

Edgar Filing: 1ST INDEPENDENCE FINANCIAL GROUP, INC. - Form 10-Q

## 1ST INDEPENDENCE FINANCIAL GROUP, INC.

Form 10-Q

November 06, 2007

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

FORM 10-Q

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2007  
or

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

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

Commission File Number 0-26570

1ST INDEPENDENCE FINANCIAL GROUP, INC.  
(Exact name of registrant as specified in its charter)

Delaware 61-1284899  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

8620 Biggin Hill Lane  
Louisville, Kentucky 40220-4117  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (502) 753-0500

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

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 registrant had 1,992,994 shares of common stock outstanding at October 29, 2007.

1st INDEPENDENCE FINANCIAL GROUP, INC.  
FORM 10-Q  
For the Quarter Ended September 30, 2007

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## PART I FINANCIAL INFORMATION

### Item 1. Financial Statements

1ST INDEPENDENCE FINANCIAL GROUP, INC.  
Condensed Consolidated Balance Sheets  
(in thousands except share data)

(Unaudited)  
September 30,  
2007

Assets	
Cash and and due from banks	\$ 11,733
Interest-bearing demand deposits	8,160
Federal funds sold	8,235
-----	
Cash and cash equivalents	28,128
Interest-bearing deposits	100
Available-for-sale securities at fair value	14,514

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Held-to-maturity securities, fair value of \$1,757 and \$1,930 at September 30, 2007 and December 31, 2006, respectively	1,746
Loans held for sale	976
Loans, net of allowance for loan losses of \$2,966 and \$3,745 at September 30, 2007 and December 31, 2006, respectively	263,963
Premises and equipment, net	8,188
Federal Home Loan Bank (FHLB) stock	2,313
Bank owned life insurance	3,593
Goodwill	11,142
Other real estate owned	2,825
Interest receivable and other assets	3,341
 Total assets	 \$340,829
 Liabilities and Stockholders' Equity	 =====
Liabilities	
Deposits	
Demand	\$ 18,319
Savings, NOW and money market	116,252
Time	127,081
 Total deposits	 261,652
Short-term borrowings	16,291
Long-term debt	20,279
Interest payable and other liabilities	2,119
 Total liabilities	 300,341
 Commitments and contingencies	 -
Stockholders' equity	
Preferred stock, \$0.10 par value, 500,000 shares authorized, no shares issued or outstanding	-
Common stock, \$0.10 par value, 5,000,000 shares authorized, 1,992,994 shares and 1,995,594 shares outstanding at September 30, 2007 and December 31, 2006, respectively	296
Additional paid-in capital	39,874
Retained earnings	15,161
Unearned ESOP compensation	(197)
Accumulated other comprehensive (loss)	(71)
Treasury stock, at cost, common, 969,835 shares and 969,835 shares at September 30, 2007 and December 31, 2006, respectively	(14,575)
 Total stockholders' equity	 40,488
 Total liabilities and stockholders' equity	 \$340,829
 =====	 =====

See notes to condensed consolidated financial statements.

1ST INDEPENDENCE FINANCIAL GROUP, INC.  
Condensed Consolidated Statements of Income  
(in thousands except per share data)

	(Unaudited) Three months ended September 30	(Unaudited) Nine month September
	-----	-----
	2007	2006

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Interest and dividend income			
Interest and fees on loans	\$ 5,078	\$ 5,373	\$15,404
Interest on securities			
Taxable	163	164	491
Tax exempt	43	46	133
Interest on federal funds sold	166	101	343
Dividends	52	38	148
Interest on deposits with financial institutions	73	75	227
	-----	-----	-----
Total interest and dividend income	5,575	5,797	16,746
	-----	-----	-----
Interest expense			
Deposits	2,711	2,614	8,034
FHLB advances	284	301	923
Other	181	192	539
	-----	-----	-----
Total interest expense	3,176	3,107	9,496
	-----	-----	-----
Net interest income	2,399	2,690	7,250
Provision for loan losses	66	543	261
	-----	-----	-----
Net interest income after provision for loan losses	2,333	2,147	6,989
	-----	-----	-----
Noninterest income			
Service charges	158	134	427
Gain on loan sales	239	277	691
Gain (loss) on sale of premises and equipment	-	(32)	-
Increase in cash value of life insurance	54	51	158
Other	86	83	247
	-----	-----	-----
Total noninterest income	537	513	1,523
	-----	-----	-----
Noninterest expense			
Salaries and employee benefits	1,320	1,004	3,758
Net occupancy	412	384	1,235
Data processing fees	204	190	614
Professional fees	71	219	358
Marketing	5	32	86
Other	461	371	1,800
	-----	-----	-----
Total noninterest expense	2,473	2,200	7,851
	-----	-----	-----
Income before income taxes	397	460	661
Income tax expense	168	111	197
	-----	-----	-----
Net income	\$ 229	\$ 349	\$ 464
	=====	=====	=====
Net income per share			
Basic	\$ 0.12	\$ 0.18	\$ 0.24
Diluted	0.12	0.18	0.23
Weighted average shares outstanding			
Basic	1,971	1,949	1,969
Diluted	1,982	1,963	1,980
Cash dividends declared per share	\$ 0.08	\$ 0.08	\$ 0.24

See notes to condensed consolidated financial statements.

