

NORTHEAST BANCORP /ME/  
Form 10-K  
September 27, 2006

FORM 10-K

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

(Mark One)

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

For fiscal year ended June 30, 2006

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 (1-14588)

NORTHEAST BANCORP

(Exact name of registrant as specified in its charter)

Maine

01-0425066

(State or other jurisdiction of incorporation or organization)

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

500 Canal Street, Lewiston, Maine

04240

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code:

(207) 786-3245

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

Title of each class

Name of each exchange on which registered:

:

Common Stock, \$1.00 par value

American Stock Exchange

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

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act.

Yes\_ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes\_ No

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

## Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [x]

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).  
Yes\_ No

The aggregate market value of the Registrant's common shares held by non-affiliates, as of December 30, 2005, was approximately \$60,655,968 based on the last reported sales price of the Company's common shares on the American Stock Exchange as of the close of business on such date. Although directors and executive officers of the registrant and its subsidiaries were assumed to be "affiliates" of the registrant for the purposes of this calculation, this classification is not to be interpreted as an admission of such status. There were 2,452,132 common shares of the registrant outstanding as of September 25, 2006.

Page 1

### DOCUMENTS INCORPORATED BY REFERENCE

The following documents, in whole or in part, are specifically incorporated by reference in the indicated Part of this Annual Report on Form 10-K:

<u>Document</u>	<u>Form 10-K Reference Location</u>
Proxy Statement for the 2006 Annual Meeting of Shareholders	III

This Annual Report on Form 10-K contains certain forward-looking statements within the meaning of Section 27A of the Securities Exchange Act of 1933 and Section 21E of the Securities Act of 1934 and is subject to risks, uncertainties, and other factors which could cause actual results to differ materially from those expressed or implied by such forward-looking statements. See "Item 1. Business -Forward Looking Statements and Risk Factors."

### PART I

#### Item 1. Business

##### Overview and History

Northeast Bancorp ("us", "our", "we", or the "Company"), a Maine corporation chartered in April 1987, is a bank holding company registered under the Bank Holding Company Act of 1956 (the "BHCA"). Prior to 1996, the Company operated under the name Bethel Bancorp. The Company's primary subsidiary and principal asset is its wholly-owned banking subsidiary, Northeast Bank (the "Bank" or "Northeast Bank"), which has eleven banking branches. The Bank has an insurance division that offers property and casualty insurance products through the Bank's wholly owned subsidiary, Northeast Bank Insurance Group, Inc. ("NBIG"). NBIG has eight insurance agency offices, four of which are located in our banking branches. In addition, we also offer investment brokerage services, including financial planning products and services, through our office in Falmouth, Maine. An investment brokerage service is a division of the Bank.

Northeast Bank, which was originally organized in 1872 as a Maine-chartered mutual savings bank and was formerly known as Bethel Savings Bank F.S.B. ("Bethel"), is a Maine state-chartered bank and a member of the Federal

Reserve System. From 1987 to August 2004, Northeast Bank was a federal savings bank and the Company was a unitary savings and loan holding company registered with the Office of Thrift Supervision ("OTS"). In August 2004 Northeast Bank's charter was converted into a Maine state-chartered universal bank and the Company became a bank holding company under the BHCA. In connection with the conversion of its charter, Northeast Bank applied for and was granted membership in the Federal Reserve System. Accordingly, the Company and Northeast Bank are currently subject to the regulatory oversight of the Federal Reserve Board ("FRB") and the State of Maine Bureau of Financial Institutions.

As of June 30, 2006, the Company, on a consolidated basis, had total assets of approximately \$563 million, total deposits of approximately \$395 million, and stockholders' equity of approximately \$39 million. Unless the context otherwise requires, references herein to the Company include the Company and its subsidiaries on a consolidated basis.

### Strategy

Northeast Bancorp through its subsidiary, Northeast Bank and the Bank's subsidiary, NBIG, as well as through third party affiliations, provides a broad range of financial services to individuals and companies in western and south-central Maine. Although historically the Bank had been primarily a residential mortgage lender, over the last decade the Bank has expanded its commercial loan business, increased its line of financial products and services, and expanded its market area. Northeast Bank is now a general commercial bank and expects to continue to provide the same corporate and personal banking and other services that it currently provides to its customers. Neither its philosophy nor its business strategy has changed as a result of its conversion from a savings bank to a commercial bank. Management believes that its strategy to continue modest, but profitable, growth by increasing our loan and deposit market share in our existing markets in western and south-central Maine, closely manage the yields on earning assets and rates on interest-bearing liabilities, introduce new financial products and services, increase the number of bank services per household, increase noninterest income from expanded investment and insurance brokerage and trust services, and control the growth of noninterest expenses will increase core earnings in the long term by providing stronger interest margins, additional noninterest income, and increased loan volume. We believe that the local character of the Bank's business and its "community bank" management philosophy allows it to compete effectively in its market area.

Our community banking strategy emphasizes the development of long-term full banking relationships with customers at each branch location by providing consistent, high quality service from:

- employees with local decision-making authority;
- employees who are familiar with the customers' needs, their business environment and competitive demands; and
- employees who are able to develop and customize personalized financial solutions that are tailored to the customer's needs.

With the goal of providing a full range of banking and other financial related services to our customers and in an effort to develop strong long-term primary banking relationships with businesses and individuals, we have expanded our commercial banking operations by selectively making commercial loans to small and medium sized companies. In this regard, our business development efforts have been directed towards full service credit packages and financial services, as well as competitively priced mortgage packages. In our effort to attract and maintain strong customer relationships, we also have continually expanded the financial products and services that we make available to our customers. In particular, we expanded our insurance division through acquisition in order to provide a broader array of insurance products to our customers and we have continued to maintain an investment banking services division to provide financial planning products and service to them as well.

The Bank is subject to examination and comprehensive regulation by the Maine Bureau of Financial Institutions (the

"Maine Bureau") and the FRB, and its deposits are insured by the Federal Deposit Insurance Corporation (the "FDIC") to the extent permitted by law. The Bank also is a member of the Federal Home Loan Bank ("FHLB") of Boston and the Federal Reserve Bank of Boston.

The principal executive offices of Northeast Bancorp and the Bank are located at 500 Canal Street, Lewiston, Maine, 04240, and their telephone number is (207) 786-3245.

### Market Area

The Bank is headquartered in Lewiston, Maine with full service branches in Auburn, Augusta, Bethel, Brunswick, Buckfield, Harrison, Lewiston (2), Mechanic Falls, Portland, and South Paris, Maine. The Bank's investment brokerage division has an office in Falmouth, Maine from which investment, insurance and financial planning products and services are offered. NBIG has offices in Auburn, Anson, Augusta, Bethel, Jackman, Mexico, Rangeley, and South Paris, Maine from where the Bank's insurance division offers casualty and property insurance products. The Company's market area, which covers western and south central regions of the State of Maine, is characterized by a diverse economy that has experienced moderate growth in recent years.

### Market for Services

Management believes that the Bank's principal markets are: (i) the residential real estate market within its primary market area; (ii) small-to-medium sized businesses within its primary market area; (iii) the growing consumer loan market, including indirect automobile dealer and recreational vehicle loans; and (iv) the growing consumer demand for a wide range of other consumer-oriented financial services and products such as financial planning services, investments, life insurance, property and casualty insurance, trust services, college loans and other similar products.

Businesses are solicited through the personal efforts of the officers and directors of both Northeast Bancorp and the Bank. We believe that a locally-based independent bank is often perceived by the local business community as possessing a clearer understanding of local commerce and its needs. Consequently, we believe that we are able to make prudent lending decisions more quickly than our competitors without compromising asset quality or profitability.

### Competition

We encounter strong competition in our market area in making loans, attracting deposits, and selling other customer products and services. The deregulation of the banking industry, the ability to create financial services holding companies to engage in a wide range of financial services other than banking, and the widespread enactment of state laws which permit multi-bank holding companies, as well as the availability of nationwide interstate banking, has created a highly competitive environment for financial services providers. In one or more aspects of our business, we compete with other savings banks, commercial banks, credit unions, mutual funds, insurance companies, brokerage and investment banking companies, finance companies, and other financial intermediaries operating in Maine and elsewhere. Many of our primary competitors, some of which are affiliated with large bank holding companies or other larger financial-based institutions, have substantially greater resources, larger established customer bases, higher lending limits, extensive branch networks, numerous ATMs, greater advertising and marketing budgets, and they may offer services that we do not currently provide.

The principal factors in competing for deposits are convenient office locations, flexible hours, interest rates and services, while those relating to loans are interest rates, the range of lending services offered, and lending fees. Additionally, we believe that an emphasis on personalized financial planning and advice tailored to individual customer needs, together with the local character of the Bank's business and its "community bank" management philosophy will enhance our ability to compete successfully in our market areas. Further, we also offer a wide range of financial services to our customers, including not only basic loan and deposit services, but also investment services,

trust services, and insurance products. We believe that our ability to provide such services and advice, and to provide the financial services and products required by our customers, will be an attractive alternative to consumers in our market area.

## Lending Activities

### General

The primary source of income generated by the Bank is from the interest earned from our loan portfolio. The principal lending activities of the Bank are the origination and purchase of conventional mortgages for the purpose of constructing, financing, or re-financing one-to-four family residential properties and commercial properties. The majority of the properties securing the mortgage loan portfolio are located in the State of Maine. However, in an effort to diversify the geographic scope of the real estate collateral held by it, the Bank does purchase in the secondary market residential mortgage loans collateralized by properties in other states. Interest rates and origination fees charged on loans originated by the Bank are generally competitive with other financial institutions and other mortgage originators in its general market area.

Although residential and commercial real estate lending remains a strong component of the Bank's lending operations, consistent with our business strategy, we also actively seek an increased volume of commercial and consumer loans. Commercial loans are originated for commercial construction, acquisition, remodeling, and general business purposes. In this regard, the Bank, among other things, also originates loans to small businesses in association with the Small Business Administration. Consumer loans include those for the purchase of automobiles, boats, home improvements and personal investments. We also pursue quality indirect lending through local automobile and recreational vehicle dealerships.

### Residential Lending

The major component of the Bank's lending activities consists of the origination of single-family residential mortgage loans collateralized by owner-occupied property, most of which is located in its primary service areas. The Bank offers a variety of mortgage loan products. Its originations are generally for adjustable rate mortgages ("ARMs") or fixed rate mortgage loans having terms of 15 years or 30 years amortized on a monthly basis, with principal and interest due each month. The Bank holds in portfolio all adjustable rate mortgage and fixed rate mortgage loans with terms of 15 years or less. Fixed rate loans with terms greater than 15 years are sold into the secondary market. Additionally, the Bank offers home equity loans and home equity lines of credit.

The Bank offers adjustable rate mortgages with rate adjustments tied to the weekly average rate of one, three, and five year U.S. Treasury securities with specified minimum and maximum interest rate adjustments. The interest rates on a majority of these mortgages are adjusted yearly with limitations on upward adjustments of 2% per adjustment period and 6% over the life of the loan. The Bank generally charges a higher interest rate if the property is not owner-occupied. It has been the Bank's experience that the proportions of fixed-rate and adjustable-rate loan originations depend in large part on the interest rates environment. As interest rates fall, there is generally a reduced demand for variable rate mortgages and, as interest rates rise, there is generally an increased demand for variable rate mortgages.

Fixed rate and adjustable rate mortgage loans collateralized by single family residential real estate generally have been originated in amounts of no more than 80% of appraised value. The Bank may, however, lend up to 95% of the value of the property collateralizing the loan, but if such loans are required to be made in excess of 80% of the value of the property, they must be insured by private or federally guaranteed mortgage insurance. In the case of mortgage loans, the Bank will procure mortgagee's title insurance to protect against defects in its lien on the property that may

collateralize the loan. The Bank in most cases requires title, fire, and extended casualty insurance to be obtained by the borrower, and, where required by applicable regulations, flood insurance. The Bank maintains its own errors and omissions insurance policy to protect against loss in the event of failure of a mortgagor to pay premiums on fire and other hazard insurance policies.

Although the contractual loan payment period for single-family residential real estate loans is generally for a 15 to 30 year period, such loans often remain outstanding for significantly shorter periods than their contractual terms. In addition, the Bank charges no penalty for prepayment of mortgage loans. Mortgage loans originated by the Bank customarily include a "due on sale" clause giving the Bank the right to declare a loan immediately due and payable in the event, among other matters, that the borrower sells or otherwise disposes of the real property subject to a mortgage. In general, the Bank enforces due on sale clauses. Borrowers are typically permitted to refinance or prepay loans at their option without penalty.

The Bank generally applies the same underwriting criteria to residential mortgage loans whether purchased or originated. In its loan purchases, the Bank generally reserves the right to reject particular loans from a loan package being purchased and does reject loans in a package that do not meet its underwriting criteria. In connection with loan purchases, the Bank receives various representations and warranties from the sellers of the loans regarding the quality and characteristics of the loans. In determining whether to purchase or originate a loan, the Bank assesses both the borrower's ability to repay the loan and the adequacy of the proposed collateral. On originations, the Bank obtains appraisals of the property securing the loan. On purchases, the Bank reviews the appraisal obtained by the loan seller or originator. On purchases and originations, the Bank reviews information concerning the income, financial condition, employment and credit history of the applicant.

We have adopted written, non-discriminatory underwriting standards for use in the underwriting and review of every loan considered for origination or purchase. These underwriting standards are reviewed and approved annually by our board of directors. Our underwriting standards for fixed rate residential mortgage loans generally conform to standards established by Fannie Mae ("FNMA") and the Federal Home Loan Mortgage Corporation (the "FHLMC"). A loan application is obtained or reviewed by the Bank's underwriters to determine the borrower's ability to repay, and confirmation of the more significant information is obtained through the use of credit reports, financial statements, and employment and other verifications.

Page 4

The Bank generally uses appraisals to determine the value of collateral for all loans it originates. When originating a real estate mortgage loan, the Bank obtains a new appraisal of the property from an independent third party to determine the adequacy of the collateral, and such appraisal is reviewed by one of the underwriters. Otherwise, the collateral value is determined by reference to the documentation contained in the original file.

The Bank also requires that a survey be conducted and title insurance be obtained, insuring the priority of its mortgage lien. Pursuant to its underwriting standards, the Bank generally requires private mortgage insurance policies on newly originated mortgage loans with loan-to-value ratios greater than 80%. All loans are reviewed by the Bank's underwriters to ensure that its guidelines are met or that waivers are obtained in limited situations where offsetting factors exist.

#### Commercial Real Estate Lending

The Bank originates both multi-family and commercial real estate loans. Multi-family and commercial property loans generally are made in amounts up to 80% of the lesser of the appraised value or purchase price of the property. Although the largest multi-family or commercial loan in our portfolio at June 30, 2006 was \$3,141,870, most of these loans have balances under \$500,000.

The Bank's permanent commercial real estate loans are secured by improved property such as office buildings, medical facilities, retail centers, warehouses, apartment buildings, condominiums, and other types of buildings, which are located in its primary market area. Multi-family and commercial real estate loans generally have fixed or variable interest rates indexed to FHLB and prime interest rates with notes having terms of 3 - 5 years. Mortgage loan maturities have terms up to 15 years.

Loans secured by multi-family and commercial real estate generally are larger and involve greater risks than one-to-four family residential mortgage loans. Because payments on loans secured by multi-family and commercial properties often are dependent on successful operation or management of the properties, repayment of such loans may be subject to a greater extent to adverse conditions in the real estate market or the economy. We seek to minimize these risks in a variety of ways, including limiting the size of our multi-family and commercial real estate loans and generally restricting such loans to our primary market area. In determining whether to originate multi-family or commercial real estate loans, we also consider such factors as the financial condition of the borrower and the debt service coverage of the property. The Company intends to continue to make multi-family and commercial real estate loans as the market demands and economic conditions permit.

### Commercial Lending

The Bank offers a variety of commercial loan services including term loans, lines of credit, equipment, and receivables financing. A broad range of short-to-medium term commercial loans, both collateralized and uncollateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisitions of real estate and improvements), and the purchase of equipment and machinery. Equipment loans are typically originated on both a one year line of credit basis and on a fixed-term basis ranging from one to five years. The purpose of a particular loan generally determines its structure.

The Bank's commercial loans primarily are underwritten in the Company's market areas on the basis of the borrowers' ability to service such debt from income. As a general practice, the Bank takes as collateral a security interest in any available real estate, equipment, or other business assets, although such loans may be made on an uncollateralized basis. Collateralized working capital loans are primarily collateralized by short-term assets whereas term loans are primarily collateralized by long-term assets.

Commercial loans typically are made on the basis of the borrower's ability to make repayment from the cash flow of their business and generally are collateralized by business assets, such as accounts receivable, equipment, and inventory. As a result, the availability of funds for the repayment of commercial loans may be substantially dependent on the success of the business itself. Further, the collateral underlying the loans, which may depreciate over time, usually cannot be appraised with as much precision as residential real estate, and may fluctuate in value based on the success of the business.

### Consumer Loans

Consumer loans made by the Bank have included automobiles, recreational vehicles, boats, second mortgages, home improvements, mobile home loans, home equity lines of credit, personal (collateralized and uncollateralized), and deposit account collateralized loans. The Bank's consumer loan portfolio consists primarily of loans to individuals for various consumer purposes, but includes some business purpose loans which are payable on an installment basis. Most of these loans are for terms of up to 60 months and although generally collateralized by liens on various personal assets of the borrower, they may be originated without collateral. Consumer loans are made at fixed and variable interest rates and may be made based on up to a 5 year amortization schedule.

Consumer loans are attractive to us because they typically have a shorter term and carry higher interest rates than that charged on other types of loans. Consumer loans, however, do pose additional risks of collectability when compared to traditional types of loans granted by banks such as residential mortgage loans. In many instances, the Bank is

required to rely on the borrower's ability to repay since the collateral may be of reduced value at the time of collection. Accordingly, the initial determination of the borrower's ability to repay is of primary importance in the underwriting of consumer loans.

Page 5

Indirect automobile lending consists of automobile loans made by the Bank through the purchase of contracts from automobile dealers. Generally, the Bank will obtain fixed-rate automobile loans indirectly through various automobile dealerships located in its market areas. These automobile dealers are selected by us. Currently most of these loans were originated by 73 dealers located in our market area. Because the collateral is a deteriorating asset, the initial determination of the borrower's ability to pay is of primary importance. The indirect origination of consumer loan products generally requires funding of dealer reserves. These reserves are maintained for the benefit of the dealer who originated such loans, but such funding is subject to performance of certain loan conditions. The dealer is generally responsible to the Bank for the amount of the reserve only if a loan giving rise to the reserve becomes delinquent or the loan has been prepaid. The same process applies to indirect recreational vehicle lending.

### Construction Loans

The Bank originates residential construction loans to finance the construction of single-family dwellings. Most of the residential construction loans are made to individuals who intend to erect owner-occupied housing on a purchased parcel of real estate. The Bank's construction loans to individuals typically range in size from \$100,000 to \$300,000. Construction loans also are made to contractors to erect single-family dwellings for resale. Construction loans are generally offered on the same basis as other residential real estate loans, except that a larger percentage down payment is typically required.

The Bank also may make residential construction loans to real estate developers for the acquisition, development, and construction of residential subdivisions. The Bank has limited involvement with this type of loan. Such loans may involve additional risk attributable to the fact that funds will be advanced to fund the project under construction, which is of uncertain value prior to completion and because it is relatively difficult to evaluate accurately the total amount of funds required to complete a project.

The Bank finances the construction of individual, owner-occupied houses on the basis of written underwriting and construction loan management guidelines. Construction loans are structured either to be converted to permanent loans with the Bank at the end of the construction phase or to be paid off upon receiving financing from another financial institution. Construction loans on residential properties are generally made in amounts up to 80% of appraised value. Construction loans to developers generally have terms of up to 12 months. Loan proceeds on builders' projects are disbursed in increments as construction progresses and as inspections warrant. The maximum loan amounts for construction loans are based on the lesser of the current appraisal value or the purchase price for the property.

Construction loans are generally considered to involve a higher degree of risk than long-term financing collateralized by improved, occupied real estate. A lender's risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property's value at the completion of construction and estimated cost (including interest) of construction. If the estimate of construction cost proves to be inaccurate, the lender could be required to advance funds beyond the amount originally committed in order to permit completion of the project. If the estimate of anticipated value proves to be inaccurate, the lender may have collateral which has value insufficient to assure full repayment.

Loans collateralized by subdivisions and multi-family residential real estate generally are larger than loans collateralized by single-family, owner-occupied housing and also generally involve a greater degree of risk. Payments on these loans depend to a large degree on the results of operations and management of the properties, and repayment of such loans may be more subject to adverse conditions in the real estate market or the economy.



### Loan Origination and Processing

Loan originations are derived from a number of sources. Residential loan originations can be attributed to real estate broker referrals, mortgage loan brokers, direct solicitation by the Bank's loan officers, present depositors and borrowers, builders, attorneys, walk-in customers and, in some instances, other lenders. Loan applications, whether originated through the Bank or through mortgage brokers, are underwritten and closed based on the same standards, which generally meet FNMA underwriting guidelines. Consumer and commercial real estate loan originations emanate from many of the same sources. The legal lending limit of the Bank, as of June 30, 2006, was approximately \$6.3 million.

The loan underwriting procedures followed by the Bank conform to regulatory specifications and are designed to assess the borrower's ability to make principal and interest payments and the value of any assets or property serving as collateral for the loan. Generally, as part of the process, a bank loan officer meets with each applicant to obtain the appropriate employment and financial information as well as any other required loan information. Upon receipt of the borrower's completed loan application, the Bank then obtains reports with respect to the borrower's credit record, and orders and reviews an appraisal of any collateral for the loan (prepared for the Bank through an independent appraiser). The loan information supplied by the borrower is independently verified. Loan officers or other loan production personnel in a position to directly benefit monetarily through loan solicitation fees from individual loan transactions do not have approval authority. Once a loan application has been completed and all information has been obtained and verified, the loan request is submitted to a final review process. As part of the loan approval process, all uncollateralized loans of more than \$100,000 and all new collateralized loans of more than \$750,000 require pre-approval by the Bank's loan committee, which is currently comprised of five directors of the Bank and meets on such basis as is deemed necessary to promptly service loan demand. Loans to one borrower are subject to limits depending on our internal risk ratings.

Page 6

Loan applicants are notified promptly of the decision of the Bank by telephone and a letter. If the loan is approved, the commitment letter specifies the terms and conditions of the proposed loan including the amount of the loan, interest rate, amortization term, a brief description of the required collateral, and required insurance coverage. Prior to closing any long-term loan, the borrower must provide proof of fire and casualty insurance on the property serving as collateral which insurance must be maintained during the full term of the loan. Title insurance is required on loans collateralized by real property. Interest rates on committed loans are normally locked in at the time of application for a 30 to 45 day period. The commitment issued at the time of approval will be for the time remaining, based on the application date.

### Other Subsidiaries

The Company acquired a wholly-owned subsidiary, ASI Data Services, Inc. (ASI), through two stock purchases during 1993-1994. ASI initially provided data processing services to the Company and its subsidiaries. The Company's board transferred the assets and operations of ASI to the Bank in 1996 and ASI now is an inactive corporate subsidiary.

NBIG, a Maine corporation and a wholly-owned subsidiary of the Bank, was originally formed in 1982 and was formerly known as Northeast Financial Services, Inc. ("NFS"). It transitioned from an entity for real estate development projects, which terminated in fiscal 2005, to acquiring insurance agencies. Subsequent to the 2004 acquisition of Solon-Anson Insurance Agency, Inc. ("Solon Anson") by NFS, Solon-Anson was merged into NFS in April, 2005. NFS's name was then changed to Northeast Bank Insurance Group, Inc in May 2005. NBIG now supports the Bank's insurance agencies, which allows the Bank to deliver insurance products to its customers. At June 30, 2006, investment in and loans to this subsidiary constituted 0.55% of the Company's total assets.

## Employees

As of June 30, 2006, the Company, the Bank and its subsidiary together employed 188 full-time and 26 part-time employees. The Company's employees are not represented by any collective bargaining unit. The Company believes that its relations with its employees are good.

## SUPERVISION AND REGULATION

The banking industry is extensively regulated under both federal and state law. This regulatory framework is intended primarily to protect depositors and the federal deposit insurance funds, and not for the protection of shareholders. The following discussion summarizes certain aspects of the regulatory framework applicable to the Company and Northeast Bank. To the extent that the following information describes statutory and regulatory provisions, it is qualified in its entirety by reference to the particular statutory and regulatory provisions.

### Bank Holding Company Regulation

#### General

. As a bank holding company registered under the Bank Holding Company Act of 1956 (the "BHCA"), the Company is subject to the regulation and supervision of, and inspection by, the Federal Reserve Board ("FRB"), its primary regulator. The Company also is registered as a Maine financial institution holding company under Maine law and is subject to regulation and examination by the Superintendent of Financial Institutions of the State of Maine ("Superintendent"). The Company is required to file reports with, and provide other information regarding its business operations and those of its subsidiaries to, the FRB and the Superintendent.

The BHCA prohibits a bank holding company, with certain limited exceptions, from (i) acquiring or retaining direct or indirect ownership or control of more than 5% of the outstanding voting stock of any company which is not a bank or bank holding company, or (ii) engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or performing services for its subsidiaries; unless such non-banking business is determined by the FRB to be so closely related to banking or managing or controlling banks as to be properly incident thereto. Generally, permissible activities for bank holding companies include, among other things, factoring accounts receivable, acquiring and servicing loans, leasing personal property, performing certain data processing services, acting as an agent or broker in selling credit life insurance and certain other types of insurance in connection with credit transactions, and conducting certain insurance underwriting activities. The BHCA does not place territorial limits on permissible non-bank activities of bank holding companies. In making determinations of what non-banking activities are permissible, the FRB is required to weigh the expected benefit to the public, such as greater convenience, increased competition or gains in efficiency, against the possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. Generally, bank holding companies, such as the Company, are required to obtain prior approval of the FRB to engage in any new activity not previously approved by the FRB. Further, despite prior approval, the FRB reserves the power to order any bank holding company or its subsidiaries to terminate any activity when the FRB has reasonable grounds to believe that continuation of such activity constitutes a serious risk to the financial soundness, safety, or stability of the bank holding company or any of its bank subsidiaries.

Financial Modernization. The Gramm-Leach-Bliley Financial Modernization Act of 1999 (the "GLB Act"), which amended the BHCA, significantly relaxed previously existing restrictions on the activities of bank holding companies and their subsidiaries to:

- allow bank holding companies that qualify as "a financial holding company" to engage in a substantially broader range of activities that are financial in nature;
- allow insurers and other financial service companies to acquire banks;
- remove various restrictions that apply to bank holding company ownership of securities firms and mutual fund

advisory companies; and

- establish the overall regulatory structure applicable to bank holding companies that also engage in insurance and securities operations.

Page 7

Under the GLB Act, an eligible bank holding company may elect to be a "financial holding company" and thereafter engage in a range of activities that are financial in nature and that were not previously permissible for bank holding companies. These activities, which can be conducted either directly or through a subsidiary, include those that are "financial in nature", such as insurance underwriting, securities underwriting and dealing, and making merchant banking investments in commercial and financial companies. A financial holding company also may engage in any activity that the FRB determines by rule or order to be financial in nature, incidental to such financial activity, or complementary to a financial activity and does not pose a substantial risk to the safety and soundness of an institution or the financial system generally. In addition to these activities, a financial holding company may engage in those activities permissible for a bank holding company.

In order for a bank holding company to be eligible for financial holding company status, all of the subsidiary insured depository institutions must be "well-capitalized" and "well-managed" and have at least a satisfactory rating on its most recent Community Reinvestment Act of 1977 ("CRA") review. A bank holding company seeking to become a financial holding company must file a declaration with the FRB that it elects to become a financial holding company. If, after becoming a financial holding company, any of the insured depository institution subsidiaries should fail to continue to meet these requirements, the financial holding company would be prohibited from engaging in activities not permissible for bank holding companies unless it was able to return to compliance within a specified period of time.

Although Northeast Bank, our sole banking subsidiary, meets the capital, management, and CRA requirements, the Company has not made a declaration to elect to become a financial holding company and at this time has no plans to do so.

### Banking Acquisitions

. The BHCA requires, among other things, the prior approval of the FRB in any case where a bank holding company proposes to (i) acquire direct or indirect ownership or control of more than 5% of the outstanding voting stock of any bank or bank holding company (unless it already owns a majority of such voting shares), (ii) acquire all or substantially all of the assets of another bank or bank holding company, or (iii) merge or consolidate with any other bank holding company. The FRB will not approve any acquisition, merger, or consolidation that would result in a monopoly, or which would have a substantially anti-competitive effect, unless the anti-competitive impact of the proposed transaction is clearly outweighed by a greater public interest in meeting the convenience and needs of the community to be served. The FRB also is required to consider the financial and managerial resources and future prospects of the holding companies and banks, the projected capital adequacy on a post-acquisition basis, and the acquiring institution's performance under the CRA.

In addition, Maine law requires the prior approval of the Superintendent for (i) the acquisition of more than 5% of the voting shares of a Maine financial institution or any financial institution holding company that controls a Maine financial institution, or (ii) the acquisition by a Maine financial institution holding company of more than 5% of a financial institution or a financial institution holding company domiciled outside the State of Maine.

### Interstate Banking and Branching

. The Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Interstate Banking and Branching Act") provides that, regardless of any previously applicable state law, bank holding companies which meet specified capital and management adequacy standards, and any state-imposed age requirements, are eligible to acquire banks in states other than their home states unless, as a result of such acquisition, the bank would control more than 10% of the total deposits of insured depository institutions in the United States or more than 30% of such deposits in that state (or other applicable state law limits).

Further, the Interstate Banking and Branching Act authorizes adequately capitalized and managed banks to cross state lines to merge with other banks, subject to certain restrictions, thereby creating interstate branches. A bank also may open new branches in a state in which it does not directly have banking operations if that state has enacted a law permitting de novo branching.

Maine law expressly authorizes interstate banking combinations that are approved by the Superintendent and do not result in deposit concentrations exceeding 30% of the total deposits of the State of Maine (unless such limitation is waived by the Superintendent). Further, interstate branch acquisitions and the establishment of de novo branches also are authorized under Maine law. However, if an out-of-state financial institution seeks to establish or acquire branches in Maine, the laws of the jurisdiction of such financial institution must expressly authorize, under conditions no more restrictive than the State of Maine, the out-of-state financial institution to engage in interstate branch acquisitions or establishment of de novo branches in that state.

#### Source of Strength: Safety and Soundness

. Under FRB policy, the Company is expected to act as a source of financial strength to, and commit resources to support, Northeast Bank. This support may be required at times when, absent such FRB policy, the Company may not be inclined to provide it. In addition, any capital loans by a bank holding company to its subsidiary banks are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary banks. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a Federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to a priority of payment.

Page 8

There are a number of obligations and restrictions imposed on bank holding companies and their depository institution subsidiaries by law and regulatory policy that are designed to minimize potential loss to the depositors of such depository institutions and the FDIC insurance funds in the event the depository institution becomes in danger of default or in default. For example, under the Federal Deposit Insurance Company Improvement Act of 1991 ("FDICIA"), to avoid receivership of an insured depository institution subsidiary, a bank holding company is required to guarantee the compliance of any insured depository institution subsidiary that may become "undercapitalized" with the terms of any capital restoration plan filed by such subsidiary with its appropriate Federal bank regulatory agency up to the lesser of (i) an amount equal to 5% of the institution's total assets at the time the institution became undercapitalized or (ii) the amount that is necessary (or would have been necessary) to bring the institution into compliance with all applicable capital standards as of the time the institution fails to comply with such capital restoration plan. See "-- Capital Adequacy Guidelines - Classification of Banking Institutions" and "- Enforcement, Policies and Actions".

In addition, the "cross-guarantee" provisions of the FDICIA require insured depository institutions which are under common control to reimburse the FDIC for any loss incurred, or reasonably expected to be incurred, by the FDIC as a result of the default of a commonly controlled insured depository institution or for any assistance provided by the FDIC to a commonly controlled insured depository institution in danger of default. Accordingly, the cross-guarantee provisions enable the FDIC to access a bank holding company's healthy members of the FDIC. The FDIC may decline to enforce the cross-guarantee provisions if it determines that a waiver is in the best interest of the insurance fund. The

FDIC's claims are superior to claims of stockholders of the insured depository institution or its holding company but are subordinate to claims of depositors, secured creditors and holders of subordinated debt (other than affiliates) of the commonly controlled insured depository institutions.

Under FDICIA, as amended, Federal banking regulatory agencies have adopted guidelines prescribing safety and soundness standards. These guidelines establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risk and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal stockholder.

## Bank Regulation

### General

. Northeast Bank is a Maine state-chartered banking corporation and a member of the Federal Reserve System and, as such, is subject to the supervision, examination, and regulation by the Maine Bureau of Financial Institutions and the FRB.

As a state-chartered commercial bank, Northeast Bank is subject to the applicable provisions of Maine law and the regulations adopted by the Maine Bureau of Financial Institutions. The FRB and the Maine Bureau of Financial Institutions will regularly examine the operations of Northeast Bank and are given authority to approve or disapprove mergers, consolidations, the establishment of branches and similar corporate actions. Maine law and the Supervisor regulate (in conjunction with applicable federal laws and regulations), among other things, Northeast Bank's capital, permissible activities, reserves, investments, lending authority, the issuance of securities, payment of dividends, transactions with affiliated parties, and borrowing. The federal and state banking regulations also have the power to prevent the continuance or development of unsafe or unsound banking practices or other violations of law.

### Transactions with Affiliates.

There are various legal restrictions on the extent to which the Company and any non-bank subsidiaries affiliated with Northeast Bank can borrow or otherwise obtain credit from Northeast Bank. Northeast Bank also is subject to certain restrictions on the purchase of, or investments in, the securities of, and purchase of assets from, the Company and of its non-bank subsidiaries, on loans or extensions of credit by a bank to third parties collateralized by the securities or obligations of the Company and any of its non-bank subsidiaries, on the issuance of guaranties, acceptances and letters of credit on behalf of the Company or any of its non-bank subsidiaries. Northeast Bank is subjected to further restrictions on most types of transactions with the Company and its non-bank subsidiaries which require the terms of such transactions to be substantially equivalent to the terms of similar transactions with non-affiliated entities.

