserve Stock equal to 6% of its Capital Stock and Surplus.



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**NOTE 4 - Loans and Allowance for Loan Losses**

The book values of loans by major type follow (in thousands):

	September 30,		December 31, 2005
	2006	2005	
Commercial and Industrial	\$ 310,236	\$ 270,807	\$ 277,827
Real Estate Mortgage - Commercial	281,107	244,966	260,736
Real Estate Mortgage - Residential	93,764	89,487	91,183
Real Estate - Construction	135,992	109,431	106,227
Loans to Individuals	36,741	39,462	38,913
	<u>857,840</u>	<u>754,153</u>	<u>774,886</u>
Allowance for Loan Losses	(10,399)	(11,131)	(11,208)
Loans - Net	<u>\$ 847,441</u>	<u>\$ 743,022</u>	<u>\$ 763,678</u>

Loans are net of unearned income of \$1,059,000 and \$945,000 at September 30, 2006 and 2005, respectively, and \$1,101,000 at December 31, 2005.

Transactions in the allowance for loan losses are summarized as follows (in thousands):

	Nine Months Ended September 30,		Year Ended December 31, 2005
	2006	2005	
Balance, Beginning of Period	\$ 11,208	\$ 10,187	\$ 10,187
Provisions, Charged to Income	3,515	765	1,105
Loans Charged-Off	(4,590)	(256)	(542)
Recoveries of Loans Previously Charged-Off	266	435	458
Net Loans (Charged-Off) Recovered	<u>(4,324)</u>	<u>179</u>	<u>(84)</u>
Balance, End of Period	<u>\$ 10,399</u>	<u>\$ 11,131</u>	<u>\$ 11,208</u>

The provisions for loan losses charged to operating expenses during the nine months ended September 30, 2006 and September 30, 2005 of \$3,515,000 and \$765,000, respectively, were considered adequate to maintain the allowance in accordance with the policy discussed in Note 1. For the year ended December 31, 2005, a provision of \$1,105,000 was recorded.

At September 30, 2006, the recorded investment in loans that are considered to be impaired under Statement of Financial Accounting Standards No. 114 was \$8,213,000 (of which \$8,213,000 were on non-accrual status). The related allowance for loan losses for these loans was \$1,506,000. The average recorded investment in impaired loans during the nine months ended September 30, 2006 was approximately \$12,875,000. For this period, the Corporation recognized interest income of \$40,000 on these impaired loans.

**NOTE 5 - Premises and Equipment**

The investment in premises and equipment stated at cost and net of accumulated amortization and depreciation is as follows (in thousands):

September 30,	December 31 2005
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	<u>2006</u>	<u>2005</u>	<u></u>
Land	\$ 3,302	\$ 3,296	\$ 3,296
Buildings and Improvements	13,436	12,519	12,957
Furniture & Equipment	13,042	11,208	12,104
	<u>29,780</u>	<u>27,023</u>	<u>28,357</u>
Total Cost	29,780	27,023	28,357
Less: Accumulated Amortization and Depreciation	13,167	11,403	11,842
	<u>16,613</u>	<u>15,620</u>	<u>16,515</u>
Net Book Value	\$ 16,613	\$ 15,620	\$ 16,515

**NOTE 6** Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in business combinations under the purchase method of accounting. The Corporation has adopted Financial Accounting Standards Board Statement No. 142 (FAS 142), Goodwill and Other Intangible Assets. FAS 142 eliminates amortization of goodwill associated with business combinations completed after September 30, 2001. Goodwill is periodically assessed for impairment when events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. The Corporation bases its evaluation on such impairment factors as the nature of the assets, the future economic benefit of the assets, any historical or future profitability measurements, as well as other external market conditions or factors that may be present.

On May 3, 2004, the Corporation completed its merger with ANB Financial Corporation and its wholly-owned subsidiary, Arlington National Bank of Arlington, Texas ( collectively ANB ). A premium of \$10.7 million was paid in connection with the acquisition of ANB, \$2.7 million of which was identified as core deposit intangibles. The remaining \$8.0 million has been recorded as goodwill. In accordance with FAS 142, the goodwill will not be amortized. The core deposit intangibles are being amortized using a straight line method over their estimated useful life of 8 years. Amortization expense on the core deposit intangibles was \$246,000, \$328,000 and \$246,000 for the nine months ended September 30, 2006, the year ended December 31, 2005 and the nine months ended September 30, 2005, respectively.

On March 21, 2005, the Corporation completed the acquisition of DFS. Goodwill of \$1.0 million was recorded in connection with the acquisition.

As of September 30, 2006, the Corporation had other intangible assets with a net book value of \$32,000. Amortization expense of \$6,000 and \$9,000 has been recorded on the other intangible assets for the year ended December 31, 2005 and for the nine months ended September 30, 2006, respectively.

**NOTE 7** - Other Real Estate

The carrying value of other real estate is as follows (in thousands):

	September 30,		December 31,
	2006	2005	2005
Other Real Estate	\$ -0-	\$ -0-	\$ -0-

There were no direct write-downs of other real estate charged to income for the nine months ended September 30, 2006 or September 30, 2005. There were also no direct write-downs of other real estate charged to income for the year ended December 31, 2005.

**NOTE 8** Deposits

The book values of deposits by major type follow (in thousands):

	September 30,		December 31
	2006	2005	2005
Noninterest-Bearing Demand Deposits	\$ 270,863	\$ 258,644	\$ 263,027
Interest-Bearing Deposits:			
Interest-Bearing Transaction			
Accounts and Money Market Accounts	261,596	241,251	268,116
Savings	161,268	177,287	156,462
Certificates of Deposits under \$100,000 and IRAs	97,177	85,765	88,273
Certificates of Deposits of \$100,000 or more	130,844	100,031	99,848
Other	7,050	3,050	3,050
Total	657,935	607,384	615,749

Total Deposits	\$	928,798	\$	866,028	\$	878,776
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**NOTE 9 - Short Term Borrowings**

Securities sold under repurchase agreements generally represent borrowings with maturities ranging from one to thirty days. Information relating to these and other borrowings is summarized as follows (in thousands):

	Nine Months Ended September 30,		Year Ended December 31, 2005
	2006	2005	
<b>Securities Sold Under Repurchase Agreements:</b>			
Average Balance	\$ 107,218	\$ 44,332	\$ 50,825
Period-End Balance	121,370	51,370	61,559
Maximum Month-End Balance During Period	127,628	51,370	67,494
<b>Interest Rate:</b>			
Average	4.23%	2.40%	2.72%
Period-End	4.59	3.04	3.65
<b>Federal Home Loan Bank Advances:</b>			
Average Balance	\$ 41,099	\$ 63,663	\$ 61,808
Period-End Balance	20,000	60,000	55,000
Maximum Month-End Balance During Period	25,000	70,000	70,000
<b>Interest Rate:</b>			
Average	3.91%	3.00%	3.10%
Period-End	3.92	3.49	3.44
<b>Federal Funds Purchased:</b>			
Average Balance	\$ 1,254	\$ 444	\$ 534
Period-End Balance	-0-	-0-	5,300
Maximum Month-End Balance During Period	7,944	-0-	5,300
<b>Interest Rate:</b>			
Average	5.43%	2.95%	3.54%
Period-End	-0-	-0-	4.33

The Corporation has available a line of credit with the FHLB of Dallas which allows it to borrow on a collateralized basis at a fixed term. The borrowings are collateralized by a blanket floating lien on certain real estate loans, the FHLB capital stock owned by the Corporation and any funds on deposit with FHLB. At September 30, 2006, the Corporation had \$20.0 million of borrowings outstanding under the line of credit at an average rate of 4.10%, \$5.0 million of which matures in 2006 and the remaining \$15.0 million of which matures in 2007. For the nine months ended September 30, 2006, the Corporation had average borrowings under the line of credit of \$41.0 million. For the nine months ended September 30, 2005, the Corporation had average borrowings of \$63.7 million. At December 31, 2005, \$55.0 million of borrowings were outstanding at an average rate of 3.44%. For the year ended December 31, 2005, the Corporation had average borrowings of \$61.8 million.

**NOTE 10 Note Payable**

On September 15, 2005, the Corporation obtained a line of credit from a bank under which the Corporation may borrow \$10,000,000 at a floating rate (three month LIBOR plus margin of 2.00%). The line of credit is secured by stock of the Bank. The original maturity date of the line of credit was extended from September 15, 2006 to December 8, 2006, whereupon, if balances are outstanding, the line converts to a term note having a five year term. The Corporation will not pay a fee for any unused portion of the line. As of September 30, 2006, there were no borrowings under this line.

**NOTE 11 - Junior Subordinated Deferrable Debentures**

On May 3, 2004, the Corporation formed SBI Trust and SBI Trust subsequently issued \$12.0 million of floating rate (three month LIBOR plus a margin of 2.65%) Capital Securities (the Trust Capital Securities). Concurrent with the issuance of the Trust Capital Securities, SBI Trust issued trust common securities to the Corporation in the aggregate liquidation value of \$372,000. The proceeds of the issuance of the Trust Capital Securities and trust common securities were invested in the Corporation's Floating Rate Junior Subordinated Deferrable Debentures (the Deferrable Debentures), which mature on July 7, 2034 and have a call feature that permits the Corporation to redeem any or all of the securities after July 7, 2009. The interest rate on the Deferrable Debentures at September 30, 2006 and December 31, 2005 was 7.72% and 6.80%, respectively. The Deferrable Debentures, which are the only assets of SBI Trust, are subordinated and junior in right of payment to all present and future senior indebtedness (as defined in the Indenture dated May 3, 2004) of the Corporation.



**NOTE 12 - Stock -Based Compensation**

Prior to January 1, 2006, the Corporation accounted for stock-based compensation utilizing the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees and related Interpretations. Accordingly no compensation expense was recognized for stock option plans because the exercise prices of stock options equaled or exceeded the market prices of the underlying stock on the dates of the grants. However, stock-based compensation has been included in pro forma disclosures in the financial statement footnotes in prior periods.