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1ST INDEPENDENCE FINANCIAL GROUP, INC.  
Condensed Consolidated Statements of Comprehensive Income  
(in thousands)

	(Unaudited) Three months ended September 30	
	2007	2006
Net income	\$ 229	\$ 349
Other comprehensive income, net of tax		
Change in unrealized gains and losses on available-for-sale securities	132	206
Less reclassification adjustment for realized gains included in net income	-	-
Other comprehensive income	132	206
Comprehensive income	\$ 361	\$ 555

See notes to condensed consolidated financial statements.

1ST INDEPENDENCE FINANCIAL GROUP, INC.  
Condensed Consolidated Statements of Cash Flows  
(in thousands)

	(Unaudited) Nine months ended Septe	
	2007	2006
Cash Flows from Operating Activities:		
Net income	\$ 464	\$
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation	533	
Provision for loan losses	261	
Gain on loan sales	(691)	
Origination of loans held for sale	(37,578)	
Proceeds from loans held for sale	38,520	
Compensation expense on stock options	52	
ESOP compensation	157	
Amortization of unearned compensation on restricted stock	22	
Amortization of premiums and discounts on securities	17	
Deferred income taxes	63	
FHLB stock dividend	-	
Amortization of loan fees	(160)	
Amortization of intangibles, net	196	
Loss on sale of premises and equipment	-	
Increase in cash value of life insurance	(158)	
Changes in:		
(Increase) in interest receivable and other assets	(104)	
Increase in interest payable and other liabilities	499	
Net cash provided by operating activities	2,093	

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Cash Flows from Investing Activities:	
Purchase of interest-bearing deposits	-
Proceeds from maturities of interest-bearing deposits	-
Purchases of available-for-sale securities	(1,995)
Proceeds from maturities of available-for-sale securities	3,884
Proceeds from sales of available-for-sale securities	-
Proceeds from maturities of held-to-maturity securities	152
Net decrease (increase) in loans	3,984
Purchases of premises and equipment	(399)
Proceeds from sale of FHLB stock	-
 Net cash provided by (used in) investing activities	5,626
Cash Flows from Financing Activities:	
Net increase in deposits	7,574
Net (decrease) increase in short-term borrowings	(20,235)
Proceeds from issuance of long-term debt	10,000
Repayment of long-term debt	-
Repurchase and retirement of common stock	(37)
Proceeds from exercise of stock options	-
Cash dividends paid	(472)
 Net cash (used in) provided by financing activities	(3,170)
Net increase (decrease) in cash and cash equivalents	4,549
Cash and cash equivalents at beginning of period	23,579
 Cash and cash equivalents at end of period	\$ 28,128
Supplemental Cash Flow Information:	
Interest paid	\$ 9,384
Income taxes paid	35
Real estate acquired in settlement of loans	2,271

See notes to condensed consolidated financial statements.

## 1ST INDEPENDENCE FINANCIAL GROUP, INC.

### Notes to Condensed Consolidated Financial Statements (Unaudited)

#### 1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of 1st Independence Financial Group, Inc. (the "Company") are presented in accordance with the requirements of Form 10-Q and accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These condensed consolidated financial statements and notes thereto included in this report should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Form 10-K annual report for the year ended December 31, 2006 filed with the United States Securities and Exchange Commission ("SEC"). In the opinion of management, all adjustments necessary to make the financial statements not misleading and to fairly present the financial position, results of operations and cash flows for the reporting interim periods have been made and were of a normal recurring nature. The results of operations for the period are not necessarily indicative of the results to be expected for the full year. The condensed consolidated balance sheet of the Company as of December 31, 2006 has been derived from the audited consolidated balance sheet of the Company as of that date.

The unaudited condensed financial statements include the accounts of the Company

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and its wholly-owned subsidiary, 1st Independence Bank, Inc. (the "Bank") and 1st Independence Mortgage, a division of the Bank.