Further, the Company and Northeast Bank are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, lease or sale of property, or furnishing of services. For example, Northeast Bank may not generally require a customer to obtain other services from Northeast Bank or the Company, and may not require the customer to promise not to obtain other services from a competitor, as a condition to an extension of credit.

Loans to Insiders. Northeast Bank also is subject to certain restrictions imposed by federal and state banking requiring agencies on extensions of credit to executive officers, directors, principal shareholders or any related interest of such persons. Sections 22(g) and 22(h) of the Federal Reserve Act, as amended, and Regulation O promulgated by the FRB provide that extensions of credit to such insiders (a) must be made on substantially the same terms, including interest rates and collateral as, and follow credit underwriting procedures that are not less stringent than those prevailing at the

time for, comparable transactions with persons not covered above and who are not employees, (b) must not involve more than the normal risk of repayment or present other unfavorable features, and (c) may not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of Northeast Bank's capital. The regulators do allow small discounts on fees on residential mortgages for directors, officers, and employees. Northeast Bank also is subject to certain lending limits and restrictions on overdrafts to such persons and extensions of credit in excess of certain limits must be approved by the board of directors of Northeast Bank. A violation of these restrictions may result in the assessment of substantial civil monetary penalties on Northeast Bank or any officer, director, employee, agent or other person participating in the conduct of the affairs of Northeast Bank or the imposition of a cease and desist order.

Page 9

#### Bank Subsidiaries' Activities

. The powers of Maine-chartered banks include provisions designed to provide these banks with competitive equity to the powers of national banks. In addition, the GLB Act permits state banks to engage in activities that are permissible for subsidiaries of Financial Holding Companies to the extent such activities are permitted under applicable state law. The GLB Act also expressly preserves the ability of state banks, such as Northeast Bank, to retain all existing subsidiaries. In order to form a financial subsidiary, a state bank must be "well capitalized." State banks with financial subsidiaries will be subject to certain capital deduction, risk management, and affiliate transaction rules. In this regard, FRB rules provide that state bank subsidiaries that engage only in activities that the bank could engage in directly will not be deemed to be a financial subsidiary.

#### Dividend Restrictions

The Company is a legal entity separate and distinct from Northeast Bank. The primary source of revenues and funds of the Company, including funds to pay dividends to our shareholders, have been and will likely continue to be from dividends, if any, paid to us by Northeast Bank. There are statutory and regulatory limitations on the payment of dividends by Northeast Bank to the Company as well as by the Company to its shareholders. As to the payment of dividends, Northeast Bank is subject to the laws and regulations of the State of Maine and to the regulations of the FRB.

If, in the opinion of the applicable federal bank regulatory authority, a depository institution or holding company under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the depository institution or holding company, could include the payment of dividends), such authority may require, after notice and hearing (except in the case of an emergency proceeding where there is no notice or hearing), that such institution or holding company cease and desist from such practice. The Federal bank regulatory agencies have indicated that paying dividends that deplete a depository institution's or holding company's capital base to an inadequate level would be such an unsafe and unsound banking practice. Moreover, under FDICIA, an insured institution may not pay a dividend if payment would cause it to become undercapitalized or if it already is undercapitalized. See "- Capital Adequacy Guidelines - Prompt Corrective Regulatory Action". Moreover, the FRB and the FDIC have issued policy statements which provide that bank holding companies and insured depository institutions generally should only pay dividends out of current operating earnings.

At June 30, 2006, under dividend restrictions imposed under federal and state laws, Northeast Bank could declare, without obtaining governmental approvals, aggregate dividends to the Company of approximately \$8,092,000.

#### Capital Adequacy Guidelines

Minimum Capital Requirements. The Company and Northeast Bank are required to comply with capital adequacy standards established by the FRB. There are two basic measures of capital adequacy for bank holding companies that

have been promulgated by the FRB: a risk-based measure and a leverage measure.

The risk-based capital standards are designed to make regulatory capital requirements more sensitive to differences in credit and market risk profile among banks and bank holding companies, to account for off-balance sheet exposure, and to minimize disincentives for holding liquid assets. Under these standards, assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items. In addition, the Federal bank regulatory agencies may from time to time require that a banking organization maintain capital above the minimum limits, whether because of its financial condition or actual or anticipated growth. FRB policy also provides that banking organizations generally, and in particular those that are experiencing internal growth or actively making acquisitions, are expected to maintain capital positions that are substantially in excess of the minimum supervisory levels, without significant reliance on intangible assets.

These risk-based capital standards define a two-tier capital framework. Under these regulations, the minimum ratio of total capital ("Total Capital") to risk-weighted assets (including certain off-balance sheet activities, such as stand-by letters of credit) is 8%. At least one-half of the Total Capital must be "Tier 1 Capital," consisting of common equity, retained earnings or undivided profits, qualifying non-cumulative perpetual preferred stock, and a limited amount of cumulative perpetual preferred stock and minority interests in the equity account of consolidated subsidiaries, less certain goodwill items and other intangible assets (i.e., at least 4% of the risk weighted assets). The remainder ("Tier 2 Capital") may consist of (a) the allowance for credit losses of up to 1.25% of risk-weighted risk assets, (b) preferred stock that does not qualify as Tier 1 Capital, (c) qualifying hybrid capital instruments, (d) perpetual debt, (e) mandatory convertible securities, and (f) subordinated debt and intermediate term-preferred stock up to 50% of Tier 1 Capital. Assets and off-balance sheet items are assigned to one of four categories of risk weights, based primarily on relative credit risk. The minimum guideline for Tier 1 Capital is 4.0%. At June 30, 2006, the Company's consolidated Tier 1 Capital ratio was 12.45% and its Total Capital ratio was 14.52%.

In addition, the FRB has established minimum leverage ratio guidelines for bank holding companies. The guidelines provide for a minimum Tier 1 Capital to average assets (less goodwill and certain other intangible assets) ("Leverage Ratio") of at least 3% plus an additional cushion of 100 to 200 basis points. The Company's Leverage Ratio at June 30, 2006, was 9.32%.

Page 10

Federal bank regulatory agencies also have adopted regulations which require regulators to take into consideration concentrations of credit risk and risks from non-traditional activities, as well as an institution's ability to manage those risks, when determining the adequacy of an institution's capital. Other factors taken into consideration include: interest rate exposure, liquidity, funding and market risk; the quality and level of earnings; the quality of loans and investments; the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operated risks, including concentrations of credit and non-traditional activities. This evaluation is made as part of the institution's regular safety and soundness examination. Further, each Federal banking agency prescribes standards for depository institution holding companies relating to internal controls, information systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, maximum rates of classified assets to capital, minimum earnings sufficient to absorb losses, and other standards as they deem appropriate. In addition, pursuant to the requirements of the FDICIA, Federal bank regulatory agencies all have adopted regulations requiring regulators to consider interest rate risk (when interest rate sensitivity of an institution's assets does not match its liabilities or its off-balance sheet position) in the evaluation of a bank's capital adequacy.

Northeast Bank is subject to substantially similar risk-based and leverage capital requirements as those applicable to the Company. As of June 30, 2006, Northeast Bank was in compliance with applicable minimum capital requirements.

#### Classification of Banking Institutions

. Among other things, the FDICIA provides Federal bank regulatory agencies with broad powers to take "prompt corrective action" with respect to depository institutions that do not meet minimum capital requirements. The extent of those powers depends upon whether the institutions in question are "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized." A depository institution's capital tier will depend upon where its capital levels are in relation to various relevant capital measures, which include a risk-based capital measure and a leverage ratio capital measure, and certain other factors.

The Federal bank regulatory agencies have adapted regulations establishing relevant capital measures and relevant capital levels. Under these regulations, a bank will be considered:

- "Well capitalized" if it has (a) a total risk-based capital ratio of 10% or greater, (b) a Tier 1 risk-based capital ratio of 6% or greater, (c) a leverage ratio of 5% or greater, and (d) is not subject to any order or written directive to meet and maintain a specific capital level for any capital measure.
- "Adequately capitalized" if it has (a) a total risk-based capital ratio of 8% or greater, (b) a Tier 1 risk-based capital ratio of 4% or greater, and (c) a leverage ratio of 4% or greater (or 3% or greater in the case of a bank with a composite CAMEL rating of 1).
- "Undercapitalized" if it has (a) a total risk-based capital ratio of less than 8%, (b) a Tier 1 risk-based capital ratio of less than 4%, or (c) a leverage ratio of less than 4% (or 3% in the case of a bank with a composite CAMEL rating of 1);
- "Significantly undercapitalized" if the bank has (a) a total risk-based capital ratio of less than 6%, (b) a Tier 1 risk-based capital ratio of less than 3%, or (c) a leverage ratio of less than 3%; and
- "Critically undercapitalized" if the bank has a ratio of tangible equity to total assets equal to or less than 2%.

Under certain circumstances, a depository institution's primary Federal bank regulatory agency may use its authority to reclassify a "well classified" bank as "adequately capitalized" or subject an "adequately capitalized" or "undercapitalized" institution to supervisory actions applicable to the next lower capital category if it determines that the bank is in an unsafe or unsound condition or deems the bank to be engaged in an unsafe or unsound practice and not have corrected the deficiency. The banking agencies are permitted to establish individual minimum capital requirements exceeding the general requirements described above. Generally, failing to maintain the status of a "well capitalized" or "adequately capitalized" depository institution subjects the institution to restrictions and limitations on its business that become progressively more severe as capital levels decrease. At June 30, 2006, Northeast Bank met the definition of a "well capitalized" institution.

#### Prompt Corrective Regulatory Action.

Federal banking regulators are required to take "prompt corrective action" if an insured depository institution fails to satisfy certain minimum capital requirements and other measures deemed appropriate by the federal banking regulators. See "- Capital Adequacy Guidelines" and "- Enforcement Policies and Actions." Failure to meet the capital adequacy guidelines could subject a banking institution to capital raising requirements. A bank is prohibited from making any capital distribution (including the payment of a dividend) or paying a management fee to its holding company if the bank would thereafter be "undercapitalized". Limitations exist for "undercapitalized" depository institutions regarding, among other things, asset growth, acquisitions, branching, new lines of business, acceptance of broker deposits and borrowings from the Federal Reserve System. These institutions also are required to submit a capital instruction plan that includes a guarantee from the institution's holding company. See "Bank Holding Company Regulation - Source of Strength; Safety and Soundness". A "significantly undercapitalized" depository institution may be subject to a number of requirements and restrictions, including orders to sell sufficient quantity of voting stock to become "adequately capitalized," requirements to reduce total assets and cessation of receipt of deposits from



correspondent banks. The appointment of a receiver or conservator may be required for "critically under capitalized" institutions.

### Brokered Deposits

Page 11

Only a "well capitalized" depository institution may accept brokered deposits without prior regulatory approval. Under implementing regulations, "well capitalized" banks may accept brokered deposits without restriction, "adequately capitalized" banks may accept brokered deposits with a waiver from the FDIC (subject to certain restrictions on payments of rates), while "undercapitalized" banks may not accept brokered deposits. Bank policy limits the use of brokered deposits to 25% of total assets. At June 30, 2006, we had brokered time deposits of \$51.9 million, or 9.22% of total assets.

### Enforcement Policies and Actions

The enforcement powers available to Federal banking regulators and the Supervisor over commercial banks and bank holding companies are extensive. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease-and-desist or removal orders, to initiate injunctive actions against banking organizations and affiliated parties, and, in extreme cases, to terminate deposit insurance. In general, these enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions or inactions may provide the basis for enforcement action, including misleading or untimely reports filed with the Federal bank regulatory agencies. Current law generally requires public disclosure of final enforcement actions.

### Community Reinvestment Act

Bank holding companies and their subsidiary banks are subject to the provisions of the CRA and the regulations promulgated thereunder by the appropriate Federal bank regulatory agency. Under the terms of the CRA, Northeast Bank has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires each appropriate Federal bank regulatory agency, in connection with its examination of a subsidiary depository institution, to assess such institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by that institution. The CRA also requires all institutions to make public disclosure of their CRA ratings. Further, such assessment also is part of the FRB's consideration of applications to acquire, merge or consolidate with, or assume the liabilities of, another banking institution or its holding company, or to open or relocate a branch office. In the case of a bank holding company applying for approval to acquire a bank or a bank holding company, the FRB will assess the record of each subsidiary bank of the applicant bank holding company in considering the application. Pursuant to current CRA regulations, an institution's CRA rating is based on its actual performance in meeting community needs. In particular, the rating system focuses on three tests: (a) a lending test, which evaluates the institution's record of making loans in its service areas; (b) an investment test, which evaluates the institution's record of investing community development projects, affordable housing, and programs benefiting low or moderate income individuals and businesses; and (c) a service test, which evaluates the institution's delivery of services through its branches, ATMs, and other offices. The current CRA regulations also clarify how an institution's CRA performance will be considered in the application process. Northeast Bank received a "satisfactory" CRA rating in its most recent examination.

### Customer Protection

Northeast Bank also is subject to various consumer laws and regulations intended to protect customers in transactions with depository institutions, as well as other laws and regulations affecting customers of financial institutions generally. The banking regulatory authorities have increased their attention in recent years to compliance with consumer protection laws and their implementing regulations. Examination and enforcement have become more intense in nature, and insured institutions have been advised to monitor carefully compliance with such laws and regulations. In addition to CRA, Northeast Bank is subject to many other federal consumer protection statutes and regulations, some of which are discussed below.

*Equal Credit Opportunity Act.* The Equal Credit Opportunity Act generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

*Truth in Lending Act.* The Truth in Lending Act ("TILA") is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

*Fair Housing Act.* The Fair Housing Act ("FHA") regulates many practices, and makes it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be illegal under the FHA, including some practices that are not specifically mentioned in the FHA.

*Home Mortgage Disclosure Act.* The Home Mortgage Disclosure Act ("HMDA") grew out of public concern over credit shortages in certain urban neighborhoods and provides public information that is intended to help to show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a "fair lending" aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes. Beginning with data reported for 2004, the amount of information that financial institutions collect and disclose concerning applicants and borrowers has expanded, which is expected to increase the attention that HMDA data receives from state and federal banking supervisory authorities, community-oriented organizations and the general public.

Page 12

*Real Estate Settlement Procedures Act.* The Real Estate Settlement Procedures ACT ("RESPA") requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements. RESPA also prohibits certain abusive practices, such as kickbacks and fee-splitting without providing settlement services.

Penalties under the above laws may include fines, reimbursements and other penalties. Due to heightened regulatory concern related to compliance with these laws generally, the Company and Northeast Bank may incur additional compliance costs or be required to expend additional funds for investments in its local community.

#### FDIC Insurance Premiums

Northeast Bank is required to pay semiannual FDIC deposit insurance assessments. Under the FDIC's risk-based insurance system, insured institutions are currently assessed premiums based on the institution's capital position and other supervisory factors. Each financial institution is assigned to one of three capital groups - well capitalized, adequately capitalized or undercapitalized - and further assigned to one of three subgroups - within a capital group, on the basis of supervisory evaluations by the institution's primary federal and, if applicable, state supervisors and other information relevant to the institution's financial condition and the risk posed to the applicable FDIC deposit insurance

fund. The actual assessment rate applicable to a particular institution (and any applicable refund) will, therefore, depend in part upon the risk assessment classification so assigned to the institution by the FDIC.

#### Gramm-Leach-Bliley Act

The GLB Act, enacted in 1999, amended and repealed portions of the Glass-Steagall Act and other federal laws restricting the ability of bank holding companies, securities firms, and insurance companies to affiliate with each other and enter into new lines of business. The GLB Act established a comprehensive framework to permit financial companies to expand their activities, including through affiliations, and to modify the federal regulatory structure governing some financial services activities. The increased authority of financial firms to broaden the type of financial services that they may offer to customers and to affiliates with other types of financial service companies may lead to further consolidation in the financial services industry. However, it also may lead to additional competition in these markets in which we operate by allowing new entrants into various segments of those markets that were not the traditional competitors in the segments. Furthermore, the authority granted by the GLB Act may encourage the growth of larger competitors.

With respect to bank securities activities, the GLB Act repeals the exemption from the definition of "broker" previously afforded to banks and replaces it with a set of limited exemptions that permits certain activities which have been performed historically by banks to continue. Further, the GLB Act amends the securities laws to include banks with the general definition of dealer.

In addition, the GLB Act imposes regulations on financial institution with respect to customer privacy. The GLB generally prohibits disclosure of customer information to non-affiliated third parties unless the customer had been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to provide written disclosure of their privacy policies to customers at the time the banking relationship is formed and annually thereafter. Financial institutions, however, are required to comply with state law if it is more protective of customer privacy than the GLB Act. The privacy provisions became effective in July 2001.

The GLB Act contains a variety of other provisions including a prohibition against ATM surcharges unless the customer has first been provided notice of the imposition and amount of the fee. The GLB Act reduces the frequency of CRA examinations for smaller institutions and imposes certain reporting requirements on depository institutions that make payment to non-governmental entities in connection with the CRA.

#### Anti-Money Laundering and Anti-Terrorism Legislation

Congress enacted the Bank Secrecy Act of 1970 (the "BSA") to require financial institutions, including the Company and Northeast Bank, to maintain certain records and to report certain transactions to prevent such institutions from being used to hide money derived from criminal activity and tax evasion. The BSA establishes, among other things, (a) record keeping requirements to assist government enforcement agencies in tracing financial transactions and flow of funds; (b) reporting requirements for Suspicious Activity Reports and Currency Transaction Reports to assist government enforcement agencies in detecting patterns of criminal activity; (c) enforcement provisions authorizing criminal and civil penalties for illegal activities and violations of the BSA and its implementing regulations; and (d) safe harbor provisions that protect financial institutions from civil liability for the cooperative efforts.

The USA Patriot Act of 2001 (the "USA Patriot Act") is intended to strengthen the ability of U.S. law enforcement agencies and the intelligence communities to work cohesively to combat terrorism on a variety of fronts. The USA Patriot Act amended the BSA and incorporates anti-terrorist financing provisions into the requirements of the BSA and its implementing regulations. Under the USA Patriot Act, FDIC insured banks and commercial banks are required to increase their due diligence efforts for correspondent accounts and private banking customers. The USA Patriot Act requires banks to engage in additional record keeping or reporting, requiring identification of owners of accounts, or of the customers of foreign banks with accounts, and restricting or prohibiting certain correspondent accounts. Among

other things, the USA Patriot Act requires all financial institutions, including the Company and Northeast Bank to institute and maintain a risk-based anti-money laundering compliance program that includes a customer identification program, provides for information sharing with law enforcement and between certain financial institutions by means of an exemption from the privacy provision of the GLB Act, prohibits U.S. banks and broker-dealers from maintaining accounts with foreign "shell" banks, establishes due diligence and enhanced due diligence requirements for certain foreign correspondent banking and foreign private banking accounts and imposes additional record keeping requirements for certain correspondent banking arrangements. The USA Patriot Act also grants broad authority to the Secretary of the Treasury to take actions to combat money laundering, and federal bank regulators are required to evaluate the effectiveness of an applicant in combating money laundering in determining whether to approve any application submitted by a financial institution. The Company and Northeast Bank have adopted policies, procedures, and controls to comply with the BSA and the USA Patriot Act, and they engage in very few transactions of any kind with foreign financial institutions or foreign persons.

Page 13

The Department of the Treasury's Office of Foreign Asset Control ("OFAC") administers and enforces economic and trade sanctions against targeted foreign countries, entities and individuals based on U.S. foreign policy and national security goals. As a result, financial institutions, including the Company and Northeast Bank, must scrutinize transactions to ensure that they do not represent obligations of, or ownership interests in, entities owned or controlled by sanctioned targets. In addition, the Company and Northeast Bank restrict transactions with certain targeted countries except as permitted by OFAC.

#### Check 21

On October 28, 2003, President Bush signed into law the Check Clearing for the 21<sup>st</sup> Century Act, also known as Check 21. This law, which was effective on October 28, 2004, gives "substitute checks," such as a digital image of a check and copies made from that image, the same legal standing as the original paper check. Some of the major provisions include:

- allowing check truncation without making it mandatory;
- demanding that every financial institution communicate to accountholders in writing a description of its substitute check processing program and their rights under the law;
- legalizing substitutions for and replacements of paper checks without agreement from consumers;
- retaining in place the previously mandated electronic collection and return of checks between financial institutions only when individuals agreements are in place;
- requiring that when accountholders request verification, financial institutions produce the original check (or copy that accurately represents the original) and demonstrate that the account debit was accurate and valid; and
- requiring recrediting of funds to an individual's account on the next business day after a consumer proves that the financial institution has erred.

This legislation will likely affect bank capital spending as many financial institutions assess whether technological or operational changes are necessary to stay competitive and take advantage of the opportunities presented by Check 21.

#### Sarbanes-Oxley Act

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act") implemented a broad range of corporate governance and accounting measures, executive compensation limitations, and enhanced and timely disclosure obligations for corporate information, all of which are designed to ensure that the stockholders of corporate America are treated fairly and have full and accurate information about the public companies in which they invest. All public companies, including companies that file periodic reports with the SEC, are affected by the Sarbanes-Oxley Act.

Specifically, the Sarbanes-Oxley Act and various regulations promulgated therefrom, established among other things:

- the creation of an independent accounting oversight board to oversee the audit of public companies and auditors who perform such audits;
- auditor independence provisions which restrict non-audit services that independent accountants may provide to their audit clients ;
- additional responsibilities regarding financial statements for the chief executive officer and chief financial officer of the reporting entity;
- a prohibition on personal loans to directors and officers, except certain loans made by financial institutions on non-preferential terms and in compliance with other bank regulatory requirements;
- additional corporate governance and responsibility measures which (a) require the chief executive officer and chief financial officer to certify financial statements and to forfeit salary and bonuses in certain situations, and (b) protect whistleblowers and informants;
- enhance independence and expertise requirements of members of an audit committee;
- expansion of the audit committee's authority and responsibility by requiring that the audit committee (a) have direct control of the outside auditor, (b) be able to hire and fire the auditor, and (c) approve all non-audit services;
- mandatory disclosure by analysts of potential conflicts of interest; and
- enhanced penalties for fraud and other violations.

Page 14

The American Stock Exchange also has adopted corporate governance rules that have been approved by the SEC. These changes are intended to allow shareholders to more easily and efficiently monitor the performance of companies and directors. The Company has taken steps to comply with the provisions of the Sarbanes-Oxley Act and the regulations adopted thereunder. Based on our total assets, the audit of internal controls on financial reporting will be complied with in fiscal 2008. The Sarbanes-Oxley Act is expected to increase the administrative costs and burdens of doing business for public companies.

#### Monetary Policy and Economic Control

The commercial banking business is affected not only by legislation, regulatory policies, and general economic conditions, but also by the monetary policy of the FRB. Changes in the discount rate on member bank borrowing, availability of borrowing at the "discount window," open market operations, the imposition of changes in reserve requirements against member banks' deposit and assets of foreign branches and the imposition of and changes in reserve requirements against certain borrowings by banks and their affiliates are some of the instruments of monetary policy available to the FRB. These monetary policies are used in varying combinations to influence overall growth

and distributions of bank loans, investments and deposits, and this use may affect interest rates charged on loans or paid on deposits. The monetary policies of the FRB have had a significant effect on the operating results of commercial banks and are expected to do so in the future. The monetary policies of these agencies are influenced by various factors, including inflation, unemployment, short-term and long-term changes in the international trade balance and in the fiscal policies of the United States Government. Future monetary policies and the effect of such policies on the future business and earnings of Northeast Bank cannot be predicted.

### Industry Restructuring

For well over a decade, the banking industry has been undergoing a restructuring process which is anticipated to continue. The restructuring has been caused by product and technological innovations in the financial services industry, deregulation of interest rates, and increased competition from foreign and nontraditional banking competitors, and has been characterized principally by the gradual erosion of geographic barrier to intrastate and interstate banking and the gradual expansion of investment and lending authorities for bank institutions.

Members of Congress and the administration may consider additional legislation designed to institute reforms to promote the viability of the industry. Such legislation could revise the federal regulatory structure for insured depository institutions; others could affect the nature of products, services, and activities that bank holding companies and their subsidiaries may offer or engage in, and the types of entities that may control depository institutions. There can be no assurance as to whether or in what form any such future legislation might be enacted, or what impact such legislation might have upon the Company or Northeast Bank.

### STATISTICAL DISCLOSURE

The additional statistical information contained in Item 8(b) of this Form 10-K, "Financial Statements and Supplementary Data" as it relates to the disclosures required by Industry Guide 3 under the Securities Exchange Act of 1934, as amended, is incorporated herein by reference.

### FORWARD-LOOKING STATEMENTS AND RISK FACTORS

This Annual Report on Form 10-K (including the Exhibits hereto) contains certain "forward-looking statements" within the meaning of federal securities law Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, such as statements relating to our financial condition, prospective results of operations, future performance or expectations, plans, objectives, prospects, loan loss reserve adequacy, simulation of changes in interest rates, capital spending and finance sources, and revenue sources. These statements relate to expectations concerning matters that are not historical facts. Accordingly, statements that are based on management's projections, estimates, assumptions, and judgments constitute forward-looking statements. These forward-looking statements, which are based on various assumptions (some of which are beyond the Company's control), may be identified by reference to a future period or periods, or by the use of forward-looking terminology such as "believe", "expect", "estimate", "anticipate", "continue", "plan", "approximately", "intend", "objective", "goal", "project", or other similar terms or variations on those terms, or the future or conditional verbs such as "will", "may", "should", "could", and "would". In addition, the Company may from time to time make such oral or written "forward-looking statements" in future filings with the Securities and Exchange Commission (including exhibits thereto), in its reports to shareholders, and in other communication made by or with the approval of the Company.

Page 15

Such forward-looking statements reflect our current views and expectations based largely on information currently available to our management, and on our current expectations, assumptions, plans, estimates, judgments, and projections about our business and our industry, and they involve inherent risks and uncertainties. Although we believe that these forward-looking statements are based on reasonable estimates and assumptions, they are not

guarantees of future performance and are subject to known and unknown risks, uncertainties, contingencies, and other factors. Accordingly, we can not give you any assurance that our expectations will in fact occur or that our estimates or assumptions will be correct. We caution you that actual results could differ materially from those expressed or implied by such forward-looking statements due to a variety of factors, including, but not limited to, those related to the economic environment, particularly in the market areas in which the Company operates, competitive products and pricing, fiscal and monetary policies of the U.S. Government, changes in government regulations affecting financial institutions, including regulatory fees and capital requirements, changes in prevailing interest rates, acquisitions and the integration of acquired businesses, credit risk management, asset/liability management, changes in technology, changes in the securities markets, and the availability of and the costs associated with sources of liquidity. Accordingly, investors and others are cautioned not to place undue reliance on such forward-looking statements.

Potential risks, uncertainties, and other factors which could cause the Company's financial performance or results of operations to differ materially from current expectations or such forward-looking statements include, but are not limited to:

- a) general economic conditions, either nationally or in the markets where the Company or its subsidiaries offer their financial products or services, may be less favorable than expected, resulting in, among other things, a deterioration of credit quality or in a decreased demand for our products or services;
- b) A significant increase in competitive pressures in the banking and financial services industry increasing significantly and, more particularly, a significant increase in competition in the Company's market areas as described under "Business -- Market for Services and Competition";
- c) changes in the interest rate environment which could reduce our margins and increase defaults in our loan portfolio, including those described under "Management's Discussion and Analysis of Results of Operations and Financial Condition --Risk Management", and also may have a negative impact on the Company's interest rate exchange agreement;
- d) the adequacy of the allowance for loan losses and the Bank's asset quality, including those matters described in "Management's Discussion and Analysis of Results of Operations and Financial Condition -- Results of Operations".
- e) changes in political conditions or changes occurring in the legislative or regulatory environment that adversely affects the businesses in which we are engaged, including the impact of any changes in laws and regulations relating to banking, securities, taxes, and insurance;
- f) changes in technology;
- g) the ability to increase market share and to control expenses, and changes in consumer spending, borrowing, and saving habits;
- h) changes in trade, tax, monetary, or fiscal policies, including the interest rate policies of the FRB;
- i) money market and monetary fluctuations, and changes in inflation or in the securities markets;
- j) future acquisitions and the integration of acquired businesses and assets;
- k) changes in the Company's organizational structure and in its compensation and benefit plans, including those necessitated by pressures in the labor market for attracting and retaining qualified personnel;
- l) the effect of changes in accounting policies and practices, as may be adopted by regulatory agencies as well as the Financial Accounting Standards Board;
- m) unanticipated litigation, regulatory, or other judicial proceedings;
- n) the success of the Company at managing the risks involved in the foregoing;
- o) other one-time events, risks and uncertainties detailed from time to time in the filings of the Company with the Securities and Exchange Commission.

All written or oral forward-looking statements that are made or attributable to us are expressly qualified in their entirety by this cautionary notice. Such forward-looking statements speak only to the date that such statements are made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

The Company's results are strongly influenced by general economic conditions in its market areas in the western, central, and mid-coastal regions of the State of Maine. Deterioration in these conditions could have a material adverse effect on the quality of the Bank's loan portfolio and the demand for its products and services. In particular, changes in the real estate or service industries, or a slow-down in population growth, may adversely impact the Company's performance. See "Item 7. Management's Discussion and Analysis of Results of Operations and Financial Condition."

Page 16

All forward-looking statements presume a continuation of the existing regulatory environment and monetary policy. The banking industry is subject to extensive state and federal regulation, and significant new laws or regulations, or changes in or repeals of existing laws or regulations may cause results of the Company to differ materially. Further federal monetary policy, particularly as implemented by the FRB, significantly affect credit conditions for the Bank and its customers. Such changes could adversely impact the Company's financial results. In addition, the Sarbanes-Oxley Act of 2002 and the numerous rulemaking initiatives adopted or proposed in connection therewith or in reaction thereto have significantly increased the regulatory burdens of publicly held corporations. Accordingly, the cost of compliance with, and the personnel necessary to satisfy the obligations imposed by, these regulatory initiatives may divert resources from our core business operations and may adversely affect our profitability. See "Item 1. Business Supervision and Regulation."

A significant source of risks arise from the possibility that losses will be sustained because borrowers, guarantors, and related parties fail to perform in accordance with the terms of their loans. The Bank has adopted underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for loan losses, that management believe are appropriate to minimize the risks in assessing the likelihood of nonperformance, tracking loan performance, and diversifying the Bank's loan portfolio. However, such policies may not prevent unexpected losses that could adversely affect the Company's results and the allowance for loan losses may not be adequate in all instances. See "Item 7. Management's Discussion and Analysis of Results of Operations and Financial Condition - Results of Operations," " - Financial Condition," and " - Risk Management." Further, certain types of lending relationships carry greater risks of nonperformance and collectability, such as commercial and consumer loans. For a discussion of the risks associated with such lending relationships, see "Item 1. Business -- Lending Activities."

#### ITEM 1.a. Risk Factors

The following discusses risks that management believes are specific to our business and could have a negative impact on Northeast Bancorp's financial performance. When analyzing an investment in Northeast Bancorp ("the Company"), the risks and uncertainties described below, together with all of the other information included or incorporated by reference in this report, should be carefully considered. This list should not be viewed as comprehensive and may not include all risks that may affect the financial performance of the Company:

##### Interest Rate Risk

The Company's profitability is largely a function of the spread between the interest rates earned on earning assets and the interest rates paid on deposits and other interest-bearing liabilities. Like most financial institutions, the Company's net interest income and margin will be affected by general economic conditions and other factors, including fiscal and monetary policies of the Federal government, that influence market interest rates and the Company's ability to respond to changes in such rates. At any given time, the Company's assets and liabilities may be such that they are affected differently by a change in interest rates. As a result, an increase or decrease in rates, the length of loan terms or the mix of adjustable- and fixed- rate loans or investment securities could have a positive or negative effect on its net income, capital and liquidity. Although management believes it has implemented strategies and guidelines to reduce the potential effects of changes in interest rates on results of operations, any substantial and prolonged change in market interest rates, including the slope of the interest rate curve, could adversely affect operating results.



## Credit Risk

As a lender, the Company is exposed to the risk that its borrowers may be unable to repay their loans and that any collateral securing the payment of their loans may not be sufficient to assure repayment in full. Credit losses are inherent in the lending business and could have a material adverse effect on the operating results of the Company. Adverse changes in the economy or business conditions, either nationally or in the Company's market areas, could increase credit-related losses and expenses and/or limit growth. Substantially all of the Company's loans are to businesses and individuals in its limited geographic area and any economic decline in this market could impact the Company adversely. We make various assumptions and judgments about the collectibility of our loan portfolio and provide for an allowance for loan losses based on a number of factors. If these assumptions are incorrect, the allowance for loan losses may not be sufficient to cover losses, thereby having an adverse effect on operating results, and may cause the Company to increase the allowance in the future by increasing the provision for loan losses. The Company has adopted underwriting and credit monitoring procedures and credit policies that management believes are appropriate to control these risks; however, such policies and procedures may not prevent unexpected losses that could have a material adverse affect on the Company's financial condition or results of operations.

## Impairment Risk

The Company regularly purchases U.S. Government-sponsored enterprise debt securities, U.S. Government agency issued mortgage-backed securities, corporate debt securities and equity securities. The Company is exposed to the risk that the issuers of these securities may experience significant deterioration in credit quality which could impact the market value of the issue. The Company periodically evaluates its investments to determine if market value declines are other-than-temporary. Once a decline is determined to be other-than-temporary, the value of the security is reduced and a corresponding charge to earnings is recognized.

## Competition

The financial services industry is highly competitive with competition for attracting and retaining deposits and making loans coming from other banks and savings institutions, credit unions, mutual fund companies, insurance companies and other non-bank businesses. Many of the Company's competitors are much larger in terms of total assets and market capitalization, have a higher lending limit, greater access to capital and funding, and offer a broader array of financial products and services. In light of this, the Company's ability to continue to compete effectively is dependent upon its ability to maintain and build relationships through top quality service.