Effective January 1, 2006, the Corporation adopted the fair value recognition provisions of SFAS No. 123R, Share-Based Payment using a modified version of prospective application. Under this method, compensation expense will be recorded for all awards granted after the date of adoption and for the unvested portion of previously granted awards that were outstanding as of the beginning of the period of adoption.

For the nine months ended September 30, 2006, stock-based compensation expense was \$128,000. The following table illustrates the effect on net income and earnings per share if the Corporation had applied the fair value recognition provisions of SFAS 123R to stock based compensation (in thousands, except for per share data):

	<b>Nine Months Ended September 30, 2005</b>	<b>Year Ended December 31, 2005</b>
Net Income, as Reported	\$ 9,660	\$ 13,176
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(196)	(241)
<b>Pro Forma Net Income</b>	<b>\$ 9,464</b>	<b>\$ 12,935</b>
<b>Earnings Per Share:</b>		
Basic - as Reported	\$ 0.78	\$ 1.06
Basic - Pro Forma	0.76	1.04
Diluted - as Reported	0.76	1.04
Diluted - Pro Forma	0.74	1.02

**NOTE 13 - Other Non-Interest Expense**

The significant components of other non-interest expense are as follows (in thousands):

	<b>Nine Months Ended September 30,</b>		<b>Year Ended December 31 2005</b>
	<b>2006</b>	<b>2005</b>	
Business Development	\$ 845	\$ 795	\$ 1,097
Legal and Professional Fees	1,061	975	1,304
Data and Item Processing	553	474	821
Printing and Supplies	349	359	475
Regulatory Fees and Assessments	262	239	325
Other	2,978	2,330	2,861
<b>Total</b>	<b>\$ 6,048</b>	<b>\$ 5,172</b>	<b>\$ 6,883</b>

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NOTE 14 - Income Taxes

Federal income taxes included in the consolidated balance sheets were as follows (in thousands):

	September 30,		December 31, 2005
	2006	2005	
Current Tax Asset (Liability)	\$ 68	\$ (82)	\$ (56)
Net Deferred Tax Asset	4,932	4,416	5,020
<b>Total Included in Other Assets</b>	<b>\$ 5,000</b>	<b>\$ 4,334</b>	<b>\$ 4,964</b>

The net deferred tax asset at September 30, 2006 of \$4,932,000 included \$1,760,000, a deferred tax asset related to unrealized losses on Available-for-Sale Securities.

The components of income tax expense were as follows (in thousands):

	Nine Months Ended September 30,		Year Ended December 31, 2005
	2006	2005	
Federal Income Tax Expense:			
Current	\$ 5,184	\$ 5,889	\$ 7,791
Deferred (Benefit)	122	(502)	(533)
<b>Total Federal Income Tax Expense</b>	<b>\$ 5,306</b>	<b>\$ 5,387</b>	<b>\$ 7,258</b>
Effective Tax Rates	35.7%	35.8%	35.0%

The reasons for the difference between income tax expense and the amount computed by applying the statutory federal income tax rate to operating earnings are as follows (in thousands):

	Nine Months Ended September 30,		Year Ended December 31, 2005
	2006	2005	
Federal Income Taxes at Statutory Rate of 35.0%	\$ 5,195	\$ 5,267	\$ 7,152
Effect of Tax Exempt Interest Income	(122)	(77)	(108)
Non-deductible Expenses	227	167	228
Other	6	30	(14)
<b>Income Taxes Per Income Statement</b>	<b>\$ 5,306</b>	<b>\$ 5,387</b>	<b>\$ 7,258</b>

**NOTE 14 - Income Taxes (cont d.)**

Deferred income tax expense (benefit) results from differences between amounts of assets and liabilities as measured for income tax return and financial reporting purposes. The significant components of federal deferred tax assets and liabilities are in the following table (in thousands):

	September 30,		December 31, 2005
	2006	2005	
<b>Federal Deferred Tax Assets:</b>			
Allowance for Loan Losses	\$ 3,639	\$ 3,896	\$ 3,923
Interest on Non-accrual Loans	250	142	135
Unrealized Losses on Available-for-Sale Securities	1,760	1,152	1,725
Deferred Compensation	865	719	747
Net Operating Loss Carryover	71	116	105
Other	4	40	48
<b>Gross Federal Deferred Tax Assets</b>	<b>6,589</b>	<b>6,065</b>	<b>6,683</b>
<b>Federal Deferred Tax Liabilities:</b>			
Depreciation and Amortization	1,297	1,414	1,385
Accretion	202	79	113
Other	158	156	165
<b>Gross Federal Deferred Tax Liabilities</b>	<b>1,657</b>	<b>1,649</b>	<b>1,663</b>
<b>Net Deferred Tax Asset</b>	<b>\$ 4,932</b>	<b>\$ 4,416</b>	<b>\$ 5,020</b>

**NOTE 15 - Related Party Transactions**

The Bank has made loan transactions in the ordinary course of business with certain of its and the Corporation's officers, directors and their affiliates. All loans included in such transactions are made on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with other unrelated persons and all such loans are current as to principal and interest payments. Total loans outstanding to such related parties amounted to approximately \$6,843,000 at September 30, 2006 and \$9,356,000 at December 31, 2005 and \$11,410,000 at September 30, 2005.

**NOTE 16 - Commitments and Contingent Liabilities**

In the normal course of business, there are various outstanding commitments and contingent liabilities, such as guarantees and commitments to extend credit, which are not reflected in the financial statements. No losses are anticipated as a result of these transactions. Commitments are most frequently extended for real estate, commercial and industrial loans.

At September 30, 2006, outstanding documentary and standby letters of credit totaled \$9,117,000 and commitments to extend credit totaled \$238,095,000.

In addition, the Corporation leases certain office facilities under operating leases. Rent expense for all operating leases totaled \$1,041,000 and \$947,000 for the nine months ended September 30, 2006 and 2005, respectively, and \$1,305,000 for the year ended December 31, 2005.

**NOTE 17 - Stock Option Plans**

On April 18, 2006, the shareholders of the Corporation approved the 2006 Long-Term Incentive Plan of the Corporation (the 2006 Plan). The 2006 Plan replaced the 1997 Stock Option Plan and is intended to enable the Corporation to remain competitive and innovative in its ability to attract, motivate, reward and retain the services of key employees. The 2006 Plan provides for the granting of stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards, dividend equivalent rights, and other awards which may be paid in cash or stock. The 2006 Plan is expected to provide flexibility to the Corporation's compensation methods in order to adapt the compensation

of key employees to a changing business environment, after giving due consideration to competitive conditions and the impact of federal tax laws. Subject to certain adjustments, the number of the Corporation's shares of common stock that may be issued pursuant to awards under the 2006 Plan is 1,250,000 shares, less the total number of shares of common stock issued pursuant to the 2006 Plan or issuable upon the exercise of awards granted under the 1997 Stock Option Plan. No more options may be granted under the 1993 Stock Option Plan or the 1997 Stock Option Plan of the Corporation, each of which has terminated. Each award granted under the 1997 Stock Option Plan is now subject to the 2006 Plan. The stock options granted under the 2006 Plan will generally be exercisable for ten years from the date of grant and generally vest ratably over a five year period. Options have been granted at prices which will not be less than 100-110% of the fair market value of the underlying common stock at the date of grant.

NOTE 17 - Stock Option Plans (cont d.)

The following is a summary of transactions during the periods presented:

	Shares Under Option Plans	
	Nine Months Ended September 30, 2006	Year Ended December 31, 2005
Outstanding, Beginning of Period	616,354	679,578
Additional Options Granted During the Period	11,500	55,200
Forfeited During the Period	(11,300)	(2,400)
Exercised During the Period	(196,704)	(116,024)
Outstanding, End of Period	419,850	616,354

Options outstanding at September 30, 2006 have exercise prices between \$5.19 to \$18.75 per share with a weighted average exercise price of \$10.95 and 356,330 shares exercisable. At September 30, 2006, there remained 798,545 shares reserved for future grants of options under the 2006 Plan. See Note 12 Stock Based Compensation for information regarding the dilutive impact of these stock options.

NOTE 18 - Employee Benefit Plans401(k) Plan

The Corporation implemented a 401(k) plan in December 1997 covering substantially all employees. The Corporation made no contribution to this plan in 1998 or 1999. Beginning in 2000, the Corporation made matching contributions, not to exceed 6% of the employee's annual compensation, to the participants' deferrals of compensation up to 100% of the employee contributions.

The amount expensed in support of the plan was \$510,000 and \$451,000 during the first nine months of 2006 and 2005, respectively, and \$592,000 for the year 2005.

Supplemental Executive Retirement Plan

In 2002, the Corporation established a Supplemental Executive Retirement Plan (the Retirement Plan) to provide key employees with retirement, death or disability benefits. For currently employed employees, the Retirement Plan replaces the previous Management Security Plan. The Retirement Plan is a defined contribution plan and the expense charged to earnings relating to the Retirement Plan was \$397,000 and \$312,000 for the first nine months of 2006 and 2005, respectively, and \$458,000 for the year 2005.

Employment Contracts

The Chief Executive Officer of the Corporation has entered into a severance agreement with the Corporation providing for salary and fringe benefits in the event of termination for other than cause and under certain changes in control.

Other Post Retirement Benefits

The Corporation provides certain health care benefits for certain retired employees who bear all costs of these benefits. These benefits are covered under the Consolidated Omnibus Budget Reconciliation Act.

Compensated Absences

Employees of the Corporation are entitled to paid vacation, paid sick days and other personal days off, depending on job classification, length of service and other factors. It is impracticable to estimate the amount of compensation for future absences, and accordingly, no liability has been recorded in the accompanying financial statements. The Corporation's policy is to recognize the costs of compensated absences when actually paid to employees.