## 2. Stock-Based Compensation

For the three months and nine months ended September 30, 2007 and September 30, 2006, the Company recorded \$9,000 and \$52,000, respectively, and \$8,000 and \$34,000, respectively, in employee stock-based compensation expense, which is included in salaries and employee benefits. As of September 30, 2007 and September 30, 2006, there was \$36,000 and \$31,000, respectively, of unrecognized stock-compensation expense for previously granted unvested options that will be recognized over a weighted-average period of 1.4 and 1.5 years, respectively.

## 3. Allowance for Loan Losses

An analysis of the changes in the allowance for loan losses for the nine months ended September 30 follows (in thousands):

	2007	2006
Beginning balance	\$3,745	\$2,911
Provision for loan losses	261	655
Loans charged off	(1,049)	(1)
Recoveries	9	4
	-----	-----
Ending balance	\$2,966	\$3,569
	=====	=====

## 4. Net Income Per Share Computations

The following is a reconciliation of the numerator and denominator of the basic and diluted per share computations (in thousands except per share data):

	Three months September 2007	-----
Income (numerator) amounts used for basic and diluted per share computations:		
Net income	\$229	=====
Shares (denominator) used for basic per share computations:		
Weighted average shares of common stock outstanding	1,971	=====
Shares (denominator) used for diluted per share computations:		
Weighted average shares of common stock outstanding	1,971	11
Plus: dilutive effect of stock options		-----
Adjusted weighted average shares	1,982	=====
Net income per share data:		
Basic	\$0.12	=====
Diluted	\$0.12	=====

Nine months  
September  
2007  
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Income (numerator) amounts used for basic and diluted per share computations:	
Net income	\$ 464
	=====
Shares (denominator) used for basic per share computations:	
Weighted average shares of common stock outstanding	1,969
	=====
Shares (denominator) used for diluted per share computations:	
Weighted average shares of common stock outstanding	1,969
Plus: dilutive effect of stock options	11
	=====
Adjusted weighted average shares	1,980
	=====
Net income per share data:	
Basic	\$ 0.24
	=====
Diluted	\$ 0.23
	=====

Options to purchase 30,500 common shares for the three months ended September 30, 2007 and 17,500 common shares for the nine months ended September 30, 2007 and 17,000 common shares for both the three months and nine months ended September 30, 2006, respectively, were excluded from the diluted calculations above because the exercise prices on the options were greater than the average market price for the period.

### 5. Contingencies and Subsequent Event

On July 18, 2007 a jury in the case of Larry Sutherland, et.al., v. Harrodsburg First Financial Bancorp, Inc., in the Circuit Court of Anderson County in the Commonwealth of Kentucky returned a verdict awarding damages to the plaintiffs of \$403,620. The lawsuit originated from offers to purchase securities made by the Company in connection with an offer to purchase up to 300,000 shares of its stock in a tender offer on or about May 28, 2003. The plaintiffs alleged that the Company made certain material misrepresentations in connection with certain statements made in the tender offer. Management, after discussion with legal counsel, decided to record an accrual of \$403,620 as of June 30, 2007 relating to the lawsuit. Notwithstanding the accrual, the Company believes that it has strong basis for appeal and thus filed an appeal in the Kentucky Court of Appeals in October 2007. Reference is made to Part II, Item 1 of this report on Form 10-Q for additional information.

### 6. Recently Issued Accounting Standards

In July 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"), which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. FIN 48 seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. FIN 48 is effective for fiscal years beginning after December 15, 2006 and the cumulative effect of applying the provisions of this Interpretation are recognized as an adjustment to the beginning balance of retained earnings. The Company adopted the Interpretation on January 1, 2007 as required. The Company and its subsidiaries file a consolidated U.S. Corporation income tax return, a combined unitary return in the state of Indiana and a corporate income tax return in the state of Kentucky. The only periods subject to examination for the Company's federal return are the 2005 and 2006 tax years. A federal examination audit of the tax year 2004 was completed in 2006 with no material adjustments. The periods subject to examination for the Company's state returns in Kentucky and Indiana are all years after 2003. The Company has no unrecognized tax benefits and does not anticipate any increase in unrecognized

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benefits during 2007 relative to any tax positions taken prior to January 1, 2007. The Company believes that its income tax filing positions and deductions would be sustained on audit and does not anticipate any adjustments that would result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

The Company chose to continue its policy for recording interest related to unrecognized tax benefits in other interest expense and penalties in other noninterest expense. No penalties or interest were recorded during the first nine months of 2007 and no such accruals existed as of January 1, 2007.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS 157"), which provides guidance on how to measure assets and liabilities that use fair value. SFAS 157 will apply whenever another US GAAP standard requires (or permits) assets or liabilities to be measured at fair value but does not expand the use of fair value to any new circumstances. This Statement also will require additional disclosures in both annual and quarterly reports. SFAS 157 will be effective for financial statements issued for fiscal years beginning after November 15, 2007, and will be adopted by the Company beginning in the first quarter of 2008. The Company is currently evaluating the potential impact this Statement may have on the Company's financial position and results of operations, but does not believe the impact of the adoption will be material.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"), which permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities using different measurement techniques. SFAS 159 requires additional disclosures related to the fair value measurements included in the entity's financial statements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. Accordingly, the Company will adopt SFAS 159 in the first quarter of 2008. The Company is currently evaluating the potential impact this Statement may have on the Company's financial position and results of operations, but does not believe the impact of the adoption will be material.