Page 17

## Government Regulation and Supervision

The banking industry is heavily regulated under both Federal and state law. Banking regulations, designed primarily for the safety of depositors, may limit a financial institution's growth and the return to its investors, by restricting such activities as the payment of dividends, mergers with or acquisitions by other institutions, expansion of branch offices and the offering of securities. The Company is also subject to capitalization guidelines established by federal law and could be subject to enforcement actions to the extent that its subsidiary bank is found, by regulatory examiners, to be undercapitalized. It is improbable to predict what changes, if any, will be made to existing Federal and state legislation and regulations or the effect that such changes may have on the Company's future business and earnings prospects. Any substantial changes to applicable laws or regulations could also subject the Company to additional costs, limit the types of financial services and products it may offer, and inhibit its ability to compete with other financial service providers.

## Internal Controls and Procedures

Management diligently reviews and updates its internal controls, disclosure controls and procedures, and corporate governance policies and procedures. This system is designed to provide reasonable, not absolute, assurances that the objectives comply with appropriate regulatory guidance; any undetected circumvention of these controls could have a material adverse impact on the Company's financial condition and results of operations.

#### Litigation

Although there is currently no litigation to which the Company is the subject, future litigation that arises during the normal course of business could be material and have a negative impact on the Company's earnings. Future litigation could also adversely impact the reputation of the Company in the communities that it serves.

#### Attracting and Retaining Skilled Personnel

Attracting and retaining key personnel is critical to the Company's success, and difficulty finding qualified personnel could have a significant impact on the Company's business due to the lack of required skill sets and years of industry experience. Management is cognizant of these risks and succession planning is built into the long-range strategic planning process.

### **Item 2. Properties**

The principal executive and administrative offices of the Company and the Bank were relocated to 500 Canal Street, Lewiston, Maine ("Headquarters Building") from 158 Court Street, Auburn, Maine in August, 2005. The Bank entered into a 15 year lease with respect to the Headquarters Building and moved our principal executive and administrative offices to this four story building located in downtown Lewiston. We lease the entire building, a total of 27,000 square feet. For the first ten years of the lease the annual expense is approximately \$264,000. In addition to executive and administrative offices, this building also houses our operations, loan processing and underwriting, loan servicing, accounting, human resources, and commercial lending departments. We also opened a 500 square foot branch office in this building and completed the relocation of the above offices and departments in August 2005.

In addition to the branch office located in our Headquarters Building, we have 11 additional banking branches located in the State of Maine, as set forth below.

<u>Branch Locations</u>	<u>Ownership</u>
232 Center Street, Auburn	Lease (1)
235 Western Avenue, Augusta	Fee Simple
11 Main Street, Bethel	Fee Simple
168 Maine Street, Brunswick	Fee Simple
2 Depot Street, Buckfield	Fee Simple
46 Main Street, Harrison	Fee Simple
882 Lisbon Street, Lewiston	Lease (2)
500 Canal Street, Lewiston	Lease (6)
26 Pleasant Street, Mechanic Falls	Fee Simple
77 Middle Street, Portland	Lease (3)
235 Main Street, South Paris	Lease (4)**

<u>Insurance Agency Locations</u>	
59 Main Street, Anson	Lease (5)
350 Minot Avenue, Auburn*	Lease (5)
235 Western Avenue, Augusta*	Fee Simple
11 Main Street, Bethel*	Fee Simple
346 Main Street, Jackman	Lease (5)

89 Main Street, Mexico	Lease (5)
2568 Main Street, Rangeley	Lease (5)
235 Main Street, South Paris*	Lease (4)**

\*Each of these insurance agency locations are situated in an existing bank branch location at the address indicated.

- (1) Lease term is ten years and expires February 1, 2007.
- (2) Lease term is 15 years and expires January 14, 2014.
- (3) Lease term is five years and expires September 30, 2007.
- (4) Lease term is ten years and expires June 1, 2007.
- (5) Lease term is one year and automatically renews in September each year.
- (6) Lease term is 15 years and expires July 15, 2020

Page 18

The Bank's investment division leases space in 202 US Route One, Falmouth, Maine which has a term of five years and expires August 31, 2007.

In addition, the Bank has leased land in Windham, Maine. The lease term is 50 years and expires August 1, 2054. This lease site was listed for sale in fiscal 2006.

In conjunction with the sale of deposits and certain loans from our Lisbon Falls branch, we closed the branch office. The building and land was listed for sale at that time.

\*\*On September 1, 2006, the Company purchased its South Paris, Maine branch previously leased from John H. Schiavi, a member of our Board of Directors. The \$400,000 purchase price was based upon an independent appraisal. The consideration paid was 5,000 shares of Company common stock and \$297,000 in cash. The common stock issued was based on the market price on the day prior to the closing. This acquisition was not material to the financial condition or the results of operations for the Company.

### Item 3. Legal Proceedings

There are no pending legal proceedings to which the Company is a party or any of its property is the subject. There are no material pending legal proceedings, other than ordinary routine litigation incidental to the business of banking, to which the Bank is a party or of which any of the Bank's property is the subject. There are no material pending legal proceedings to which any director, officer or affiliate of the Company, any owner of record beneficially of more than five percent of the common stock of the Company, or any associate of any such director, officer, affiliate of the Company or any security holder is a party adverse to the Company or has a material interest adverse to the Company or the Bank.

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

There were no matters submitted to a vote of the Company's securities-holders during the fourth quarter of the fiscal year ended June 30, 2006.

### Executive Officers of the Registrant

Pursuant to the Instructions of Form 10-K and Item 401(b) of Regulation S-K, the name, age, and position of each executive officer of the Company and the Bank are set forth below along with such officer's business experience during the past five years. Officers are elected annually by the respective Boards of Directors of the Company and the Bank to hold office until the earlier of their death, resignation, or removal.

<u>Name</u>	<u>Age</u>	<u>Position with Company and/or Bank</u>
James D. Delamater	55	President and Chief Executive Officer (1)
Philip C. Jackson	62	Senior Vice President of Bank Trust Operations
Gary Berlucci	60	Senior Vice President of Bank - Special Projects
Pender J. Lazenby	56	Chief Risk Officer
Marcel Blais	47	Chief Operating Officer
Robert S. Johnson	54	Chief Financial Officer (1)
Suzanne Carney	39	Clerk

(1) Each of these individuals serves both the Company and the Bank in the same capacities as indicated above.

James D. Delamater

has been President, Chief Executive Officer, and a director of the Company and the Bank, since 1987.

Philip C. Jackson

has been a director of the Company and the Bank since 1987. Mr. Jackson also has served as the Senior Vice President of the Bank's Trust Operations since 1997. From 1991 to 1994, Mr. Jackson served as President of Bethel Savings Bank, the predecessor to the Bank.

Gary Berlucci

has been the Senior Vice President of the Bank - Operations since January 1999. From 1972 to 1995, Mr. Berlucci was a Vice President of Casco Northern Bank, N.A., in operations and credit policy. Previous to joining Northeast Bank, Mr. Berlucci was self-employed as a financial consultant.

Marcel Blais

has been the Senior Vice President of the Bank - Retail Banking since 1998. Mr. Blais joined the Company in 1997 as the Vice President of the Bank - Branch Administration. Prior to joining the Company he served as Vice President of Atlantic Bank from 1995 to 1997, and as Vice President - Branch Manager of Casco Bank from 1977 until 1995.

Robert S. Johnson

has been the Chief Financial Officer of the Bank since December 2001. Prior to joining the company he served as Mortgage Controller of Banknorth Group from 1998 to 1999 and as President and Chief Financial Officer of Pepperell Bank & Trust from 1999 to 2001.

**Pender J. Lazenby** has been a director of the Company and the Bank since 2003. Mr. Lazenby has also served as the Senior Vice President Chief Risk Officer since February 2005 and prior to joining the Company served in a variety of positions with Fleet Boston and Bank Boston prior to its acquisition in 1999.

Page 19

Suzanne Carney

has been Clerk of the Bank since March 1999 and has been with the company since 1994 in the Accounting Division.

There is no family relationship between any of the directors or executive officers of the Company.

## PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchase of Equity Securities

The Common Stock of Northeast Bancorp trades on the American Stock Exchange ("AMEX") under the symbol "NBN". As of the close of business on September 1, 2006, there were approximately 2,447,132 shares of common stock outstanding held by approximately 468 stockholders of record.

The following table sets forth the high and low closing sales prices of the Company's Common Stock as reported on AMEX, and dividends paid during each quarter for periods indicated.

<u>2005 - 2006</u>	<u>High</u>	<u>Low</u>	<u>Div Pd</u>
Jul 1 - Sep 19	22.50	19.85	.090
Oct 1 - Dec 31	24.00	21.66	.090
Jan 1 - Mar 31	24.50	20.80	.090
Apr 1 - Jun 30	22.10	20.76	.090

<u>2004 - 2005</u>	<u>High</u>	<u>Low</u>	<u>Div Pd</u>
Jul 1 - Sep 30	19.39	18.65	.090
Oct 1 - Dec 31	23.00	18.50	.090
Jan 1 - Mar 31	23.00	19.94	.090
Apr 1 - Jun 30	22.00	19.45	.090

On September 25, 2006, the last reported sale price of the Company's Common stock as quoted on AMEX was \$20.57. Holders of the Company's Common stock are entitled to receive dividends when and if declared by the Board of Directors out of funds legally available. The amount and timing of future dividends payable on the Company's Common Stock will depend on, among other things, the financial condition of the Company, regulatory considerations, and other factors. The Company is a legal entity separate from the Bank, but the revenues are derived primarily from the Bank. Accordingly, the ability of the Company to pay cash dividends on its stock in the future generally will be dependent upon the earnings of the Bank and the Bank's ability to pay dividends to the Company. The payment of dividends by the Bank will depend on a number of factors, including capital requirements, regulatory limitations, the Bank's results of operations and financial condition, tax considerations, and general economic conditions. National banking laws regulate and restrict the ability of the Bank to pay dividends to the Company. See "Item 1. Business - Supervision and Regulation".

Stock repurchases under the 2004 Stock Repurchase Plan for the year ended June 30, 2006 totaled 90,200 shares at an average price per share of \$23.75.

There were no purchases made by or on behalf of the Company of shares of Northeast Bancorp common stock during the 4<sup>th</sup> quarter on 2006.

Page 20

#### **Item 6. Selected Financial Data**

	At or for the Year				
	Ended June 30,				
	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(Dollars in thousands except for Per Share Data)				
Selected operations data:					
Interest income	\$ 34,909	\$ 32,159	\$ 27,660	\$ 28,586	\$ 31,664
Interest expense	<u>16,761</u>	<u>13,967</u>	<u>12,079</u>	<u>13,769</u>	<u>16,998</u>

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Net interest income	18,148	18,192	15,581	14,817	14,666
Provision for loan losses	1,226	1,302	962	1,091	842
Other operating income (1)	7,125	5,598	5,134	4,614	3,675
Net securities gains	17	68	201	922	547
Other operating expenses (2)	<u>18,209</u>	<u>16,684</u>	<u>14,799</u>	<u>13,530</u>	<u>12,146</u>
Income before income taxes	5,855	5,872	5,155	5,732	5,900
Income tax expense	<u>1,851</u>	<u>1,853</u>	<u>1,643</u>	<u>1,877</u>	<u>2,047</u>
Net income	\$ 4,004	\$ 4,019	\$ 3,512	\$ 3,855	\$ 3,853
	=====	=====	=====	=====	=====

Consolidated per share data:

Net income:

Basic	\$ 1.61	\$ 1.60	\$ 1.38	\$ 1.46	\$ 1.48
Diluted	\$ 1.59	\$ 1.57	\$ 1.35	\$ 1.44	\$ 1.44
Cash dividends	\$ 0.36	\$ 0.36	\$ 0.35	\$ 0.32	\$ 0.25

Selected balance sheet data:

Total assets	\$ 562,918	\$ 575,900	\$ 538,754	\$ 467,684	\$ 442,216
Loans receivable	435,663	461,052	432,594	378,987	374,634
Deposits	395,293	396,219	377,820	318,743	303,198
Borrowings	95,222	102,914	96,558	93,769	93,130
Total stockholders' equity	39,096	39,870	36,453	36,499	34,731

Other ratios:

Return on average assets	0.70%	0.71%	0.71%	0.86%	0.88%
Return on average equity	9.95%	10.39%	9.50%	10.58%	11.73%
Average equity to average total assets	7.07%	6.86%	7.51%	8.11%	7.51%
Common dividend payout ratio	22.40%	22.93%	25.93%	22.22%	17.36%

(1) Includes fees for deposit, investment brokerage, and trust services to customers and gains on the sale of loans.

(2) Includes salaries, employee benefits, occupancy, equipment and other expenses.

Item 7. Management's Discussion and Analysis of Results of Operations and Financial Condition

The Management's Discussion and Analysis of Results of Operations and Financial Condition which follows presents a review of the consolidated operating results of Northeast Bancorp, Inc. (the "Company") for the fiscal years ended June 30, 2006, 2005 and 2004. This discussion and analysis is intended to assist you in understanding the results of our operations and financial condition. You should read this discussion together with your review of the Company's Consolidated Financial Statements and related notes and other statistical information included in this report. Certain amounts in the years prior to 2006 have been reclassified to conform to the 2006 presentation.

A NOTE ABOUT FORWARD LOOKING STATEMENTS

This report contains certain "forward-looking statements" within the meaning of federal securities law Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, such as statements relating to our financial condition, prospective results of operations, future performance or expectations, plans, objectives, prospects, loan loss reserve adequacy, simulation of changes in interest rates, capital spending and finance sources, and revenue sources. These statements relate to expectations concerning matters that are not historical facts. Accordingly, statements that are based on management's projections, estimates, assumptions, and judgments constitute forward-looking statements. These forward looking statements, which are based on various assumptions (some of which are beyond the Company's control), may be identified by reference to a future period or periods, or by the use of forward-looking terminology such as "believe", "expect", "estimate", "anticipate", "continue", "plan", "approximately", "intend", "objective", "goal", "project", or other similar terms or variations on those terms, or the future or conditional verbs such as "will", "may", "should", "could", and "would". In addition, the Company may from

time to time make such oral or written "forward-looking statements" in future filings with the Securities and Exchange Commission (including exhibits thereto), in its reports to shareholders, and in other communications made by or with the approval of the Company.

Page 21

Such forward-looking statements reflect our current views and expectations based largely on information currently available to our management, and on our current expectations, assumptions, plans, estimates, judgments, and projections about our business and our industry, and they involve inherent risks and uncertainties. Although we believe that these forward-looking statements are based on reasonable estimates and assumptions, they are not guarantees of future performance and are subject to known and unknown risks, uncertainties, contingencies, and other factors. Accordingly, we can not give you any assurance that our expectations will in fact occur or that our estimates or assumptions will be correct. We caution you that actual results could differ materially from those expressed or implied by such forward-looking statements due to a variety of factors, including, but not limited to, those related to the economic environment, particularly in the market areas in which the Company operates, competitive products and pricing, fiscal and monetary policies of the U.S. Government, changes in government regulations affecting financial institutions, including regulatory fees and capital requirements, changes in prevailing interest rates, acquisitions and the integration of acquired businesses, credit risk management, asset/liability management, changes in technology, changes in the securities markets, and the availability of and the costs associated with sources of liquidity. Accordingly, investors and others are cautioned not to place undue reliance on such forward-looking statements. For a more complete discussion of certain risks and uncertainties affecting the Company, please see "Item 1. Business - Forward-Looking Statements and Risk Factors" set forth in our Form 10-K. These forward-looking statements speak only as of the date of this report and we do not undertake any obligation to update or revise any of these forward-looking statements to reflect events or circumstances occurring after the date of this report or to reflect the occurrence of unanticipated events.

### **CRITICAL ACCOUNTING POLICIES**

The Notes to the Consolidated Financial Statements contain a summary of Northeast Bancorp's significant accounting policies. The level of the allowance for loan losses is important to the portrayal of the Company's results of operations and financial condition. The determination of what the loan loss allowance should be requires management to make subjective or difficult judgments, some of which may relate to matters that are inherently uncertain. Actual results may differ materially from these estimates and assumptions. See Note 1 to the Consolidated Financial Statements.

#### Allowance for Loan Loss

The allowance for loan losses represents management's estimate of probable losses inherent in the loan portfolio. This evaluation process is subject to numerous estimates and judgments. The frequency of default, risk ratings, and the loss recovery rates, among other things, are considered in making this evaluation, as are the size and diversity of individual large credits. Changes in these estimates could have a direct impact on the provision and could result in a change in the allowance. The larger the provision for loan loss, the greater the negative impact on our net income. Larger balance, non-homogeneous loans representing significant individual credit exposures are evaluated based upon the borrower's overall financial condition, resources, and payment record; the prospects for support from any financially responsible guarantors; and, if appropriate, the realizable value of any collateral. The allowance for loan losses attributed to these loans is established through a process that includes estimates of historical and projected default rates and loss severities; internal risk ratings; and geographic, industry, and other environmental factors. Management also considers overall portfolio indicators, including trends in internally risk-rated loans, classified loans, nonaccrual loans, and historical and forecasted write-offs; and a review of industry, geographic, and portfolio concentrations, including current developments. In addition, management considers the current business strategy and credit process, including credit limit setting and compliance, credit approvals, loan underwriting criteria, and loan workout procedures. Each portfolio of smaller balance, homogeneous loans, including residential real estate and consumer

loans, is collectively evaluated for impairment. The allowance for loan losses is established via a process that includes historical delinquency and credit loss experience, together with analyses that reflect current trends and conditions. Management also considers overall portfolio indicators including historical credit losses; delinquent, non-performing and classified loans; trends in volumes; terms of loans; an evaluation of overall credit quality and the credit process, including lending policies and procedures; and economic factors.

For a further description of our estimation process in determining the allowance for loan losses, see "Asset Quality" below.

## GENERAL

Northeast Bancorp (the "Company") is a Maine corporation and a bank holding company registered with the Federal Reserve Bank of Boston ("FRB") under the Bank Holding Company Act of 1956. We conduct business from our headquarters in Lewiston, Maine and, as of June 30, 2006, from 11 banking offices and 8 insurance agency offices all located in western and south-central Maine. At June 30, 2006, we had consolidated assets of \$562.9 million and consolidated stockholders' equity of \$39.1 million.

Northeast Bancorp's principal asset is all the capital stock of Northeast Bank (the "Bank"), a Maine state-chartered universal bank. Accordingly, Northeast Bancorp's results of operations are primarily dependent on the results of the operations of the Bank. In addition to the Bank's eleven branch offices, its investment brokerage division has an office in Falmouth, Maine from which investment, insurance and financial planning products and services are offered. The Bank's wholly owned subsidiary Northeast Bank Insurance Group, Inc. offers personal and commercial property and casualty insurance products. Four of its eight insurance agency's offices operate in our Auburn, Augusta, Bethel, and South Paris, Maine branches.

Page 22

On August 29, 2004, the Bank converted its charter to a state bank, and became a member of the Federal Reserve Bank of Boston ("FRB"). It is subject to the joint regulatory oversight by the FRB and the State of Maine Bureau of Financial Institutions. The name of the Company's wholly-owned subsidiary was changed to Northeast Bank.

## Business Strategy

The principal business of the Bank consists of attracting deposits from the general public and applying those funds to originate or acquire residential mortgage loans, commercial loans, commercial real estate loans, and a variety of consumer loans. The Bank sells residential mortgage loans into the secondary market. The Bank also invests in mortgage-backed securities and securities issued by United States Government-sponsored enterprises. The Bank emphasizes the growth of noninterest sources of income from trust management, financial planning, and investment and insurance brokerage. The Bank's profitability depends primarily on net interest income, which is the difference between interest income earned from interest-earning assets (i.e. loans and investments) and interest expense incurred on interest-bearing liabilities (i.e. customer deposits and borrowed funds). Net interest income is affected by the relative balances of interest-earning assets and interest-bearing liabilities, and the rates paid on these balances.

Our goal is to continue modest, but profitable, growth by increasing our loan and deposit market share in our existing markets in western and south-central Maine, closely manage the yields on earning assets and rates on interest-bearing liabilities, introduce new financial products and services, increase the number of bank services per household, increase noninterest income from expanded trust, investment and insurance brokerage services, and control the growth of noninterest expenses. It also is part of our business strategy to make targeted acquisitions in our current market areas from time to time when opportunities present themselves.



The Company's profitability is affected by the Bank's interest rate spread, which is the difference between the average yield earned on its interest-earning assets and the average rate paid on its interest-bearing liabilities. It is also affected by the level of the provision for loan losses, noninterest income and noninterest expense of Northeast Bancorp and the Bank, and the effective tax rate. noninterest income consists primarily of loan and deposit service fees; trust, investment brokerage and insurance brokerage fees; and gains on the sales of loans and investments. noninterest expenses consist of compensation and benefits, occupancy related expenses, deposit insurance premiums paid to the FDIC, and other operating expenses which include advertising, computer services, supplies, telecommunication and postage expenses.

### Economic Conditions

We believe that our market area has generally witnessed modest economic growth and a slowing of real estate appreciation from 2005 through 2006. The economy and real estate markets in our market areas will continue to be significant determinants of the quality of our assets in future periods and our results of operations, liquidity, and financial condition. We believe future economic activity will significantly depend on consumer confidence, consumer spending and business expenditures for new capital equipment, all of which are tied to strong employment.

### EXECUTIVE SUMMARY

The following were significant factors comparing our results for fiscal 2006 to fiscal 2005:

- ◆ Revenues from our investment brokerage, insurance, and trust and wealth management divisions increased by 29%.
- ◆ Loans declined by approximately \$25 million from June 30, 2005. This decline was caused by three factors: the time lag replacing seasoned commercial lenders who were hired away by competing banks, the loss of customer relationships from competitive pricing not reflecting risk, and tightening our credit underwriting standards due to higher delinquent loans and increasing classified and criticized commercial loans.
- ◆ We sold the deposits and certain loans of our Lisbon Falls branch in May 2006 and closed the branch.

Our financial condition and liquidity remain strong, and are supported by the following in fiscal 2006:

- ◆ We increased customer deposits during fiscal 2006 while reducing utilization of brokered certificates of deposit. Total liquidity at June 30, 2006 was \$156.7 million, exceeding policy minimums;
- ◆ The Company and Bank are "well capitalized" under regulatory definitions;
- ◆ Stock repurchases under the 2004 Stock Repurchase Plan totaled 90,200 shares at an average per share price of \$23.75 in fiscal 2006;
- ◆ We focus on the return on average equity ("ROAE"), return on average assets ("ROAA") and the efficiency ratio in evaluating our results of operations. The ROAE decreased to 9.95% in fiscal 2006 from 10.39% in fiscal 2005. The ROAA decreased to 0.70% in fiscal 2006 compared to 0.71% in fiscal 2005. The efficiency ratio of 72.0% for fiscal 2006 increased from 69.9% for fiscal 2005 primarily from higher noninterest expense; and
- ◆ Net income was \$4,004,199 for fiscal 2006, virtually flat in comparison to fiscal 2005.

### RESULTS OF OPERATIONS

#### Comparison of Fiscal Years Ended June 30, 2006 and 2005

#### Overview

For the fiscal year ended June 30, 2006 ("fiscal 2006"), we reported net income of \$4,004,199, or \$1.59 per diluted share, as compared to \$4,018,634, or \$1.57 per diluted share, for the fiscal year ended June 30, 2005 ("fiscal 2005"), a decrease of \$14,435, or less than 1%. This decrease was attributable to increased noninterest expense which slightly exceeded the increase in noninterest income. The return on average assets was 0.70% in fiscal 2006 compared to 0.71% in fiscal 2005. The return on average assets changed due to total average assets increasing by \$5.8 million, or 1%, compared to fiscal 2005. The return on average equity was 9.95% in fiscal 2006 and 10.39% in fiscal 2005. The decrease in our return on average equity was due to decreased net income for those periods and an increase in average equity of 4%.

Net interest income decreased by less than 1% during fiscal 2006. This decrease was primarily due to a decrease in our net interest margin of 4 basis points. Average earning assets increased approximately \$5.4 million as compared to the average earning assets in fiscal 2005. Of the increase in average earning assets, average investment securities increased \$10.6 million and average loans decreased \$4.8 million. Net interest margin, the ratio of net interest income to average earning assets decreased to 3.37% in fiscal 2006 from 3.41% in fiscal 2005. Net interest spread, the difference between the yield on earning assets and the cost of funds, decreased by 11 basis points to 3.03% in fiscal 2006 from 3.14% in fiscal 2005. The Bank balance sheet moved during fiscal 2006 from an asset sensitive profile, where the yields on assets reprice faster than the cost of funds, to a slightly liability sensitive profile, where cost of funds reprice faster than the yields on assets. Noninterest income increased 26% during fiscal 2006 primarily from increased investment brokerage and insurance commission revenue, loan servicing fees, gains on the sale of residential real estate loans, and the gain on sale of deposits. This increase was partially offset from lower net securities gains. The provision for loan losses decreased 6% primarily from a decrease in loans. Noninterest expense increased 9% during fiscal 2006, which was primarily due to increases in salaries and employee benefits expense, occupancy and equipment expense associated with the consolidation of the Bank's operations and administration functions into a new Gateway headquarters in Lewiston, full year impact of the Solon-Anson Insurance Agency acquisition (September, 2004) partially offset by a decrease in other expense. Other expense in fiscal 2005 included a loss from the write-off of deferred issuance costs related to trust preferred securities redeemed on December 31, 2004.

#### Net Interest Income

Net interest income increased by \$43,600, or less than 1%, during fiscal 2006 primarily from decreased net interest margin. Average earning assets increased \$5.4 million during fiscal 2006 comprised of \$10.6 million increase in average investment securities partially offset by a \$4.8 million decrease in average loans and a \$0.5 million decrease in interest-bearing deposits (primarily with the Federal Home Loan Bank of Boston). The increase in average investment securities was due to purchase of mortgage-backed securities, to pledge as eligible collateral for FHLB advances and securities sold under agreements to repurchase, and the purchase of municipal securities. The decrease in average loans resulted from a decrease in construction loans, commercial loans and commercial real estate loans of \$18.8 million, partially offset by increases in residential real estate loans and consumer loans of \$3.0 million and \$11.0 million, respectively. Origination of commercial loans and commercial real estate loans decreased by \$60 million in fiscal 2006 compared to fiscal 2005. Average interest-bearing deposits increased by \$1.9 million, or 0.5%, during fiscal 2006 primarily from time deposits. Average time deposits increased by \$43.7 million. All other interest-bearing deposits decreased including average brokered time deposits which decreased by \$31.7 million, or 36%, reducing our use of wholesale funding. Average repurchase agreements increased during fiscal 2006 by \$0.9 million, or 3%. Average borrowings increased primarily due to a new obligation under a capital lease. The yield on average earning assets increased 45 basis points to 6.47% in fiscal 2006. The cost of funds increased 56 basis point to 3.45% due to an increase in the cost of interest-bearing deposits partially offset by a decrease in the costs of advance from the FHLB and junior subordinated debentures (refinanced in fiscal 2005). Table 1 provided in Item 8 of this Form 10-K shows the average balances, yields and rates of assets, liabilities, and net worth of the Company for the past three years. The table below shows the changes from 2005 to 2006 in net interest income by category due to changes in rate and volume.

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Rate/Volume Analysis for the Year Ended  
June 30, 2006 versus June 30, 2005

	Difference Due to	
	<u>Volume</u>	<u>Rate</u>
		<u>Total</u>
Investments	\$ 431,470	
	\$ 267,085	
	\$ 698,555	
Loans, net		(308,978)
		2,300,881
		1,991,903
FHLB deposits & other		<u>(8,388)</u>
		<u>68,088</u>
		<u>59,700</u>
Total interest-earning assets		114,104
		2,636,054
		2,750,158

Deposits

14,332  
2,513,176  
2,527,508

Repurchase agreements

11,589  
512,560  
524,149

Borrowings

42,541  
(300,440)  
(257,899)

Total interest-bearing liabilities

68,462  
2,725,296  
2,793,758

Net interest income

\$ 45,642  
=====

\$ (89,242)  
=====

\$ (43,600)

=====

Rate/volume amounts are spread proportionately between Volume and Rate. Borrowings in the table above include FHLB advances, obligation under capital lease, and junior subordinated debentures.

## Provision for Loan Losses

The provision for loan losses in fiscal 2006 was \$1,226,413, a decrease of \$75,187, or 6%, compared to fiscal 2005. This decrease in the provision for loan losses reflects the significant overall decrease in loans of approximately \$25.4 million and a decrease in net loan charge-offs. Although we experienced higher loan delinquency, higher nonperforming loans, and higher classified and criticized loans for fiscal 2006, the level of expected loan defaults and the level of loss did not increase. Net charge-offs were \$630,000 in fiscal 2006 compared to \$774,600 in fiscal 2005. This \$144,600 decrease was in residential real estate, commercial real estate loans and consumer loans. Net charge-offs to average loans outstanding was 0.14% in fiscal 2006 compared to 0.17% in fiscal 2005.

The allowance for loan losses at June 30, 2006 was \$5,496,000 as compared to \$5,104,000 at June 30, 2005, an increase of \$392,000, or 8%. This increase was net of \$204,000 reclassified from the allowance for loan losses to a separate reserve account for off-balance credit risk (unadvanced lines of credit and loan commitments) included in other liabilities. This off-balance credit risk had been included in the allowance for loan loss in prior years. The allowance to total portfolio loans was 1.26% at June 30, 2006 compared to 1.11% at June 30, 2005. The ratio of the allowance for loan losses to nonperforming loans was 106% at June 30, 2006 and 301% at June 30, 2005, reflecting an increase of \$3.5 million in nonperforming loans to \$5.2 million, primarily from nonperforming commercial real estate and commercial loans. Of total non-performing loans at June 30, 2006, \$1.9 million was current with principal and interest payments. Nonperforming loans were 1.19% of total loans at June 30, 2006 as compared to 0.37% at June 30, 2005, also due to the increase in nonperforming loans at June 30, 2006 and a decrease in total loans. For additional information on the allowance for loan losses, see "Critical Accounting Policies" above, and see "Asset Quality" below for additional discussion on loans.

## Noninterest Income

Noninterest income for the fiscal years ended June 30, 2006 and 2005 was \$7,141,949 and \$5,666,131, respectively, an increase of \$1,475,818, or 26%, in fiscal 2006. Most of this increase was due to the increase in investment brokerage and insurance commission revenue and a gain from the sale of the deposits and certain loans of the Lisbon Falls branch.

Fees for other services to customers of \$1,114,081 increased \$46,965, or 4%, during fiscal 2006. This increase was due to higher transaction service fees, overdraft fees, and ATM and debit card fee revenue as compared to fiscal 2005.

Net securities gains of \$17,335 decreased \$50,605, or 74%, during fiscal 2006. The volume of securities sold in fiscal 2006 decreased from fiscal 2005. Gains from the sale of equity and bond securities are subject to market and economic conditions and there can be no assurance that gains reported in prior periods will be achieved in the future. Other-than-temporary write-downs on equity securities of \$38,394 and \$27,849 during fiscal 2006 and 2005, respectively, were included in noninterest expense.

Gains on the sales of loans of \$308,777 increased \$75,750, or 33%, during fiscal 2006. This increase was primarily due to higher sales volume of residential real estate loans, an increase of \$4 million to \$15 million in fiscal 2006 compared to \$11 million in fiscal 2005. Sold loan volume was impacted by 30 year fixed rate residential real estate loan origination volume, which is subject to changing interest rates and a shift in the demand for loans with fixed or adjustable interest rates. The Bank continues to hold in portfolio all new 15 year fixed rate loans and all adjustable rate loans. Residential real estate loans were sold to reduce our exposure to interest rate risk.

Investment commission revenue of \$1,769,300 increased \$314,437, or 22%, during fiscal 2006. This increase was primarily due to adding investment brokers and increased production from existing investment brokers.

Insurance commissions of \$1,916,822 increased \$512,787, or 37%, during the fiscal year 2006 due to the full year impact of the acquisition of the Solon Anson Insurance Agency (September 2004) and increased contingency payments from insurance carriers based on loss experience.

BOLI income of \$366,939 increased \$36,239, or 11%, during fiscal 2006. This increase was due to an increase in the average interest yield to 4.21% in fiscal 2006 from 4.15% in fiscal 2005. The additions to cash surrender value are based on this average interest yield. These interest rates are determined by the life insurance companies and are reset quarterly or annually. Each policy is subject to minimum interest rates.

Other income of \$1,003,997 increased \$511,273, or 104%, during fiscal 2006. This increase was primarily from the deposit premium received for \$500,845 from the sale of the deposits and certain loans of the Lisbon Falls branch to Androscoggin Bank. Trust fee revenue also increased by \$109,266. The deposit premium and increased trust fees were partially offset by change in loss on the disposal of fixed assets of \$188,082. The latter represents costs written off for a new branch site which we have abandoned in fiscal 2006. A \$59,719 gain was realized in fiscal 2005 from the sale of our former Richmond branch building.

#### Noninterest Expense

Noninterest expense for fiscal years ended June 30, 2006 and 2005 was \$18,208,504 and \$16,684,174, respectively, an increase of \$1,524,330, or 9%. The increase in fiscal 2006 was primarily from an increase in salaries and employee benefits and occupancy and equipment expenses. Our efficiency ratio increased to 72.0% during fiscal 2006 from 69.9% in fiscal 2005.

Page 25

Salaries and employee benefits expense of \$10,637,758 increased \$1,083,441, or 11%, during the fiscal year 2006. This increase includes the salary and benefits for new positions in commercial lending, investment brokerage, insurance agency, trust, and risk management divisions. Total full-time equivalents were 201 compared to 193 at June 30, 2006 and 2005, respectively. Deferred compensation expense related to the Solon-Anson Insurance acquisition was \$399,845, an increase of \$301,769 compared to fiscal 2005.