Other Employment Letter Agreements

In conjunction with the merger agreement, Cullen/Frost entered into employment letters with certain Summit executives. Under the employment letters, each of the executives will be employed by Cullen/Frost through at least the second anniversary of the completion of the merger, unless earlier terminated pursuant to the terms of the letter agreements. The executives who entered into the letter agreements, also entered into a Confidential Information, Non-Solicitation and Noncompetition Agreement (referred to herein as the non-compete agreement ) with Cullen/Frost and Summit, which became effective as of the date the merger agreement was signed. Under the non-compete agreement the executives agreed to keep confidential information confidential and not to compete with the business of Cullen/Frost and its affiliates in Tarrant County, Texas.



**NOTE 19 - Earnings per Share**

The following data shows the amounts used in computing earnings per share ( EPS ) and the weighted average number of shares of dilutive potential common stock (dollars in thousands):

	Nine Months Ended September 30,		Year Ended December 31, 2005
	2006	2005	
Net income	\$ 9,539	\$ 9,660	\$ 13,176
Weighted average number of common shares used in Basic EPS	12,532,768	12,405,183	12,414,366
Effect of dilutive stock options	267,044	300,294	295,957
Weighted number of common shares and dilutive potential common stock used in Diluted EPS	12,799,812	12,705,477	12,710,323

The incremental shares for the assumed exercise of the outstanding options were determined by application of the treasury stock method.

**NOTE 20 - Financial Instruments with Off-Balance Sheet Risk**

The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include loan commitments, standby letters of credit and documentary letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the financial statements.

The Corporation's exposure to credit loss in the event of non-performance by the other party of these loan commitments and letters of credit is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The total contractual amounts of financial instruments with off-balance sheet risk are as follows (in thousands):

	September 30,	
	2006	2005
<b>Financial Instruments Whose Contract Amounts Represent Credit Risk:</b>		
Loan Commitments Including Unfunded Lines of Credit	\$ 238,095	\$ 189,257
Letters of Credit	9,117	5,112

Loan commitments are agreements to lend to a customer as long as there is no customer violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Letters of credit are conditional commitments by the Corporation to 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.

Since many of the loan commitments and letters of credit may expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. The Corporation evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, owner-occupied real estate and income-producing commercial properties.

The Corporation originates real estate, commercial and consumer loans primarily to customers in the Tarrant County area. Although the Corporation has a diversified loan portfolio, a substantial portion of its customers' ability to honor their contracts is dependent upon the local economy and the real estate market.

The Corporation maintains funds on deposit at correspondent banks which at times exceed the federally insured limits. Management of the Corporation monitors the balance in these accounts and periodically assesses the financial condition of correspondent banks.

NOTE 21 - Concentrations of Credit Risk

The Bank makes commercial, consumer and real estate loans in its direct market which is defined as Fort Worth and its surrounding area. The Board of Directors of the Bank monitors concentrations of credit by purpose, collateral and industry at least quarterly. Certain limitations for concentration are set by the Board of Directors of the Bank. Additional loans in excess of these limits must have prior approval of the Bank's directors' loan committee. Although the Bank has a diversified loan portfolio, a substantial portion of its debtors' abilities to honor their contracts is dependent upon the strength of the local and state economy.

NOTE 22 - Litigation

The Corporation is involved in legal actions arising in the ordinary course of business. It is the opinion of management, after reviewing such actions with outside legal counsel, that the settlement of these matters will not materially affect the Corporation's financial position.

NOTE 23 - Stock Repurchase Plan

On April 18, 2006, the Board of Directors of the Corporation approved a stock purchase plan (the 2006 Stock Purchase Plan) authorizing management to purchase up to 623,675 shares of the Corporation's common stock on behalf of the Corporation over the twelve-month period beginning April 19, 2006 and ending on April 18, 2007, including in open market transactions, privately negotiated transactions or other transactions in accordance with all applicable state and federal laws and regulations. In the quarter ended September 30, 2006, no shares were purchased by the Corporation pursuant to the 2006 Stock Purchase Plan in privately negotiated transactions.

The Corporation's ability to purchase shares of the Corporation's common stock is subject to various banking laws, regulations and policies as well as rules and regulations of the Securities and Exchange Commission.

NOTE 24 - Subsequent Events

On October 5, 2006, the Company filed a Form 8-K Report with the Securities and Exchange Commission reporting a loan charge-off recovery of \$3.0 million was recorded resulting from a cash payment of \$4.5 million on the credit. This payment satisfies the full obligation of the borrower with the exception of an \$183,000 secured note. It is anticipated that the recovery will result in a reduction in the provision for loan losses for the year of 2006 that is to be recorded in the fourth quarter.

On October 18, 2006, the Board of Directors of the Corporation approved a quarterly dividend of \$.08 per share to be paid on November 15, 2006 to shareholders of record on November 1, 2006.

NOTE 25 - Fair Values of Financial Instruments

The following methods and assumptions were used by the Corporation in estimating its fair value disclosures for financial instruments:

*Cash and cash equivalents:* The carrying amounts reported in the balance sheet for cash and due from banks and federal funds sold approximate those assets' fair values.

*Investment securities (including mortgage backed securities):* Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

*Loans:* For variable rate loans, fair values are based on carrying values. The fair values for fixed rate loans such as mortgage loans (e.g., one-to-four family residential) and installment loans are estimated using discounted cash flow analysis. The carrying amount of accrued interest receivable approximates its fair value.

*Deposit liabilities:* The fair value disclosed for interest-bearing and noninterest-bearing demand deposits, passbook savings, and certain types of money market accounts are, by definition, equal to the amount payable on demand at the reporting date or their carrying amounts. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

*Short term borrowings:* The carrying amounts of borrowings under repurchase agreements, Federal Home Loan Bank advances and Federal Funds Purchased approximate their fair values.

The estimated fair values of the Corporation's financial instruments are as follows (in thousands):

NOTE 25 - Fair Values of Financial Instruments (cont d)

	September 30,			
	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial Assets:</b>				
Cash and due from banks	\$ 29,837	\$ 29,837	\$ 34,967	\$ 34,967
Federal funds sold and interest bearing deposits	1,015	1,015	15,671	15,671
Investment securities	251,153	251,153	236,544	236,544
Loans	857,840	846,505	754,153	735,864
Allowance for loan losses	(10,399)	(10,399)	(11,131)	(11,131)
<b>Financial Liabilities:</b>				
Deposits	928,798	931,508	866,028	866,701
Short term borrowings	141,370	141,184	111,370	111,224
<b>Off-balance Sheet Financial Instruments:</b>				
Loan commitments		238,095		189,257
Letters of credit		9,117		5,112

NOTE 26 - Comprehensive Income

The Corporation has adopted Financial Accounting Standards Board Statement of Financial Accounting Standards No. 130 Reporting Comprehensive Income. This standard requires an entity to report and display comprehensive income and its components. Comprehensive income is as follows (in thousands):

	Nine Months Ended September 30,		Year Ended December 31, 2005
	2006	2005	
Net Income	\$ 9,539	\$ 9,660	\$ 13,176
<b>Other Comprehensive Income:</b>			
Change in unrealized loss on securities available-for-sale, net of tax benefit	(67)	(1,762)	(2,875)
<b>Comprehensive Income</b>	<b>\$ 9,472</b>	<b>\$ 7,898</b>	<b>\$ 10,301</b>

NOTE 27 Dividends from Subsidiaries

The primary source of funds for the Corporation is cash dividends received from the Bank. The amount of dividends that the Bank may pay in any one year, without the approval of the Comptroller of the Currency, is the sum of the retained net profits for the preceding two years plus its total of the retained net profits for the current year. Under this formula, as defined, as of September 30, 2006, the Bank can legally initiate dividend payments of \$19,510,000 for the remainder of 2006. The Bank is also restricted from paying dividends that would cause the Bank to be under-capitalized.

Internal dividend policies limit dividends paid by the Bank if its equity capital falls below certain minimum levels as determined by the Bank's Board of Directors.

Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

*The following discussion should be read in conjunction with the consolidated financial statements, accompanying notes and selected financial data appearing elsewhere in this Quarterly Report on Form 10-Q and in our most recent Annual Report on Form 10-K and may contain certain forward-looking statements that are based on current management expectations. Generally, verbs in the future tense and the words believe, expect, anticipate, estimate, intends, opinion, potential and similar expressions identify forward-looking statements. Examples of this forward-looking information can be found in, but are not limited to, the expected effects of accounting pronouncements and government regulation applicable to our operations, the discussion of allowance for loan losses, and quantitative and qualitative disclosure about market risk. Our actual results could differ materially from the forward-looking statements and management expectations. Further information concerning our business, including additional risk factors and uncertainties that could cause actual results to differ materially from the forward-looking statements contained in this Quarterly Report on Form 10-Q, is set forth below under the heading Risk Factors. These risk factors and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. The forward-looking statements contained herein speak only as of the date of this Quarterly Report on Form 10-Q and, except as may be required by applicable law and regulation, we do not undertake, and specifically disclaim any obligation to, publicly update or revise such statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. Except as the context otherwise requires, references herein to the Corporation, we, us, or our refer to Summit Bancshares, Inc. and its consolidated subsidiaries.*

Overview

Our business has been conducted primarily through our wholly-owned subsidiaries, Summit Bank, National Association (the Bank) and Summit Delaware Financial Corporation. The Bank currently operates its branch offices in twelve locations in Tarrant County, Texas.

Our results of operations are primarily dependent on net interest income, which is the difference between the income earned on our loans and investment portfolios and our cost of funds, consisting of the interest paid on deposits and borrowings. Results of operations are also affected by our allowance for loan losses, investment activities, loan servicing fees and other fees. Our non-interest expense principally consists of salary and benefits, occupancy and equipment expense, business development costs, professional fees, data processing expense and other expenses.

