

FIRST CAPITAL INC  
Form 10-Q  
November 13, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended SEPTEMBER 30, 2006

OR

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

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

Commission File No. 0-25023

**First Capital, Inc.**

(Exact name of registrant as specified in its charter)

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

**35-2056949**  
(I.R.S. Employer  
Identification Number)

**220 Federal Drive NW, Corydon, Indiana 47112**

(Address of principal executive offices) (Zip Code)

Registrant's telephone number including area code 1-812-738-2198

Not applicable

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

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

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

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 2,846,543 shares of common stock were outstanding as of October 31, 2006.

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FIRST CAPITAL, INC.

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**PART I FINANCIAL INFORMATION****FIRST CAPITAL, INC. AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS***(Unaudited)*

	September 30,	December 31,
	2006	2005
	<i>(In thousands)</i>	
<b>ASSETS</b>		
Cash and due from banks	\$ 9,551	\$ 12,625
Interest bearing deposits with banks	4,994	1,780
Fed funds sold	689	268
<b>Total cash and cash equivalents</b>	<b>15,234</b>	<b>14,673</b>
Securities available for sale, at fair value	69,133	75,721
Securities-held to maturity	1,124	1,194
Loans, net	340,653	322,453
Loans held for sale	1,058	
Federal Home Loan Bank stock, at cost	3,605	3,746
Foreclosed real estate	1,192	749
Premises and equipment	9,003	9,287
Accrued interest receivable	2,428	2,462
Cash value of life insurance	1,338	1,308
Goodwill	5,386	5,386
Core deposit intangibles	408	463
Other assets	1,163	912
<b>Total Assets</b>	<b>\$ 451,725</b>	<b>\$ 438,354</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing	\$ 34,950	\$ 35,110
Interest-bearing	288,678	282,154
<b>Total Deposits</b>	<b>323,628</b>	<b>317,264</b>
Retail repurchase agreements	19,723	10,704
Advances from Federal Home Loan Bank	61,911	65,947
Accrued interest payable	1,656	1,498
Accrued expenses and other liabilities	1,299	984
<b>Total Liabilities</b>	<b>408,217</b>	<b>396,397</b>
<b>STOCKHOLDERS EQUITY</b>		
Preferred stock of \$.01 par value per share		
Authorized 1,000,000 shares; none issued		
Common stock of \$.01 par value per share		
Authorized 5,000,000 shares; issued 3,113,358 shares (2,852,509 shares in 2005)	31	29
Additional paid-in capital	23,620	19,403
Retained earnings-substantially restricted	26,230	28,989
Unearned ESOP shares	(184)	(246)

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Unearned stock compensation	(1)	(2)
Accumulated other comprehensive income	(694)	(766)
Less treasury stock, at cost 266,815 shares (264,398 shares in 2005)	(5,494)	(5,450)
Total Stockholders' Equity	43,508	41,957
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 451,725</b>	<b>\$ 438,354</b>

See accompanying notes to consolidated financial statements.

## PART I FINANCIAL INFORMATION

## FIRST CAPITAL, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<i>(In thousands, except per share data)</i>				
<b>INTEREST INCOME</b>				
Loans, including fees	\$ 5,837	\$ 5,193	\$ 16,936	\$ 15,110
Securities:				
Taxable	548	599	1,712	1,650
Tax-exempt	181	160	530	479
Federal Home Loan Bank dividends	41	45	134	123
Fed funds sold and interest bearing deposits with banks	28	49	108	169
Total interest income	6,635	6,046	19,420	17,531
<b>INTEREST EXPENSE</b>				
Deposits	2,339	1,831	6,499	5,129
Retail repurchase agreements	292	100	618	178
Advances from Federal Home Loan Bank	720	734	2,120	2,296
Total interest expense	3,351	2,665	9,237	7,603
Net interest income	3,284	3,381	10,183	9,928
Provision for loan losses	215	150	585	463
Net interest income after provision for loan losses	3,069	3,231	9,598	9,465
<b>NON-INTEREST INCOME</b>				
Service charges on deposit accounts	611	543	1,769	1,575
Commission income	69	93	239	283
Gain on sale of mortgage loans	116	26	229	192
Mortgage brokerage fees	5	40	71	134
Other income	29	25	68	84
Total non-interest income	830	727	2,376	2,268
<b>NON-INTEREST EXPENSE</b>				
Compensation and benefits	1,524	1,392	4,570	4,342
Occupancy and equipment	304	281	881	847
Data processing	163	178	469	561
Professional fees	102	92	301	277
Advertising	73	85	246	240
Other operating expenses	479	437	1,438	1,381
Total non-interest expense	2,645	2,465	7,905	7,648
Income before income taxes	1,254	1,493	4,069	4,085
Income tax expense	402	518	1,347	1,382
<b>Net Income</b>	<b>\$ 852</b>	<b>\$ 975</b>	<b>\$ 2,722</b>	<b>\$ 2,703</b>
<b>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX</b>				
Unrealized gain (loss) on securities:				