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

This section should be read in conjunction with the condensed consolidated financial statements and notes thereto included in Item 1 of Part I of this report in addition to the consolidated financial statements of the Company and the notes thereto included in the Company's Form 10-K for the year ended December 31, 2006, including note 1 which describes the Company's significant accounting policies including its use of estimates. See the caption entitled "Application of Critical Accounting Policies" in this section for further information.

#### **Forward-Looking Statements**

The following discussion contains statements which are forward-looking rather than historical fact. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and involve known and unknown risks, uncertainties and other factors, which may cause the Company's actual results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such statements are subject to certain risks and uncertainties including among other things, changes in economic conditions in

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the market areas the Company conducts business, changes in policies by regulatory agencies, fluctuations in interest rates, demand for loans in the market areas the Company conducts business, competition that could cause actual results to differ materially from historical earnings and those presently anticipated or projected and other risks as detailed in the Company's various filings with the United States Securities and Exchange Commission. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made.

### **General**

The Company provides commercial and retail banking services, including commercial real estate loans, one-to-four family residential mortgage loans via 1st Independence Mortgage, home equity loans and lines of credit and consumer loans as well as certificates of deposit, checking accounts, money-market accounts and savings accounts within its market area. At September 30, 2007, the Company had total assets, deposits and stockholders' equity of \$340.8 million, \$261.7 million, and \$40.5 million, respectively. The Company's business is conducted principally through the Bank. Unless otherwise indicated, all references to the Company refer collectively to the Company and the Bank.

On July 18, 2007 a jury in the case of Larry Sutherland, et.al., v. Harrodsburg First Financial Bancorp, Inc., in the Circuit Court of Anderson County in the Commonwealth of Kentucky returned a verdict awarding damages to the plaintiffs of \$403,620. The lawsuit originated from offers to purchase securities made by the Company in connection with an offer to purchase up to 300,000 shares of its stock in a tender offer on or about May 28, 2003. The plaintiffs alleged that the Company made certain material misrepresentations in connection with certain statements made in the tender offer. Management, after discussion with legal counsel, decided to record an accrual of \$403,620 as of June 30, 2007 relating to the lawsuit. Notwithstanding the accrual, the Company believes that it has strong basis for appeal and thus filed an appeal in the Kentucky Court of Appeals in October 2007.

### **Application of Critical Accounting Policies**

The discussion and analysis of the Company's financial condition and results of operation is based upon the Company's unaudited condensed consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information and with the instructions for Form 10-Q. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company's most critical accounting policies require the use of estimates relating to other than temporary impairment of securities, the allowance for loan losses and the valuation of goodwill. See the caption entitled "Critical Accounting Policies" in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of the Company's Form 10-K for the year ended December 31, 2006 for additional information.

### **Overview**

Net income for the quarter ended September 30, 2007 was \$229,000 or \$0.12 per diluted share compared to \$349,000 or \$0.18 per diluted share for the comparable period in 2006. Net income for the nine months ended September 30, 2007 was \$464,000 or \$0.23 per diluted share compared to \$1,470,000 or \$0.75 per diluted share for the comparable period in 2006. The decrease in net income and net income per diluted share for the nine-month period was primarily due to a decrease in net interest income after taxes of \$529,000, an increase in noninterest expenses after taxes of \$731,000 (which includes \$259,000 after taxes relating to the litigation accrual made in the second quarter of 2007

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previously discussed) and an increase in tax expense due to an adjustment relating to the tax deduction for employee benefit plans which increased income tax expense approximately \$41,000. Partially offsetting these factors was a decrease of \$260,000 after taxes in the provision for loan losses and an increase in noninterest income after taxes of \$60,000. The decrease in net income and net income per diluted share for the quarter was primarily due to a decrease in net interest income after taxes of \$192,000 and an increase in noninterest expenses after taxes of \$180,000 and the increase of \$41,000 in income tax expense discussed above. Partially offsetting these factors was a decrease of \$315,000 after taxes in the provision for loan losses and an increase in noninterest income after taxes of \$16,000.

### Results of Operations

#### Net Interest Income

Net interest income is the most significant component of the Company's revenues. Net interest income is the difference between interest income on interest-earning assets (primarily loans and investment securities) and interest expense on interest-bearing liabilities (deposits and borrowed funds). Net interest income depends on the volume and rate earned on interest-earning assets and the volume and rate paid on interest-bearing liabilities.