Net income for the third quarter of 2006 was \$3,590,000, which represented an increase of \$134,000, or 3.9%, compared to \$3,456,000 for the third quarter of 2005. On a weighted average share basis, net income for the third quarter of 2006 was \$0.28 per diluted share as compared to \$0.27 per diluted share for the third quarter of 2005, an increase of 3.7%. The increase in net income for the third quarter of 2006 reflected an increase in net interest income (tax equivalent) of \$1,659,000, or 14.7%, over the third quarter of 2005. Net income for the first nine months of 2006 was \$9,539,000, which represented a decrease of \$121,000, or 1.3%, compared to net income of \$9,660,000 for the first nine months of 2005. On a weighted average share basis, net income for the first nine months of 2006 was \$0.75 per diluted share, which represented a decrease of 1.3% from \$0.76 per diluted share for the first nine months of 2005. The decrease in earnings during the first nine months of 2006 compared to the first nine months of 2005 was primarily due to an increase of \$2,750,000 in the provision for loan losses. The increase in the provision for loan losses reflected a higher level of charge offs and an increase in loan volume.

Total loans were \$858.0 million at September 30, 2006, which represented an increase of \$104.0 million, or 13.7%, from the amount reported as of September 30, 2005 and an increase of \$83.0 million, or 10.7% over total loans at December 31, 2005. Total deposits at September 30, 2006 of \$928.8 million increased \$62.8 million, or 7.2%, from \$866.0 million at September 30, 2005 and increased \$50.0 million, or 5.7%, from \$878.8 million at December 31, 2005. Compared to the third quarter of 2005, we experienced growth in every category of deposits during the third quarter of 2006. Shareholders' equity was \$88.8 million at September 30, 2006, an increase of \$9.1 million, or 11.4%, compared to shareholders' equity of \$79.7 million at September 30, 2005. See the Statement of Changes in Shareholders' Equity for a detail of the changes.

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The following table shows selected performance ratios for the first nine months of 2006 and 2005 that management believes to be key indicators of our performance:

	<u>September 30, 2006</u>	<u>September 30, 2005</u>
Annualized Return on Average Assets (ROAA)	1.12%	1.27%
Annualized Return on Average Shareholders' Equity (ROAE)	15.08	16.75
Shareholders' Equity to Assets - Average	7.42	7.61
Dividend Payout Ratio	31.54	26.95
Net Interest Margin (tax equivalent)	4.72	4.54
Efficiency Ratio	57.76	58.49
Net Income Per Share - Diluted	\$ 0.75	\$ 0.76

The return on average assets ratio is calculated by dividing annualized net income by average total assets for the period. Our return on average assets ratio was 1.12% for the first nine months of 2006. Our return on average assets for the first nine months of 2006 was negatively affected by the level of the provision for loan losses.

The return on average shareholders' equity ratio is calculated by dividing annualized net income by average shareholders' equity for the period. Our return on average shareholders' equity ratio was 15.08% in the first nine months of 2006.

The shareholders' equity to assets ratio is calculated by dividing average shareholders' equity by average total assets for the period. Our shareholders' equity to assets ratio was 7.42% in the first nine months of 2006.

The dividend payout ratio is determined by dividing the total dividends paid by net income for the period. Our dividend payout ratio was 31.54 % in the first nine months of 2006.

Net interest margin is calculated by dividing annualized net interest income on a tax equivalent basis by average total earning assets. Our net interest margin was 4.72% in the first nine months of 2006.

The efficiency ratio is calculated by dividing non-interest expenses by the sum of total non-interest income and tax equivalent interest income for the period. Our efficiency ratio was 57.76% in the first nine months of 2006 and provides a measure of the extent to which our revenues are absorbed by our non-interest expenses.

Summary of Earning Assets and Interest-Bearing Liabilities

The following schedule presents average balance sheets that highlight earning assets and interest-bearing liabilities and their related rates earned and paid for the third quarters of 2006 and 2005 (rates on tax equivalent basis):

	Three Months Ended September 30,					
	2006			2005		
	Average Balances	Interest	Average Yield/Rate	Average Balances	Interest	Average Yield/Rate
(Dollars in Thousands)						
<b>Earning Assets:</b>						
Federal Funds Sold & Interest Bearing Deposits	\$ 1,875	\$ 24	4.87%	\$ 13,294	\$ 114	3.40%
Investment Securities (Taxable)	227,135	2,389	4.21%	216,541	2,073	3.83%
Investment Securities (Tax-exempt)	15,293	213	5.57%	9,900	133	5.37%
Loans, Net of Unearned Discount <sup>(1)</sup>	843,458	17,308	8.14%	735,109	13,203	7.13%
<b>Total Earning Assets</b>	<b>1,087,761</b>	<b>19,934</b>	<b>7.27%</b>	<b>974,844</b>	<b>15,523</b>	<b>6.32%</b>
<b>Non-interest Earning Assets:</b>						
Cash and Due From Banks	34,114			30,876		
Other Assets	49,588			43,824		
Allowance for Loan Losses	(10,184)			(10,916)		
<b>Total Assets</b>	<b>\$ 1,161,279</b>			<b>\$ 1,038,628</b>		
<b>Interest-Bearing Liabilities:</b>						
Interest-Bearing Transaction Accounts and Money Market Funds	\$ 255,760	1,475	2.29%	\$ 232,640	886	1.51%
Savings	163,024	1,198	2.92%	173,539	866	1.98%
Certificates of Deposit under \$100,000 and IRAs	96,505	965	3.97%	82,786	614	2.94%
Certificates of Deposit \$100,000 or more	124,301	1,291	4.12%	98,670	794	3.19%
Other Time	5,680	74	5.17%	2,755	25	3.60%
Other Borrowings	161,058	2,012	4.96%	121,435	1,078	3.52%
<b>Total Interest-Bearing Liabilities</b>	<b>806,328</b>	<b>7,015</b>	<b>3.45%</b>	<b>711,825</b>	<b>4,263</b>	<b>2.38%</b>
<b>Non-interest Bearing Liabilities:</b>						
Demand Deposits	261,768			242,849		
Other Liabilities	6,320			4,901		
Shareholders' Equity	86,863			79,053		
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 1,161,279</b>			<b>\$ 1,038,628</b>		
<b>Net Interest Income and Margin (Tax-equivalent Basis)<sup>(2)</sup></b>		<b>\$ 12,919</b>	<b>4.71%</b>		<b>\$ 11,260</b>	<b>4.58%</b>

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- (1) Loan interest income includes fees and loan volumes include loans on non-accrual. The loan fees include loan origination fees which are considered adjustments to interest income. These fees aggregated \$490,000 and \$427,000 at September 30, 2006 and 2005, respectively.
- (2) Presented on tax equivalent basis using a federal income tax rate of 35% for 2006 and 2005.



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The following schedule presents average balance sheets that highlight earning assets and interest-bearing liabilities and their related rates earned and paid for the first nine months of 2006 and 2005 (rates on tax equivalent basis):

	Nine Months Ended September 30,					
	2006			2005		
	Average Balances	Interest	Average Yield/Rate	Average Balances	Interest	Average Yield/Rate
(Dollars in Thousands)						
<b>Earning Assets:</b>						
Federal Funds Sold & Interest Bearing Deposits	\$ 1,548	\$ 56	4.87%	\$ 7,823	\$ 181	3.09%
Investment Securities (Taxable)	232,074	7,084	4.07%	212,369	5,913	3.71%
Investment Securities (Tax-exempt)	13,917	569	5.45%	8,796	349	5.29%
Loans, Net of Unearned Discount <sup>(1)</sup>	822,546	48,827	7.94%	721,952	36,905	6.83%
<b>Total Earning Assets</b>	<b>1,070,085</b>	<b>56,536</b>	<b>7.06%</b>	<b>950,940</b>	<b>43,348</b>	<b>6.09%</b>
<b>Non-interest Earning Assets:</b>						
Cash and Due From Banks	32,633			30,361		
Other Assets	48,262			42,663		
Allowance for Loan Losses	(11,763)			(10,644)		
<b>Total Assets</b>	<b>\$ 1,139,217</b>			<b>\$ 1,013,320</b>		
<b>Interest-Bearing Liabilities:</b>						
Interest-Bearing Transaction Accounts and Money Market Funds	\$ 259,503	4,041	2.08%	\$ 233,203	2,400	1.38%
Savings	155,337	3,032	2.61%	168,002	2,206	1.76%
Certificates of Deposit under \$100,000 and IRAs	93,154	2,571	3.69%	78,341	1,585	2.70%
Certificates of Deposit \$100,000 or more	116,450	3,361	3.86%	89,253	1,951	2.92%
Other Time	5,687	204	4.80%	1,028	27	3.51%
Other Borrowings	161,960	5,561	4.59%	126,073	2,890	3.06%
<b>Total Interest-Bearing Liabilities</b>	<b>792,091</b>	<b>18,770</b>	<b>3.17%</b>	<b>695,900</b>	<b>11,059</b>	<b>2.12%</b>
<b>Non-interest Bearing Liabilities:</b>						
Demand Deposits	257,008			235,896		
Other Liabilities	5,571			4,435		
Shareholders Equity	84,547			77,089		
<b>Total Liabilities and Shareholders Equity</b>	<b>\$ 1,139,217</b>			<b>\$ 1,013,320</b>		
<b>Net Interest Income and Margin (Tax-equivalent Basis)<sup>(2)</sup></b>		<b>\$ 37,766</b>	<b>4.72%</b>		<b>\$ 32,289</b>	<b>4.54%</b>

(1) Loan interest income includes fees and loan volumes include loans on non-accrual. The loan fees include loan origination fees which are considered adjustments to interest income. These fees aggregated \$1,454,000 and \$1,263,000 at September 30, 2006 and 2005, respectively.