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Unrealized holding gains (losses) arising during the period	573	(226)	72	(368)
Less: reclassification adjustment				
<b>Other comprehensive income (loss)</b>	<b>573</b>	<b>(226)</b>	<b>72</b>	<b>(368)</b>
<b>Comprehensive Income</b>	<b>\$ 1,425</b>	<b>\$ 749</b>	<b>\$ 2,794</b>	<b>\$ 2,335</b>
<b>Net income per common share, basic</b>	<b>\$ 0.30</b>	<b>\$ 0.35</b>	<b>\$ 0.96</b>	<b>\$ 0.96</b>
<b>Net income per common share, diluted</b>	<b>\$ 0.30</b>	<b>\$ 0.34</b>	<b>\$ 0.96</b>	<b>\$ 0.95</b>

See accompanying notes to consolidated financial statements.

## PART I FINANCIAL INFORMATION

## FIRST CAPITAL, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

*(Unaudited)*

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<i>(In thousands)</i>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 2,722	\$ 2,703
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums and accretion of discounts	25	110
Depreciation and amortization expense	546	617
Deferred income taxes	(133)	172
ESOP and stock compensation expense	138	119
Increase in cash value of life insurance	(30)	(30)
Provision for loan losses	585	463
Proceeds from sales of mortgage loans	13,048	13,030
Mortgage loans originated for sale	(13,877)	(12,610)
Net gain on sale of mortgage loans	(229)	(192)
Stock dividends on Federal Home Loan Bank stock		(78)
(Increase) decrease in accrued interest receivable	34	(126)
Increase in accrued interest payable	159	47
Net change in other assets/liabilities	152	288
<b>Net Cash Provided By Operating Activities</b>	<b>3,140</b>	<b>4,513</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of securities available for sale	(4,390)	(22,466)
Proceeds from maturities of securities available for sale	8,056	6,023
Proceeds from maturities of securities held to maturity	35	25
Principal collected on mortgage-backed securities	3,043	4,136
Net increase in loans receivable	(19,559)	(3,299)
Redemption of Federal Home Loan Bank stock	140	
Proceeds from sale of foreclosed real estate	331	674
Purchase of premises and equipment	(206)	(111)
<b>Net Cash Used In Investing Activities</b>	<b>(12,550)</b>	<b>(15,018)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	6,364	7,794
Net decrease in advances from Federal Home Loan Bank	(4,036)	(6,452)
Net increase in retail repurchase agreements	9,018	9,367
Exercise of stock options	19	61
Purchase of treasury stock	(44)	(203)
Dividends paid	(1,350)	(1,179)
<b>Net Cash Provided By Financing Activities</b>	<b>9,971</b>	<b>9,388</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>561</b>	<b>(1,117)</b>

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Cash and cash equivalents at beginning of period	14,673	17,425
<b>Cash and Cash Equivalents at End of Period</b>	<b>\$ 15,234</b>	<b>\$ 16,308</b>

See accompanying notes to consolidated financial statements.