Occupancy expense of \$1,672,505 increased \$253,809, or 18%, during the fiscal year 2006. This increase was primarily due to the relocation of our commercial, administration, and operations to the new Southern Gateway building in Lewiston completed in August 2005. Expenses contributing to this increase were amortization of capital lease asset, depreciation of leasehold improvements, and real estate taxes. Repairs to the Mechanic Falls branch for mold remediation increased building repairs by \$25,305. Higher heating fuel oil costs increased utilities expense by \$55,611.

Equipment expense of \$1,440,238 increased \$330,130, or 30%, during the fiscal year 2006. As with occupancy expense, moving expense and increased depreciation expense from new furniture and equipment for the new Southern Gateway building accounted for most of this increase. Additional licensing fees for our core operating system for new customer relationships also contributed to this increase.

Other expense of \$4,216,975 decreased \$134,377, or 3%, during fiscal year 2006. This decrease was due in part to the \$396,425 loss recognized in fiscal 2005 from the write-off of unamortized deferred issuance costs related to the redemption of the 9.60% trust preferred stock. Also contributing to this decrease was other-than-temporary write downs on equity and non-marketable securities of \$38,394 and \$42,257, respectively, for fiscal 2006 compared to \$27,849 and \$96,931, respectively, in fiscal 2005, an aggregate decrease of \$44,129. These other-than-temporary write downs resulted from the periodic analysis by management of impaired securities whereby management determined that recovery of cost was unlikely within a reasonable period of time for certain equity and non-marketable securities. Partially offsetting this decrease was an increase of \$155,720 in advertising expense resulting from increased use of television advertising, and an increase of \$108,841 in computer services expenses resulting from higher investment brokerage transaction costs, increased processing fees from higher trust activity, increased internet banking costs from higher customer enrollment and conversion costs and core system users in the insurance agency.

#### Taxes

The Company's effective tax rate was 31.6% and 31.5% for the fiscal years ended June 30, 2006 and 2005, respectively. See the Note 13 in the Consolidated Financial Statements for additional information.

## Comprehensive Income

The Company's comprehensive income was \$2,051,917 and \$4,745,415 during 2006 and 2005, respectively. Comprehensive income differed from our net income in 2006 and 2005 due to the change in the fair value of available for sale securities, net of income tax. In fiscal 2006, there was a net decrease in fair value of \$1,952,282 to a net unrealized loss on investments available for sale, net of income tax. There was a net increase in fair value in fiscal 2005 of \$726,781. See the Consolidated Statements of Changes in Shareholders' Equity and Note 17 in the Consolidated Financial Statements for additional information.

## Comparison of Fiscal Years Ended June 30, 2005 and 2004

For the fiscal year ended June 30, 2005 ("fiscal 2005"), we reported net income of \$4,018,634, or \$1.57 per diluted share, as compared to \$3,512,179, or \$1.35 per diluted share, for the fiscal year ended June 30, 2004 ("fiscal 2004"), an increase of 14%. This increase was attributable to increased net interest income and noninterest income, partially offset by an increased provision for loan losses and higher noninterest expense. The return on average assets was 0.71% in fiscal 2005 and fiscal 2004. The return on average assets was unchanged due to total average assets increasing by \$71.1 million, or 14%, compared to fiscal 2004. The return on average equity was 10.39% in fiscal 2005 and 9.50% in fiscal 2004. The increase in our return on average equity was due to increased net income for those periods while average equity increased 5%.

Net interest income increased 17% during fiscal 2005. The increase in our net interest income was primarily due to an increase in our average earning assets. The growth in average earning assets increased approximately \$68.8 million as compared to the average earning assets in fiscal 2004. Of the increase in average earning assets, average loans accounted for \$56.3 million. We experienced a reversal from the prolonged period of declining interest rates to increasing interest rates during fiscal 2005 due to the increase in short-term interest rates imposed by the Open Market Committee of the Federal Reserve Bank. Net interest margin, the ratio of net interest income to average earning assets, likewise increased by 6 basis points to 3.41% in fiscal 2005 from 3.35% in fiscal 2004. Net interest spread, the difference between the yield on earning assets and the cost of funds, increased by 7 basis points to 3.14% in fiscal 2005 from 3.07% in fiscal 2004. The asset sensitive profile of our statement of financial condition, where the yields on assets reprice faster than the cost of funds, contributed to this increase in net interest margin and net interest spread. Noninterest income increased 6% during fiscal 2005 primarily from increased insurance commission revenue. This increase was partially offset from lower net securities gains, lower gains on sales of residential real estate loans and lower investment commission revenue. The provision for loan losses increased 35% primarily from higher net charge-offs during fiscal 2005. Noninterest expense increased 13% during fiscal 2005, which was primarily due to increases in salaries and employee benefits expense, occupancy and equipment expense associated with the acquisition of the Solon-Anson Insurance Agency Inc, loss recognized upon the redemption of the 9.60% trust preferred securities, and other-than-temporary write-downs on securities.

## Net Interest Income

Net interest income increased by \$2,611,329, or 17%, during fiscal 2005 primarily from increased average earning assets. Average earning assets increased \$68.8 million during fiscal 2005, and was comprised of average interest-bearing deposits in the Federal Home Loan Bank of Boston and stock in the Federal Reserve Bank of Boston increasing \$1.2 million (primarily from overnight deposits and federal funds sold), average investment securities increasing \$11.3 million, and average loans increasing \$56.3 million. The increase in average investment securities was due to purchase of government sponsored enterprise and mortgage-backed securities to pledge as eligible collateral for FHLB advances and securities sold under agreements to repurchase. The increase in average loans resulted from growth in all loan portfolios, but was primarily due to residential real estate, commercial real estate, and consumer loans originated during fiscal 2005. Average interest-bearing deposits increased by \$55.0 million, or 18%, during fiscal 2005 primarily from time deposits and brokered time deposits. Average time deposits increased by \$20.2 million. Average brokered time deposits increased by \$30.6 million to fund increases in loans and investment security

purchases. Average repurchase agreements increased during fiscal 2005 by \$5.5 million, or 22%. Average borrowings increased due to new issues of junior subordinated debentures. The yield on earning assets increased 7 basis points to 6.02% in fiscal 2005. The cost of funds increased 1 basis point due to the decline in the costs junior subordinated debentures refinanced in fiscal 2005. Table 1 provided in Item 8 of this Form 10-K shows the average balances, yields and rates of assets, liabilities, and net worth of the Company for the past three years. The table below shows the changes from 2004 to 2005 in net interest income by category due to changes in rate and volume.

Rate/Volume Analysis for the Year Ended  
June 30, 2005 versus June 30, 2004

	Difference Due to	
	<u>Volume</u>	<u>Rate</u>
		<u>Total</u>
Investments	\$ 454,580	\$ 187,521
	\$ 642,101	
Loans, net	3,615,023	187,689
	3,802,712	
FHLB deposits & other	<u>6,976</u>	<u>47,607</u>



	<u>54,583</u>
Total interest-earning assets	
	4,076,579
	422,817
	4,499,396
Deposits	
	1,285,373
	773,160
	2,058,533
Repurchase agreements	
	67,784
	56,011
	123,795
Borrowings	
	<u>231,005</u>
	<u>(525,266)</u>
	<u>(294,261)</u>
Total interest-bearing liabilities	
	<u>1,584,162</u>
	<u>303,905</u>
	<u>1,888,067</u>
Net interest income	
	\$ 2,492,417
	=====
	\$ 118,912
	=====

\$ 2,611,329  
=====

Rate/volume amounts are spread proportionately between Volume and Rate. Borrowings in the table above include junior subordinated debentures and FHLB advances.

#### Provision for Loan Losses

The provision for loan losses in fiscal 2005 was \$1,301,600, an increase of \$339,662, or 35%, compared to fiscal 2004. This increase in the provision for loan losses reflects increased net loan charge-offs, higher loan delinquency, higher nonperforming loans, higher classified loans for fiscal 2005, and an increase in total loans. Net charge-offs were \$774,600 in fiscal 2005 compared to \$400,938 in fiscal 2004. This \$373,662 increase, or 93%, was due to increased gross charge-offs of commercial and consumer loans. Net charge-offs to average loans outstanding was 0.17% in fiscal 2005 compared to 0.10% in fiscal 2004.

The allowance for loan losses at June 30, 2005 was \$5,104,000 as compared to \$4,577,000 at June 30, 2004, an increase of \$527,000, or 12%. The allowance to total portfolio loans was 1.11% at June 30, 2005 compared to 1.06% at June 30, 2004. The ratio of the allowance for loan losses to nonperforming loans was 301% at June 30, 2005 and 273% at June 30, 2004, reflecting an increase the allowance for loan loss. Total nonperforming loans increased 1% from the prior year, which was due to nonperforming residential loans contractually past due 90 days or more. Nonperforming loans were 0.37% of total loans at June 30, 2005 as compared to 0.39% at June 30, 2004. This decrease in nonperforming loans as a percentage of total loans was primarily due to an increase in total loans outstanding at June 30, 2005. For additional information on the allowance for loan losses, see "Critical Accounting Policies" above, and see "Asset Quality" below for additional discussion on loans.

#### Noninterest Income

Noninterest income for the fiscal years ended June 30, 2005 and 2004 was \$5,666,131 and \$5,335,653, respectively, an increase of \$330,478, or 6%, in fiscal 2005. Most of this increase was due to the increase in insurance commission revenue partially offset by a decrease in net securities gains, gains on sales of loans, insurance commissions and BOLI income.

Fees for other services to customers of \$1,067,116 increased \$91,230, or 9%, during fiscal 2005. This increase was due to higher transaction service fees, overdraft fees, ATM and debit card fee revenue as compared to fiscal 2004.

Net securities gains of \$67,940 decreased \$132,875, or 66%, during fiscal 2005. The volume of securities sold in fiscal 2005 decreased from fiscal 2004. Gains from the sale of equity and bond securities are subject to market and economic conditions and there can be no assurance that gains reported in prior periods will be achieved in the future. Other-than-temporary write-downs on equity securities of \$27,849 and \$171,312 during fiscal 2005 and 2004, respectively, were included in noninterest expense.

Gains on the sales of loans of \$233,027 decreased \$449,768, or 66%, during fiscal 2005. This decrease was primarily due to lower sales volume of residential real estate loans, a decrease of \$19 million to \$11 million in fiscal 2005 compared to \$30 million in fiscal 2004. Sold loan volume was impacted by a decrease in residential real estate loan origination volume due to increasing interest rates and a shift in loans with variable interest rates during fiscal 2005, and by management's decision to hold in portfolio all new 15 year fixed rate loans. Residential real estate loans were sold to reduce our exposure to interest rate risk.

Investment commission revenue of \$1,454,863 decreased \$58,938, or 4%, during fiscal 2005. This decrease was primarily to lower sales for the year.

Insurance commissions of \$1,404,035 increased \$1,018,717, or 264%, during the fiscal year 2005 due to the acquisition of the Solon Anson Insurance Agency. This acquisition added six agency locations for the sale of personal

and commercial property and casualty insurance policies compared to one agency in fiscal 2004.

BOLI income of \$330,700 decreased \$48,935, or 13%, during fiscal 2005. This decrease was due to a decrease in the average interest yield to 4.26% in fiscal 2005 from 4.94% in fiscal 2004. The additions to cash surrender value are based on this average interest yield. They are reset quarterly for one policy and annually for a second to a yield determined by the life insurance companies. Each policy is subject to minimum interest rates.

Page 27

Other income of \$492,724 decreased \$82,319, or 14%, during fiscal 2005. This decrease was primarily from not repeating a \$264,395 gain realized from the sale of deposits of the former Richmond Maine branch partially offset by a gain of \$59,719 on the sale of the Richmond branch building, increase in trust fees of \$69,233, improved real estate operations by \$25,433, and the appreciation of a deferred compensation annuity of \$38,076.

#### Noninterest Expense

Noninterest expense for fiscal years ended June 30, 2005 and 2004 was \$16,684,174 and \$14,799,072, respectively, an increase of \$1,885,102, or 13%. The increase in fiscal 2005 was primarily from an increase in salaries and employee benefits and other expenses. Our efficiency ratio decreased slightly to 69.9% during fiscal 2005 from 70.8% in fiscal 2004.

Salaries and employee benefits expense of \$9,554,317 increased \$1,269,889, or 15%, during the fiscal year 2005. This increase included the salary and benefits for the 18 positions from the Solon-Anson acquisition. Total full-time equivalents were 193 compared to 186 at June 30, 2005 and 2004, respectively.

Occupancy expense of \$1,418,696 increased \$192,916, or 16%, during the fiscal year 2005. This increase was primarily due to the six leased locations of Solon-Anson Insurance Agency. Agency offices in Augusta and South Paris were relocated to existing branch locations in the fourth quarter of fiscal 2005 to reduce future lease expense. In addition, the corporate headquarters building at 158 Court Street in Auburn was sold and leased back for twelve months pending the completion of our new corporate headquarters in Lewiston, Maine. The lease of the former corporate headquarters totaled \$66,000 for fiscal 2005. We completed our move to the new building in August, 2005.

Equipment expense of \$1,110,108 increased \$159,641, or 17%, during the 2005 fiscal year. As with salaries and occupancy expense, equipment expense increased from the Solon-Anson Insurance Agency acquisition. Computer and software depreciation and related maintenance expense from technology investments accounts for the increase in fiscal 2005. This increase was partially offset by the recovery of personal property taxes of \$36,923 under the State of Maine Revenue Department's Business Equipment Property Tax Reimbursement program (BETR).

Other expense of \$4,351,352 increased \$267,908, or 7%, during fiscal 2005. This increase was due in part to the \$396,425 loss recognized from the redemption of the 9.60% trust preferred stock issuance. The loss was from the write-off of unamortized deferred issuance cost. Other-than-temporary writedowns on equity and non-marketable securities were \$27,849 and \$96,931, respectively, in fiscal 2005, an aggregate decrease of \$388,076 compared to fiscal 2004. These other-than-temporary write downs resulted from the periodic analysis by management of impaired securities whereby management determined that recovery of cost was unlikely within a reasonable period of time for certain equity and non-marketable securities. Professional fees increased \$223,137 compared to fiscal 2004 from additional consulting services for the documentation and testing of our financial reporting controls and efficiency study consulting services. Computer services increased from item processing charges and the full year impact of our out-sourced data center supporting internet banking.

#### Taxes

The Company's effective tax rate was 31.5% and 31.9% for the fiscal years ended June 30, 2005 and 2004, respectively. See the Note 13 in the Consolidated Financial Statements for additional information.

### Comprehensive Income

The Company's comprehensive income was \$4,745,415 and \$2,024,042 during 2005 and 2004, respectively. Comprehensive income differed from our net income in 2005 and 2004 due to the change in the fair value of available for sale securities, net of income tax. In fiscal 2005, there was a net increase in fair value of \$726,781 to a net unrealized loss on investments available for sale, net of income tax. There was a decrease in fair value in fiscal 2004 of \$1,488,137. See the Consolidated Statements of Changes in Shareholders' Equity and Note 17 in the Consolidated Financial Statements for additional information.

### FINANCIAL CONDITION

The Company's total assets decreased \$12,982,530, or 2%, to \$562,917,802 at June 30, 2006 compared to \$575,900,332 at June 30, 2005. This decrease was due to a \$25,389,859 decrease in total loans, primarily construction, commercial real estate, and commercial loans, partially offset by an \$11,791,769 increase in securities classified as available for sale. The cash flow from the decrease in loans was utilized to repay Federal Home Loan Bank term advances at maturity. Stockholders' Equity totaled \$39,096,125 and \$39,869,573 at June 30, 2006 and 2005, respectively, a decrease of \$773,448. Stockholders' equity was increased by net income of \$4,004,199, and proceeds from the exercise of previously granted stock options of \$213,972. These increases were offset by a change in net unrealized losses on available for sale securities of \$1,952,282, share repurchases and retirements of \$2,142,250, and payment of cash dividends of \$897,087.

### Cash and Cash Equivalents

Average cash and cash equivalents (cash and due from bank and short-term investments) decreased \$3,513,129 to \$12,433,022 in fiscal 2006 as compared to \$15,946,151 in fiscal 2005. This decrease was due to reducing reserves balances maintained at the Federal Reserve Bank of Boston.

### Investments Securities and Other Earning Assets

Page 28

The average balance of the available for sale securities portfolio was \$80,050,271 and \$69,451,314 for fiscal 2006 and fiscal 2005, respectively. A portion of the increase of \$10,598,957, or 15%, provided additional collateral for FHLB advances and securities sold under agreements to repurchase. The portfolio is comprised of U.S. Government-sponsored enterprises, mortgage-backed securities, municipal securities, and equity and bank-issued trust preferred securities, with most of our investment portfolio consisting of federal agency mortgage-backed securities and short-term U.S. Government-sponsored enterprise bonds. See Item 8 Tables 2 and 3 for a detail of available for sale securities and investment maturities, respectively.

All of the Company's securities are classified as available for sale and are carried at fair value at \$86,137,707 and \$74,345,938 as of June 30, 2006 and 2005, respectively. These securities had net unrealized losses after taxes of \$2,622,469 at June 30, 2006 and \$670,187 at June 30, 2005. See Note 2 to the Consolidated Financial Statements. These unrealized losses do not impact net income or regulatory capital, but are recorded as an adjustment to stockholders' equity, net of related deferred income taxes, and are a component of comprehensive income contained in the Consolidated Statements of Changes in Stockholders' Equity.

### Loans

The average balance for loans, including loans held for sale, was \$448,610,511 in fiscal 2006 compared to \$453,379,411 in fiscal 2005. This decrease of \$4,768,900, or 1%, in our average balance of loans at June 30, 2006, was attributable to decreases in commercial real estate, commercial, and construction loans, partially offset by

increases in residential real estate and consumer loans. See Item 8 Tables 4 and 5 for additional information on the composition of the loan portfolio.

Residential real estate loans averaged \$149,940,456 in fiscal 2006 as compared to \$146,977,479 in fiscal 2005. This increase of \$2,962,977, or 2%, was attributable to an increase adjustable rate residential real estate loans, closed-end home equity loans, and home equity lines of credit. We continued to sell most of the 30 year fixed rate residential real estate loans originated by us into the secondary market. Residential real estate loans were 34% and 32% of the total loan portfolio at June 30, 2006 and 2005, respectively. Of residential real estate loans at June 30, 2006, approximately 43% were variable rate products compared to 42% at June 30, 2005. The increase in the percentage of variable rate product resulted from holding new variable rate loans in portfolio while selling fixed rate product into the secondary market. As interest rates increase, we expect variable rate residential real estate loans to increase allowing the asset sensitivity of the statement of financial condition to be maintained.

Commercial real estate and commercial loans both decreased during fiscal 2006 as the Bank replaced three open commercial lending positions at the beginning of the fiscal year, tightened credit underwriting standards as delinquencies and classified and criticized commercial loans increased, and priced these loans to reflect risk.

Commercial real estate loans averaged \$121,279,403 in fiscal 2006 and \$125,914,966 in fiscal 2005. This decrease of \$4,635,563, or 4%, reflects the factors noted above. Our focus was primarily to lend to small businesses within our market areas. This portfolio consists of loans secured primarily by income-producing commercial real estate and multifamily residential real estate. Commercial real estate loans were 26% and 27% of the total loan portfolio at June 30, 2006 and 2005, respectively. Approximately 96% of the commercial real estate loans were variable rate product, minimizing the interest rate risk for this portfolio, compared to approximately 97% of this portfolio at June 30, 2005.

Construction loans averaged \$8,840,891 in fiscal 2006 and \$10,638,635 in fiscal 2005. This decrease of \$1,797,744, or 17%, was primarily in commercial construction loans. Construction loans were 1% and 3% of the total loan portfolio at June 30, 2006 and 2005, respectively. Most construction loans are subject to interest rates based on the prime rate, have contractual maturities under 12 months, and disbursements made on construction as completed and verified by inspection. Approximately 30% of the construction loans were variable rate product at June 30, 2006 compared to approximately 56% at June 30, 2005.

Commercial loans averaged \$58,416,018 in fiscal 2006 and \$70,744,229 in fiscal 2005. This decrease of \$12,328,211, or 17%, reflects the above factors and our decision to restructure the indirect equipment lending portion of this portfolio to improve its profitability. Commercial loans were 12% and 15% of total loans at June 30, 2006 and 2005, respectively. Variable rate products comprised 56% and 58% of this loan portfolio at June 30, 2006 and 2005, respectively. The commercial loan credit risk exposure is highly dependent on the cash flow of the customer's business. The Company mitigates credit risk by strictly adhering to our underwriting and credit policies.

Consumer and other loans averaged \$107,591,979 in fiscal 2006 and \$96,589,511 in fiscal 2005. This increase of \$11,002,468, or 11%, is attributable to new indirect auto and recreational vehicle loans. Consumer and other loans comprise 26% and 23% of total loans at June 30, 2006 and 2005, respectively. Consumer, including indirect auto and recreational vehicle, and other loans are mostly fixed rate products. At June 30, 2006 and 2005, we held \$39,075,798 and \$34,872,792 of indirect auto loans, respectively. Indirect auto, indirect RV and indirect mobile home loans together comprise approximately 96% of total consumer and other loans, a slight increase from 95% in 2005. The detail of consumer loans at June 30, 2006 and 2005 appears in the following table. The Company underwrites all automobile dealer finance, recreational vehicle and mobile home loans to protect credit quality. The Company pays a nominal one-time origination fee on these loans. The fees are deferred and amortized over the contractual life of the loan as a yield adjustment. Management attempts to mitigate credit and interest rate risk by keeping the products offered short-term, earning a rate of return commensurate with the risk, and lending to individuals in the Company's known market areas.

Consumer Loans

	<u>June 30, 2006</u>		<u>June 30, 2005</u>	
Indirect Auto	\$ 39,075,798	35%	\$ 34,872,792	34%
Indirect RV	41,111,060	36%	30,235,107	29%
Indirect Mobile Home	<u>28,212,411</u>	<u>25%</u>	<u>32,749,004</u>	<u>32%</u>
Subtotal Indirect	108,399,269			96%
				97,856,903
				95%
Other				<u>4,793,128</u>
				<u>4%</u>
				<u>5,007,999</u>
				<u>5%</u>
Total				\$ 113,192,397
				=====
				100%
				=====
				\$ 102,864,902
				=====
				100%
				=====

BOLI was invested in the general account of two insurance companies and separate accounts in a third quality insurance company. There was approximately \$5.0 million transferred to the separate accounts in the third company. Standard and Poor's rated these companies AA+ or better at June 30, 2006. Interest earnings, net of mortality costs, increase the cash surrender value. These interest earnings are based on interest rates reset each year, subject to minimum interest rates. The increases in cash surrender value offset all or a portion of the increase in employee benefit costs. The increase in cash surrender value was recognized in other income and was not subject to income taxes. Borrowing on or surrendering the policy may subject the Bank to income tax expense on the increase in cash surrender value. For these reasons, management considers BOLI an illiquid asset. BOLI represented 19.95% of capital plus the allowance for loan losses at June 30, 2006.

## Deposits

Average demand deposit accounts were \$39,161,547 for the year ended June 30, 2006 as compared to \$37,841,020 in 2005. This increase of \$1,320,527, or 3%, is consistent with our focus of increasing consumer and commercial core deposits.

Average interest-bearing deposits increased by \$589,810, or less than 1%, during fiscal 2006 to \$356,114,677. This increase was primarily due to increasing consumer and business time deposits. Average time deposit balances increased \$43,708,611 to \$199,469,782 primarily from the promotion of time deposits as interest rates increased during fiscal 2006. This increase allowed the Bank to decrease brokered time deposits as they matured. Average brokered time deposit balances decreased \$31,721,680, or 36%, to \$56,129,614 in fiscal 2006 from \$87,851,294 in fiscal 2005. All other interest-bearing deposits decreased during the year. NOW and savings balances declined as customers moved balances to higher yielding time deposits. In fiscal 2006, the Maximum Return Sweep account was discontinued and the balances moved to repurchase agreements from money market accounts causing the decline in average balances. Average NOW accounts decreased \$5,792,225, or 9%, during fiscal 2006 to \$59,968,676. The average interest rate paid on NOW accounts increased from 1.23% in fiscal 2005 to 1.93% in fiscal 2006. Average money market accounts decreased \$4,002,689, or 23%, to \$13,093,206 in fiscal 2006. The average interest rate paid on money market accounts increased from 1.25% in fiscal 2005 to 1.88% in fiscal 2006. Average savings accounts decreased \$1,602,207, or 6%, to \$27,453,399 during fiscal 2006. The average interest rate paid on savings accounts increased from 0.79% in fiscal 2005 to 0.83% in fiscal 2006. The average interest rate paid on time deposits increased from 3.03% in fiscal 2005 to 3.77% in fiscal 2006. See [Item 8 Table 10](#) for the scheduled maturities of time deposits of \$100,000 or more.

Brokered time deposits are used by us as part of our overall funding strategy and as an alternative to customer time deposits, FHLB advances, and junior subordinated debentures to fund the growth of our earning assets. These deposits are limited by policy to 25% of total assets. We use four national brokerage firms to source time deposits, which are obtained through agents of the brokerage company soliciting customers from throughout the United States. The terms of these brokered time deposits allow for termination prior to maturity only in the case of the depositor's death, have maturities generally beyond one year, individual brokered time deposit maturities do not exceed \$5 million in any one month and have interest rates equal to or slightly above comparable FHLB advances. At June 30, 2006, outstanding brokered time deposits of \$51,859,091 as a percentage of total assets was 9.21% compared to 12.23% at June 30, 2005. The average interest rate paid on brokered time deposits increased from 2.94% in fiscal 2005 to 3.58% in fiscal 2006. Generally, interest rates paid on brokered time deposits exceed rates paid on FHLB advances, with similar maturities, but the incremental interest expenses did not have a material impact on the results of operations for fiscal 2006.

## Other Funding Sources

Securities sold under repurchase agreements, Federal Home Loan Bank of Boston (FHLB) advances, and junior subordinated debentures are the Company's sources of funding other than deposits.

Average securities sold under repurchase agreements during fiscal 2006 were \$31,427,133, compared to \$30,572,443 during fiscal 2005. This increase was primarily due to the discontinued Maximum Return Sweep accounts and transfer from money market deposit accounts to repurchase agreements in fiscal 2006. This liability was collateralized by U.S. government-sponsored enterprise and federal agency mortgage-backed securities. See Note 9 to the Consolidated Financial Statements.

Average FHLB advances for fiscal 2006 were \$79,648,575, compared to \$82,233,871 in fiscal 2005. This decrease of \$2,585,296, or 3%, was attributed to repayment of FHLB advances at maturity. These advances had an average cost of 4.37% during fiscal 2006 compared to 4.67% during fiscal 2005. At June 30, 2006 and 2005, FHLB advances were \$75,888,598 and \$86,197,602, respectively. The Company had unused advance capacity with the FHLB of

\$37,565,000 at June 30, 2006. Management intends to increase available FHLB advance capacity by continuing to add qualifying securities. See Note 8 to the Consolidated Financial Statements.

The Bank has a secured line of credit under the Borrower in Custody program through the Fed Discount Window. Under the terms of this credit line, the Bank has pledged its indirect auto loans and the line bears an interest rate equal to the then current federal funds rate plus 1.00%. At June 30, 2006, the credit availability under the Borrower in Custody program was \$30,288,974. There were no borrowings outstanding under this credit line at June 30, 2006.

The following is a summary of the unused borrowing capacity of the Bank at June 30, 2006 and available to meet our short-term funding needs:

Brokered time deposits	\$ 88,853,000	Subject to policy limitation of 25% of total assets
Federal Home Loan Bank of Boston	\$ 37,565,000	Unused advance capacity subject to eligible and qualified collateral
Fed Discount Window	<u>\$ 30,289,000</u>	Unused credit line subject to the pledge of indirect auto
Borrower-in-Custody		loans
Total Unused Borrowing Capacity	\$ 156,707,000	

We had outstanding \$16,496,000 at June 30, 2006 and 2005, respectively, of junior subordinated debentures issued by us to affiliated trusts. See "Capital" for more information on junior subordinated debentures and affiliated trusts.

Page 30

## ASSET QUALITY

We monitor our asset quality with lending and credit policies which require the regular review of our loan portfolio. We maintain an internal rating system which provides a process to regularly monitor the credit quality of our loan portfolio.

At June 30, 2006 and 2005, the allowance for loan losses was \$5,496,000 and \$5,104,000, respectively. The increase in the allowance for loan losses was attributed to the increasing mix of consumer indirect loans, with a higher risk profile, in the Bank's loan portfolio, the increase in loan delinquencies, an increase in non-performing loans, and an increase in internally classified and criticized loans.

The allowance for loan losses as a percentage of total loans was 1.26% and 1.11% at June 30, 2006 and 2005, respectively. This increase of 15 basis points was attributable to a decline in loans in fiscal 2006 compared to fiscal 2005.

Classified loans, exclusive of non-performing loans, that could potentially become non-performing due to delinquencies or marginal cash flows were \$3,349,000 and \$1,950,000 at June 30, 2006 and 2005, respectively. Significant credit losses are not expected.

The following table reflects the annual trend of total delinquencies 30 days or more past due, including loans on non-accrual status, which are not delinquent, as a percentage of total loans:

<u>06/30/06</u>	<u>06/30/05</u>	<u>06/30/04</u>	<u>06/30/03</u>
2.09%	1.09%	1.13%	1.36%

The delinquency for the years prior to June 30, 2006 have been restated because we changed the method of measuring past due loans to the number of days lapsed from the date of last payment from the number of payments past due. For the years ended June 30, 2005, 2004, and 2003, the previously reported delinquency and current non-accrual loans were 0.96%, 0.66%, and 1.09%, respectively.



## Non-performing Assets

Total non-performing loans were \$5,195,000 and \$1,698,000 at June 30, 2006 and 2005, respectively. This increase of \$3,497,000, or 206%, was attributable primarily to commercial real estate and commercial loans. Of non-performing commercial real estate and commercial loans, \$1,720,000 and \$131,000, respectively, were current and paying as agreed. The tightening of credit standards in fiscal 2006 resulted in an increase in discretionary non-accrual practices, accounting for this increase. Many of these substandard loans were subject to a name-by-name review determining the risk of loss based on the liquidation of the collateral. The risk of loss is incorporated in determining the adequacy of the allowance for loan losses, and represented approximately 12% of the allowance at June 30, 2006. The following table represents the non-performing loans as of June 30, 2006 and 2005.

<u>Description</u>	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Residential real estate	\$ 521,000	\$ 515,000
Commercial real estate	2,980,000	867,000
Commercial loans	1,553,000	256,000
Consumer and other	<u>141,000</u>	<u>60,000</u>
Total non-performing	\$ 5,195,000	\$ 1,698,000
	=====	=====

Non-performing loans as a percentage of total loans were 1.19% and 0.37% at June 30, 2006 and 2005, respectively. The allowance for loan losses was equal to 106% and 301% of total non-performing loans at June 30, 2006 and 2005, respectively. At June 30, 2006, non-performing loans included \$1,882,000 of loans that are current and paying as agreed, but which the Bank maintains as non-performing until the borrower has demonstrated a sustainable period of performance. Excluding these loans, the total delinquencies 30 days and more past due as a percentage of total assets would be 1.66% and .86% for June 30, 2006 and 2005, respectively.

See Item 8 Table 8 for a summary of non-performing assets for the last five years.

We continue to focus on asset quality issues and allocate significant resources to credit policy and loan review. The collection, workout and asset management functions focus on the reduction of non-performing assets. Despite this ongoing effort on asset quality, there can be no assurance that adverse changes in the real estate markets and economic conditions will not result in higher non-performing assets levels in the future and negatively impact our operations through higher provision for loan losses, net loan charge-offs, decreased accrual of income and increased noninterest expenses.

Residential real estate, commercial real estate, commercial, and consumer and other loans are generally placed on nonaccrual when reaching 90 days past due. Secured consumer loans are written down to realizable value and unsecured consumer loans are charged-off upon reaching 90 days past due. Based on our judgment, we may place on nonaccrual status loans which are currently less than 90 days past due or performing in accordance with their terms but are likely to present future principal and/or interest repayment problems thus classified as non-performing.

Net charge-offs were \$630,000 during 2006 compared to \$774,600 in 2005. Net charge-offs as a percentage of average loans outstanding were 0.14% and 0.17% in 2006 and 2005, respectively. The decrease of \$144,600 was due to lower gross charge-offs in residential real estate, commercial real estate, and consumer loans. See Item 8 Table 6 for more information concerning charge-offs and recoveries for the last five years.

## Potential Problem Loans

Commercial real estate and commercial loans are periodically evaluated under an eight point risk rating system. These ratings are guidelines in assessing the risk of a particular loan. We had classified commercial real estate and commercial loans totaling \$12,228,000 and \$6,761,000 at June 30, 2006 and 2005, respectively, as substandard or lower on our risk rating system. This increase was primarily due to 38 commercial customer relationships ranging from \$5,000 to \$2,198,000, experiencing weaknesses in the underlying businesses and also reflects a tightening of our credit standards. These loans were subject to our internal name-by-name review for the risk of loss based on the liquidation of collateral. This risk of loss was included in determining the adequacy of the allowance for loan loss. At June 30, 2006, \$3,169,000 of this amount was non-performing commercial real estate and commercial loans. The remaining \$9,059,000 of commercial real estate and commercial loans classified as substandard at June 30, 2006 evidence one or more weaknesses or potential weaknesses and may become non-performing loans in future periods.

Management actively monitors the Bank's asset quality to evaluate the adequacy of the allowance for loan losses and, when appropriate, to charge-off loans against the allowance for loan losses, provide specific loss allowances, and change the level of the loan loss allowance. The process of evaluating the allowance involves a high degree of management judgment. The methods employed to evaluate the allowance for loan losses are quantitative in nature and consider such factors as the loan mix, the level of non-performing loans, delinquency trends, past charge-off history, loan reviews and classifications, collateral, and the current economic climate. The liquidation value of collateral for each classified commercial real estate or commercial loan is considered in the evaluation of the allowance for loan loss.