- (2) Presented on tax equivalent basis using a federal income tax rate of 35% for 2006 and 2005.

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Net Interest Income

The net interest margin was 4.71% for the third quarter of 2006, which represented an increase of 13 basis points from the third quarter of 2005. This increase in net interest margin reflected a 95 basis point increase in yield on earning assets from the third quarter of 2005 to the third quarter of 2006, which was partially offset by a 107 basis point increase in rates paid on interest-bearing liabilities from the third quarter of 2005 to the third quarter of 2006. The increase in the net interest margin also reflected the impact of our non-interest bearing funding sources, primarily demand deposits and shareholders' equity. Average demand deposits were \$261.8 million in the third quarter of 2006, an increase of \$19.0 million, or 7.8%, over the third quarter of 2005.

Net interest income (tax equivalent) for the third quarter of 2006 was \$12,919,000, which represented an increase of \$1,659,000, or 14.7%, compared to the third quarter of 2005. In the third quarter of 2006, tax equivalent interest income increased \$4,411,000, or 28.4%, while interest expense increased \$2,752,000, or 64.6%, compared to the third quarter of 2005. The increase in net interest income resulted from a 11.6% growth in average earning assets for the third quarter of 2006 compared to the third quarter of 2005, along with a 166 basis point increase in market interest rates (as measured by the prime rate as published in the *Wall Street Journal*) from September 2005 through September 2006.

The net interest margin was 4.72% for the nine months ended September 30, 2006 which represented a 18 basis point increase over the net interest margin of 4.54% for the nine months ended September 30, 2005. The increase in net interest margin reflected a 97 basis point increase in yield on earning assets from the first nine months of 2005 to the first nine months of 2006, which was partially offset by a 105 basis point increase in rates paid on interest-bearing liabilities from the first nine months of 2005 to the first nine months of 2006. The increase in net interest margin also reflected an increase in the volume of loans, up \$100.6 million, or 13.9%, over the first nine months of 2005 and increases in non-interest bearing funding sources, such as demand deposits and shareholders' equity. Average demand deposits were \$257.0 million in the first nine months of 2006, an increase of \$21.1 million, or 8.9%, over the first nine months of 2005.

Net interest income (tax equivalent) for the first nine months of 2006 was \$37,766,000, which represented an increase of \$5,477,000, or 17.0%, compared to the first nine months of 2005. In the first nine months of 2006, tax equivalent interest income increased \$13,188,000, or 30.4%, while interest expense increased \$7,711,000, or 69.7% compared to the first nine months of 2005. The increase in net interest income reflected a 12.5% increase in average earning assets for the first nine months of 2006 compared to the first nine months of 2005 and the higher interest rate environment.

In the event that our average loans continue to increase and we are unable to fund such growth solely through the generation of additional deposits, we may be required to obtain additional funding from secondary sources, such as the Federal Home Loan Bank, Federal Funds purchased, or brokered deposits, which could have a negative impact on our net interest margin. We may experience a slower growth in our net interest margin during the remainder of 2006 if we are required to obtain additional funding from secondary sources, but should benefit as our investment portfolio and maturing fixed rate loans reprice at higher rates. Because of the composition of our balance sheet and our emphasis on commercial lending, we are market interest rate sensitive and expect to benefit from any market interest rate increases, assuming that interest rates on deposits and borrowings do not increase significantly faster than interest rates on earning assets.

The table below analyzes the increase in net interest income on a fully tax equivalent basis for the three month periods ended September 30, 2006 and 2005. Non-accruing loans have been included in assets for these computations, thereby reducing yields on total loans. For purposes of this table, changes attributable to both rate and volume which cannot be segregated have been allocated to rate.

**ANALYSIS OF CHANGES IN NET INTEREST INCOME**  
(Dollars in Thousands)

	3rd Qtr. 2006 vs. 3rd Qtr. 2005			3rd Qtr. 2005 vs. 3rd Qtr. 2004		
	Increase (Decrease) Due to Changes in:			Increase (Decrease) Due to Changes in:		
	Volume	Rate	Total	Volume	Rate	Total
<b>Interest Earning Assets:</b>						
Federal Funds Sold & Interest Bearing Deposits	\$ (106)	\$ 16	\$ (90)	\$ (10)	\$ 74	\$ 64
Investment Securities	156	240	396	84	69	153
Loans, Net of Unearned Discount	1,946	2,159	4,105	852	2,054	2,906

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Total Interest Income	1,996	2,415	4,411	926	2,197	3,123
Interest-Bearing Liabilities:						
Deposits	368	1,450	1,818	209	980	1,189
Other Borrowings	(71)	1,005	934	15	526	541
Total Interest Expense	297	2,455	2,752	224	1,506	1,730
Net Interest Income	\$ 1,699	\$ (40)	\$ 1,659	\$ 702	\$ 691	\$ 1,393

Non-Interest Income

The major component of non-interest income is various charges and fees that we earn on deposit accounts and related services. The following table reflects the changes in non-interest income during the periods presented (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2006	2005	% Change	2006	2005	% Change
Service Charges on Deposit Accounts	\$ 1,046	\$ 992	5.4%	\$ 2,968	\$ 2,904	2.2%
Non-recurring Income	-0-	315	(100.0)	-0-	449	(100.0)
Gain on Sale of Student Loans	25	25	-0-	229	263	(12.9)
Other Non-interest Income	1,030	844	22.0	2,973	2,475	20.1
<b>Total Non-interest Income</b>	<b>\$ 2,101</b>	<b>\$ 2,176</b>	<b>(3.4)%</b>	<b>\$ 6,170</b>	<b>\$ 6,091</b>	<b>1.3%</b>

Non-interest income was \$2.1 million for the third quarter of 2006, a decrease of \$75,000, or 3.4%, over the third quarter of 2005. Non-interest income was \$6.2 million for the nine months ended September 30, 2006, an increase of \$79,000, or 1.3%, over the nine months ended September 30, 2005.

In the third quarter of 2006 compared to the third quarter of 2005, there were positive increases in service charges on deposits, investment service fees, mortgage origination fees and debit card fees.

Non-recurring non-interest income for the first nine months of 2005 includes a gain of \$247,000 on the sale of land carried in Premises and Equipment in the third quarter of 2005 that was previously held for future bank expansion. The other component of non-recurring income for the first nine months of 2005 resulted from extraordinary payments of \$202,000 received from Pulse EFT as a participant in that ATM network.

The increase in other non-interest income in the third quarter and first nine months of 2006, as compared to the same periods last year, is largely due to increases in investment services fees, mortgage loan origination fees, debit card income and insurance commissions.

Non-interest Expense

Non-interest expense includes all expenses other than interest expense, the provision for loan losses and income tax expense. The following table summarizes the changes in non-interest expense during the periods presented (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2006	2005	% Change	2006	2005	% Change
Salaries & Employee Benefits	\$ 4,895	\$ 4,579	6.9%	\$ 14,731	\$ 13,296	10.8%
Occupancy Expense - Net	847	724	17.0	2,456	1,988	23.5
Furniture and Equipment Expense	648	587	10.4	1,887	1,756	7.5
Other Real Estate and Foreclosed						
Asset Expense - Net	-0-	-0-	-0-	-0-	(11)	(100.0)
Intangible Asset Amortization	85	82	3.7	255	246	3.7
Other Expenses:						
Business Development	269	236	14.0	845	795	6.3
Insurance - Other	63	72	(12.5)	212	167	26.9
Legal & Professional Fees	443	282	57.1	1,061	975	8.8
Data & Item Processing	191	173	10.4	553	474	16.7
Franchise Taxes	18	38	(52.6)	55	82	(32.9)
Postage & Courier	139	108	28.7	401	342	17.3
Printing & Supplies	96	141	(31.9)	349	359	(2.8)

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Regulatory Fees & Assessments	87	76	14.5	262	239	9.6
Other Operating Expenses	1,176	539	118.2	2,310	1,739	32.8
<b>Total Other Expenses</b>	<b>2,482</b>	<b>1,665</b>	<b>49.1</b>	<b>6,048</b>	<b>5,172</b>	<b>16.9</b>
<b>Total Non-interest Expense</b>	<b>\$ 8,957</b>	<b>\$ 7,637</b>	<b>17.3%</b>	<b>\$ 25,377</b>	<b>\$ 22,447</b>	<b>13.1%</b>

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Total non-interest expense increased 17.3% in the third quarter of 2006 over the third quarter of 2005. As a percent of average assets, non-interest expense was 3.06% in the third quarter of 2006 (annualized) compared with 2.92% in the same period last year. Total non-interest expense for the first nine months of 2006 was 13.1% higher than the first nine months of last year. The higher levels of non-interest expense for third quarter of 2006 and for the nine months ended September 30, 2006 were largely the result of increases in salaries and benefits and occupancy expense.

The efficiency ratio (non-interest expenses divided by total non-interest income plus net interest income) was 59.63% for the third quarter of 2006 compared to 56.84% for the third quarter of 2005.

The increases in salaries and benefits during the third quarter of 2006 and the first nine months of 2006 compared to the same periods in 2005 were due to salary merit increases, increases in the cost of employee benefit programs, expenses associated with Summit Financial Partners and the recognition of expense related to employee stock options. Effective January 1, 2006, the Corporation adopted the fair value recognition provisions of SFAS No. 123R, Share-Based Payment using a modified version of prospective application. Under this method, compensation expense will be recorded for all awards granted after the date of adoption and for the unvested portion of previously granted awards that were outstanding as of the beginning of the period of adoption. For the three month and nine month periods ended September 30, 2006, stock-based compensation expense was \$26,000 and \$128,000, respectively. For periods prior to January 1, 2006, stock based compensation has been included in pro forma disclosures in the financial statement footnotes.