Net interest income was \$2.4 million and \$7.3 million, respectively, for the three months and nine months ended September 30, 2007, a decrease of \$0.3 million or 11% and \$0.8 million or 10%, respectively, from \$2.7 million and \$8.1 million, respectively, for the comparable periods of 2006. On an annualized basis, the net interest spread and net interest margin were 2.67% and 3.08%, respectively, for the current quarter, compared to 2.94% and 3.39% for the same period of 2006. For the nine months ended September 30, 2007 the net interest spread and net interest margin were 2.73% and 3.16%, respectively, compared to 3.03% and 3.45% for the first nine months of 2006. The decrease in the net interest margin was primarily due to a faster increase in interest rates on interest-bearing liabilities compared to the rates on interest-earning assets, a decrease in the volume of net earning assets and the reversal of \$96,000 of interest income on certain loans which were placed on nonaccrual in the third quarter of 2007. Changes in volume resulted in a decrease in net interest income of \$0.1 million and \$0.3 million, respectively, for the third quarter and first nine months of 2007 compared to the same periods in 2006, and changes in interest rates and the mix resulted in a decrease in net interest income of \$0.2 million and \$0.5 million, respectively, for the third quarter and first nine months of 2007 versus the comparable periods in 2006.

The Bank, like many other financial institutions, is vulnerable to an increase in interest rates to the extent that interest-bearing liabilities mature or reprice more rapidly than interest-earning assets. Historically, the lending activities of commercial banks emphasized the origination of short to intermediate term variable rate loans that are more closely matched with the deposit maturities and repricing of interest-bearing liabilities which occur closer to the same general time period. While having interest-bearing liabilities that reprice more frequently than interest-earning assets is generally beneficial to net interest income during periods of declining interest rates, it is generally detrimental during periods of rising interest rates.

To reduce the effect of interest rate changes on net interest income, the Bank has adopted various strategies to improve matching interest-earning asset maturities to interest-bearing liability maturities. The principal elements of these strategies include; originating variable rate commercial loans that include interest rate floors; originating one-to-four family residential mortgage loans with adjustable rate features, or fixed rate loans with short maturities; maintaining interest-bearing demand deposits, federal funds sold, and U.S. government securities with short to intermediate term maturities; maintaining an investment portfolio that provides stable cash flows, thereby providing investable funds in varying interest rate cycles; lengthening the

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maturities of our time deposits and borrowings when it would be cost effective; and attracting low cost checking and transaction accounts, which tend to be less interest rate sensitive when interest rates increase.

The Bank measures its exposure to changes in interest rates using an overnight upward and downward shift (shock) in the Treasury yield curve. As of September 30, 2007, if interest rates increased 200 basis points and decreased 200 points, respectively, the Bank's net interest income would increase by 1.4% and increase by 0.4%, respectively.

### **Provision for Loan Losses**

The provision for loan losses was \$66,000 and \$261,000 for the three months and nine months ended September 30, 2007, compared to \$543,000 and \$655,000 for the same periods in 2006. Nonperforming loans were \$5.0 million at September 30, 2007 and \$3.7 million at December 31, 2006, or 1.89% and 1.36%, respectively, of total loans. The increase in nonperforming loans is primarily due to an increase in nonperforming real estate construction and development loans, primarily in the 1-4 family markets. The allowance for loan losses was \$3.0 million and \$3.7 million at September 30, 2007 and December 31, 2006, or 1.11% and 1.37%, respectively, of total loans. Net charge-offs were \$1,040,000 in the first nine months of 2007 compared to a net recovery of \$3,000 in the same period in 2006. The increase in net charge-offs in 2007 was primarily due to three large borrowers in the real estate construction and commercial and industrial portfolios. These charge-offs taken in the first quarter of 2007 had been adequately reserved for in previous periods.

The Company maintains the allowance for loan losses at a level that it considers to be adequate to provide for credit losses inherent in its loan portfolio. Management determines the level of the allowance by performing a quarterly analysis that considers concentrations of credit, past loss experience, current economic conditions, the amount and composition of the loan portfolio (including nonperforming and potential problem loans), estimated fair value of underlying collateral, loan commitments outstanding, and other information relevant to assessing the risk of loss inherent in the loan portfolio. As a result of management's analysis, a range of the potential amount of the allowance for loan losses is determined.

The Company will continue to monitor the adequacy of the allowance for loan losses and make additions to the allowance in accordance with the analysis referred to above. Because of uncertainties inherent in estimating the appropriate level of the allowance for loan losses, actual results may differ from management's estimate of credit losses and the related allowance.