Management believes that the allowance for loan losses is adequate considering the level of risk in the loan portfolio. While management believes that it uses the best information available to make its determinations with respect to the allowance, there can be no assurance that the Company will not have to increase its allowance for loan losses in the future as a result of changing economic conditions, adverse markets for real estate or other factors. Regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. These agencies may require the Bank to recognize additions to the allowance for loan losses based on their judgments about information available to them at the time of their examination. No such adjustments were proposed by the Federal Reserve Bank of Boston or the Maine Bureau of Financial Institutions based on their 2005 examination.

At June 30, 2006, the Company had acquired assets of \$10,384 compared to \$88,646 at June 30, 2005. The decrease of \$78,262 was due to a decrease in repossessed vehicles and in substance foreclosures. The Bank has an allowance for losses on acquired assets. It was established to provide for declines in market values and estimated selling costs. The Company provided for the allowance through a charge against earnings of \$2,500 and \$20,000 for the years ending June 30, 2006 and 2005, respectively. See Note 5 of the Consolidated Financial Statements for additional information. Management periodically receives independent appraisals on acquired assets. As a result of this review and the review of the acquired assets portfolio, the Company believes the allowance for losses on acquired assets is adequate to state acquired assets at lower of cost or fair value less estimated selling costs.

## RISK MANAGEMENT

### Asset-Liability Management

The Company's success is largely dependent upon its ability to manage interest rate risk. Interest rate risk can be defined as the exposure of the Company's net interest income to adverse movements in interest rates. Although the Company regularly manages other risks, such as credit and liquidity risk, in the normal course of its business, management considers interest rate risk to be its most significant market risk and could potentially have the most material effect on the Company's financial condition and results of operations. The Company does not believe that it is exposed to significant market risk from trading activities because these activities are not material.

Asset-liability management is governed by policies reviewed and approved annually by the Board. The Board delegates responsibility for asset-liability management to the Asset Liability Management Committee (ALCO) which

is comprised of members of senior management who set the strategic directives that guide the day-to-day asset-liability management activities. ALCO reviews and approves all major risk, liquidity and capital management programs, except for pricing, which is a subcommittee of ALCO members.

The Company continues to minimize the volatility of its net interest income by managing the relationship of interest-rate sensitive assets to interest-rate sensitive liabilities. To accomplish this, management undertakes steps to increase the percentage of variable rate assets as a percentage of its total earning assets. The focus has been to originate variable rate commercial and commercial real estate loans, which reprice or mature more quickly than similar fixed-rate loans. Variable rate and 15 year fixed rate residential real estate loans are originated for the loan portfolio. Fixed rate, 30 year residential real estate loans are originated for sale to the secondary market. Consumer loans, including indirect auto and recreational vehicle loans, are primarily originated with fixed rates. The Company's adjustable-rate loans are primarily tied to published indices, such as the Wall Street Journal prime rate and one-year U.S. Treasury Bills. Management considers the Bank's assets and liabilities well matched. The balance sheet is slightly liability sensitive.

The overall objective of interest rate risk management is to deliver consistent net interest income growth over a range of possible interest rate environments. We focus on interest rates, careful review of the cash flows of loans and deposits and other modeling assumptions, and asset liability strategies to help attain our goals and objectives.

Another objective of interest rate risk management is to control our estimated exposure to interest rate risk within limits established by the asset/liability committee and approved by our Board. These limits reflect our tolerance for interest rate risk over a wide range of both short-term and long-term measurements. We also evaluate the liquidation or run-off measures of assets and liabilities on our balance sheet and stress test measures. Stress testing demonstrates the impact of very extreme but lower probability events. The combination of these measures gives management a comprehensive view of the possible risk to future earnings. We attempt to control interest rate risk by identifying and quantifying these risks.

Page 32

Net interest income is our largest source of revenue. Net interest income sensitivity is our primary short-term measurement used to assess the interest rate risk of our on-going business. We believe that net interest income sensitivity gives us the best perspective on how day-to-day decisions affect our interest rate risk profile. We subject estimated net interest income over a 12 month period to various rate movements using a simulation model for various specified interest rate scenarios. Simulations are run quarterly and include scenarios where market rates are shocked up and down. Our base simulation assumes that rates do not change for the next 12 months. The sensitivity measurement is calculated as a percentage variance of the net interest income simulations to the base simulation results. The results are compared to policy guidelines and are disclosed in the following table.

Assuming a 200 basis point increase and decrease in interest rates starting on June 30, 2006, we estimate that our net interest income in the following 12 months would decrease by 0.17% if rates went up 200 basis points and increase by 2.33% if rates went down 200 basis points. This demonstrates the liability sensitivity of our balance sheet where the simulated increase in interest expense would be greater than the increase in interest income because our interest-earning liabilities reprice more quickly than the repricing of our interest-bearing assets. In falling rates, the interest earning liabilities reprice downward more quickly than the repricing of our interest-bearing assets. Also shown in the table are the results assuming a 200 basis increase and decrease in interest rates starting June 30, 2005. Our balance sheet shifted to slightly liability sensitive at June 30, 2006 from assets sensitive in the prior year reflecting a change in customer demand for fixed interest rates on loans as general interest rates increased over the year ended June 30, 2006 combined with demand for certificates of deposit with maturities of 15 months or less.

	<u>Up 200 Basis Points</u>	<u>Down 200 Basis Points</u>
June 30, 2006	-0.17%	2.33%

	<u>Up 200 Basis Points</u>	<u>Down 200 Basis Points</u>
June 30, 2005	1.91%	-2.02%

## LIQUIDITY

On a parent Company only basis, our commitments and debt service requirements at June 30, 2006 consisted of junior subordinated notes issued to NBN Capital Trust II and NBN Capital Trust III totaling \$6,000,000 due March 30, 2034 and junior subordinated debentures issued to NBN Capital Trust IV totaling \$10,000,000 due February 23, 2035. NBN Capital Trust II issued \$3,000,000 of junior subordinated notes with a variable interest rate based on three month LIBOR plus 2.80% and reprices quarterly. The interest rate was 8.30% at June 30, 2006. NBN Capital Trust III also issued \$3,000,000 of junior subordinated notes with a fixed interest rate of 6.50% until March 30, 2009, when the interest rate will become variable based on three month LIBOR. NBN Capital Trust IV issued \$10,000,000 of junior subordinated debentures with a fixed interest rate of 5.88% until February 23, 2010, when the interest rate will become variable based on three month LIBOR. NBN Capital Trust II and III have a call option on March 30, 2009 and NBN Capital Trust IV has a call option on February 23, 2010. See Note 19 to the Consolidated Financial Statements. Based on the interest rates at June 30, 2006, the annual aggregate payments to meet the debt service of the junior subordinated debentures is approximately \$1,064,000.

<u>Affiliated Trusts</u>	Trust Preferred <u>Securities</u>	Common <u>Securities</u>	Junior Subordinated <u>Debentures</u>	Interest <u>Rate</u>	<u>Maturity Date</u>
NBN Capital Trust II	\$ 3,000,000	\$ 93,000	\$ 3,093,000	8.30%	March 30, 2034
NBN Capital Trust III	3,000,000	93,000	3,093,000	6.50%	March 30, 2034
NBN Capital Trust IV	<u>10,000,000</u>	<u>310,000</u>	<u>10,310,000</u>	<u>5.88%</u>	February 23, 2035
Total	\$ 16,000,000	\$ 496,000	\$ 16,496,000	6.45%	

The principal sources of funds for us to meet parent-only obligations are dividends from our banking subsidiary, which are subject to regulatory limitations, and borrowings from public and private sources. For information on the restrictions on the payment of dividends by our banking subsidiary, see Note 10 to the Consolidated Financial Statements.

For our banking subsidiary, liquidity represents the ability to fund asset growth, accommodate deposit withdrawals and meet other contractual obligations and commitments. Liquidity risk is the danger that a bank cannot meet anticipated or unexpected funding requirements or can meet them only at excessive cost. Liquidity is measured by the ability to raise cash when needed at a reasonable cost. Many factors affect a bank's ability to meet liquidity needs, including variation in the markets served, its asset-liability mix, its reputation and credit standing in the market and general economic conditions.

In addition to traditional deposits, the Bank has other liquidity sources, including the proceeds from maturing securities and loans, the sale of securities, asset securitizations and borrowed funds such as FHLB advances and brokered time deposits. We monitor and forecast our liquidity position. There are several interdependent methods used by us for this purpose, including daily review of federal funds positions, monthly review of balance sheet changes, monthly review of liquidity ratios, quarterly review of liquidity forecasts and periodic review of contingent funding plans.

At June 30, 2006, our banking subsidiary had \$157 million of immediately accessible liquidity, defined as cash that could be raised within 7 days through collateralized borrowings, brokered deposits or security sales. This represented 28% of total assets, compared to a policy minimum of 10%.

## OFF-BALANCE SHEET ARRANGEMENTS &amp; AGGREGATE CONTRACTUAL OBLIGATIONS

The Company 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 commitments to extend credit, unused lines of credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amounts recognized in the condensed consolidated balance sheet. The contract or notional amounts of these instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit, unused lines of credit and standby letters of credit is represented by the contractual amount of those instruments. To control the credit risk associated with entering into commitments and issuing letters of credit, the Company uses the same credit quality, collateral policies, and monitoring controls in making commitments and letters of credit as it does with its lending activities. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation.

Commitments to extend credit are agreements to lend to a customer as long as there is no 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. Since many of the commitments are expected to expire without being drawn upon, the total committed amounts do not necessarily represent future cash requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counter party.

Standby letters of credit are conditional commitments issued by the Company 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 loans to customers.

Unused lines of credit and commitments to extend credit typically result in loans with a market interest rate.

A summary of the amounts of the Company's (a) contractual obligations, and (b) other commitments with off-balance sheet risk, both at June 30, 2006, follows:

Contractual obligations	Total	Payments Due by Period			
		Less Than <u>1 Year</u>	1-3 <u>Years</u>	4-5 <u>Years</u>	After 5 <u>Years</u>
FHLB advances	\$ 75,888,598	\$ 34,831,900	\$ 36,056,698	\$ 5,000,000	\$ -
Junior subordinated debentures	16,496,000	-	6,186,000	10,310,000	-
Capital lease obligation	2,781,046	127,535	275,062	304,049	2,074,400
Other borrowings	<u>57,129</u>	<u>57,129</u>	-	-	-
Total long-term debt	95,222,773	35,016,564	42,517,760	15,614,049	2,074,400
Operating lease obligations	<u>3,482,189</u>	<u>504,573</u>	<u>414,275</u>	<u>344,478</u>	<u>2,218,863</u>
Total contractual obligations	\$ 98,704,962 =====	\$ 35,521,137 =====	\$ 42,932,035 =====	\$ 15,958,527 =====	\$ 4,293,263 =====

Commitments with off-balance sheet risk	Amount of Commitment Expiration - Per Period				
	<u>Total</u>	<u>Less Than 1 Year</u>	<u>1-3 Years</u>	<u>4-5 Years</u>	<u>After 5 Years</u>
Commitments to extend credit (1)(3)	\$ 18,172,000	\$ 18,172,000	\$ -	\$ -	\$ -
Commitments related to loans held for sale(2)	1,393,000	1,393,000	-	-	-
Unused lines of credit (3)(4)	43,505,000	22,277,000	2,639,000	1,446,000	17,143,000
Standby letters of credit (5)	<u>1,538,000</u>	<u>1,538,000</u>	<u>-</u>	<u>-</u>	<u>-</u>
	\$ 64,608,000	\$ 43,380,000	\$ 2,639,000	\$ 1,446,000	\$ 17,143,000
	=====	=====	=====	=====	=====

(1) Represents commitments outstanding for residential real estate, commercial real estate, and commercial loans.

(2) Commitments of residential real estate loans that will be held for sale.

(3) Loan commitments and unused lines of credit for commercial and construction loans expire or are subject to renewal in twelve months or less.

(4) Represents unused lines of credit from commercial, construction, and home equity loans.

(5) Standby letters of credit generally expire in twelve months.

The Bank has written options limited to those residential real estate loans designated for sale in the secondary market and subject to a rate lock. These rate-locked loan commitments are used for trading activities, not as a hedge. The fair value of the outstanding written options at June 30, 2006 was a loss of \$2,959.

Page 34

## CAPITAL

At June 30, 2006 and 2005, stockholders' equity totaled \$39,096,125 and \$39,869,573 respectively, or 6.95% and 6.92% of total assets, respectively. In addition, we had on June 30, 2006 and 2005, \$16,496,000, respectively, of junior subordinated debentures which mature in 2034 and 2035 and qualify as Tier 1 Capital. See Note 19 to the Consolidated Financial Statements. The changes in stockholders' equity include net income for the year ended June 30, 2006 of \$4,004,199 and stock issued for \$213,972 from the exercise of stock options offset by a change in the net unrealized loss on available for sales securities of \$1,952,282, dividend payments of \$897,087, and stock repurchases of \$2,142,250, representing 90,200 shares with an average cost of \$23.75 per share. See Note 10 to the Consolidated Financial Statements for additional information on capital ratios.

The 2004 Stock Repurchase Plan was approved by the Board of Directors on January 16, 2004. It was extended by the Board of Directors on December 16, 2005 and will terminate on December 31, 2006. The repurchase program may be discontinued by Northeast Bancorp at any time. Under the 2004 Stock Repurchase Plan, the Company may purchase up to 200,000 shares of its common stock from time to time in the open market at prevailing prices. Common stock repurchased pursuant to the plan is classified as authorized but un-issued shares of common stock available for future issuance as determined by the Board of Directors. From time to time, the Company believes that the current market price for its common stock makes the stock attractive as a use of the Company's funds and at such times purchases its common stock in the market. Total stock repurchases under the 2004 Plan in fiscal 2006 were 90,200 shares for \$2,142,250 at an average price of \$23.75 per share. The remaining repurchase capacity of the 2004 Plan is 54,500 shares. Since inception, total stock repurchases under the 2004 plan were 145,500 shares for \$3,204,902 through June 30, 2006. Management believes that these and future purchases have not and will not have a significant impact on the Company's liquidity. The repurchases had a positive effect on earnings per share during 2006 and 2005, by reducing the number of common stock shares outstanding.

Regulatory capital guidelines require the Bank to maintain certain capital ratios. The Bank's Tier 1 Capital was \$50,864,000 or 9.07% of total assets at June 30, 2006 compared to \$47,131,000 or 8.20% of total assets at June 30, 2005. We are also required to maintain capital ratios based on the level of assets, as adjusted to reflect their perceived level of risk. Our regulatory capital ratios currently exceed all applicable requirements. See Note 10 on the Consolidated Financial Statements.

The Maine Business Corporation Act eliminated the concept of treasury stock effective July 1, 2003. The Act treats the shares acquired by the Company as authorized but unissued shares. All stock held by the Company as treasury stock has been reclassified as authorized but unissued stock in accordance with the Act.

#### IMPACT OF INFLATION

The consolidated financial statements and related notes have been presented in terms of historic dollars without considering changes in the relative purchasing power of money over time due to inflation. Unlike industrial companies, substantially all of the assets and virtually all of the liabilities of the Company are monetary in nature. As a result, interest rates have a more significant impact on the Company's performance than the general level of inflation. Over short periods of time, interest rates may not necessarily move in the same direction or in the same magnitude as inflation.

#### IMPACT OF NEW ACCOUNTING STANDARDS

The Financial Accounting Standards Board (FASB) and the SEC issued the following statements and interpretations affecting the Company:

FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities" ("VIE") ("FIN46R") establishes the criteria used to identify VIE's and to determine whether or not to consolidate a VIE. VIEs are those entities in which the total equity investment at risk does not provide the holders of that investment with the characteristics of a controlling financial interest. Pursuant to the criteria established by FIN 46 in 2004, we deconsolidated three affiliated trusts which had been formed for the purposes of issuing capital securities to unaffiliated parties and investing the proceeds in junior subordinated debentures issued by us. Our investment in these affiliated trusts totaled \$496,000 at June 30, 2005 which funds were also used by the trusts to invest in junior subordinated debentures issued by us. The results of the deconsolidation and the accounting for these entities was to recognize our equity investments in these entities of \$496,000 as other assets and to increase long-term debt by the same amount. The adoption of FIN 46R did not have a material impact on our financial condition, results of operations, earnings per share, or cash flows.

FASB issued FASB Statement No. 123 (Revised 2004), "Share-Based Payments" ("FAS 123R") which requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees, including employee stock option plans. Current disclosure provisions under FAS 123 are still applicable. In addition to stock options awards granted after July 1, 2005, compensation expense on unvested equity-based awards that were granted prior to the effective date must be recognized in the income statement. FAS123R is effective for the interim and annual periods beginning after June 15, 2005. The adoption of FAS123R is not expected to have a material impact on our financial condition, results of operations, earnings per share or cash flows.

During fiscal 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 155, an amendment of FASB Statements No. 133 and 140, Accounting for Certain Hybrid Financial Instruments, and No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement 140. Both Statements become effective for the Company in fiscal 2007. Neither Statement is expected to have a significant impact on the Company's reported financial condition or results of operations.

Item 7 A. Quantitative and Qualitative Disclosure about Market Risk

See Item 7 of our Form 10-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations - Risk Management" and accompanying table set forth therein for quantitative and qualitative disclosures about market risk.

Item 8. Financial Statements and Supplementary Data

a. Financial Statements Required by Regulation S-X

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors  
Northeast Bancorp and Subsidiaries

We have audited the consolidated statements of financial condition of Northeast Bancorp and Subsidiaries (the Company) as of June 30, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended June 30, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Northeast Bancorp and Subsidiaries as of June 30, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2006, in conformity with U.S. generally accepted accounting principles.

Portland, Maine  
August 11, 2006

/s/ Baker Newman & Noyes  
Baker Newman & Noyes  
Limited Liability Company

NORTHEAST BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION  
June 30, 2006 and 2005

	<u>ASSETS</u>	
	<u>2006</u>	<u>2005</u>
Cash and due from banks (note 1)	\$ 9,573,908	\$ 9,254,312
Interest-bearing deposits	1,099,813	1,063,923
Federal Home Loan Bank overnight deposits	<u>1,430,000</u>	<u>3,555,000</u>
Total cash and cash equivalents	12,103,721	13,873,235
Available for sale securities, at market value (notes 2, 8 and 9)	86,137,707	74,345,938
Loans held for sale	681,143	318,850
Loans receivable (notes 3 and 8):		
Mortgage loans:		
Residential real estate	149,099,809	148,840,093
Construction	7,480,823	17,446,722
Commercial real estate	<u>115,327,157</u>	<u>125,898,821</u>
Total mortgage loans	271,907,789	292,185,636



Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Commercial loans	50,261,725	68,715,530
Consumer and other loans	<u>113,192,397</u>	<u>102,864,902</u>
	435,361,911	463,766,068
Undisbursed portion of construction loans	(2,375,257)	(5,245,369)
Net deferred loan origination costs	<u>2,675,875</u>	<u>2,531,689</u>
	435,662,529	461,052,388
Less allowance for loan losses (note 3)	<u>5,496,000</u>	<u>5,104,000</u>
Net loans	430,166,529	455,948,388
Premises and equipment - net (note 4)	7,315,881	4,507,114
Acquired assets - net (note 5)	10,384	88,646
Accrued interest receivable - loans	2,011,391	2,039,682
Accrued interest receivable - investments	667,167	515,207
Federal Home Loan Bank stock, at cost (note 8)	5,498,300	6,644,500
Federal Reserve Bank stock, at cost	459,500	405,500
Goodwill	407,897	407,897
Intangible assets, net of accumulated amortization of \$2,366,564 in 2006 and \$2,125,536 in 2005 (note 6)	1,919,665	2,160,693
Bank owned life insurance (BOLI)	8,895,326	8,563,475
Other assets (note 13)	<u>6,643,191</u>	<u>6,081,207</u>
Total assets	\$ 562,917,802	\$ 575,900,332

Page 36

LIABILITIES AND STOCKHOLDERS' EQUITY

	<u>2006</u>	<u>2005</u>
Liabilities:		
Deposits (note 7):		
Demand	\$ 38,137,357	\$ 39,854,720
NOW	54,432,157	64,386,939
Money market	9,430,378	17,142,325
Regular savings	24,247,324	29,807,392
Brokered time deposits	51,859,091	70,424,426
Certificates of deposit under \$100,000	152,681,352	124,301,081
Certificates of deposit \$100,000 or more	<u>64,505,718</u>	<u>50,301,839</u>
Total deposits	395,293,377	396,218,722
FHLB advances (note 8)	75,888,598	86,197,602
Securities sold under repurchase agreements (note 9)	29,637,426	33,379,412
Junior subordinated debentures issued to affiliated trusts (note 19)	16,496,000	16,496,000
Capital lease obligation (note 8)	2,781,046	-
Other liabilities	<u>3,725,230</u>	<u>3,739,023</u>
Total liabilities	523,821,677	536,030,759

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Commitments and contingent liabilities (notes 13, 14, 15 and 19)

Stockholders' equity (notes 10, 11, 13 and 14):

Common stock, at stated value, 15,000,000 shares authorized; 2,447,132 and 2,519,832 shares outstanding at June 30, 2006 and 2005, respectively	2,447,132	2,519,832
Additional paid-in capital	4,675,258	6,530,836
Retained earnings	34,596,204	31,489,092
Accumulated other comprehensive loss (note 2)	<u>(2,622,469)</u>	<u>(670,187)</u>

Total stockholders' equity	39,096,125	39,869,573
----------------------------	------------	------------

Total liabilities and stockholders' equity	<u>\$ 562,917,802</u>	<u>\$ 575,900,332</u>
--	-----------------------	-----------------------

See accompanying notes.

Page 37

NORTHEAST BANCORP AND SUBSIDIARIES

Consolidated Statements of Income  
Years Ended June 30, 2006, 2005 and 2004

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Interest and dividend income:			
Interest on loans	\$ 31,095,935	\$ 29,104,032	\$ 25,301,320
Interest on Federal Home Loan Bank overnight deposits	93,017	52,912	16,696
Interest and dividends on available for sale securities	3,342,668	2,715,236	2,163,955
Dividends on Federal Home Loan Bank stock	335,900	264,777	173,957
Other interest and dividend income	<u>41,620</u>	<u>22,025</u>	<u>3,658</u>
Total interest and dividend income	34,909,140	32,158,982	27,659,586
Interest expense:			
Deposits (note 7)	11,152,306	8,624,798	6,566,265
Repurchase agreements	927,688	403,539	279,744
FHLB advances	3,486,348	3,850,815	4,290,459
Obligation under capital lease agreement	130,583	-	-
Junior subordinated notes issued to affiliated trusts	<u>1,063,681</u>	<u>1,087,696</u>	<u>942,313</u>
Total interest expense	<u>16,760,606</u>	<u>13,966,848</u>	<u>12,078,781</u>

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Net interest income before provision for loan losses	18,148,534	18,192,134	15,580,805
Provision for loan losses (note 3)	<u>1,226,413</u>	<u>1,301,600</u>	<u>961,938</u>
Net interest income after provision for loan losses	16,922,121	16,890,534	14,618,867
Noninterest income:			
Fees and service charges on loans	644,698	615,810	613,420
Fees for other services to customers	1,114,081	1,067,116	975,886
Net securities gains (note 2)	17,335	67,940	200,815
Gain (loss) on trading activities	--	(83)	8,940
Gain on sales of loans	308,777	233,027	682,795
Investment and insurance commissions	3,686,122	2,858,897	1,899,119
BOLI income	366,939	330,700	379,635
Other income (note 7)	<u>1,003,997</u>	<u>492,724</u>	<u>575,043</u>
Total noninterest income	7,141,949	5,666,131	5,335,653
Noninterest expense:			
Salaries and employee benefits (note 14)	\$ 10,637,758	\$ 9,554,317	\$ 8,284,428
Occupancy expense	1,672,505	1,418,696	1,225,780
Equipment expense	1,440,238	1,110,108	950,467
Intangible assets amortization	241,028	249,701	254,953
Other (notes 2 and 12)	<u>4,216,975</u>	<u>4,351,352</u>	<u>4,083,444</u>
Total noninterest expense	<u>18,208,504</u>	<u>16,684,174</u>	<u>14,799,072</u>
Income before income taxes	5,855,566	5,872,491	5,155,448
Income tax expense (note 13)	<u>1,851,367</u>	<u>1,853,857</u>	<u>1,643,269</u>
Net income	<u>\$ 4,004,199</u>	<u>\$ 4,018,634</u>	<u>\$ 3,512,179</u>
Earnings per common share (notes 11 and 14):			
Basic	\$ 1.61	\$ 1.60	\$ 1.38
Diluted	\$ 1.59	\$ 1.57	\$ 1.35

See accompanying notes.

Page 38

NORTHEAST BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES  
IN STOCKHOLDERS' EQUITY  
Years Ended June 30, 2006, 2005 and 2004

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>
Balance at June 30, 2003	\$ 2,786,095	\$ 10,381,692
Net income	-	-
Other comprehensive income net of tax:		
Net unrealized losses on investments available for sale, net of reclassification adjustment (note 17)	-	-
Total comprehensive income	-	-
Reclassification of treasury stock (note 1)	(260,679)	(2,255,661)
Purchase of 88,286 shares of Company stock	-	(1,535,235)
Stock options exercised	-	353,098
Dividends on common stock at \$0.35 per share	<u>-</u>	<u>-</u>
Balance at June 30, 2004	2,525,416	6,943,894
Net income	-	-
Other comprehensive income net of tax:		
Net unrealized losses on investments available for sale, net of reclassification adjustment (note 17)	-	-
Total comprehensive income	-	-
Purchase of 43,609 shares of Company stock	(43,609)	(799,893)
Stock options exercised	37,875	385,410
Stock grant	150	1,425
Dividends on common stock at \$0.36 per share	<u>-</u>	<u>-</u>
Balance at June 30, 2005	2,519,832	6,530,836
Net income	-	-
Other comprehensive income net of tax:		
Net unrealized losses on investments available for sale, net of reclassification adjustment (note 17)	-	-
Total comprehensive income	-	-
Purchase of 90,200 shares of Company stock	(90,200)	(2,052,050)
Stock options exercised	17,500	196,472
Dividends on common stock at \$0.36 per share	<u>-</u>	<u>-</u>
Balance at June 30, 2006	<u>\$ 2,447,132</u>	<u>\$ 4,675,258</u>

See accompanying notes.

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

<u>Retained Earnings</u>	Accumulated Other <u>Comprehensive Income (Loss)</u>	<u>Treasury Stock</u>	<u>Total</u>
\$ 25,756,832	\$ 91,169	\$ (2,516,340)	\$ 36,499,448
3,512,179	-	-	3,512,179
-	(1,488,137)	-	<u>(1,488,137)</u>
			2,024,042
-	-	2,516,341	-
-	-	-	(1,535,235)
-	-	-	353,098
<u>(888,333)</u>	<u>-</u>	<u>-</u>	<u>(888,333)</u>
28,380,678	(1,396,968)	-	36,453,020
4,018,634	-	-	4,018,634
-	726,781	-	<u>(726,781)</u>
			4,745,415
-	-	-	(843,502)
-	-	-	423,285
-	-	-	1,575
<u>(910,220)</u>	<u>-</u>	<u>-</u>	<u>(910,220)</u>
31,489,092	(670,187)	-	39,869,573
4,004,199	-	-	4,004,199
-	(1,952,282)	-	<u>(1,952,282)</u>
-	-	-	2,051,917
-	-	-	(2,142,250)
-	-	-	213,972
<u>(897,087)</u>	<u>-</u>	<u>-</u>	<u>(897,087)</u>
\$ 34,596,204 =====	\$ (2,622,469) =====	\$ - =====	\$ 39,096,125 =====

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

NORTHEAST BANCORP AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended June 30, 2006, 2005 and 2004

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:			
Net income	\$ 4,004,199	\$ 4,018,634	\$ 3,512,179
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	1,226,413	1,301,600	961,938
Provision for losses on acquired assets	2,500	20,000	32,000
Provision made for deferred compensation	399,845	98,000	-
Write-down of available for sale securities	38,394	27,849	171,312
Write-down of non-marketable securities	42,257	96,931	341,544
Deferred income tax benefit	(323,220)	(197,522)	(294,737)
BOLI income	(366,939)	(330,700)	(379,635)
Depreciation of premises and equipment	1,048,529	711,339	625,602
Amortization of intangible assets	241,028	249,701	254,953
Net gain on sale of available for sale securities	(17,335)	(67,940)	(200,815)
Net gain on sales of loans	(308,777)	(233,027)	(682,795)
Net loss (gain) on disposals and sale of fixed assets	128,363	(59,719)	-
Gain on sale of deposits (note7)	(500,845)	-	(264,395)
Originations of loans held for sale	(26,390,343)	(11,730,861)	(27,134,263)
Proceeds from sale of loans held for sale	26,211,650	11,777,575	30,114,874
Other	21,962	(293,675)	442,996
Change in other assets and liabilities:			
Interest receivable	(123,669)	(361,720)	(260,581)
Other assets and liabilities	<u>106,976</u>	<u>631,272</u>	<u>(35,425)</u>
Net cash provided by operating activities	5,440,988	5,657,737	7,204,752
Cash flows from investing activities:			
Federal reserve stock purchased	(54,000)	(405,500)	-
Proceeds from redemption of Federal Home Loan Bank stock	1,146,200	-	-
Proceeds from the sale of available for sale securities	1,354,098	1,126,131	14,204,637
Purchases of available for sale securities	(25,311,089)	(22,862,781)	(47,429,152)
Proceeds from maturities and principal payments on available for sale securities	9,078,452	15,859,638	8,160,266
Net decrease (increase) in loans	24,855,095	(29,089,041)	(53,960,186)
Purchases of premises and equipment	(1,111,469)	(1,241,683)	(1,105,164)
Proceeds from sale of premises and equipment	-	481,794	15,153
Proceeds from sale of acquired assets	244,722	497,507	434,339
Other	-	(75,492)	-
Purchase of retirement annuity	-	(900,000)	-
Purchase of BOLI	-	(529,184)	-

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Cash paid in connection with acquisition of Solon-Anson Insurance Agency (note 6)	_____ -	_____ (993,469)	_____ -
Net cash provided (used) by investing activities	10,202,009	(38,132,080)	(79,680,107)
Cash flows from financing activities:			
Net increase in deposits	\$ 7,267,169	\$ 18,398,993	\$ 64,580,608
Cash paid on sale of deposits (note 7)	(7,691,669)	-	(5,239,432)
Advances from the Federal Home Loan Bank	105,000,000	33,000,000	17,500,000
Repayment of advances from the Federal Home Loan Bank	(115,309,004)	(24,403,032)	(23,449,936)
Net (repayments) advances on Federal Home Loan Bank overnight advances	-	(5,377,000)	2,332,000
Net (decrease) increase in repurchase agreements	(3,741,986)	8,494,543	8,782,451
Dividends paid	(897,087)	(910,220)	(888,333)
Company stock purchased	(2,142,250)	(698,812)	(1,535,235)
Issuance of common stock	213,972	280,170	353,098
Debt issuance costs paid	-	-	(120,000)
Proceeds from issuance of junior subordinated debentures	-	10,310,000	6,000,000
Repayment of junior subordinated debentures	-	(7,394,849)	-
Repayment on capital lease obligation	<u>(111,656)</u>	<u>-</u>	<u>-</u>
Net cash (used) provided by financing activities	<u>(17,412,511)</u>	<u>31,699,793</u>	<u>68,315,221</u>
Net decrease in cash and cash equivalents	(1,769,514)	(774,550)	(4,160,134)
Cash and cash equivalents, beginning of year	<u>13,873,235</u>	<u>14,647,785</u>	<u>18,807,919</u>
Cash and cash equivalents, end of year	\$ 12,103,721 =====	\$ 13,873,235 =====	\$ 14,647,785 =====
Supplemental schedule of cash flow information:			
Interest paid	\$ 16,872,352	\$ 13,214,688	\$ 11,830,290
Income taxes paid	2,220,561	2,017,222	1,799,868
Supplemental schedule of noncash investing and financing activities:			
Transfer from loans to acquired assets	\$ 173,800	\$ 570,339	\$ 408,166
Deconsolidation of NBN Capital Trusts, increase in other assets and junior subordinated debentures issued to affiliated trusts	-	-	407,851
Stock tendered in cashless stock option exercise	-	144,690	-
Change in valuation allowance for unrealized losses (gains) on available for sale securities, net of tax	1,952,282	(726,781)	1,488,137
Net change in deferred taxes for unrealized losses (gains) on available for sale securities	1,005,701	(374,404)	766,616

## Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Transfer from loan loss allowance to other liabilities for off balance sheet credit risk	204,086	-	-
Capital lease asset and related obligation	2,892,702	-	-

See note 6 for non-cash activities related to acquisition during fiscal 2005.

See accompanying notes.

Page 40

### NORTHEAST BANCORP AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2006, 2005 and 2004

##### **1. Summary of Significant Accounting Policies**

The accounting and reporting policies of Northeast Bancorp and Subsidiaries (the Company) conform to accounting principles generally accepted in the United States of America and general practice within the banking industry.

##### **Business**

Northeast Bancorp (the Company) is a Maine corporation and a bank holding company registered with the Federal Reserve Bank of Boston (FRB) under the Bank Holding Company Act of 1956. The Company provides a full range of banking services to individual and corporate customers throughout south-central and western Maine through its wholly-owned subsidiary, Northeast Bank (the Bank), a Maine state-chartered universal bank. Effective August, 2004, the Bank converted its charter to a state bank, and became a member of the Federal Reserve Bank of Boston. As a result, the Bank is no longer a federal savings and loan association subject to regulation by the Office of Thrift Supervision, but instead is subject to the joint regulatory oversight by the FRB and the State of Maine Bureau of Financial Institutions. The Bank's name was changed to Northeast Bank at conversion from Northeast Bank, FSB. The Bank is also subject to the regulations of the Federal Deposit Insurance Corporation (FDIC). The Bank faces vigorous competition from banks and other financial institutions.