The higher levels of occupancy expense for the third quarter and first nine months of 2006 compared to the same periods of 2005 year were due to several factors, including increases in rent expense, utilities and ad valorem taxes. Also contributing to the increase in occupancy expense was the loss of tenant rents at a bank-owned facility beginning in September 2005.

The increases in insurance expense during the first nine months of 2006 were largely attributable to higher costs of blanket bond and directors and officers liability policies.

The increases in data and item processing expense during the third quarter and first nine months of 2006 were largely attributable to higher costs related to the Corporation's internet banking product.

Included in the third quarter 2006 total non-interest expense was the expense impact of a \$524,000 check fraud loss representing approximately 40% of the increase for the quarter. Also, in the third quarter of 2006, there was a 68% increase in legal and professional fees compared to the third quarter of 2005. A portion of this increase is attributable to legal and consulting fees incurred in connection with collection efforts related to a problem credit that was reported in January 2006.

### Allowance for Loan Losses and Non-Performing Assets

The allowance for loan losses was \$10,399,000, or 1.21% of total loans, as of September 30, 2006 compared to \$11,131,000, or 1.48% of total loans, as of September 30, 2005. The provision for loan losses was \$3,515,000 for the first nine months of 2006 compared with \$765,000 for the same period last year. For the nine months ended September 30, 2006 and 2005, net charge-offs (recoveries) were 0.05% and (0.02)% of average loans, respectively, not annualized.

Transactions in the provision for loan losses are summarized as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance, Beginning of Period	\$ 9,958	\$ 10,798	\$ 11,208	\$ 10,187
Provisions, Charged to Income	415	315	3,515	765
Loans Charged-Off	(22)	(25)	(4,590)	(256)
Recoveries of Loans Previously Charged-Off	48	43	266	435
Net Loans (Charged-Off) Recovered	26	18	(4,324)	179
Balance, End of Period	\$ 10,399	\$ 11,131	\$ 10,399	\$ 11,131

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The increase in the provision for loan losses for the quarter and nine month period ended September 30, 2006 reflected an increase in charge offs, a higher level of non-accrual loans and the increase in loan volume. Net loans recovered were \$26,000 for the third quarter of 2006 compared with net recoveries of \$18,000 for the same period last year. Non-accrual loans were \$9.3 million at September 30, 2006, an increase of \$4.3 million, or 86.2%, from September 30, 2005, and an increase of \$6.3 million, or 210.0%, from December 31, 2005.



We reported in a filing on Form 8-K in February 2006 that our largest classified borrower had experienced further deterioration in its financial condition and had requested a standstill agreement until September 30, 2006. All loans to this borrower were placed on non-accrual status in February 2006 with an agreement, subject to an infusion of a specified amount of capital and certain other conditions, to defer all payments of principal and interest from this borrower until September 30, 2006. Also in February 2006, an outside investor contributed to the borrower the specified amount of additional capital in the form of debt subordinated to the Corporation's loans. Subsequent to placing the loans to this borrower on non-accrual, the outstanding principal balance was reduced to \$6.9 million as of June 30, 2006 prior to any charge-offs. Based on our evaluation of collateral value, the borrower's financial prospects and other considerations, we recorded a charge-off of \$4.3 million on these credits as of June 30, 2006. Our exposure on these credits was thereby reduced to approximately \$2.6 million. On October 5, 2006, the Company filed a Form 8-K Report with the Securities and Exchange Commission reporting a \$3.0 million loan charge-off recovery resulting from a cash payment of \$4.5 million on the problem credit. This payment satisfied the full obligation of the borrower with the exception of an \$183,000 secured note. It is anticipated that the recovery will result in a reduction in the provision for loan losses in the fourth quarter of 2006.

In March 2006, we placed loans to a second borrower on non-accrual based on deterioration in that borrower's financial condition. The loans to the second borrower had a combined balance of approximately \$2.1 million as of June 30, 2006.

As of September 30, 2006, the allowance for loan losses as a percentage of non-accrual loans was 111.9% compared with 373.6% as of December 31, 2005. Total non-performing assets as a percentage of loans and foreclosed assets was 1.08% at September 30, 2006 compared with 0.39% as of December 31, 2005.

The following table summarizes the non-performing assets as of the end of the last five quarters (dollars in thousands):

	September 30, 2006	June 30, 2006	March 31, 2006	December 31, 2005	September 30, 2005
Non-Accrual Loans	\$ 9,289	\$ 6,058	\$ 11,164	\$ 3,000	\$ 4,989
Renegotiated Loans	-0-	-0-	-0-	-0-	-0-
Other Real Estate Owned and Other Foreclosed Assets	-0-	-0-	387	-0-	-0-
<b>Total Non-Performing Assets</b>	<b>\$ 9,289</b>	<b>\$ 6,058</b>	<b>\$ 11,551</b>	<b>\$ 3,000</b>	<b>\$ 4,989</b>
As a Percent of:					
Total Assets	0.79%	0.52%	1.03%	0.27%	0.46%
Total Loans and Other Real Estate/ Foreclosed Assets	1.08%	0.72%	1.43%	0.39%	0.66%
Loans Past Due 90 days or More and Still Accruing	\$ 636	\$ -0-	\$ -0-	\$ -0-	\$ 2,178

As of September 30, 2006, non-accrual loans were comprised of \$5,382,000 in commercial loans, \$3,819,000 in real estate mortgage loans and \$88,000 in consumer loans.

The following table summarizes the relationship between non-performing loans, criticized loans and the allowance for loan losses (dollars in thousands):

	September 30, 2006	June 30, 2006	March 31, 2006	December 31, 2005	September 30, 2005
Non-Performing Loans	\$ 9,289	\$ 6,058	\$ 11,164	\$ 3,000	\$ 4,989
Criticized Loans	32,808	31,620	30,732	35,161	39,450
Allowance for Loan Losses	10,399	9,958	13,092	11,208	11,131
Allowance for Loan Losses as a Percent of:					
Non-Performing Loans	112%	164%	117%	374%	223%
Criticized Loans	32%	31%	43%	32%	28%

Loans are graded on a system similar to that used by the banking industry regulators. The first level of criticized loans is Other Assets Especially Mentioned (OAEM). These loans are fundamentally sound but have potential weaknesses which may, if not corrected, weaken the asset or inadequately protect the bank's credit position at some future date. The second level is Substandard, which are loans inadequately protected by current sound net worth, paying capacity or pledged collateral of the borrower. The last level of criticized loans, before they are charged-off, is Doubtful. Doubtful loans are considered to have inherent weaknesses because collection or liquidation in full is highly questionable. In addition to the above grading system, the Corporation maintains a separate

watch list which further aids the Corporation in monitoring loan quality. Watch list loans show warning elements where the present status portrays one or more deficiencies that require attention in the short run or where pertinent ratios of the account have weakened to a point where more frequent monitoring is warranted. The Corporation remains diligent in its efforts to identify any loan that might reflect weakness of the borrower as soon as possible. Management is not aware of any potential loan problems that have not been disclosed to which serious doubt exists as to the ability of the borrower to substantially comply with the present repayment terms.

Total criticized loans were \$32.8 million at September 30, 2006, a decrease of \$2.4 million and \$6.6 million from the levels of December 31, 2005 and September 30, 2005, respectively. The loan charge-off previously discussed materially contributed to the decrease in criticized loans. Criticized loans as a percentage of total loans were 3.8%, 4.5% and 5.2% as of September 30, 2006, December 31, 2005 and September 30, 2005, respectively.

#### Interest Rate Sensitivity

Interest rate sensitivity is the relationship between changes in market interest rates and net interest income due to the repricing characteristics of assets and liabilities.

The following table, commonly referred to as a static GAP report, indicates the interest rate sensitivity position at September 30, 2006 and may not be reflective of positions in subsequent periods (dollars in thousands):

	Matures or Reprices within:			Total Rate Sensitive One Year or Less	Repriced After 1 Year or Non-interest Sensitive	Total
	30 Days or Less	31-180 Days	181 to One Year			
<b>Earning Assets:</b>						
Loans	\$ 385,963	\$ 60,320	\$ 63,421	\$ 509,704	\$ 348,136	\$ 857,840
Investment Securities	14,395	54,058	27,381	95,834	155,319	251,153
Federal Funds Sold and Interest Bearing Deposits	1,015	-0-	-0-	1,015	-0-	1,015
<b>Total Earning Assets</b>	<b>401,373</b>	<b>114,378</b>	<b>90,802</b>	<b>606,553</b>	<b>503,455</b>	<b>1,110,008</b>
<b>Interest Bearing Liabilities:</b>						
Interest-Bearing Transaction Accounts and Savings	422,864	-0-	-0-	422,864	-0-	422,864
Certificates of Deposit under \$100,000 and IRAs	11,038	31,158	29,813	72,009	25,168	97,177
Certificates of Deposit \$100,000 or More	15,508	42,832	46,498	104,838	33,056	137,894
Borrowings	121,370	5,000	15,000	141,370	-0-	141,370
<b>Total Interest Bearing Liabilities</b>	<b>570,780</b>	<b>78,990</b>	<b>91,311</b>	<b>741,081</b>	<b>58,224</b>	<b>799,305</b>
<b>Interest Sensitivity Gap</b>	<b>\$ (169,407)</b>	<b>\$ 35,388</b>	<b>\$ (509)</b>	<b>\$ (134,528)</b>	<b>\$ 445,231</b>	<b>\$ 310,703</b>
<b>Cumulative Gap</b>	<b>\$ (169,407)</b>	<b>\$ (134,019)</b>	<b>\$ (134,528)</b>			
Periodic Gap to Total Assets	(14.39)%	3.01%	(0.04)%			
Cumulative Gap to Total Assets	(14.39)%	(11.38)%	(11.42)%			

The preceding static GAP report reflects a cumulative liability sensitive position during the one year horizon. An inherent weakness of this report is that it ignores the relative volatility any one category may have in relation to other categories or market rates in general. For instance, the rate paid on NOW accounts typically moves slower than the three month T-Bill. Management attempts to capture this relative volatility by utilizing a simulation model with a beta factor adjustment which estimates the volatility of rate sensitive assets and/or liabilities in relation to other market rates.