### **Noninterest Income**

Noninterest income was \$0.5 million for the three months ended September 30, 2007, compared to \$0.5 million for the same period in 2006 and \$1.5 million for the nine months ended September 30, 2007, compared to \$1.4 million for the first nine months of 2006. The gain on loan sales was down for the third quarter and first nine months of 2007 versus the same periods of 2006 due to a decrease in volume in the third quarter that reversed an increase in volume in the first half of 2007 versus a softened housing market leading to a slow down in secondary market mortgage activity and lower margins in 2006. The gain on loan sales was \$239,000 for the three months ended September 30, 2007, compared to \$277,000 for the comparable period in 2006 and \$691,000 for the first nine months of 2007 compared to \$703,000 for the first nine months of 2006. Service charge income was \$158,000 for the three months ended September 30, 2007, compared to \$134,000 for the comparable period in 2006 and \$427,000 for the first nine months of 2007 compared to \$380,000 for the first nine months of 2006. The Company continues to evaluate its deposit product offerings with the intention of continuing to expand its offerings to the consumer and business depositor. Currently, the Company is pursuing a strategy to increase its core deposit base by expanding the Company's offering of remote deposit capture

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products for current and prospective business depositors.

### **Noninterest Expense**

Noninterest expense was \$2.5 million for the quarter ended September 30, 2007 compared to \$2.2 million the same period in 2006 and \$7.9 million for the nine months ended September 30, 2007 compared to \$6.7 million for the first nine months of 2006. Contributing to the increases were an increase in salaries and employee benefits due to merit and promotional salary increases and management additions including the hiring of an experienced commercial lending team in the second quarter of 2007, increased health care costs, increased stock option expense and increased restricted stock expense. Partially offsetting these increases in salaries and employee benefits was a reduction in the amount of expense necessary to cover the Company's 401(k) match as the match is now covered by released ESOP shares. Additional factors contributing to the overall increase in noninterest expenses were an increase in data processing expenses which was primarily due to the growth of the Bank's services and its commitment to upgrade systems productivity and various increases in other noninterest expenses including an increase in expenses relating to other real estate owned due to the higher levels of other real estate owned and as previously discussed the litigation accrual made in the second quarter of 2007 of \$404,000. Other factors were an increase in net occupancy expenses relating to the Bank's branch expansion plans and certain equipment upgrades. Partially offsetting these increases was a decrease in professional fees due to a reduced amount of services required notwithstanding an increased amount of services required regarding preparation work for compliance with certain of the upcoming requirements of the Sarbanes-Oxley Act of 2002 and a decrease in marketing expense for the third quarter of 2007 versus the third quarter of 2006.

### **Income Tax Expense (Benefit)**

The effective income tax rate on income before income taxes was 42.3% for the three months ended September 30, 2007 compared to 24.1% for the same period in 2006 and 29.8% for the first nine months of 2007 compared to 29.5% for the first nine months of 2006. The increase in the effective tax rate for the third quarter of 2007 was primarily due to an adjustment relating to the tax deduction for employee benefit plans which increased income tax expense approximately \$41,000. The effective tax rate for the nine-month period of 2007 was flat compared to the same period in 2006 primarily due to an increase in the percentage of tax exempt interest income compared to income before income taxes which offset the adjustment discussed above.

### **Financial Condition**

The Company's total assets were \$340.8 million at September 30, 2007 compared to \$342.8 million at December 31, 2006, a decrease of 2.0 million or 0.6%. Net loans decreased \$6.5 million, investments decreased \$2.1 million, loans held for sale decreased \$0.3 million, while other real estate owned went up \$2.4 million, cash and cash equivalents increased \$4.5 million, and bank owned life insurance went up \$0.2 million.

Net loans were \$264.0 million at September 30, 2007, compared to \$270.5 million at December 31, 2006, a decrease of \$6.5 million or 2.4%. The decrease in loans was primarily due to a decrease in residential real estate loans which decreased \$13.8 million or 11.4%. The decrease in total loans was partially offset by increases in real estate construction and real estate commercial loan portfolios, which increased \$3.7 million or 5.8% and \$5.6 million or 11.2%, respectively. All loan categories increased or remained the same as a percentage of total loans, except residential real estate loans, which decreased from approximately 45% to 41% of total loans and home equity loans which decreased from 5% to 4%. The decrease in residential real estate loans as a percentage of total loans is partly due to those loans now being sold in the secondary market through 1st Independence Mortgage, a division of the Bank, rather than being retained for the Company's loan portfolio. The Company continues to identify opportunities to cross sell its other products, including home equity and

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consumer loans for its loan portfolio resulting from customer relationships established through the origination of loans by 1st Independence Mortgage.