##### **Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of Northeast Bancorp, and its wholly-owned subsidiary, Northeast Bank (including the Bank's wholly-owned subsidiary, Northeast Bank Insurance Group, Inc.). All significant intercompany transactions and balances have been eliminated in consolidation.

In December 2003, the Financial Accounting Standards Board (FASB) issued a revised FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* ("FIN 46R") which, in part, specifically addresses limited purpose trusts formed to issue trust preferred securities. FIN 46R establishes the criteria used to identify variable interest entities and to determine whether or not to consolidate a variable interest entity. In fiscal 2004, pursuant to the criteria established by FIN 46R, the Company deconsolidated three trusts which the Company had formed for the purposes of issuing trust preferred securities to unaffiliated parties and investing the proceeds from the sale thereof and the common securities of the trusts in junior subordinated debentures issued by the Company. The affiliated trusts are NBN Capital Trust, NBN Capital Trust II and NBN Capital Trust III. The result of the deconsolidation and the accounting for these entities was to recognize investments in these entities of approximately \$408,000 in the aggregate in other assets and to report the amount of junior subordinated debentures issued by the Company to such entities, rather than the related trust preferred securities, in the consolidated statement of financial condition which resulted in a \$408,000 increase in this liability. The adoption of FIN 46R did not have any additional impact on the Company's financial condition, results of operations, earnings per share or cash flows.

NBN Capital Trust, NBN Capital Trust II and NBN Capital Trust III are considered affiliates. Prior to the adoption of FIN 46R in 2004, these trusts were included in consolidation and were considered subsidiaries. (See note 19).

##### **Use of Estimates**

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the statement of financial condition and income and expenses for the period. Actual results could differ significantly from those estimates.



## Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses and a determination as to whether declines in the fair values below cost of investments is other-than-temporary.

In connection with the determination of the allowance for loan losses, management obtains independent appraisals for significant properties. A substantial portion of the Company's loans are secured by real estate in the State of Maine. Accordingly, the ultimate collectibility of a substantial portion of the Company's loan portfolio is susceptible to changes in market conditions in Maine.

In connection with the determination of whether fair value declines of investments are other-than-temporary, management investigates the underlying cause for the declines, the near term prospects for recovery and the Company's intent and ability to hold the investments.

### Cash and Cash Equivalents

For purposes of presentation in the consolidated statements of cash flow, cash and cash equivalents consist of cash and due from banks, Federal Home Loan Bank overnight deposits, federal funds sold and interest bearing deposits. The Company is required to maintain a certain reserve balance in the form of cash or deposits with the Federal Reserve Bank. At June 30, 2006, the reserve balance was approximately \$2,300,000.

Page 41

### Available for Sale Securities

Marketable equity securities and debt securities, which may be sold prior to maturity, are classified as available for sale and are carried at market value. Market value is determined based on bid prices published in financial newspapers or bid quotations received from securities dealers. Changes in market value, net of applicable income taxes, are reported as a separate component of stockholders' equity. When a decline in market value of a security is considered other-than-temporary, the loss is charged to other expense in the consolidated statements of income and is treated as a write-down of the security's cost. Realized gains and losses on the sale of securities are recognized on the trade date using the specific identification method.

### Non-marketable Investment Securities

The Company has a limited number of investments in enterprises that are not actively traded on a public exchange. These investments are carried at cost less other-than-temporary declines in fair value below cost. These investments are included in other assets in the consolidated statements of financial condition. The amount of such investments was approximately \$528,000 at June 30, 2006 and \$667,000 at June 30, 2005. These investments represent an ownership interest of less than 5% of the enterprise and the Company does not exercise significant influence over these entities. When a decline in fair value below cost of a non-marketable security is considered other-than-temporary, the loss is charged to other expense in the consolidated statements of income and is treated as a write-down of the security's basis. Fair values of non-marketable securities are based on discounted cash flows calculations prepared by management. The cash flows are estimates based on a combination of the anticipated return of capital projected from investment managers and the operating results of the underlying investments reported on a quarterly or more frequent basis to management. The fair values are calculated annually, or sooner if the operating results or other financial information indicates impairment has occurred. Based on management's assessment, there has been a decline in value below cost on certain non-marketable investments. Accordingly, the Company recorded write-downs of non-marketable securities of \$42,257, \$96,931 and \$341,544 in 2006, 2005 and 2004, respectively.

### Federal Home Loan Bank and Federal Reserve Bank Stock

Federal Home Loan Bank stock and Federal Reserve Bank stock are carried at cost. Each is a restricted investment.

### Loans Held for Sale and Mortgage Banking Activities

Loans originated for sale are specifically identified and carried at the lower of aggregate cost or fair value, estimated based on bid quotations from loan dealers. The carrying value of loans held for sale approximates the fair value at June 30, 2006 and 2005. Realized gains and losses on sale of loans are determined using the specific identification method and are reflected as gains on sale of loans in the consolidated statements of income.

The Company sells loans both on a servicing released and servicing retained basis. The Company recognizes as separate assets the rights to service mortgage loans for others, and performs an assessment of capitalized mortgage servicing rights for impairment based on the current fair value of those rights. The Company capitalizes mortgage servicing rights at their allocated cost (based on the relative fair values of the rights and the related loans) upon the sale of the related loans.

The Company's mortgage servicing rights asset at June 30, 2006 and 2005 was approximately \$303,000 and \$368,000, respectively, and is included in other assets in the consolidated statements of financial condition. The fair value of mortgage servicing rights exceeds their carrying value. Mortgage servicing rights are amortized over the estimated weighted average life of the loans. The Company's assumptions with respect to prepayments, which affect the estimated average life of the loans, are adjusted periodically to reflect current circumstances. The Company evaluates the estimated life and fair value of its servicing portfolio based on data which is disaggregated to reflect note rate, type and term on the underlying loans.

#### Loans

Loans are carried at the principal amounts outstanding plus net premiums paid and net deferred loan origination fees and costs. Loan origination fees and certain direct loan origination costs are deferred and recognized in interest income as an adjustment to the loan yield over the life of the related loans. Loan premiums paid to acquire loans are recognized as a reduction of interest income over the estimated life of the loans. Loans are generally placed on nonaccrual status when they are past due 90 days as to either principal or interest, or when in management's judgment the collectibility of interest or principal of the loan has been significantly impaired. When a loan has been placed on nonaccrual status, previously accrued and uncollected interest is reversed against interest on loans. A loan can be returned to accrual status when collectibility of principal is reasonably assured and the loan has performed for a period of time, generally six months. Loans are classified as impaired when it is probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status and collateral value.

#### Allowance for Loan Losses

The allowance for loan losses is established through a provision for loan losses charged to operations. Loan losses are charged against the allowance when management believes that the collectibility of the loan principal is unlikely. Recoveries on loans previously charged off are credited to the allowance.

Page 42

The allowance for loan losses represents management's estimate of probable losses inherent in the loan portfolio. This evaluation process is subject to numerous estimates and judgments. The frequency of default, risk ratings and the loss recovery rates, among other things, are considered in making this evaluation, as are the size and diversity of individual large credits. Larger balance, non-homogeneous loans representing significant individual credit exposures are evaluated based upon the borrower's overall financial condition, resources and payment record; the prospects for support from any financially responsible guarantors; and, if appropriate, the realizable value of any collateral. The allowance for loan losses attributed to these loans is established through a process that includes estimates of historical and projected default rates and loss severities; internal risk ratings; and geographic, industry, and other environmental factors. Management also considers overall portfolio indicators, including trends in internally risk-rated loans, classified loans, nonaccrual loans and historical and forecasted write-offs; and a review of industry, geographic, and portfolio concentrations, including current developments. In addition, management considers the current business strategy and credit process, including credit limit setting and compliance, credit approvals, loan underwriting criteria, and loan workout procedures. Each portfolio of smaller balance, homogeneous loans, including residential real estate and consumer loans, is collectively evaluated for impairment. The allowance for loan losses for these loans is established via a process that includes historical delinquency and credit loss experience, together with analyses that reflect current trends and conditions. Management also considers overall portfolio indicators including historical credit losses; delinquent, non-performing and classified loans; trends in volumes; terms of loans; an evaluation of overall credit quality and the credit process, including lending policies and procedures; and economic factors. Changes in these estimates could have a direct impact on the provision and could result in a change in the allowance.

Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, changing economic conditions and the economic prospects of the borrowers might necessitate future additions to the allowance. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

#### Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed by the straight-line and accelerated methods over the estimated useful lives of the assets. Premises and equipment under capital leases are amortized over the estimated useful lives of the assets or the respective lease terms, whichever is shorter. Maintenance and repairs are charged to expense as incurred and the cost of major renewals and betterments are capitalized. Premises and equipment are evaluated periodically for impairment. An assessment of recoverability is performed prior to any write-down of the asset. If circumstances suggest that their value may be impaired, then an expense would be charged in the then current period.

#### Income Taxes

## Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

### Acquired Assets

Acquired assets are carried at the lower of cost or fair value of the collateral less estimated selling expenses.

### Goodwill and Intangible Assets

Goodwill arising from the acquisition of a bank in prior years is deemed to have an indefinite useful life. The Company ceased amortization of goodwill on July 1, 2001, with the adoption of Statement of Financial Accounting Standard No. 142, *Goodwill and Other Intangible Assets*. Intangible assets include a noncompete agreement and customer lists which are being amortized on a straight-line basis over the estimated lives of the asset ranging from five to twelve years. The weighted average amortization period for intangibles subject to amortization is 10.76 years. Goodwill and intangible assets are reviewed annually for possible impairment, and if the assets are deemed impaired, an expense would be charged in the then current period. The estimated aggregate amortization expense for each of the five succeeding fiscal years is as follows: 2007 - \$246,000; 2008 - \$217,000; 2009 - \$199,000; 2010 - \$173,000; and 2011 - \$173,000.

### Advertising Expense

Advertising costs are expensed as incurred. Advertising costs were approximately \$492,000, \$336,000 and \$358,000 for the years ended June 30, 2006, 2005 and 2004, respectively.

### Stock-Based Compensation

The Company has stock-based employee compensation plans, which are described more fully in note 14. The Company adopted Statement of Financial Accounting Standard No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123-R"), effective for the fiscal year beginning July 1, 2005, superseding APB Opinion 25 and replacing FASB Statement No. 123. Prior to July 1, 2005, the Company utilized the intrinsic value methodology allowed by APB Opinion 25. SFAS 123-R requires companies to measure and record compensation expense for stock options and other share-based payments based on the instruments' fair value reduced by expected forfeitures. Under the modified prospective approach adopted by the Company, the Company recognizes expense for new options awarded and to awards modified, repurchased or canceled after the effective date. Since there were no new options granted (or modifications of existing options) during fiscal 2006 and since all previously granted options were fully vested at the grant date, adoption of SFAS 123-R had no impact on the 2006 financial statements.

Page 43

The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	Years Ended June 30,		
	2006	2005	2004
Net income, as reported	\$ 4,004,199	\$ 4,018,634	\$ 3,512,179
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	-	1,513	-
Pro forma net income	\$ 4,004,199	\$ 4,017,121	\$ 3,512,179

Earnings per share:

## Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Basic - as reported	\$ 1.61	\$ 1.60	\$ 1.38
	=====	=====	=====
Basic - pro forma	\$ 1.61	\$ 1.59	\$ 1.38
	=====	=====	=====
Diluted - as reported	\$ 1.59	\$ 1.57	\$ 1.35
	=====	=====	=====
Diluted - pro forma	\$ 1.59	\$ 1.57	\$ 1.35
	=====	=====	=====

The following table presents the weighted average fair value and related assumptions using the Black-Scholes option-pricing model for all stock options granted during the periods indicated. There were no stock options granted in fiscal 2006 and fiscal 2004.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Weighted average fair value	\$ -	\$ 1,513	\$ -
Dividend yield	-	2.8%	-
Expected volatility	-	24.3%	-
Risk-free interest rates	-	4.5%	-
Expected lives	-	8 years	-

### Bank-Owned Life Insurance

Bank-owned life insurance ("BOLI") represents life insurance on the lives of certain employees. Increases in the cash value of the policies, as well as insurance proceeds received, are recorded in other noninterest income, and are not subject to income taxes. The cash surrender value is included in assets. The Company reviews the financial strength of the insurance carriers prior to the purchase of BOLI and annually thereafter.

### Comprehensive Income

Accumulated other comprehensive income or loss consists solely of unrealized gains or losses on investment securities available for sale, net of related income taxes.

### Derivatives

The Company accounts for derivatives in accordance with Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, which requires the Company to recognize all derivatives on the statement of financial condition at fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives are either offset against the change in fair value of assets, liabilities or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value will be immediately recognized in earnings.

The Company has only limited involvement with derivative financial instruments and they are used for trading and hedging purposes. The derivative financial instruments used by the Company are covered call and put contracts on its equity securities portfolio and certain residential mortgage loan commitments for resale into the secondary market. The total value of securities under call and put contracts and commitments to originate residential mortgage loans for resale at June 30, 2006, 2005 and 2004, which are not used as a hedge but are classified as trading, is immaterial to the Company's financial position, liquidity, and results of operations.

Page 44

### Trust Assets

Assets of the Company's trust department are not included in these consolidated financial statements because they are not assets of the Company. As of June 30, 2006, total assets held in trust for customers, for which the Company has fiduciary responsibility, amounted to approximately \$83,758,000.

### Treasury Stock

On July 1, 2003, the Maine Business Corporation Act became effective. This Act eliminated the concept of treasury stock, instead providing that shares of its stock acquired by the Company simply constitute authorized but unissued shares. Accordingly, all stock held by the Company as

## Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

treasury stock has been reclassified as authorized but unissued stock in accordance with the Act.

### Reclassifications

Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

### New Accounting Pronouncements

During 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 155, an amendment of FASB Statements No. 133 and 140, *Accounting for Certain Hybrid Financial Instruments*, and No. 156, *Accounting for Servicing of Financial Assets*, an amendment of FASB Statement No. 140. Both Statements become effective for the Company in fiscal 2007. Neither Statement is expected to have a significant impact on the Company's reported financial condition or results of operations.

### 2. Available for Sale Securities

A summary of the cost and approximate market values of available for sale securities at June 30, 2006 and 2005 follows:

	<u>2006</u>		<u>2005</u>	
	<u>Cost</u>	<u>Market Value</u>	<u>Cost</u>	<u>Market Value</u>
Debt securities issued by U.S.				
Government-sponsored enterprises	\$ 25,766,682	\$ 24,694,409	\$ 26,271,307	\$ 25,762,186
Mortgage-backed securities	50,618,118	48,126,031	46,647,228	46,153,494
Municipal bonds	11,075,274	10,770,167	-	-
Corporate bonds	500,000	477,520	500,000	493,085
Equity securities	<u>2,151,072</u>	<u>2,069,580</u>	<u>1,942,837</u>	<u>1,937,173</u>
	 \$ 90,111,146	 \$ 86,137,707	 \$ 75,361,372	 \$ 74,345,938
	=====	=====	=====	=====

The gross unrealized gains and unrealized losses on available for sale securities are as follows:

	<u>2006</u>		<u>2005</u>	
	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>
Debt securities issued by U. S.				
Government-sponsored enterprises	\$ -	\$ 1,072,273	\$ 7,891	\$ 517,012
Mortgage-backed securities	2,289	2,494,376	48,517	542,251
Municipal bonds	-	305,107	-	-
Corporate bonds	-	22,480	-	6,915
Equity securities	<u>22,809</u>	<u>104,301</u>	<u>34,668</u>	<u>40,332</u>
	 \$ 25,098	 \$ 3,998,537	 \$ 91,076	 \$ 1,106,510
	=====	=====	=====	=====

At June 30, 2006, mortgage-backed and U.S. Government-sponsored enterprise securities with a market value of approximately \$70,496,000 were pledged as collateral to secure outstanding repurchase agreements, FHLB advances and other purposes.

The following summarizes the Company's gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2006.

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

	<u>Less than 12 Months</u>		<u>More than 12 Months</u>		<u>Total</u>	
	<u>Market Value</u>	<u>Unrealized Losses</u>	<u>Market Value</u>	<u>Unrealized Losses</u>	<u>Market Value</u>	<u>Unrealized Losses</u>
U.S. Government-sponsored enterprises	\$ 386,175	\$ 14,198	\$24,308,234	\$1,058,075	\$24,694,409	\$1,072,273
Mortgage-backed securities	17,932,793	569,232	29,999,499	1,925,144	47,932,292	2,494,376
Municipal bond	10,055,167	305,107	-	-	10,055,167	305,107
Corporate bond	-	-	477,520	22,480	477,520	22,480
Equity securities	<u>1,550,030</u>	<u>92,476</u>	<u>79,725</u>	<u>11,825</u>	<u>1,629,755</u>	<u>104,301</u>
	\$ 29,924,165	\$ 981,013	\$ 54,864,978	\$ 3,017,524	\$ 84,789,143	\$ 3,998,537
	=====	=====	=====	=====	=====	=====

Page 45

Unrealized losses within U.S. Government-sponsored enterprises of \$1,072,273 consist of thirteen individual debt securities issued by the FHLB, FHLMC and FNMA of which twelve securities have had continuous losses for more than one year. Unrealized losses within the mortgage-backed securities category of \$2,494,376 consist of twenty-six individual debt securities, of which sixteen securities have had continuous losses for more than one year. Unrealized losses within the municipal bond category of \$305,107 consist of thirty-two individual debt securities, all of which have had continuous losses of less than a year. The primary cause for unrealized losses within the above investment categories is the impact movements in market interest rates have had in comparison to the underlying yields on these securities, and normal market fluctuations. Unrealized losses within the equity security category of \$104,301 consist of fifty-eight individual equity securities, of which seven have had continuous losses for more than one year.

The following summarizes the Company's gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2005.

	<u>Less than 12 Months</u>		<u>More than 12 Months</u>		<u>Total</u>	
	<u>Market Value</u>	<u>Unrealized Losses</u>	<u>Market Value</u>	<u>Unrealized Losses</u>	<u>Market Value</u>	<u>Unrealized Losses</u>
U.S. Government-sponsored enterprises	\$ 9,597,766	\$ 70,143	\$15,756,908	\$ 446,869	\$25,354,674	\$ 517,012
Corporate bond	493,085	6,915	-	-	493,085	6,915
Mortgage-backed securities	26,299,153	134,058	12,974,563	408,193	39,273,716	542,251
Equity securities	<u>594,302</u>	<u>40,332</u>	<u>-</u>	<u>-</u>	<u>594,302</u>	<u>40,332</u>
	\$ 36,984,306	\$ 251,448	\$ 28,731,471	\$ 855,062	\$ 65,715,777	\$ 1,106,510
	=====	=====	=====	=====	=====	=====

Unrealized losses within U.S. Government-sponsored enterprises of \$517,012 consist of thirteen individual debt securities issued by the FHLB, FHLMC and FNMA of which eight securities have had continuous losses for more than one year. Unrealized losses within the mortgage-backed securities category of \$542,251 consist of fifteen individual debt securities, of which thirteen securities have had continuous losses for more than one year. The primary cause for unrealized losses within the above investment categories is the impact movements in market interest rates have had in comparison to the underlying yields on these securities, and normal market fluctuations. Unrealized losses on equity securities consist of forty-six equity securities that have been in a loss position for less than one year.

Management of the Company, in addition to considering current trends and economic conditions that may affect the quality of individual securities within the Company's investment portfolio, also considers the Company's ability and intent to hold such securities to maturity or recovery of cost. Management does not believe any of the Company's available for sale securities are other-than-temporarily impaired at June 30, 2006 or 2005, except as discussed below.

Based on management's assessment of available for sale securities, there has been more than a temporary decline in market value of certain equity securities. During the years ended June 30, 2006, 2005 and 2004, write-downs of available for sale securities were \$38,394, \$27,849 and \$171,312, respectively, and are included in other expense in the consolidated statements of income.

Included in accumulated other comprehensive loss as an adjustment to stockholders' equity are the following:

2006

2005

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Net unrealized losses	\$ (3,973,439)	\$ (1,015,434)
Deferred tax effect	<u>1,350,970</u>	<u>345,247</u>

Accumulated other comprehensive (loss) income	\$ (2,622,469)	\$ (670,187)
	=====	=====

The cost and market values of available for sale securities at June 30, 2006, by contractual maturity are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>Cost</u>	<u>Market Value</u>
Due one year or less	\$ 4,000,000	\$ 3,944,960
Due after one year through five years	17,884,659	17,106,005
Due after five years through ten years	2,990,309	2,868,150
Due after ten years	<u>12,466,988</u>	<u>12,022,981</u>
	37,341,956	35,942,096
Mortgage-backed securities (consisting of securities with interest rates ranging from 4.0% to 6.375% maturing November 2007 to September 2032)	50,618,118	48,126,031
Equity securities	<u>2,151,072</u>	<u>2,069,580</u>
	\$ 90,111,146	\$ 86,137,707
	=====	=====

Page 46

Realized gains and losses on sales of available for sale securities for the year ended June 30, 2006, were \$21,073 and \$3,738, respectively, for the year ended June 30, 2005, were \$72,238 and \$4,298, respectively, and for the year ended June 30, 2004, were \$215,572 and \$14,757, respectively.

### 3. Loans Receivable

The Company's lending activities are predominantly conducted in south-central and western Maine. However, the Company occasionally purchases residential mortgage loans in the open market out of this geographical area when management believes such purchases are prudent. The Company grants single-family and multi-family residential loans, commercial real estate loans, commercial loans and a variety of consumer loans. In addition, the Company grants loans for the construction of residential homes, multi-family properties, commercial real estate properties and for land development. The majority of loans granted by the Company are collateralized by real estate. The ability and willingness of residential and commercial real estate, commercial and construction loan borrowers to honor their repayment commitments is generally dependent on the health of the real estate sector in the borrowers' geographic area and/or the general economy. Also, the Company participates in indirect lending arrangements for automobile, equipment, mobile home and recreational vehicle loans. The Company's indirect lending activities are conducted throughout the State of Maine, but are concentrated in south-central and western Maine.

In the ordinary course of business, the Company has loan transactions with its officers, directors and their associates and affiliated companies ("related parties") at substantially the same terms as those prevailing at the time for comparable transactions with others. Such loans amounted to \$2,792,962 and \$3,309,289 at June 30, 2006 and 2005, respectively. In 2006, new loans and advances totaled \$573,262 and payments and reductions amounted to \$1,089,589. In 2005, new loans and advances granted to related parties totaled \$2,056,722, and payments and reductions amounted to \$1,166,063.

Included in the loan portfolio are unamortized premiums on purchased loans of approximately \$98,000 and \$132,000 at June 30, 2006 and 2005, respectively.

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Activity in the allowance for loan losses was as follows:

	<u>Years Ended June 30,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Balance at beginning of year	\$ 5,104,000	\$ 4,577,000	\$ 4,016,000
Provision charged to operating expenses	1,226,413	1,301,600	961,938
Transferred to off balance sheet credit risk reserve include in other liabilities	(204,086)	-	-
Loans charged off	(793,653)	(935,285)	(736,706)
Recoveries on loans previously charged off	<u>163,326</u>	<u>160,685</u>	<u>335,768</u>
Net loans charged off	<u>(630,327)</u>	<u>(774,600)</u>	<u>(400,938)</u>
Balance at end of year	\$ 5,496,000 =====	\$ 5,104,000 =====	\$ 4,577,000 =====

As shown above, during fiscal 2006 the Company transferred \$204,086, representing the portion of the allowance related to unfunded loans and commitments at the transfer date, to other liabilities.

Commercial and commercial real estate loans with balances greater than \$25,000 are considered impaired when it is probable that the Company will not collect all amounts due in accordance with the contractual terms of the loan. Loans that are returned to accrual status are no longer considered to be impaired. Certain loans are exempt from individual impairment evaluation, including large groups of smaller-balance homogenous loans that are collectively evaluated for impairment, such as consumer and residential mortgage loans and commercial loans with balances less than \$25,000.

The allowance for loan losses includes allowances related to loans that are identified as impaired, which are based on discounted cash flows using the loan's effective interest rate, the fair value of the collateral for collateral-dependent loans, or the observable market price of the impaired loan. When foreclosure is probable, impairment is measured based on the fair value of the collateral. Loans that experience insignificant payment delays (less than 60 days) or insignificant shortfalls in payment amounts (less than 10%) generally are not classified as impaired. Restructured loans are reported as impaired in the year of restructuring. Thereafter, such loans may be removed from the impaired loan disclosure if the loans were paying a market rate of interest at the time of restructuring and are performing in accordance with their renegotiated terms.

The Company recognizes interest on impaired loans on a cash basis when the ability to collect the principal balance is not in doubt; otherwise, cash received is applied to the principal balance of the loan.

The following table summarizes information about impaired loans at or for the years ended:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Impaired loans	\$ 7,128,111	\$ 2,190,143	\$ 2,050,454
Impaired loans with related allowances	5,950,923	810,543	928,211
Allowances on impaired loans	1,290,960	118,778	170,000
Average balance of impaired loans during the year	4,584,621	1,760,925	899,853
Interest recognized on impaired loans	71,400	85,900	-

Impaired loans at June 30, 2006 include loans totaling \$2,544,000 which were current as to both principal and interest payments at that date, but which were considered impaired based on current estimates of collateral valuation.



## Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Loans on nonaccrual status, including certain impaired loans described above, at June 30, 2006 and 2005, totaled approximately \$5,195,000 and \$1,698,000, respectively. Interest income that would have been recorded under the original terms of such loans, net of interest income actually recognized for the years ended June 30, 2006, 2005 and 2004, totaled approximately \$158,000, \$35,000 and \$65,000 respectively. The Company has no material outstanding commitments to lend additional funds to customers whose loans have been placed on nonaccrual status or the terms of which have been modified.

The Company was servicing, for others, loans of approximately \$54,829,000, \$61,320,000 and \$69,462,000 at June 30, 2006, 2005 and 2004, respectively.

#### 4. Premises and Equipment

Premises and equipment at June 30, 2006 and 2005, are summarized as follows:

	<u>2006</u>	<u>2005</u>
Land	\$ 875,096	\$ 875,096
Buildings	1,790,720	1,913,105
Assets recorded under capital lease (note8)	2,892,702	-
Leasehold and building improvements	1,908,861	1,674,504
Furniture, fixtures and equipment	<u>5,245,108</u>	<u>5,244,651</u>
	12,712,487	9,707,356
Less accumulated depreciation	<u>5,396,606</u>	<u>5,200,242</u>
	\$ 7,315,881	\$ 4,507,114
Net premises and equipment	=====	=====

Depreciation of premises and equipment and amortization of capital lease, included in occupancy and equipment expense, was \$1,048,529, \$711,339 and \$625,602 for the years ended June 30, 2006, 2005 and 2004, respectively. The net carrying value of assets recorded under capital lease totaled \$2,715,926 at June 30, 2006.

#### 5. Acquired Assets

The following table summarizes the composition of acquired assets at June 30:

	<u>2006</u>	<u>2005</u>
Real estate properties acquired in settlement of loans and other acquired assets	\$ 12,000	\$ 109,312
Less allowance for losses	<u>1,616</u>	<u>20,666</u>
	<u>\$ 10,384</u>	<u>\$ 88,646</u>

Activity in the allowance for losses on acquired assets was as follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
--	-------------	-------------	-------------

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Balance at beginning of year	\$ 20,666	\$ 13,007	\$ 10,659
Provision for losses on acquired assets	2,500	20,000	32,000
Write-downs	<u>(21,550)</u>	<u>(12,341)</u>	<u>(29,652)</u>
	)	)	)
Balance at end of year	\$ 1,616	\$ 20,666	\$ 13,007
	=====	=====	=====

Page 48

6. Acquisition of Insurance Agency

On September 29, 2004, the Bank's wholly owned subsidiary, Northeast Financial Services, Inc ("NFS"), acquired 100% of the outstanding stock of Solon-Anson Insurance Agency, Inc. ("Solon-Anson"), headquartered in Rangeley, Maine. See the details of the purchase price below. In connection with the acquisition, NFS entered into certain compensation arrangements with the sellers. NFS purchased an annuity for \$900,000 to provide deferred compensation payments to the former owners. The annuity remains an asset of the Company and is included in other assets in the consolidated statement of financial position. These payments are contingent on meeting the conditions of their respective employment contracts, and are subject to a vesting schedule over the term of each employment contract. Compensation expense is being recorded over the vesting period, and the related liability totaled approximately \$498,000 at June 30, 2006. The acquisition of Solon-Anson Insurance Agency used purchase accounting and resulted in a customer list intangible asset of \$2,081,500, which will be amortized over twelve years. No goodwill was recognized. The results of operations of Solon-Anson have been included in the consolidated financial statements of the Company since the acquisition date. There is no pro-forma disclosure included because Solon-Anson was not considered a significant acquisition. The following is a summary of the assets and liabilities acquired and allocation of the purchase price.

Purchase price:		
Cash paid		\$ 993,469
Debt assumed		683,104
Other liabilities		<u>457,620</u>
	Total	\$ 2,134,193
		=====
Allocation:		
Customer list intangible asset		\$ 2,081,500
Office equipment		50,831
Other assets		<u>1,862</u>
	Total	\$ 2,134,193
		=====

This transaction added six insurance offices located in Anson, Auburn, Augusta, Mexico, Rangeley, and South Paris, Maine and 15,000 customers. This acquisition is part of the Company's plans to enhance sources of fee income.

Solon-Anson merged with NFS, with NFS being the surviving company, effective April 1, 2005. This had no impact on the financial position or results of operations of the Company. On May 2, 2005, NFS changed its name to Northeast Bank Insurance Group, Inc.

7. Deposits

Deposits at June 30 are summarized as follows:

Weighted Average Rate at June 30, <u>2006</u>	<u>2006</u>		<u>2005</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Demand	0.00%	\$ 38,137,357	9.6%	\$ 39,854,720	10.1%
NOW	2.06	54,432,157	13.8	64,386,939	16.3
Money market	2.22	9,430,378	2.4	17,142,325	4.3
Regular savings	0.76	24,247,324	6.1	29,807,392	7.5
Certificates of deposit and brokered time deposits:					
Less than 1.00%	0.75	150,855	0.0	150,097	0.0
1.00 - 3.75%	3.26	56,262,927	14.2	200,317,648	50.6
3.76 - 5.75%	4.55	212,373,529	53.8	43,973,486	11.1
5.76 - 7.75%	6.07	<u>258,850</u>	<u>0.1</u>	<u>586,115</u>	<u>0.1</u>
	3.65%	\$ 395,293,377	100.0%	\$ 396,218,722	100.0%
	=====	=====	=====	=====	=====

The scheduled maturities of certificates of deposit and brokered time deposits for the twelve months ended June 30, respectively, are as follows:

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Thereafter</u>
Less than 1.00%	\$ 150,855	\$ -	\$ -	\$ -	\$ -	\$ -
1.00-3.75%	44,557,246	8,021,553	3,684,128	-	-	-
3.76-5.75%	147,506,705	41,751,390	7,040,406	12,589,783	3,274,656	210,589
5.76-7.75%	<u>228,708</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>30,142</u>	<u>-</u>
	\$ 192,443,514	\$ 49,772,943	\$ 10,724,534	\$ 12,589,783	\$ 3,304,798	\$ 210,589
	=====	=====	=====	=====	=====	=====

Page 49

Interest expense on deposits for the years ended June 30, 2006, 2005 and 2004 is summarized as follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
NOW	\$ 1,065,675	\$ 808,762	\$ 650,203
Money market	246,283	212,744	179,462
Regular savings	227,830	230,201	244,789
Certificates of deposit and brokered time deposits	<u>9,612,518</u>	<u>7,373,091</u>	<u>5,491,811</u>
	\$ 11,152,306	\$ 8,624,798	\$ 6,566,265
	=====	=====	=====

In the fourth quarter of fiscal year 2006, the Company sold the deposits of its Lisbon Falls, Maine branch and the branch was closed. The deposits sold totaled approximately \$8,908,000. The Company recognized a gain on sale of deposits of \$500,845 from this transaction, which is included in other income in the 2006 consolidated statement of income.

In fiscal year 2004, the Company sold the deposits of its Richmond, Maine branch and the branch was closed. The deposits sold totaled approximately \$5,518,000. The Company recognized a gain on sale of deposits of \$264,395 from this transaction, which is included in other income in the 2004 consolidated statement of income.

**8. Borrowings**

Federal Home Loan Bank

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

A summary of advances from the Federal Home Loan Bank of Boston are as follows:

<u>Principal Amounts</u>	<u>June 30, 2006</u>	<u>Maturity Dates</u>
	<u>Interest Rates</u>	
\$ 34,831,900		2.22%
- 5.31%		
	2007	
	31,056,698	2.68
- 5.68		
	2008	
	5,000,000	4.88
- 4.88		
	2009	
	<u>5,000,000</u>	4.81
- 4.99		
	2011	
	\$ 75,888,598	
	=====	

---

<u>June 30, 2005</u>
<u>Principal Amounts</u>
<u>Interest Rates</u>
<u>Maturity Dates</u>

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

\$ 49,309,004

2.08%

- 6.79%

2006

13,831,915

2.22

- 3.57

2007

16,056,683

2.68

- 5.68

2008

7,000,000

4.50

- 4.99

2011

\$ 86,197,602

=====

At June 30, 2006, FHLB advances of \$18,000,000 are subject to call provisions and may be called prior to the stated maturity.

Certain mortgage loans, free of liens, pledges and encumbrances and certain investment securities maintained at the FHLB not otherwise pledged have been pledged under a blanket agreement to secure these advances. The Company is required to own stock of the Federal Home Loan Bank of Boston in order to borrow from the Federal Home Loan Bank.

As of June 30, 2006, the Company had a \$2,103,000 line of credit arrangement with the FHLB which was fully available. Also at June 30, 2006, the Company had approximately \$37,565,000 of additional capacity to borrow from the FHLB for long-term advances.