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Beta factors are an estimation of the long term, multiple interest rate environment relation between an individual account and market rates in general. For instance, NOW, savings and money market accounts, which are repricable within 30 days, will have considerably lower beta factors than variable rate loans and most investment categories. Taking this into consideration, it is quite possible for a bank with a negative cumulative GAP to total asset ratio to have a positive beta adjusted GAP risk position. As a result of applying the beta factors established by management to the earning assets and interest bearing liabilities in the static gap report via a simulation model, the negative cumulative GAP to total assets ratio at one year of (11.42%) was reversed to a positive 16.65% beta adjusted GAP position. Management feels that the beta adjusted GAP risk technique more accurately reflects the Corporation's GAP position.

Capital

At September 30, 2006, shareholders' equity totaled \$88.8 million, an increase of \$7.4 million, or 9.1%, compared to December 31, 2005, and an increase of \$9.0 million, or 11.3%, compared to September 30, 2005. This increase reflects the increase in retained earnings which was partially offset by the payment of dividends, the increase in the unrealized loss on available-for-sale investment securities and the impact of the purchase of treasury stock. The unrealized loss, net of tax benefit, on available-for-sale investment securities increased \$67,000 in the nine months ended September 30, 2006.

On April 18, 2006, the Board of Directors of the Corporation approved a stock purchase plan (the 2006 Stock Purchase Plan) authorizing management to purchase up to 623,675 shares of the Corporation's common stock on behalf of the Corporation over the twelve-month period beginning April 19, 2006 and ending on April 18, 2007, including in open market transactions, privately negotiated transactions or other transactions in accordance with all applicable state and federal laws and regulations. In the quarter ended September 30, 2006, no shares were purchased by the Corporation pursuant to the 2006 Stock Purchase Plan.

The Corporation's ability to purchase shares of the Corporation's common stock is subject to various banking laws, regulations and policies as well as rules and regulations of the Securities and Exchange Commission.

We and the Bank are subject to capital adequacy guidelines established by the Federal Reserve Board and other regulatory authorities. The table below illustrates the Bank's and our compliance with the capital adequacy guidelines as of September 30, 2006 and 2005 (dollars in thousands):

	September 30, 2006		September 30, 2005	
	The Consolidated Corporation	Summit Bank, N.A.	The Consolidated Corporation	Summit Bank, N.A.
Total Assets	\$ 1,177,313	\$ 1,178,730	\$ 1,074,261	\$ 1,073,868
Risk Weighted Assets	884,807	884,781	801,549	801,532
Equity Capital (Tier 1)	93,120	92,378	82,627	82,632
Qualifying Allowance for Loan Losses	10,399	10,399	10,037	10,033
Total Capital	\$ 103,519	\$ 102,777	\$ 92,664	\$ 92,665
Leverage Ratio	8.25%	8.03%	8.04%	8.05%
Risk Capital Ratio:				
Tier I Capital	10.52%	10.44%	10.31%	10.31%
Total Capital	11.70	11.62	11.56	11.56

As of September 30, 2006, the Bank exceeded the risk-based capital and leverage requirements set by regulatory authorities and satisfied the criteria for classification as a well capitalized institution under the rules of the Federal Deposit Insurance Corporation Improvement Act of 1991.

Liquidity

Our primary internal sources of liquidity consist of the federal funds that we sell and our portfolio of marketable investment securities, particularly those with shorter maturities. Federal funds sold and investment securities maturing within 90 days represented \$28.8 million, or 2.45%, of total assets as of September 30, 2006. Additionally, our ability to sell loan participations, purchase federal funds and obtain advances from the Federal Home Loan Bank serve as secondary sources of liquidity. The Bank has approved federal funds lines at other banks.

Our liquidity is enhanced by the fact that 85.2% of our total deposits at September 30, 2006 were core deposits. Core deposits are defined as total deposits less public funds, brokered deposits and certificates of deposit greater than \$100,000. Core deposits are generally more stable (i.e., less likely to be withdrawn) than other deposits. Additionally interest-bearing core deposits may have lower interest rates than other interest-bearing deposits. Our loan to deposit ratio averaged 92.7% for the nine month period ended September 30, 2006.

In the event that our average loans continue to grow during 2006 and we are unable to fund any such growth solely through the generation of additional deposits, we may be required to obtain funding from secondary sources, including purchasing federal funds, obtaining advances from the Federal Home Loan Bank or other secondary sources. In such an event, our business, results of operations and financial condition could be negatively impacted.

Our income, which provides funds for the payment of dividends to our shareholders and for other corporate purposes, is derived from our investment in the Bank.

On May 3, 2004, the Corporation formed SBI Trust and SBI Trust subsequently issued \$12.0 million of floating rate (three month LIBOR plus a margin of 2.65%) Capital Securities (the Trust Capital Securities). Concurrent with the issuance of the Trust Capital Securities, SBI Trust issued trust common securities to the Corporation in the aggregate liquidation value of \$372,000. The proceeds of the issuance of the Trust Capital Securities and trust common securities were invested in the Corporation's Floating Rate Junior Subordinated Deferrable Debentures (the Deferrable Debentures), which mature on July 7, 2034 and have a call feature that permits the Corporation to redeem any or all of the securities after July 7, 2009. The interest rate on the Deferrable Debentures at September 30, 2006 was 8.16%. The Deferrable Debentures, which are the only asset of SBI Trust, are subordinated and junior in right of payment to all present and future senior indebtedness (as defined in the Indenture dated May 3, 2004) of the Corporation.

On September 15, 2005, we obtained a line of credit from a bank under which we may borrow \$10,000,000 at a floating rate (three month LIBOR plus a margin of 2.00%). The line of credit is secured by stock of the Bank. The original maturity date of the line of credit was extended from September 15, 2006 to December 8, 2006, whereupon, if balances are outstanding, the line converts to a term note having a five year term. The Corporation will not pay a fee for any unused portion of this line. At September 30, 2006, there were no amounts outstanding under the line. The purpose of the line is to provide an additional liquidity source.

#### Off-Balance-Sheet Arrangements, Commitments, Guarantees and Contractual Obligations

Except as set forth herein, during the nine months ended September 30, 2006, there have been no material changes outside the ordinary course of the Corporation's business in the contractual obligations specified in Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations Off-Balance-Sheet Arrangements, Commitments, Guarantees and Contractual Obligations in our Annual Report on Form 10-K for the year ended December 31, 2005.

At September 30, 2006, outstanding documentary and standby letters of credit totaled \$9,117,000 and commitments to extend credit totaled \$238,095,000. Documentary and standby letters of credit and commitments to extend credit totaled \$6,637,000 and \$227,031,000 at December 31, 2005. The increase in commitments to extend credit reflects the continued demand for credit facilities in our market.

#### Related Party Transactions

The Bank has made loan transactions in the ordinary course of business with certain of its and the Corporation's officers, directors and their affiliates. All loans included in such transactions are made on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with other unrelated persons and all such loans are current as to principal and interest payments. Total loans outstanding to such related parties amounted to approximately \$6,843,000 at September 30, 2006 and \$9,356,000 at December 31, 2005.

#### Merger

On July 2, 2006, the Corporation and Cullen/Frost Bankers, Inc., a Texas corporation (Cullen/Frost), entered into an Agreement and Plan of Merger (the Agreement) pursuant to which the Corporation will merge with and into Cullen/Frost. Under the terms of the Agreement, the Corporation's shareholders will have the right, subject to pro-rata, to elect to receive cash, shares of Cullen/Frost common stock or a combination thereof having a value equal to \$11.50 plus 0.2933 Cullen/Frost shares. The total consideration consists of approximately \$143.4 million in cash and approximately 3.84 million shares of Cullen/Frost common stock (assuming the treasury stock method of accounting for options before giving effect to any exercises of outstanding options). The transaction is subject to customary closing conditions, including the receipt of regulatory approvals and approval of the shareholders of the Corporation. The merger is currently expected to be completed in the fourth quarter of 2006, although delays could occur.

The foregoing summary of the Agreement is not complete and is qualified in its entirety by reference to the complete text of such document, which is filed as Exhibit 2.1 to the Report on Form 8-K filed with the Securities and Exchange Commission on July 3, 2006 and which is incorporated herein by reference.

#### Subsequent Events

On October 5, 2006, the Company filed a Form 8-K Report with the Securities and Exchange Commission reporting a loan charge-off recovery of \$3.0 million was recorded resulting from a cash payment of \$4.5 million on the credit. This payment satisfies the full obligation of the borrower with the exception of an \$183,000 secured note. It is anticipated that the recovery will result in a reduction in the provision for loan losses for the year of 2006 that is to be recorded in the fourth quarter.

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On October 18, 2006, the Board of Directors of the Corporation approved a quarterly dividend of \$.08 per share to be paid on November 15, 2006 to shareholders of record on November 1, 2006.

### Critical Accounting Policies

Our accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. We have identified our policy with respect to allowance for loan losses as critical because it requires management to make particularly difficult, subjective or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. We, in consultation with our Audit Committee of the Board of Directors, have reviewed and approved this critical accounting policy, which is further described under the caption "Loan and Allowance for Loan Losses" in Note 1 ("Summary of Significant Accounting Policies") to the Financial Statements.

These evaluations are inherently subjective because, even though they are based on objective data, it is management's interpretation of that data that determines the amount of the appropriate allowance. Therefore, from time to time (but at least quarterly), management reviews the actual performance and write-off history of the loan portfolio and compares that to previously determined allowance coverage percentages. In this manner, management evaluates the impact the previously mentioned variables may have had on the loan portfolio to determine which changes, if any, should be made to the assumptions and analyses. Recent analysis has indicated that projections of estimated losses inherent in the loan portfolio have approximated actual write-off experience during the current economic environment.