Deposits increased \$7.6 million or 3.0% to \$261.7 million at September 30, 2007 compared to \$254.1 million at December 31, 2006. This increase was attributable to an increase in savings, NOW and money market deposits of \$38.2 million which more than offset a decrease in time deposits of \$30.7 million while demand deposits remained flat. The increase in savings, NOW and money market deposits resulted primarily from the effects of a general marketing campaign promoting a more competitively priced NOW account product in an effort to reduce the Company's dependency on higher costing time deposits.

Short-term borrowings decreased \$20.2 million to \$16.3 million at September 30, 2007, compared to \$36.5 million at December 31, 2006 while long-term debt increased \$10.0 million to \$20.3 million at September 30, 2007, compared to \$10.3 million at December 31, 2006. The increase in long-term debt was due to the Company deciding to utilize a long-term FHLB fixed rate advance and thus reducing the level of short-term FHLB advances. The Company uses short-term borrowings, primarily short-term FHLB advances, to fund short-term liquidity needs and manage net interest margin.

### **Off-Balance Sheet Arrangements**

In the normal course of operations, the Company engages in financial transactions that contain credit, interest rate, and liquidity risk that are not recorded in the financial statements such as loan commitments and performance letters of credit. As of September 30, 2007, unused loan commitments and performance letters of credit were \$43,219,000 and \$4,456,000, respectively.

Since many of the unused loan commitments are expected to expire or be only partially used, the total amount of commitments does not necessarily represent future cash requirements.

### **Liquidity and Capital Resources**

Liquidity to meet borrowers' credit and depositors' withdrawal demands is provided by maturing assets, short-term liquid assets that can be converted to cash and the ability to attract funds from depositors. Additional sources of liquidity include brokered deposits, advances from the FHLB and other short-term borrowings, such as federal funds purchased and securities sold under repurchase agreements.

At September 30, 2007 and December 31, 2006, brokered deposits were \$17.1 million and \$23.7 million, respectively. The weighted average cost and maturity of brokered deposits were 4.85% and six months at September 30, 2007 compared to 4.86% and six months at December 31, 2006. The Company plans to continue using brokered deposits for the foreseeable future to support loan demand when pricing for brokered deposits is more favorable than short-term borrowings or rates within the Company's local markets.

At September 30, 2007 and December 31, 2006, the Bank had total FHLB advances outstanding of \$26.0 million and \$36.0 million, respectively, with \$11.0 million and \$1.0 million, respectively, included in long-term debt in the accompanying condensed consolidated balance sheet and the remaining amount included in short-term borrowings. Additionally, the Bank had \$55.0 million of unused commitments under its line of credit with the FHLB and sufficient collateral to borrow an additional \$53.8 million.

The Company's liquidity depends primarily on dividends paid to it as sole stockholder of the Bank. At September 30, 2007, the Bank may pay up to \$9.2 million in dividends to the Company without regulatory approval, subject to the ongoing capital requirements of the Bank.

The Company has \$9.3 million of subordinated debentures outstanding, which are

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included in long-term debt in the accompanying condensed consolidated balance sheet with \$4.1 million of the debentures being variable rate obligations with interest rates that reprice quarterly (March 26, June 26, September 26 and December 26) and are tied to the three-month London Interbank Offering Rate ("LIBOR") plus 3.15%. The weighted average rate on the variable rate obligations was 8.50% for both the third quarter and first nine months of 2007, respectively, compared to 8.61% and 8.15% for the same periods in 2006. At September 30, 2007 the rate on the variable rate obligations was 8.35% compared to 8.52% at September 30, 2006. The remaining \$5.2 million of debentures carry a fixed interest rate of 6.4% until March 26, 2008 when the debentures become variable rate obligations that reprice quarterly at the three-month LIBOR rate plus 3.15%.

Stockholders' equity increased \$0.2 million from \$40.3 million at December 31, 2006 to \$40.5 million at September 30, 2007. The individual items within stockholders' equity that changed were net income of \$0.5 million, cash dividends declared of \$0.5 million (\$0.24 per share) and an increase of \$0.2 million relating to stock option and ESOP plan transactions and other miscellaneous equity transactions.

Bank holding companies and their subsidiary banks are required by regulators to meet risk based capital standards. These standards, or ratios, measure the relationship of capital to a combination of balance sheet and off-balance sheet risks. The following table presents these ratios as of September 30, 2007 and December 31, 2006 for the Consolidated Company and the Bank along with the regulator's minimum ratio to be considered well capitalized.