Capital Lease Obligations

During fiscal 2006, the Company recognized a capital lease obligation for its new headquarters known as the Southern Gateway building located at 500 Canal Street in Lewiston, Maine. The present value of the lease payments over fifteen years (\$264,262 per year for each of the initial ten years of the lease term and \$305,987 per year for each of the last five years) exceeded 90% of the fair value of the Southern Gateway building. Northeast Bank's commercial lending and underwriting, consumer loan underwriting, loan servicing, deposit operations, accounting, human resources, risk management, and executive administration departments occupy the approximately 27,000 square feet of space.

## Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

The future minimum lease payments over the remaining terms of the lease and the outstanding capital lease obligation at June 30, 2006 are as follows:

2007		\$ 264,262
2008		264,262
2009		264,262
2010		264,262
2011		264,262
2012 and after		<u>2,609,109</u>
	Total minimum lease payments	3,930,419
Less imputed interest		<u>1,149,373</u>
	Capital lease obligation	\$ 2,781,046
		=====

### Fed Discount Window Borrower-in-Custody Program

The Bank also has a secured line of credit of \$30,288,974 through the Fed Discount Window Borrower-in-Custody program. The Bank pledged \$37,861,218 of its indirect auto loan portfolio as collateral for this line of credit. If used, interest is based upon the current federal funds rate plus 1.00%. There were no outstanding balances under this line of credit at June 30, 2006.

### **9. Securities Sold Under Repurchase Agreements**

During 2006 and 2005, the Company sold securities under agreements to repurchase. The weighted average interest rate on repurchase agreements was 3.79% and 1.48% at June 30, 2006 and 2005, respectively. These borrowings, which were scheduled to mature the next business day, were collateralized by mortgage-backed and U.S. Government-sponsored enterprise securities with a market value of \$33,112,000 and amortized cost of \$34,893,000 at June 30, 2006 and a market value of \$34,816,000 and amortized cost of \$35,400,000 at June 30, 2005. The average balance of repurchase agreements was \$31,427,133 and \$30,572,422 during the years ended June 30, 2006 and 2005, respectively. The maximum amount outstanding at any month-end during 2006 and 2005 was \$37,237,000 and \$36,506,000, respectively. Securities sold under these agreements were under the control of the Company throughout 2006 and 2005.

### **10. Capital and Regulatory Matters**

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Company and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The prompt corrective action regulations define specific capital categories based on an institution's capital ratios. The capital categories, in declining order, are "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized."

As of June 30, 2006 and 2005, the most recent notification from the Company's and the Bank's regulators categorized the Company and the Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Company and the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 capital as set forth in the table below. There are no conditions or events since that notification that management believes have changed the institution's category.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios as set forth in the table below. At June 30, 2006 and 2005, the Company and the Bank ratios exceeded the regulatory requirements. Management believes that the Company and the Bank meet all capital adequacy requirements to which they were subject as of June 30, 2006 and 2005.

The following tables illustrate the actual and required amounts and ratios for the Company at the dates indicated.

For Capital	To Be "Well Capitalized" Under Prompt Corrective
-------------	--

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

	<u>Actual</u>		<u>Adequacy Purposes</u>		<u>Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
(Dollars in Thousands)						
As of June 30, 2006:						
Northeast Bancorp:						
Total capital to risk weighted assets	\$60,940	14.52%	≥	≥	≥	≥
			\$33,582	8.0%	\$41,981	10.0%
Tier 1 capital to risk weighted assets	52,252	12.45	≥	≥	≥	≥
			\$16,793	4.0	\$25,189	6.0
Tier 1 capital to total average assets	52,252	9.32	≥	≥	≥	≥
			\$22,437	4.0	\$28,047	5.0
As of June 30, 2005:						
Northeast Bancorp:						
Total capital to risk weighted assets	\$59,395	13.54%	≥	≥	≥	≥
			\$35,082	8.0%	\$43,852	10.0%
Tier 1 capital to risk weighted assets	51,085	11.65	≥	≥	≥	≥
			\$17,541	4.0	\$26,311	6.0
Tier 1 capital to total average assets	51,085	8.85	≥	≥	≥	≥
			\$23,081	4.0	\$28,852	5.0

Page 51

The following tables illustrate the actual and required amounts and ratios for the Bank at the dates indicated.

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be "Well Capitalized" Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
(Dollars in Thousands)						
As of June 30, 2006:						
Northeast Bank:						
Total capital to risk weighted assets	\$56,088	13.44%	≥	≥	≥	≥
			\$33,395	8.0%	\$41,743	10.0%
Tier 1 capital to risk weighted assets	50,864	12.18	≥	≥	≥	≥
			\$16,697	4.0	\$25,046	6.0
Tier 1 capital to total average assets	50,864	9.07	≥	≥	≥	≥
			\$22,426	4.0	\$28,032	5.0

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

As of June 30, 2005:

Northeast Bank:

Total capital to risk weighted assets	\$52,235	11.97%	≥	≥	≥	≥
				\$34,901	8.0%	\$43,627
Tier 1 capital to risk weighted assets	47,131	10.80	≥	≥	≥	≥
				\$17,451	4.0	\$26,176
Tier 1 capital to total average assets	47,131	8.20	≥	≥	≥	≥
				\$22,979	4.0	\$28,724
						5.0

The Bank may not declare or pay a cash dividend on, or repurchase, any of its capital stock from the Parent if the effect thereof would cause the capital of the Bank to be reduced below the capital requirements imposed by the regulatory authorities or if such amount exceeds the otherwise allowable amount under FRB rules (approximately \$8,092,000 was available at June 30, 2006).

The 2004 Stock Repurchase Plan was approved by the Board of Directors on January 16, 2004. It was extended by the Board of Directors on December 16, 2005 and will terminate on December 31, 2006. The repurchase program may be discontinued by Northeast Bancorp at any time. Under the 2004 Stock Repurchase Plan, the Company may purchase up to 200,000 shares of its common stock from time to time in the open market at prevailing prices. Common stock repurchased pursuant to the plan will be classified as authorized but un-issued shares of common stock available for future issuance as determined by the Board of Directors. From time to time, the Company believes that the current market price for its common stock makes the stock attractive as a use of the Company's funds and at such times purchases its common stock in the market. Total stock repurchases under the 2004 plan were 145,500 shares for \$3,204,092 through June 30, 2006. Total stock repurchases in fiscal 2006 were 90,200 shares for \$2,142,250 at an average price of \$23.75 per share. The remaining repurchase capacity of the 2004 Plan is 54,500 shares. Management believes that these and future purchases have not and will not have a significant impact on the Company's liquidity. The repurchases had a positive effect on earnings per share during 2006 and 2005, by reducing the number of common stock shares outstanding.

11. Earnings Per Common Share

Basic earnings per share (EPS) are computed by dividing net income available to common stockholders by the weighted average number of shares outstanding. The following table shows the weighted average number of shares outstanding for each of the last three years. Shares issuable relative to stock options granted have been reflected as an increase in the shares outstanding used to calculate diluted EPS, after applying the treasury stock method. The number of shares outstanding for basic and diluted EPS are presented as follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Average shares outstanding, used in computing Basic EPS	2,493,560	2,518,764	2,543,812
Dilutive effect of stock options	<u>32,535</u>	<u>44,781</u>	<u>61,098</u>
Average equivalent shares outstanding, used in computing Diluted EPS	2,526,095 =====	2,563,545 =====	2,604,910 =====

12. Other Expenses

Other expenses include the following for the years ended June 30, 2006, 2005 and 2004:

<u>2006</u>	<u>2005</u>	<u>2004</u>
-------------	-------------	-------------



Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Professional fees	\$ 620,914	\$ 658,334	\$ 435,197
Advertising expense	491,920	336,201	358,352
Write-down of non-marketable securities	42,257	96,931	341,544
Computer services and processing costs	580,995	472,154	330,535
Real estate owned expenses	4,666	8,117	6,079
Write-down of available for sale securities	38,394	27,849	171,312
Other	<u>2,437,829</u>	<u>2,751,766</u>	<u>2,440,425</u>
	\$ 4,216,975	\$ 4,351,352	\$ 4,083,444
	=====	=====	=====

Page 52

13. Income Taxes

The current and deferred components of income tax expense (benefit) were as follows for the years ended June 30, 2006, 2005 and 2004:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Federal:			
Current	\$ 2,089,538	\$ 1,965,463	\$ 1,859,264
Deferred	<u>(323,220)</u>	<u>(197,522)</u>	<u>(294,737)</u>
	1,766,318	1,767,941	1,564,527
State - current	<u>85,049</u>	<u>85,916</u>	<u>78,742</u>
	\$ 1,851,367	\$ 1,853,857	\$ 1,643,269
	=====	=====	=====

Total income tax expense is different from the amounts computed by applying the U.S. federal income tax rates in effect to income before income taxes. The reasons for these differences are as follows for the years ended June 30, 2006, 2005 and 2004:

	<u>2006</u>		<u>2005</u>		<u>2004</u>	
	<u>Amount</u>	<u>% of Pretax Income</u>	<u>Amount</u>	<u>% of Pretax Income</u>	<u>Amount</u>	<u>% of Pretax Income</u>
Expected income tax expense at federal tax rate	\$ 1,990,892	34.0%	\$ 1,996,646	34.0%	\$ 1,752,852	34.0%
State tax, net of federal tax benefit	56,132	1.0	56,705	1.0	51,970	1.0
Dividend received deduction	(30,634)	(0.5)	(34,310)	(0.6)	(32,916)	(0.6)
Non-taxable BOLI income	(112,829)	(1.9)	(93,278)	(1.6)	(129,076)	(2.5)
Other	<u>(52,194)</u>	<u>(0.9)</u>	<u>(71,906)</u>	<u>(1.3)</u>	<u>439</u>	<u>0.0</u>
	\$ 1,851,367	31.7%	\$ 1,853,857	31.5%	\$ 1,643,269	31.9%
	=====	=====	=====	=====	=====	=====

The tax effect of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at June 30, 2006 and 2005, are presented below:

2005 2005

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Deferred tax assets:

Loans, principally due to allowance for loan losses	\$ 1,882,000	\$ 1,735,000
Interest on nonperforming loans	54,000	29,000
Deferred gain on loan sales	4,000	12,000
Difference in tax and financial statement bases of investments	1,444,000	441,000
Difference in tax and financial statement amortization of goodwill and other intangible assets	313,000	297,000
Other	<u>321,000</u>	<u>208,000</u>

Total deferred tax assets	4,018,000	2,722,000
---------------------------	-----------	-----------

Deferred tax liabilities:

Mortgage servicing rights	(110,000)	(136,000)
Premises and equipment	(229,000)	(273,000)
Prepaid expenses	(143,000)	(109,000)
Other	<u>(3,000)</u>	<u>-</u>

Total deferred tax liabilities	<u>(485,000)</u>	<u>(518,000)</u>
--------------------------------	------------------	------------------

Net deferred tax assets, included in other assets	\$ 3,533,000	\$ 2,204,000
	=====	=====

The Company has sufficient refundable taxes paid in available carryback years to fully realize its recorded deferred tax assets. Accordingly, no valuation allowance has been recorded.

Page 53

In prior years, the Bank utilized the percentage of income bad debt deduction to calculate its bad debt expense for tax purposes as was then permitted by the Internal Revenue Code. Subsequent tax legislation required the Company to recapture a portion of its tax bad debt reserves. Except as stated below, the unrecaptured base year reserves will not be subject to recapture as long as the Bank continues to carry on the business of banking. However, the balance of the tax bad debt reserves is subject to provisions of present law that require recapture in the case of certain excess distributions to stockholders. For federal income tax purposes, the Company has designated approximately \$1,967,000 of net worth as a reserve for tax basis bad debts on loans. No deferred taxes have been provided for base year reserve recapture as management plans to avoid the events that would cause such recapture.

14. Employee Benefit Plans

401(k) Plan

The Company offers a contributory 401(k) plan which is available to all full-time salaried and hourly-paid employees who are regularly scheduled to work 1,000 hours or more in a Plan year, have attained age 18, and after completing 90 days of employment. Employees may contribute between 1% and 15% of their base compensation to which the Company will match 50% up to the first 6% contributed. For the years ended June 30, 2006, 2005 and 2004, the Company contributed \$181,729, \$186,649 and \$165,337, respectively.

The Company also has a profit sharing plan which covers substantially all full-time employees. Contributions and costs are determined as a percent of each covered employee's salary and are at the Board of Directors' discretion. There were no discretionary contributions in 2006, 2005 or 2004.

Stock Option Plans

The Company has adopted Stock Option Plans. Both "incentive stock options" and "nonqualified stock options" may be granted pursuant to the Stock Option Plans. Under the Stock Option Plans, incentive stock options may only be granted to employees of the Company and nonqualified stock options may be granted to employees and directors. All options granted under the Stock Option Plans will be required to have an exercise

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

price per share equal to at least the fair market value per share of common stock on the date the option is granted. Options immediately vest upon being granted. The options are exercisable for a maximum of ten years after the options are granted in the case of all incentive stock options and five years after the grant date for nonqualified stock options.

In accordance with the Stock Option Plans, a total of 383,000 shares of unissued common stock were reserved for granting. At June 30, 2006, a total of 178,500 shares remained available to be granted.

A summary of the qualified and nonqualified stock option activity for the years ended June 30 follows:

	<u>2006</u>		<u>2005</u>		<u>2004</u>	
	<u>Shares</u>	<u>Weighted-Average Exercise Price</u>	<u>Shares</u>	<u>Weighted-Average Exercise Price</u>	<u>Shares</u>	<u>Weighted-Average Exercise Price</u>
Outstanding at beginning of year	71,500	\$ 12.31	108,875	\$ 11.79	146,000	\$ 11.26
Granted	-	-	1,000	12.75	-	-
Exercised	(17,500)	12.23	(37,875)	11.18	(36,625)	9.58
Expired	<u>(1,500)</u>	<u>14.90</u>	<u>(500)</u>	<u>18.50</u>	<u>(500)</u>	<u>18.50</u>
Outstanding and exercisable at end of year	52,500	\$ 12.13	71,500	\$ 12.31	108,875	\$ 11.79
	=====	=====	=====	=====	=====	=====

The following table summarizes information about stock options outstanding at June 30, 2006:

<u>Range of Exercise Prices</u>	<u>Number Outstanding at June 30, 2005</u>	<u>Options Outstanding</u>		<u>Intrinsic Value</u>
		<u>Weighted-Average Remaining Contractual Life</u>	<u>Weighted-Average Exercise Price</u>	
\$8.00 to \$9.00	25,000	3.7	\$ 8.47	\$313,000
\$13.10	15,500	5.1	13.10	122,000
\$18.50	<u>12,000</u>	1.6	<u>18.50</u>	<u>30,000</u>
\$8.00 to \$18.50	52,500		\$12.13	\$465,000
	=====		=====	=====

Page 54

15. Commitments, Contingent Liabilities and Other Off-Balance Sheet Risks

The Company 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 and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of financial condition. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments with contract amounts which represent credit risk:

2006

2005

## Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

### Commitments to originate loans:

Residential real estate mortgages	\$ 5,810,000	\$ 7,510,000
Residential real estate mortgages held for sale	1,393,000	2,197,000
Commercial real estate mortgages, including multi-family residential real estate	10,985,000	5,684,000
Commercial business loans	<u>1,377,000</u>	<u>2,667,000</u>

	\$ 19,565,000	\$ 18,058,000
	=====	=====

Unused lines of credit	\$ 41,130,000	\$ 41,618,000
Standby letters of credit	1,538,000	3,332,000
Unadvanced portions of construction loans	2,375,000	5,245,000

Commitments to extend credit are agreements to lend to a customer as long as there is no 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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counter party. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties. As discussed in note 3, the Company has recorded an allowance for possible losses on commitments and unfunded loans totaling \$204,086 at June 30, 2006.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are issued to support private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

### Lease Obligations

The Company leases certain properties and equipment used in operations under terms of operating leases which include renewal options. Rental expense under leases approximated \$662,000, \$708,000 and \$505,000 for the years ended June 30, 2006, 2005 and 2004, respectively.

Approximate future minimum lease payments over the remaining terms of leases at June 30, 2006 are as follows:

2007	\$ 504,573
2008	240,768
2009	173,507
2010	172,156
2011	172,322
2012 and after	<u>2,218,863</u>

	\$ 3,482,189
	=====

### Legal Proceedings

The Company and its subsidiaries are parties to litigation and claims arising in the normal course of business. Management believes that the liabilities, if any, arising from such litigation and claims will not be material to the Company's consolidated financial position or results of operations.

Page 55

### 16. Condensed Parent Information

Condensed financial statements for Northeast Bancorp at June 30, 2006 and 2005, and for each of the years in the three year period ended June 30, 2006, are presented below.

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Balance Sheets

<u>Assets</u>	<u>June 30,</u>	
	<u>2006</u>	<u>2005</u>
Cash (primarily deposited with banking subsidiary)	\$ 615,784	\$ 3,279,426
Available for sale securities	833,971	667,214
Investment in banking subsidiary	50,194,825	48,676,098
Investment in common securities of affiliated trusts	496,000	496,000
Goodwill, net	407,897	407,897
Other assets	<u>3,127,862</u>	<u>2,913,218</u>

Total assets	\$ 55,676,339	\$ 56,439,853
	=====	=====

Liabilities and Stockholders' Equity

Junior Subordinated Debentures issued to affiliated trusts	\$ 16,496,000	\$ 16,496,000
Other liabilities	<u>84,214</u>	<u>74,280</u>

	16,580,214	16,570,280
--	------------	------------

Stockholders' equity	<u>39,096,125</u>	<u>36,869,573</u>
----------------------	-------------------	-------------------

Total liabilities and stockholders' equity	\$ 55,676,339	\$ 56,439,853
	=====	=====

Statements of Income

	<u>Years Ended June 30,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Income:			
Dividends from banking subsidiary	\$ 1,250,000	\$ 300,000	\$ 2,350,000
Other income	<u>147,233</u>	<u>175,715</u>	<u>26,534</u>
Total income	1,397,233	475,715	2,376,534
Expenses:			
Interest on Junior Subordinated Debentures paid to affiliated trusts	1,063,681	1,087,696	942,313
General and administrative expenses	<u>151,421</u>	<u>610,330</u>	<u>91,930</u>
Total expenses	<u>1,215,102</u>	<u>1,698,026</u>	<u>1,034,243</u>

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Income (loss) before income tax benefit and equity in undistributed net income of subsidiaries	182,131	(1,222,311)	1,342,291
Income tax expense (benefit)	<u>367,542</u>	<u>602,665</u>	<u>(267,830)</u>
Income (loss) before equity in undistributed net income of subsidiaries	549,673	(619,646)	1,610,121
Equity in undistributed net income of subsidiaries	<u>3,454,526</u>	<u>4,638,280</u>	<u>1,902,058</u>
Net income	\$ 4,004,199 =====	\$ 4,018,634 =====	\$ 3,512,179 =====

<u>Statements of Cash Flows</u>	<u>Years Ended June 30.</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:			
Net income	\$ 4,004,199	\$ 4,018,634	\$ 3,512,179
Adjustments to reconcile net income to net cash provided (used) by operating activities:			
Amortization	24,000	47,170	60,174
Undistributed earnings of subsidiaries	(3,454,526)	(4,638,280)	(1,902,058)
Write down on available for sale securities	33,404	27,849	-
Net gain on available for sale securities	(17,693)	(64,174)	-
Other	-	7,783	-
Increase in other assets	(230,154)	(883,669)	(268,736)
Increase (decrease) in other liabilities	<u>9,934</u>	<u>73,386</u>	<u>(432)</u>
Net cash provided (used) by operating activities	369,164	(1,411,301)	1,401,127
Cash flows from investing activities:			
Purchase of common securities of affiliated trusts	-	(310,000)	(186,000)
Increase in investment of bank subsidiary	-	(1,800,000)	-
Proceeds from the sale of securities of affiliated trusts	-	221,851	-
Available for sale securities transferred from the bank	-	(669,045)	-
Purchase of available for sale securities	(1,063,076)	(733,351)	-
Sales of available for sale securities	<u>855,635</u>	<u>748,615</u>	<u>-</u>
Net cash used by investing activities	(207,441)	(2,541,930)	(186,000)
Cash flows from financing activities:			
Issuance of common stock	213,972	280,170	353,098
Repayment of junior subordinate debentures	-	(7,394,849)	-
Company stock purchased	(2,142,250)	(698,812)	(1,535,235)
Dividends paid to stockholders	(897,087)	(910,220)	(888,333)
Payments for debt issuance costs	-	-	(120,000)
Proceeds from issuance of junior subordinated debentures to affiliated trusts	<u>-</u>	<u>10,310,000</u>	<u>6,186,000</u>

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Net cash (used) provided by financing activities	<u>(2,825,365)</u>	<u>1,586,289</u>	<u>3,995,530</u>
Net (decrease) increase in cash	(2,663,642)	(2,366,942)	5,210,657
Cash, beginning of year	<u>3,279,426</u>	<u>5,646,368</u>	<u>435,711</u>
Cash, end of year	\$ 615,784 =====	\$ 3,279,426 =====	\$ 5,646,368 =====
Supplemental schedule of cash flow information:			
Interest paid	\$ 1,039,681	\$ 1,087,696	\$ 942,313

Page 56

17. Other Comprehensive Income

The components of other comprehensive income (loss) for the years ended June 30, 2006, 2005 and 2004 are as follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Unrealized (losses) gains arising during the period, net of tax effect of \$997,265 in 2006, \$(339,093) in 2005 and \$756,585 in 2004	\$(1,935,868)	\$ 658,431	\$(1,468,665)
Reclassification adjustment for losses (gains) on investments, net of write-downs, included in net income, net of tax effect of \$8,456 in 2006, \$35,311 in 2005, and \$10,031 in 2004	<u>16,414</u>	<u>(68,350)</u>	<u>19,472</u>
Other comprehensive (loss) income	<u>\$(1,952,282)</u>	<u>\$ 726,781</u>	<u>\$(1,488,137)</u>

18. Segment Reporting

Northeast Bancorp through its banking subsidiary, Northeast Bank and its subsidiary, Northeast Bank Insurance Group, Inc., provides a broad range of financial services to individuals and companies in western and south-central Maine. These services include lending, demand, savings and time deposits, cash management, investment, insurance and trust services. While the Company's senior management team monitors the operations of the subsidiaries, the subsidiaries are primarily organized to operate in the banking industry. Substantially all income and services are derived from banking products and services in Maine. Accordingly, the Company's subsidiaries are considered by management to be aggregated in one reportable operating segment.

19. Junior Subordinated Debentures

NBN Capital Trust II and III were created in December 2003 and NBN Capital Trust IV was created December 2004. Each such trust is a Delaware statutory trust (together, the "Private Trusts"). The exclusive purpose of the Private Trusts was (i) issuing and selling Common Securities and Preferred Securities in a private placement offering, (ii) using the proceeds of the sale of the Private Trust Securities to acquire Junior Subordinated Deferrable Interest Notes ("Junior Subordinated Notes"); and (iii) engaging only in those other activities necessary, convenient, or incidental thereto. Accordingly the Junior Subordinated Notes are the sole assets of each of the Private Trusts.

The following table summarizes the junior subordinated debentures issued by the Company to each affiliated trust and the trust preferred and common securities issued by each affiliated trust at June 30, 2006 and 2005. Amounts include junior subordinated debentures acquired by the affiliated trusts from the Company with the capital contributed by the Company in exchange for the common securities of such trust. The trust preferred securities were sold in two separate private placement offerings. The Company has the right to redeem the junior subordinated debentures, in whole or in part, on or after March 30, 2009 for NBN Capital Trust II and III, and on or after February 23, 2010, for NBN Capital

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Trust IV at the redemption price specified in the Indenture plus any accrued but unpaid interest to the redemption date.

<u>Affiliated Trusts</u>	<u>Trust Preferred Securities</u>	<u>Common Securities</u>	<u>Junior Subordinated Debentures</u>	<u>Interest Rate</u>	<u>Maturity Date</u>
NBN Capital Trust II	\$ 3,000,000	\$ 93,000	\$ 3,093,000	8.30%	March 30, 2034
NBN Capital Trust III	3,000,000	93,000	3,093,000	6.50%	March 30, 2034
NBN Capital Trust IV	<u>10,000,000</u>	<u>310,000</u>	<u>10,310,000</u>	<u>5.88%</u>	February 23, 2035
Total	\$ 16,000,000	\$ 496,000	\$ 16,496,000	6.45%	
	=====	=====	=====	=====	

NBN Capital Trust II pays a variable rate based on three month LIBOR, NBN Capital Trust III pays a 6.50% fixed rate until March 30, 2009 when the rate changes to a variable rate based on three month LIBOR, and NBN Capital Trust IV pays a 5.88% fixed rate until February 23, 2010 when the rate changes to a variable rate based on three month LIBOR. Accordingly, the Preferred Securities of the Private Trusts currently pay quarterly distributions at an annual rate of 8.30% for the stated liquidation amount of \$1,000 per Preferred Security for NBN Capital Trust II, an annual rate of 6.50% for the stated liquidation amount of \$1,000 per Preferred Security for NBN Capital Trust III and an annual rate of 5.88% for the stated liquidation amount of \$1,000 per Preferred Security for NBN Capital Trust IV. The Company has fully and unconditionally guaranteed all of the obligations of each trust. The guaranty covers the quarterly distributions and payments on liquidation or redemption of the Private Trust Preferred Securities, but only to the extent of funds held by the trusts.

20. Fair Value of Financial Instruments

Fair value estimates, methods and assumptions are set forth below for the Company's significant financial instruments.

*Cash and Cash Equivalents* - The fair value of cash, due from banks, interest bearing deposits and FHLB overnight deposits approximates their relative book values, as these financial instruments have short maturities.

Page 57

Available for Sale Securities

- The fair value of available for sale securities is estimated based on bid prices published in financial newspapers or bid quotations received from securities dealers.

Federal Home Loan Bank and Federal Reserve Bank Stock

- These financial instruments do not have a market nor is it practical to estimate the fair value without incurring excessive costs.

Loans and Loans Held for Sale

- Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimates of maturity are based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic conditions, lending conditions and the effects of estimated prepayments.

Fair value for significant nonperforming loans is based on estimated cash flows and is discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and historical information.

Management has made estimates of fair value using discount rates that it believes to be reasonable. However, because there is no market for many of these financial instruments, management has no basis to determine whether the fair value presented would be indicative of the value negotiated in an actual sale.

The fair value of loans held for sale is estimated based on bid quotations received from loan dealers.



Interest Receivable

- The fair value of this financial instrument approximates the book value as this financial instrument has a short maturity. It is the Company's policy to stop accruing interest on loans past due by more than ninety days. Therefore this financial instrument has been adjusted for estimated credit loss.

Bank Owned Life Insurance (BOLI)

- The fair value of this financial instrument approximates its book value due to the nature of the asset. The book value approximates the cash surrender value.

Deposits

- The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW accounts and money market accounts, is equal to the amount payable on demand. The fair values of time deposits are based on the discounted value of contractual cash flows.

The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

The fair value estimates do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market. If that value was considered, the fair value of the Company's net assets could increase.

Borrowed Funds and Repurchase Agreements

- The fair value of the Company's borrowings with the Federal Home Loan Bank is estimated by discounting the cash flows through maturity or the next repricing date based on current rates available to the Company for borrowings with similar maturities.

The fair value of repurchase agreements approximates the carrying value, as these financial instruments have a short maturity.

Junior Subordinated Debentures

- The fair value of the Company's Junior Subordinated Debentures is estimated based on current interest rates.

Commitments to Originate Loans

- The Company has not estimated the fair value of commitments to originate loans due to their short term nature and their relative immateriality.

Limitations

- Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These values do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Other significant assets and liabilities that are not considered financial instruments include the deferred tax asset, premises and equipment and intangible assets, including the customer base. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

The following table presents the estimated fair value of the Company's significant financial instruments at June 30, 2006 and 2005:

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

	<u>Carrying Value</u>	<u>Estimated Fair Value</u>	<u>Carrying Value</u>	<u>Estimated Fair Value</u>
	(Dollars in Thousands)			
Financial assets:				
Cash and cash equivalents	\$ 12,104	\$ 12,104	\$ 13,873	\$ 13,873
Available for sale securities	86,138	86,138	74,346	74,346
Regulatory stock	5,958	5,958	7,050	7,050
Loans held for sale	681	703	319	319
Loans	430,167	437,196	455,948	464,567
Interest receivable	2,679	2,679	2,555	2,555
BOLI	8,895	8,895	8,563	8,563
Financial liabilities:				
Deposits (with no stated maturity)	126,247	126,247	151,191	151,191
Time deposits	269,046	266,685	245,028	244,458
Borrowed funds	75,889	75,457	86,198	86,957
Repurchase agreements	29,637	29,587	33,379	33,379
Junior Subordinated Debentures	16,496	15,034	16,496	16,496
Capital lease obligation	2,781	2,656	-	-

Page 59

**Item 8.b. Statistical Disclosures Required by Industry Guide 3**

**Table 1**

Northeast Bancorp Consolidated

Distribution of Assets, Liabilities and Net Worth (in thousands)

Interest Rates and Interest Differential

Years Ended June 30, 2006, 2005 and 2004

	<u>June 30, 2006</u>			<u>June 30, 2005</u>			<u>June 30, 2004</u>		
	Average Daily <u>Balance</u>	Interest Income/ <u>Expense</u>	Average Yield/ <u>Rate</u>	Average Daily <u>Balance</u>	Interest Income/ <u>Expense</u>	Average Yield/ <u>Rate</u>	Average Daily <u>Balance</u>	Interest Income/ <u>Expense</u>	Average Yield/ <u>Rate</u>
Assets:									
Interest earning-assets:									
Investment securities (1)	\$ 80,050	\$ 3,343	4.18%	\$ 69,451	\$ 2,715	3.91%	\$ 58,130	\$ 2,165	3.72%
Loans (2)(3)(4)	448,611	31,096	6.93%	453,379	29,104	6.42%	397,045	25,301	6.37%
Regulatory stock	6,919	336	4.86%	6,982	265	3.80%	6,645	174	2.62%
Short-term investments (5)	<u>3,588</u>	<u>134</u>	<u>3.73%</u>	<u>3,998</u>	<u>75</u>	<u>1.88%</u>	<u>3,133</u>	<u>20</u>	<u>0.64%</u>
Total interest-earning assets/interest income/average rates earned	<u>539,168</u>	<u>34,909</u>	<u>6.47%</u>	<u>533,810</u>	<u>32,159</u>	<u>6.02%</u>	<u>464,953</u>	<u>27,660</u>	<u>5.95%</u>
Noninterest earning assets:									
Cash & due from banks	8,845			11,948			11,651		
Bank premises and equipment, net	7,050			4,230			4,251		
Other assets (6)	19,816			18,512			16,020		
Allowance for loan losses	<u>(5,451)</u>			<u>(4,862)</u>			<u>(4,322)</u>		
Total noninterest earning assets	<u>30,260</u>			<u>29,828</u>			<u>27,600</u>		
Total assets	\$569,428			\$563,638			\$492,553		
	=====			=====			=====		

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Liabilities & net worth:

Interest-bearing liabilities:

Now	\$ 59,969	\$ 1,158	1.93%	\$ 65,761	\$ 809	1.23%	\$ 63,414	\$ 650	1.03%
Money market	13,093	246	1.88%	17,096	213	1.25%	15,900	179	1.13%
Savings	27,453	228	0.83%	29,056	230	0.79%	28,361	245	0.86%
Time	<u>255,599</u>	<u>9,520</u>	<u>3.72%</u>	<u>243,612</u>	<u>7,373</u>	<u>3.03%</u>	<u>192,814</u>	<u>5,492</u>	<u>2.85%</u>
Total interest-bearing deposits	356,114	11,152	3.13%	355,525	8,625	2.43%	300,489	6,566	2.19%
Repurchase agreements	31,427	928	2.95%	30,572	403	1.32%	25,052	280	1.12%
Borrowed funds	82,143	3,617	4.40%	82,542	3,851	4.67%	82,794	4,291	5.18%
Junior subordinated debentures	<u>16,496</u>	<u>1,064</u>	<u>6.45%</u>	<u>15,248</u>	<u>1,088</u>	<u>7.14%</u>	<u>10,640</u>	<u>942</u>	<u>8.85%</u>
Total interest-bearing liabilities/ interest expense/average rates paid	<u>486,180</u>	<u>16,761</u>	<u>3.45%</u>	<u>483,887</u>	<u>13,967</u>	<u>2.89%</u>	<u>418,975</u>	<u>12,079</u>	<u>2.88%</u>

Total noninterest bearing liabilities:

Demand deposits and escrow accounts	39,162			37,841			33,791		
Other liabilities	<u>3,827</u>			<u>3,237</u>			<u>2,810</u>		

Total liabilities 529,169 524,965 455,576

Stockholders' equity 40,259 38,673 36,977

Total liabilities and stockholders' equity \$569,428 \$563,638 \$492,553  
=====

Net interest income \$18,148 \$18,192 \$15,581  
=====

Interest rate spread 3.02% 3.13% 3.07%  
Net yield on interest earning assets (7) 3.37% 3.41% 3.35%

- (1) Taxable. The yield information does not give effect to changes in fair value that are reflected as a component of stockholders equity.
- (2) Non-accruing loans are included in computation of average balance, but unpaid interest on nonperforming loans has not been included for purposes of determining interest income.
- (3) Interest income on loans includes amortization of net deferred costs of \$946 in 2006, \$902 in 2005, and \$869 in 2004.
- (4) Includes Loans Held for Sale.
- (5) Short term investments include FHLB overnight deposits and other interest-bearing deposits.
- (6) Other assets includes BOLI of \$8,717 which contributed \$367 to fee revenue.
- (7) The net yield on average earning assets is net interest income divided by average interest-earning assets.

Page 60

**Table 2**  
Northeast Bancorp Consolidated  
Investment Securities Portfolio  
(\$ in thousands)

As of June 30,  
2006 2005 2004

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Available for sale (1)

Debt securities issued by U.S. Government-sponsored enterprises	\$ 24,694	\$ 25,762	\$ 24,746
Mortgage-backed securities	48,126	46,154	40,587
Municipal bonds	10,770	-	-
Other bonds	478	493	-
Equity securities	2,070	1,937	2,138
Total available for sale (2):	<u>\$ 86,138</u>	<u>\$ 74,346</u>	<u>\$ 67,471</u>

- (1) Carried at estimated market value. Northeast Bancorp does not have any securities classified as held to maturity.  
(2) Cost of such securities (\$ in thousands) was \$90,111 as of June 30, 2006, \$75,361 as of June 30, 2005 and \$69,588 as of June 30, 2004.