Actual results could differ materially from estimates as a result of changes in economic or market conditions and other factors. Changes in our evaluations and the assumptions underlying these evaluations could result in a material change in the allowance. While we believe that the allowance for loan losses has been established and maintained at levels adequate to reflect the risks inherent in the loan portfolio, future increases may be necessary if economic or market conditions and other factors differ substantially from the conditions that existed at the time of the initial determination.

The Corporation adopted FAS No. 123R, "Share-Based Payments," effective January 1, 2006, utilizing the modified prospective method as described in the standard. Under the modified prospective method, compensation cost is recognized for all share-based payments granted after the effective date and for all unvested awards granted prior to the effective date. Prior to adoption, the Corporation accounted for stock-based compensation under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. The Corporation recognized \$128,000 in total stock-based compensation expense during the first nine months of 2006.

There have been no significant changes in critical accounting policies or management estimates since the year ended December 31, 2005 other than the adoption of FAS No. 123R as described above. A comprehensive discussion of the Company's critical accounting policies and management estimates is included in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

### Item 3 Quantitative and Qualitative Disclosure about Market Risk

There were no material changes in market risks faced by the Corporation from December 31, 2005 to September 30, 2006. For more information regarding quantitative and qualitative disclosures about market risk, please refer to the Corporation's Annual Report on Form 10-K as of and for the year ended December 31, 2005, and in particular, Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations - Interest Rate Sensitivity and Liquidity."

### Item 4 Controls and Procedures

The Corporation's management, including the Corporation's principal executive officer and principal financial officer, has evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on that evaluation, the Corporation's principal executive officer and principal financial officer have concluded that the Corporation's disclosure controls and procedures were effective as of the end of the period covered by this report.

There was no change in the Corporation's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or Rule 15d-15 under the Exchange Act that occurred during the Corporation's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.



## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

Not applicable

### Item 1A. Risk Factors

#### Risks Associated with our Pending Merger with Cullen/Frost Bancshares, Inc. ( Cullen/Frost )

#### **Failure to complete the pending merger with Cullen/Frost could materially and adversely affect our stock price and our results of operations.**

On July 2, 2006, we entered into an Agreement and Plan of Merger with Cullen/Frost whereby we would merge with and into Cullen/Frost. Completion of the merger is subject to certain conditions, including approval by our holders of common stock, regulatory approvals, and various other closing conditions. We cannot assure you that these conditions will be met or waived, that the necessary approvals will be obtained or that we will be able to successfully consummate the merger as currently contemplated under the merger agreement or at all. If the merger is not completed:

the market price of our common stock may decline to the extent that the current market price includes a market assumption that the merger will be completed;

we will remain liable for significant transaction costs, including legal, accounting, financial advisory and other costs related to the merger, and may not receive any termination fee from Cullen/Frost;

the inability to retain employees in the interim period may be significant and we may find it difficult to continue as a stand-alone entity; and

we may experience a negative reaction to the termination of the merger from our customers, employees or affiliates which may adversely impact our future results of operations as a stand-alone entity.

The occurrence of any of these events individually or in combination could have a material adverse effect on our financial condition, results of operations and our stock price. In addition, if the merger agreement is terminated and our board of directors seeks another merger or business combination, we may not be able to find a party willing to pay a price equal to or more attractive than the price Cullen/Frost has agreed to pay.

#### **Fluctuations in market prices of Cullen/Frost common stock will affect the value that our shareholders receive for their shares of our common stock.**

Upon completion of the merger, shares of our common stock (other than any dissenting shares) will be converted into shares of Cullen/Frost common stock and cash. While the merger consideration has been generally structured to provide that our shareholders will receive, for each of their shares of common stock, 0.2933 shares of Cullen/Frost common stock and \$11.50 in cash, in the event the average share price of Cullen/Frost common stock during the 15 consecutive trading days ending on and including the date of receipt of the last requisite regulatory approval falls below \$45.95, Cullen/Frost has the discretion, but not the obligation, to increase either the exchange ratio with respect to the number of shares of Cullen/Frost common stock that our shareholders will receive, the per share cash consideration or a combination of both. Because the price of Cullen/Frost common stock will fluctuate prior to the merger, Cullen/Frost cannot assure our shareholders of the market value or number of the shares of Cullen/Frost common stock or of the amount of cash that they will receive in the merger.

The price of Cullen/Frost common stock may vary from its price on the date the proxy statement/prospectus is sent to our shareholders, the date of our special meeting of shareholders and the date for determining the average trading price discussed elsewhere. Stock price fluctuations may result from a variety of factors, some of which are beyond the control of Cullen/Frost, including, among other things, changes in Cullen/Frost's businesses, operations and prospects, regulatory considerations and general market and economic conditions. Because the date the merger is to be completed will be later than the date of the special meeting, the price of the Cullen/Frost common stock on the date of the special meeting may not be indicative of its price on the date the merger is to be completed.

**If the price of Cullen/Frost common stock falls and the decrease exceeds certain pre-agreed levels, and if Cullen/Frost does not elect to alter the exchange ratio to provide more shares and/or alter the amount of the per share cash consideration to provide more cash, we have the right to terminate the merger agreement and the merger will not occur.**

**Cullen/Frost may have difficulty combining our operations with its own operations or realizing the anticipated benefits of the merger.**

Because the markets and industries in which we and Cullen/Frost operate are highly competitive, and due to the inherent uncertainties associated with the integration of acquired companies, Cullen/Frost may not be able to integrate our operations without encountering difficulties, including, without limitation, the loss of key employees and customers, the disruption of their respective ongoing businesses and possible inconsistencies in standards, controls and procedures. We expect the merger to result in certain benefits for the combined company, such as cost savings and other financial and operational benefits. We cannot assure you, however, when, if ever, or to the extent to which the combined company will be able to realize these benefits. Difficulties associated with integrating the two companies could have a material adverse effect on the combined company and the market price of the Cullen/Frost common stock.

Except as set forth herein, there have been no material changes from the risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2005 in response to Item 1A. to Part I of Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On April 18, 2006, the Board of Directors of the Corporation approved a stock purchase plan (the 2006 Stock Purchase Plan) authorizing management to purchase up to 623,675 shares of the Corporation's common stock on behalf of the Corporation over the twelve-month period beginning April 19, 2006 and ending on April 18, 2007, including in open market transactions, privately negotiated transactions or other transactions in accordance with all applicable state and federal laws and regulations.

The Corporation's ability to purchase shares of the Corporation's common stock is subject to various banking law regulations and policies as well as rules and regulations of the Securities and Exchange Commission.

In the quarter ended September 30, 2006, no shares were purchased by the Corporation pursuant to the 2006 Stock Purchase Plan. No information is required to be furnished by Item 703 of Regulation S-K for any other purchase made in the quarter covered by this report.

**Item 3. Defaults Upon Senior Securities**

Not applicable

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits**

- 2.1 Agreement and Plan of Merger by and between the Corporation and Cullen/Frost Bankers, Inc dated July 2, 2006 (incorporated herein by reference to Exhibit 2.1 to the Corporation's Current Report on Form 8-K dated July 2, 2006 and filed on July 3, 2006)
- 3.1 Restated Articles of Incorporation of the Corporation (incorporated herein by Reference to Exhibit 3(a) to the Corporation's Annual Report on Form 10-K for the year ended December 31, 1998)
- 3.2 Amended and Restated Bylaws of the Corporation (incorporated herein by reference to Exhibit 3(b) to the Corporation's Annual Report on Form 10-K for the year ended December 31, 2002)

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- 3.3 Amendment to the Amended and Restated Bylaws of the Corporation adopted by resolution of the Board of Directors of the Corporation (incorporated herein by reference to Exhibit 99.1 to the Corporation's Current Report on Form 8-K filed February 22, 2005)
- 4.1 Rights Agreement, dated April 17, 1990, by and between the Corporation and Summit Bancservices, Inc. (incorporated herein by reference to Exhibit 1 to the Corporation's Current Report on Form 8-K dated April 18, 1990 filed on April 24, 1990)
- 4.2 Amendment No. 1 to the Rights Agreement, effective as of April 16, 2000, by and between the Corporation and Summit Bancservices, Inc. (incorporated herein by reference to Exhibit 4(b) to the Corporation's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2000)
- 4.3 Junior Subordinated Debt Securities Indenture Agreement dated May 3, 2004 (incorporated herein by reference to Exhibit 4(a) to the Corporation's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2004)
- 4.4 Junior Subordinated Debt Securities Due 2034 (incorporated herein by reference to Exhibit 4(b) to the Corporation's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2004)
- 4.5 Loan Agreement dated September 15, 2005 between the Corporation and Frost National Bank (incorporated herein by reference to Exhibit 10 to the Corporation's Quarterly Report on Form 10-Q/A for the quarterly period ended September 30, 2005)
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- 31.1 Certification of Principal Executive Officer of Summit Bancshares, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
- 31.2 Certification of Principal Financial Officer of Summit Bancshares, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
- 32.1 Certification of Principal Executive Officer of Summit Bancshares, Inc. pursuant to Section 1350, Chapter 63 of Title 18 of the United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Principal Financial Officer of Summit Bancshares, Inc. pursuant to Section 1350, Chapter 63 of Title 18 of the United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

**SUMMIT BANCSHARES, INC.**  
Registrant

Date: November 8, 2006

By: /s/ Philip E. Norwood

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Philip E. Norwood, Chairman, President  
and Chief Executive Officer

Date: November 8, 2006

By: /s/ Bob G. Scott

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Bob G. Scott, Executive Vice President  
and Chief Operating Officer  
(Chief Financial Officer)

## EXHIBIT INDEX

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