	September 30, 2007	December 31, 2006
Total risk-based capital to risk-weighted assets		
Consolidated company	15.6%	15.9%
Bank	14.9	14.7
Tier 1 capital to risk-weighted assets		
Consolidated company	14.5	14.6
Bank	13.8	13.5
Tier 1 capital to average assets		
Consolidated company	11.5	11.6
Bank	11.0	10.7

### Regulatory Matters

On July 20, 2006, the Bank received its most recent Community Reinvestment Act ("CRA") Performance Evaluation prepared as of May 15, 2006. The Bank was assigned a "Needs to Improve" rating due in part to the Bank's low level of residential lending to low and moderate income borrowers within the Louisville, Kentucky Metropolitan Statistical Area. Management has taken appropriate steps to improve the residential lending issues cited by the Federal Deposit Insurance Corporation ("FDIC") during the CRA Performance Evaluation. By statute, a bank with a "less than satisfactory" CRA rating has limitations on certain future business activities until the CRA rating improves. Management does not believe these limitations will have any material affect on the Bank's current business plan.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Information required by this item is included in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" under the caption "Results of Operations - Net Interest Income."

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## Item 4. Controls and Procedures

### (a) Evaluation of Disclosure Controls and Procedures

As required by Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the Company's management carried out an evaluation, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures as of the end of the quarter ended September 30, 2007. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in its reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the United States Securities and Exchange Commission's rules and forms.

### (b) Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during the quarter ended September 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II OTHER INFORMATION

## Item 1. Legal Proceedings

The Company, from time to time, is a party to ordinary routine litigation, which arises in the normal course of business, such as claims to enforce liens, condemnation proceedings on properties in which the Company holds security interests, claims involving the making and servicing of real property loans, and other issues incident to its business. Except as discussed below, there were no potentially material lawsuits or other legal proceedings pending or known to be contemplated against the Company at September 30, 2007.

On or about May 28, 2004, a complaint was filed in the Circuit Court of Anderson County in the Commonwealth of Kentucky by Larry Sutherland, Judy Sutherland, John Henry Disponett, Brenda Disponett, Todd Hyatt, Lois Ann Disponett, Sue Saufley, and Hugh Coomer. Soon thereafter, an amended complaint was filed which added Lois Hawkins and Norma K. Barnett as plaintiffs. The lawsuit arises from offers to purchase securities made by the Company in connection with an offer to purchase up to 300,000 shares of its stock in a tender offer on or about May 28, 2003. The Plaintiffs allege that the Company made certain material misrepresentations in connection with certain statements made in the tender offer. In the lawsuit, the plaintiffs sought to recover compensatory and punitive damages in connection with the shares they sold in the tender offer and their attorneys' fees. On April 14, 2006 a partial summary judgment was entered against the plaintiffs. In the partial summary judgment, the Circuit Court held that the only remedy available to the plaintiffs is the return of the stock upon the tender of the consideration received by the plaintiffs in exchange for the stock. Subsequent to the partial summary judgment, the plaintiffs amended their complaint to allege certain additional material misrepresentations had been made by the Company. On July 18, 2007 a jury in the Circuit Court of Anderson County in the Commonwealth of Kentucky returned a verdict awarding damages to the plaintiffs of \$403,620. Management, after discussion with legal counsel, decided to record an accrual of \$403,620 as of June 30, 2007 relating to the lawsuit. Notwithstanding the accrual, the Company believes that it has strong basis for appeal and thus filed an appeal in the Kentucky Court of Appeals in

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October 2007.

## Item 6. Exhibits

### (a) Exhibits

- 3.1 Certificate of Incorporation (incorporated by reference from the Exhibits to the Company's Form S-1 Registration Statement, initially filed on June 14, 1995, Registration No. 33-93458).
- 3.2 Amended Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to the Company's Form 10-KSB filed on December 29, 2004).
- 3.3 Bylaws (incorporated by reference to Exhibit 3.2 to the Company's Form 8-K filed on August 21, 2007).
- 31.1 Rule 13a-14(a) / 15d-14(a) Certification of Principal Executive Officer ("Section 302 Certifications").
- 31.2 Rule 13a-14(a) / 15d-14(a) Certification of Principal Financial Officer ("Section 302 Certifications").
- 32.1 Section 1350 Certifications ("Section 906 Certifications").

## SIGNATURES

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

1st INDEPENDENCE FINANCIAL GROUP, INC.

Date: November 6, 2007

By: /s/ R. Michael Wilbourn

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R. Michael Wilbourn  
Executive Vice President  
and Chief Financial Officer

## Exhibit Index

Exhibit Number	Description
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- 31.1 Rule 13a-14(a) / 15d-14(a) Certification of Principal Executive Officer ("Section 302 Certifications").
- 31.2 Rule 13a-14(a) / 15d-14(a) Certification of Principal Financial Officer ("Section 302 Certifications").
- 32.1 Section 1350 Certifications ("Section 906 Certifications").