**Table 3**

Northeast Bancorp Consolidated  
Investment Maturity  
(\$ in thousands)

	<u>Within One Year</u>		<u>After One Year But Within 5 Years</u>		<u>After Five Years But Within 10 Years</u>		<u>After 10 Years</u>		<u>Total</u>	
	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>
Year Ended June 30, 2006										
U. S. Government sponsored enterprises	\$ -	0.00%	\$ 20,573	3.35%	\$ 2,868	4.85%	\$ 1,253	5.23%	\$ 24,694	3.62%
Mortgage-backed securities	-	0.00%	766	4.38%	23,872	4.19%	23,488	5.08%	48,126	4.63%
Municipal bonds (Tax equivalent yields)	-	0.00%	-	0.00%	-	0.00%	10,770	5.97%	10,770	5.97%
Other bonds	-	0.00%	478	4.05%	-	0.00%	-	0.00%	478	4.05%
Equity securities	<u>2,070</u>	<u>6.56%</u>	<u>-</u>	<u>0.00%</u>	<u>-</u>	<u>0.00%</u>	<u>-</u>	<u>0.00%</u>	<u>2,070</u>	<u>6.56%</u>
	<u>\$ 2,070</u>	<u>6.56%</u>	<u>\$ 21,817</u>	<u>3.41%</u>	<u>\$ 26,740</u>	<u>4.26%</u>	<u>\$ 35,511</u>	<u>5.36%</u>	<u>\$ 86,138</u>	<u>4.55%</u>
Year Ended June 30, 2005										
U. S. Government sponsored enterprises	\$ -	0.00%	\$ 21,433	3.40%	\$ 2,979	4.85%	\$ 1,350	5.23%	\$ 25,762	3.66%
Mortgage-backed securities	-	0.00%	1,127	4.38%	31,280	4.20%	13,747	4.70%	46,154	4.36%
Other bonds	-	0.00%	493	4.05%	-	0.00%	-	0.00%	493	4.05%
Equity securities	<u>1,937</u>	<u>7.28%</u>	<u>-</u>	<u>0.00%</u>	<u>-</u>	<u>0.00%</u>	<u>-</u>	<u>0.00%</u>	<u>1,937</u>	<u>7.28%</u>
	<u>\$ 1,937</u>	<u>7.28%</u>	<u>\$ 23,053</u>	<u>3.46%</u>	<u>\$ 34,259</u>	<u>4.26%</u>	<u>\$ 15,097</u>	<u>4.75%</u>	<u>\$ 74,346</u>	<u>4.19%</u>

No tax-exempt securities were carried in our investment portfolio prior to June 30, 2005.

Page 61

**Table 4**

Northeast Bancorp Consolidated  
Loan Portfolio  
(\$ in thousands)

As of	<u>June 30, 2006</u>		<u>June 30, 2005</u>		<u>June 30, 2004</u>	
	<u>Amount</u>	<u>Percent of Total Loans</u>	<u>Amount</u>	<u>Percent of Total Loans</u>	<u>Amount</u>	<u>Percent of Total Loans</u>
Loan portfolio:						
Residential real estate	\$ 149,100	34.44%	\$ 148,840	32.46%	\$ 138,031	32.10%
Commercial real estate	115,327	26.63%	125,899	27.46%	127,866	29.74%

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Construction	5,106	1.18%	12,201	2.66%	8,367	1.95%
Commercial	50,262	11.61%	68,716	14.99%	64,304	14.95%
Consumer and other	113,192	26.14%	102,865	22.43%	91,434	21.26%
Total loans	<u>432,987</u>	<u>100.00%</u>	<u>458,521</u>	<u>100.00%</u>	<u>430,002</u>	<u>100.00%</u>
Net deferred loan costs	2,676		2,531		2,592	
Less:						
Allowance for loan losses	5,496		5,104		4,577	
Net loans	<u>\$ 430,167</u>		<u>\$ 455,948</u>		<u>\$ 428,017</u>	
	=====		=====		=====	

As of	<u>June 30, 2003</u>		<u>June 30, 2002</u>	
	<u>Amount</u>	<u>Percent of Total Loans</u>	<u>Amount</u>	<u>Percent of Total Loans</u>
Loan portfolio:				
Residential real estate	\$ 125,437	33.33%	\$ 159,567	42.92%
Commercial real estate	97,854	26.00%	80,423	21.63%
Construction	7,201	1.92%	8,958	2.41%
Commercial	67,585	17.96%	48,535	13.06%
Consumer and other	78,235	20.79%	74,268	19.98%
Total loans	<u>376,312</u>	<u>100.00%</u>	<u>371,751</u>	<u>100.00%</u>
Net deferred loan costs	2,675		2,883	
Less:				
Allowance for loan losses	4,016		3,496	
Net loans	<u>\$ 374,971</u>		<u>\$ 371,138</u>	
	=====		=====	

**Table 5**

Northeast Bancorp Consolidated  
Maturities and Repricing of Loans (\$ in thousands)  
As of June 30, 2006

	<u>1 Year or Less</u>	<u>1 to 5 Years</u>	<u>5 to 10 Years</u>	<u>Over 10 Years</u>	<u>Total Loans</u>
Mortgages:					
Residential	\$ 38,790	\$ 27,294	\$ 22,319	\$ 60,697	\$ 149,100
Commercial	57,669	53,644	2,345	1,669	115,327
Construction	5,031	75	-	-	5,106
Non-mortgage loans:					
Commercial	24,879	24,493	890	-	50,262
Consumer and other	1,356	39,546	23,171	49,119	113,192
Total loans	<u>\$ 127,725</u>	<u>\$ 145,052</u>	<u>\$ 48,725</u>	<u>\$ 111,485</u>	<u>\$ 432,987</u>
	=====	=====	=====	=====	=====

Type of interest rate:	
Predetermined rate, maturity greater than 1 year	\$220,983
Floating or adjustable rate due after one year	84,279
Total due after 1 year:	<u>\$305,262</u>
	=====

Scheduled repayments are reported in the maturity category in which the payment is due. Demand loans and overdrafts are reported in one year or less. Maturities are based upon contract terms.

**Table 6**

Northeast Bancorp Consolidated  
Summary of Loan Losses Experience  
(\$ in thousands)

For Years Ended June 30,	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Average net loans outstanding during the period (1)	\$ 448,070	\$ 452,951	\$ 395,774	\$ 380,948	\$ 370,195
Net loans at end of period (1)	\$ 435,663	\$ 461,052	\$ 432,594	\$ 378,987	\$ 374,634
Allowance at beginning of period	\$ 5,104	\$ 4,577	\$ 4,016	\$ 3,496	\$ 3,778
Loans charged-off during the period:					
Residential real estate	15	67	142	120	69
Commercial real estate	35	7	124	22	413
Commercial	326	389	49	130	200
Consumer and other	417	472	422	699	650
Total loans charged-off	<u>793</u>	<u>935</u>	<u>737</u>	<u>971</u>	<u>1,332</u>
Recoveries on loans previously charged-off:					
Residential real estate	1	-	60	41	8
Commercial real estate	25	10	34	55	39
Commercial	6	41	120	166	60
Consumer and other	131	109	122	138	101
Total recoveries	<u>163</u>	<u>160</u>	<u>336</u>	<u>400</u>	<u>208</u>
Net loans charged off during the period	630	775	401	571	1,124
Provision for loan losses	1,226	1,302	962	1,091	842
Reclassified to off-balance sheet credit risk reserve	(204)	-	-	-	-
Allowance at end of period	\$ 5,496	\$ 5,104	\$ 4,577	\$ 4,016	\$ 3,496
Ratio of net charge-offs to average loans outstanding	0.14%	0.17%	0.10%	0.15%	0.30%
Allowance as a percentage of total loans	1.26%	1.11%	1.06%	1.06%	0.93%
Allowance as a percentage of non-performing and non-accrual loans (2)	105.79%	300.59%	272.93%	219.57%	298.55%

(1) Excludes loans held for sale.

(2) The increase in non-performing loans in fiscal 2006 caused the allowance as a percentage of non-performing and non-accrual loans to decrease compared to prior years.

Management believes that the allowance for loan losses is adequate.

For each period indicated, this table summarizes loans outstanding at the end of each period, the average amount of loans out outstanding, changes in the allowance for loan losses, and other selected statistics.

**Table 7**



Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Northeast Bancorp Consolidated  
 Non-performing Loans  
 (\$ in thousands)

	For Years Ended June 30,				
	2006	2005	2004	2003	2002
Non-accrual loans:					
Residential real estate	\$ 521	\$ 515	\$ 214	\$ 568	\$ 486
Commercial real estate	1,260	33	47	524	254
Commercial loans	1,423	3	85	28	183
Consumer and other	<u>109</u>	<u>60</u>	<u>101</u>	<u>76</u>	<u>161</u>
Total non-accrual loans	3,313	611	447	1,196	1,084
Current non-accrual loans (1)	<u>1,882</u>	<u>1,087</u>	<u>1,230</u>	<u>633</u>	<u>87</u>
Total non-performing loans (2)	5,195	1,698	1,677	1,829	1,171
Acquired assets	<u>10</u>	<u>89</u>	<u>39</u>	<u>97</u>	<u>587</u>
Total non-performing assets	\$ 5,205	\$ 1,787	\$ 1,716	\$ 1,926	\$ 1,758
	=====	=====	=====	=====	=====
Non-performing loans to total loans	1.19%	0.37%	0.39%	0.49%	0.31%
Non-performing assets to total assets	0.92%	0.31%	0.32%	0.41%	0.40%

As of June 30, 2006, there were no troubled debt restructured loans.

See additional information concerning non-performing and impaired loans in note 3 of the consolidated financial statements as well as in the Management's Discussion and Analysis.

- (1) As of June 30, 2006, comprised of commercial real estate loans of \$1,720 thousand, commercial loans of \$130 thousand and consumer loans of \$32 thousand.
- (2) Total non-performing loans increased in fiscal 2006 as compared to prior years primarily from commercial real estate and commercial loans. Loans past due 90 days or more and discretionary actions by management to place loans on non-accrual account for the increase in both portfolios. Estimated credit losses were included in the determination of the adequacy of the allowance for loan losses.

**Table 9**

Northeast Bancorp Consolidated  
 Average Deposits (\$ in thousands) and Rates

For Years Ended	June 30, 2006			June 30, 2005			June 30, 2004		
	Amount	Rate	% of Deposits	Amount	Rate	% of Deposits	Amount	Rate	% of Deposits
Average deposits:									
Noninterest bearing									
demand deposits	\$ 39,162	0.00%	9.91%	\$ 37,841	0.00%	9.62%	\$ 33,791	0.00%	10.11%
Regular savings	27,453	0.83%	6.95%	29,056	0.79%	7.39%	28,361	0.86%	8.48%
NOW and money market	73,062	1.92%	18.48%	82,857	1.23%	21.06%	79,314	1.05%	23.73%
Time deposits	255,599	3.72%	64.66%	243,612	3.03%	61.93%	192,814	2.85%	57.68%
Total average deposits	<u>\$ 395,276</u>	<u>2.82%</u>	<u>100.00%</u>	<u>\$ 393,366</u>	<u>2.19%</u>	<u>100.00%</u>	<u>\$ 334,280</u>	<u>1.97%</u>	<u>100.00%</u>
	=====	=====	=====	=====	=====	=====	=====	=====	=====

This table shows the average daily amount of deposits and average rates paid on such deposits for the periods indicated.

Page 65

**Table 10**

Northeast Bancorp Consolidated  
 Maturities of Time Deposits \$100,000 & Over  
 For Year Ended June 30, 2006



Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

(\$ in thousands)

	<u>Balance</u>
3 months or less	\$ 16,871
Over 3 through 6 months	7,819
Over 6 through 12 months	18,716
Over 12 months	21,100
Total time deposits \$100,000 & over	<u>\$ 64,506</u>

**Table 11**

Northeast Bancorp Consolidated  
Repurchase Agreements  
(\$ in thousands)

	<u>For Years Ended June 30,</u>					
	<u>2006</u>		<u>2005</u>		<u>2004</u>	
	<u>Balance</u>	<u>Weighted Rate</u>	<u>Balance</u>	<u>Weighted Rate</u>	<u>Balance</u>	<u>Weighted Rate</u>
Balance at year end	\$ 29,637	3.79%	\$ 33,379	1.48%	\$ 24,885	1.19%
Average outstanding during year	31,427	2.95%	30,572	1.32%	25,052	1.12%
Maximum outstanding at any month end	37,237		36,506		31,022	

These borrowings, which were scheduled to mature within 3 days, were collateralized by securities with the market value of \$33,112,000 and amortized cost of \$34,893,000 at June 30, 2006, a market value of \$34,816,000 and amortized cost of \$35,400,000 at June 30, 2005, and a market value of \$26,179,000 and amortized cost of \$27,144,000 at June 30, 2004. Securities sold under these agreements were under the control of the Company during 2006, 2005 and 2004.

**Table 12**

Northeast Bancorp Consolidated  
FHLB Advances Due in 1 Year or Less  
(\$ in thousands)

	<u>For Years Ended June 30,</u>					
	<u>2006</u>		<u>2005</u>		<u>2004</u>	
	<u>Balance</u>	<u>Weighted Rate</u>	<u>Balance</u>	<u>Weighted Rate</u>	<u>Balance</u>	<u>Weighted Rate</u>
Balance at year end	\$ 34,832	4.03%	\$ 49,309	4.85%	\$ 21,493	3.78%
Average outstanding during year	39,017	4.28%	41,339	5.03%	21,214	4.55%
Maximum outstanding at any month end	49,306		51,566		29,383	

This table shows the Federal Home Loan Advances the Company had due to mature in one year or less as of June 30, 2006, 2005 and 2004.

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

**Table 13**

Northeast Bancorp Consolidated  
Maturities and Repricing of Earning Assets & Interest-bearing Liabilities  
For Year Ended of June 30, 2006  
(\$ in thousands)

	Term to Repricing or Maturity				% of Total
	Less Than 1 Year	1-5 Years	Over 5 Years	Total	
Interest earning assets:					
Investment securities	\$ 2,070	22,992	61,076	86,138	16.30%
Regulatory stock	5,498		460	5,958	1.13%
Short-term investments (1)	3,211			3,211	0.61%
Mortgage loans:					
Residential real estate:					
Fixed rate loans	450	2,295	82,728	85,473	16.18%
Variable loans	38,340	24,999	288	63,627	12.04%
Commercial real estate	57,669	53,644	4,014	115,327	21.83%
Construction	5,031	75		5,106	0.97%
Other loans:					
Commercial	24,879	24,493	890	50,262	9.51%
Consumer and other	1,356	39,546	72,290	113,192	21.43%
Total loans	127,725	145,052	160,210	432,987	81.96%
Total interest-earning assets	\$ 138,504	168,044	221,746	528,294	100.00%
Interest-bearing liabilities:					
Customer deposits:					
NOW accounts	54,432			54,432	11.36%
Money market accounts	9,430			9,430	1.97%
Regular savings	24,247			24,247	5.06%
Certificates of deposit	193,069	75,766	211	269,046	56.15%
Total customer deposits	281,178	75,766	211	357,155	74.54%
Borrowings:					
Repurchase agreements	29,637			29,637	6.18%
Other borrowings	57,332	18,557		75,889	15.84%
Junior subordinated debentures	3,093	13,403	-	16,496	3.44%
Total borrowings	90,062	31,960	-	122,022	25.46%
Total interest-bearing liabilities	371,240	107,726	211	479,177	100.00%
Interest sensitivity gap	\$ (232,736)	60,318	221,535	49,117	
Cumulative gap	\$ (232,736)	(172,418)	49,117	49,117	
Cumulative gap ratio	37.31%	64.00%	110.25%	110.25%	

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Cumulative gap as a percentage of total assets	-41.34%	-30.63%	8.73%	8.73%
	=====	=====	=====	=====

(1) Includes FHLB overnight deposits, interest earning deposits and loans held for sale.

This table summarizes the anticipated maturities and repricing of the Company's earning assets and interest-bearing liabilities at June 30, 2006.

The Company's internal asset/liability analysis considers regular savings, NOW and money market accounts core deposits. Due to this consideration, the Company's internal asset/liability model has these core deposits designated in a five year or greater maturity category and not one year or less as the above schedule shows. Because of this difference, the Company does not consider its cumulative gap position to be as high of a negative amount as presented in the schedule above.

Page 67

**Table 14**

Northeast Bancorp Consolidated  
Quarterly Data (Unaudited)  
For Year Ended June 30, 2006

	1st Qtr Sept. 30 <u>2005</u>	2nd Qtr Dec. 31 <u>2005</u>	3rd Qtr Mar. 31 <u>2006</u>	4th Qtr June 30 <u>2006</u>
Interest income				
Interest on loans	\$ 7,827,133	\$ 7,844,011	\$ 7,635,409	\$ 7,789,382
Interest & dividends on investments & available for sale securities	<u>852,350</u>	<u>922,229</u>	<u>975,370</u>	<u>1,063,256</u>
Total interest and dividend income	<u>8,679,483</u>	<u>8,766,240</u>	<u>8,610,779</u>	<u>8,852,638</u>
Interest expense				
Interest on deposits	2,513,254	2,771,214	2,808,774	3,059,064
Interest on repurchase agreements	160,437	224,204	251,767	291,280
Interest on borrowings	1,008,655	775,365	856,253	976,658
Interest on trust preferred securities	<u>262,056</u>	<u>266,346</u>	<u>264,548</u>	<u>270,731</u>
Total interest expense	<u>3,944,402</u>	<u>4,037,129</u>	<u>4,181,342</u>	<u>4,597,733</u>
Net interest income	4,735,081	4,729,111	4,429,437	4,254,905
Provision for loan losses	<u>300,505</u>	<u>300,104</u>	<u>325,356</u>	<u>300,448</u>
Net interest income after provision for loan losses	4,434,576	4,429,007	4,104,081	3,954,457
Securities transactions	6,736	3,031	1,683	5,885
Other operating income	1,581,281	1,518,990	1,842,793	2,181,550
Other operating expense	<u>4,459,094</u>	<u>4,386,326</u>	<u>4,692,209</u>	<u>4,670,875</u>
Income before income taxes	1,563,499	1,564,702	1,256,348	1,471,017
Income tax expense	<u>521,402</u>	<u>493,506</u>	<u>382,607</u>	<u>453,852</u>
Net income	<u>\$ 1,042,097</u>	<u>\$ 1,071,196</u>	<u>\$ 873,741</u>	<u>\$ 1,017,165</u>
Earnings per share:				
Basic	\$ 0.41	\$ 0.42	\$ 0.35	\$ 0.43
Diluted	\$ 0.41	\$ 0.42	\$ 0.35	\$ 0.41

Edgar Filing: NORTHEAST BANCORP /ME/ - Form 10-K

Northeast Bancorp Consolidated  
 Quarterly Data (Unaudited)  
 For Year Ended June 30, 2005

	1st Qtr Sept. 30 <u>2004</u>	2nd Qtr Dec. 31 <u>2004</u>	3rd Qtr Mar. 31 <u>2005</u>	4th Qtr June 30 <u>2005</u>
Interest income				
Interest on loans	\$ 6,830,932	\$ 7,199,425	\$ 7,428,522	\$ 7,645,153
Interest & dividends on investments & available for sale securities	<u>736,969</u>	<u>752,850</u>	<u>707,650</u>	<u>857,481</u>
Total interest and dividend income	<u>7,567,901</u>	<u>7,952,275</u>	<u>8,136,172</u>	<u>8,502,634</u>
Interest expense				
Interest on deposits	1,973,528	2,102,444	2,175,502	2,373,324
Interest on repurchase agreements	79,399	101,311	112,369	110,460
Interest on borrowings	957,474	928,893	970,297	994,151
Interest on trust preferred securities	<u>281,151</u>	<u>301,056</u>	<u>249,286</u>	<u>256,203</u>
Total interest expense	<u>3,291,552</u>	<u>3,433,704</u>	<u>3,507,454</u>	<u>3,734,138</u>
Net interest income	4,276,349	4,518,571	4,628,718	4,768,496
Provision for loan losses	<u>300,137</u>	<u>299,984</u>	<u>400,554</u>	<u>300,925</u>
Net interest income after provision for loan losses	3,976,212	4,218,587	4,228,164	4,467,571
Securities transactions	(947)	34,881	32,071	1,852
Other operating income	1,164,886	1,392,970	1,578,503	1,461,915
Other operating expense	<u>3,753,814</u>	<u>4,534,355</u>	<u>4,203,748</u>	<u>4,192,257</u>
Income before income taxes	1,386,337	1,112,083	1,634,990	1,739,081
Income tax expense	<u>430,221</u>	<u>347,201</u>	<u>520,625</u>	<u>555,810</u>
Net income	<u>\$ 956,116</u>	<u>\$ 764,882</u>	<u>\$ 1,114,365</u>	<u>\$ 1,183,271</u>
Earnings per share:				
Basic	\$ 0.38	\$ 0.30	\$ 0.44	\$ 0.48
Diluted	\$ 0.37	\$ 0.30	\$ 0.44	\$ 0.46

Page 68

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable

Item 9A. Controls and Procedures

An evaluation was performed under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our internal controls and procedures over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) as of the end of the period covered by this annual report.

Management was responsible for establishing and maintaining adequate internal controls over financial reporting. We do not expect that our disclosure of controls and procedures will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only

reasonable, not absolute assurance that the control system's objective will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, errors, and instances of fraud, if any, within the Company have been or will be detected. The inherent limitations include, among other things, the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Controls and procedures also can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management or employee override of the controls and procedures. The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls and procedures may become inadequate because of changes in conditions or deterioration in the degree of compliance with its policies or procedures. Because of the inherent limitation in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. If and when management learns that any control or procedure is not being properly implemented (a) it immediately reviews its controls and procedures to determine whether they are appropriate to accomplish the control objective and, if necessary, modify and improve its controls and procedures to assure compliance with our control objectives, (b) it takes immediate action to cause its controls and procedures to be strictly adhered to, (c) it immediately informs all relevant personnel throughout our organization, and (d) it implements in its managers' training program specific emphasis on such controls and procedures throughout the Company to assure compliance with such controls and procedures. The development, modification, improvement, implementation and evaluation of our systems of controls and procedures is a continuous project that requires changes and modification to them to remedy deficiencies, to improve training, and to improve implementation in order to assure the achievement of the overall control objectives.

Based on their evaluation of disclosure controls and procedures, our Chief Executive Officer and Chief Financial Officer concluded, subject to the limitations described above, that our internal controls and procedures over financial reporting as of the end of the period covered by this report were effective.

There have been no significant changes in our internal controls, or in other factors that could significantly affect our internal controls, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

The Company is not subject to an attestation report from its registered public accounting firm until the fiscal year ended June 30, 2008. No attestation report on management's assessment of our internal controls over financial reporting is included in this annual report.

Item 9B. Other Information.

None.

Page 69

PART III

Item 10. Directors and Executive Officers of the Registrant.

The information required by Item 10 of Form 10-K with respect to our directors and executive officers is incorporated by reference from the information contained in the section captioned "Election of Directors" in the Company's definitive Proxy Statement for the 2006 Annual Meeting of Stockholders which will be filed with the Securities and Exchange Commission no later than

120 days after the close of the Company's 2006 fiscal year (the "2006 Proxy Statement"). Certain information with respect to executive officers is included in Part I, Item 4A of this report. The information required by Item 10 of Form 10-K with respect to compliance with Section 16(a) of the Securities Exchange Act of 1934 is incorporated by reference from the information contained in the section captioned "Section 16(a) Beneficial Ownership Reporting Compliance" in the 2006 Proxy Statement. Information regarding the information required by Item 406 of Regulation S-K is incorporated herein by reference from the information contained in the section captioned "Corporate Governance - Code of Ethics" in the 2006 Proxy Statement.

Item 11. Executive Compensation

The information required by Item 11 of Form 10-K is incorporated by reference from the information contained in the sections captioned "Election of Directors - Compensation of Directors," "Compensation of Executive Officers," "Report on Executive Compensation", "Compensation Committee Interlocks" and "Stock Price Performance Graph" in the 2006 Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholders

- (a) The information required by Item 12 of Form 10-K is incorporated by reference from the information contained in the section captioned "Security Ownership of Management and Certain Beneficial Owners" in the 2006 Proxy Statement
- (b) The following table provided information about the Company's Common Stock that may be issued upon the exercise of stock options under all of the registrant's equity compensation plans in effect as of June 30, 2006.

<u>Plan category</u>	(a) Number of securities to be issued upon exercise of <u>outstanding options</u>	(b) Weighted-average exercise price of <u>outstanding options</u>	(c) Number of securities remaining available for future issuance under equity compensation plan (excluding securities referenced in the first <u>column (a)</u> )
Equity compensation Plan approved by Security holders (1)	52,500	\$ 12.13	178,500
Equity compensation Plan not approved by Security holders	0	\$ 0.00	0

- (1) Includes stock options granted or available under the following stockholder approved plans of 2001, 1999, 1992 and 1989 (the "Stock Option Plans").

Our Stock Option Plans provide for a proportionate adjustment to the number of shares reserved for issuance in the event of any stock dividend, stock split, combination, recapitalization, or similar event.

Item 13. Certain Relationships and Related Transactions

The information required by Item 13 of Form 10-K is incorporated by reference from the information contained in the section captioned "Certain Relationships and Related Transactions" in the 2006 Proxy Statement.

Item 14. Principal Accountant Fees and Services

The information required by Item 14 of Form 10-K is incorporated herein by reference from the information contained in the section "Relationship with Independent Accountants" in the 2006 Proxy

Statement .

## PART IV

Item 15. Exhibits and Financial Statement Schedules(a) List of Financial Statements Filed as Part of This Report

The following financial statements are submitted herewith in response to Part II Item 8:

Consolidated Statements of Financial Condition as of June 30, 2006 and 2005

Consolidated Statements of Income for the years ended June 30, 2006, 2005 and 2003

Consolidated Statements of Changes in Stockholders' Equity for the years ended June 30, 2006, 2005 and 2004

Consolidated Statements of Cash Flows for the years ended June 30, 2006, 2005 and 2004

(b) Exhibits

The exhibits listed below are filed herewith or are incorporated herein by reference to other filings.

- 3.1 Conformed Articles of Incorporation of Northeast Bancorp, incorporated by reference to Exhibit 3.1 to Northeast Bancorp's Registration Statement on Form S-4 (No.333-31797) filed with the Securities and Exchange Commission.
- 3.2 Bylaws of Northeast Bancorp, incorporated by reference to Exhibit 3.2 to amendment No.1 to Northeast Bancorp's Registration Statement on Form S-4 (No.333-31797) filed with the Securities and Exchange Commission.
- 4.1 Form of Indenture with respect to Northeast Bancorp's Junior Subordinated Debentures, incorporated by reference to Exhibit 4.1 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.
- 4.2 Form of Junior Subordinated Debentures (included in Exhibit 4.1), incorporated by reference to Exhibit 4.2 to Northeast Bancorp's Registration Statement of Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.
- 4.3 Trust Agreement of NBN Capital Trust (including Certificate of Trust of NBN Capital Trust), incorporated by reference to Exhibit 4.3 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.
- 4.4 Form of Amended and Restated Trust Agreement of NBN Capital Trust, incorporated by reference to Exhibit 4.4 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.
- 4.5 Form of Preferred Securities of NBN Capital Trust (included in Exhibit 4.4), incorporated by reference to Exhibit 4.5 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.
- 4.6 Form of Guarantee Agreement, incorporated by reference to Exhibit 4.6 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.
- 10.1 1987 Stock Option Plan of Northeast Bancorp (formerly known as Bethel Bancorp), incorporated by reference to Bethel Bancorp's Registration Statement on Form S-1 (No. 33-12815), filed with the Securities and Exchange Commission.
- 10.2 1989 Stock Option Plan of Northeast Bancorp (formerly known as Bethel Bancorp) is incorporated by reference to Exhibit 10.6 to Bethel Bancorp's Quarterly Report on Form 10-Q for the quarter ended September 30, 1994.
- 10.3 1992 Stock Option Plan of Northeast Bancorp (formerly known as Bethel Bancorp), incorporated by reference to Exhibit 10.7 to Bethel Bancorp's Annual Report on Form 10-K for the year ended June 30, 1992.
- 10.4 1999 Stock Option Plan of Northeast Bancorp incorporated by reference to Exhibit 10 to Northeast Bancorp's Quarterly Report on Form 10-Q for quarter ended December 31, 1999.
- 10.5

2001 Stock Option Plan of Northeast Bancorp incorporated by reference to Northeast Bancorp's Registration Statement on Form S-8, filed with the Securities and Exchange Commission on March 31, 2002.

- 11 Statement regarding computation of per share earnings is submitted herewith as Exhibit 11.
- 21 A list of subsidiaries of Northeast Bancorp.
- 23.1 The Consent of Baker Newman & Noyes, Limited Liability Company.
- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(a)).
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(a)).
- 32.1 Certificate of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(b)).

With the exception of the information expressly incorporated herein by reference, the Company's 2006

Proxy Statement for the 2006 Annual Meeting of Shareholders is not to be deemed filed as part of this Annual Report on Form 10-K

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

NORTHEAST BANCORP

Date: September 26, 2006

By: /s/ James D. Delamater  
James D. Delamater President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Name</u>	<u>Title</u>	<u>Date</u>
<u>/s/ John B. Bouchard</u>	Director	September 26, 2006
John B. Bouchard		
<u>/s/ James P. Day</u>	Director	September 26, 2006
James P. Day		
<u>/s/ James D. Delamater</u>	Director, President and Chief Executive Officer	September 26, 2006
James D. Delamater	(Principal Executive Officer)	
<u>/s/ Ronald J. Goguen</u>	Director	September 26, 2006
Ronald J. Goguen		
<u>/s/ Philip C. Jackson</u>	Director	September 26, 2006



Philip C. Jackson <u>/s/ Judith W. Kelley</u>	Chairman of the Board	September 26, 2006
Judith W. Kelley <u>/s/ Pender J. Lazenby</u>	Director	September 26, 2006
Pender J. Lazenby <u>/s/ John Rosmarin</u>	Vice-Chairman of the Board	September 26, 2006
John Rosmarin <u>/s/ John Schiavi</u>	Director	September 26, 2006
John Schiavi <u>/s/ Stephen W. Wight</u>	Director	September 26, 2006
Stephen W. Wight <u>/s/ Dennis A. Wilson</u>	Director	September 26, 2006
Dennis A. Wilson <u>/s/ Robert S. Johnson</u>	Chief Financial Officer (Principal Financial and Accounting Officer)	September 26, 2006
Robert S. Johnson		

Page 72

EXHIBIT INDEX

- | <u>Exhibit</u><br><u>Number</u> | <u>Exhibit</u>  |
|---------------------------------|---|
| 3.1                             | Conformed Articles of Incorporation of Northeast Bancorp, incorporated by reference to Exhibit 3.1 to Northeast Bancorp's Registration Statement on Form S-4 (333-31797) filed with the Securities and Exchange Commission.   |
| 3.2                             | Bylaws of Northeast Bancorp, incorporated by reference to Exhibit 3.2 to amendment No.1 to Northeast Bancorp's Registration Statement on Form S-4 (No.333-31797) filed with the Securities and Exchange Commission.   |
| 4.1                             | Form of Indenture with respect to Northeast Bancorp's Junior Subordinated Debentures, incorporated by reference to Exhibit 4.1 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.       |
| 4.2                             | Form of Junior Subordinated Debentures (included in Exhibit 4.1), incorporated by reference to Exhibit 4.2 to Northeast Bancorp's Registration Statement of Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.                           |
| 4.3                             | Trust Agreement of NBN Capital Trust (including Certificate of Trust of NBN Capital Trust), incorporated by reference to Exhibit 4.3 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission. |
| 4.4                             | Form of Amended and Restated Trust Agreement of NBN Capital Trust, incorporated by reference to Exhibit 4.4 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.                          |
| 4.5                             | Form of Preferred Securities of NBN Capital Trust (included in Exhibit 4.4), incorporated by reference to Exhibit 4.5 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.                |
| 4.6                             | Form of Guarantee Agreement, incorporated by reference to Exhibit 4.6 to Northeast Bancorp's Registration Statement on Form S-2 (No. 333-88853-01), filed with the Securities and Exchange Commission.  |

- 10.1 1987 Stock Option Plan of Northeast Bancorp (formerly known as Bethel Bancorp), incorporated by reference to Bethel Bancorp's Registration Statement on Form S-1 (No. 33-12815), filed with the Securities and Exchange Commission.
- 10.2 1989 Stock Option Plan of Northeast Bancorp (formerly known as Bethel Bancorp) is incorporated by reference to Exhibit 10.6 to Bethel Bancorp's Quarterly Report on Form 10-Q for the quarter ended September 30, 1994.
- 10.3 1992 Stock Option Plan of Northeast Bancorp (formerly known as Bethel Bancorp), incorporated by reference to Exhibit 10.7 to Bethel Bancorp's Annual Report on Form 10-K for the year ended June 30, 1992.
- 10.4 1999 Stock Option Plan of Northeast Bancorp incorporated by reference to Exhibit 10 to Northeast Bancorp's Quarterly Report on Form 10-Q for quarter ended December 31, 1999.
- 10.5 2001 Stock Option Plan of Northeast Bancorp incorporated by reference to Northeast Bancorp's Registration Statement on Form S-8, filed with the Securities and Exchange Commission on March 31, 2002.
- 11 Statement regarding computation of per share earnings is submitted herewith as Exhibit 11.
- 21 A list of subsidiaries of Northeast Bancorp.
- 23.1 The Consent of Baker Newman & Noyes, Limited Liability Company.
- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(a)).
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(a)).
- 32.1 Certificate of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(b)).