**FIRST CAPITAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS***(Unaudited)***1. Presentation of Interim Information**

First Capital, Inc. ( Company ) is the holding company for First Harrison Bank ( Bank ). The information presented in this report relates primarily to the Bank's operations. The Bank has three wholly-owned subsidiaries that manage a portion of its investment securities portfolio. First Harrison Investments, Inc. and First Harrison Holdings, Inc. are Nevada corporations that jointly own First Harrison, LLC, a Nevada limited liability corporation that holds and manages an investment portfolio.

In the opinion of management, the unaudited consolidated financial statements include all normal adjustments considered necessary to present fairly the financial position as of September 30, 2006, and the results of operations for the three and nine months ended September 30, 2006 and 2005 and cash flows for the nine months ended September 30, 2006 and 2005. All of these adjustments are of a normal, recurring nature. Such adjustments are the only adjustments included in the unaudited consolidated financial statements. Interim results are not necessarily indicative of results for a full year.

The accompanying unaudited consolidated financial statements and notes have been prepared in accordance with generally accepted accounting principles for interim financial statements and are presented as permitted by the instructions to Form 10-Q. Accordingly, they do not contain certain information included in the Company's annual audited consolidated financial statements and related notes for the year ended December 31, 2005 included in the Form 10-K.

The unaudited consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation.

**2. Comprehensive Income**

Comprehensive income is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive income for the Company includes net income and other comprehensive income representing the net unrealized gains and losses on securities available for sale. The following tables set forth the components of other comprehensive income and the allocated tax amounts for the three and nine months ended September 30, 2006 and 2005:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<i>(In thousands)</i>		<i>(In thousands)</i>	
Unrealized gains (losses) on securities:				
Unrealized holding gains (losses) arising during the period	\$ 949	\$ (374)	\$ 119	\$ (610)
Income tax (expense) benefit	(376)	148	(47)	242
Net of tax amount	573	(226)	72	(368)
Less: reclassification adjustment for gains included in net income				
Income tax benefit				
Net of tax amount				
Other comprehensive income (loss)	\$ 573	\$ (226)	\$ 72	\$ (368)



## FIRST CAPITAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. Supplemental Disclosure for Earnings Per Share**

(As restated for the stock dividend declared on June 19, 2006)

	Three Months Ended		Nine Months Ended	
	9/30/2006	9/30/2005	9/30/2006	9/30/2005
(Dollars in thousands, except for share and per share data)				
<b>Basic</b>				
Earnings:				
Net income	\$ 852	\$ 975	\$ 2,722	\$ 2,703
Shares:				
Weighted average common shares outstanding	2,825,249	2,823,290	2,823,034	2,822,333
Net income per common share, basic	\$ 0.30	\$ 0.35	\$ 0.96	\$ 0.96
<b>Diluted</b>				
Earnings:				
Net income	\$ 852	\$ 975	\$ 2,722	\$ 2,703
Shares:				
Weighted average common shares outstanding	2,825,249	2,823,290	2,823,034	2,822,333
Add: Dilutive effect of outstanding options	25,149	25,764	24,483	28,005
Add: Dilutive effect of restricted stock	55	72	67	261
Weighted average common shares outstanding, as adjusted	2,850,453	2,849,126	2,847,584	2,850,599
Net income per common share, diluted	\$ 0.30	\$ 0.34	\$ 0.96	\$ 0.95

**4. Stock Option Plan**

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards ( SFAS ) 123R, a revision of SFAS 123, *Accounting for Stock-Based Compensation*. The Company's stock option plan was previously accounted for in accordance with the provisions of Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*, and, as such, no stock-based employee compensation cost was reflected in net income because all options granted under the stock option plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The Company adopted SFAS 123R using the modified prospective method and, as such, results from prior periods have not been restated. Under the statement's transition provisions, compensation cost is recognized on or after the effective date for the portion of outstanding awards, for which the requisite service has not yet been rendered, based on the grant date fair value of those awards calculated under the statement.

**FIRST CAPITAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS***(Unaudited)*

The Company recognized compensation expense of \$24,000 and \$8,000 for the nine month and three month periods ended September 30, 2006, respectively, related to the stock option plan as expense is recognized ratably over the five-year vesting period of the options. At September 30, 2006, there was \$86,000 of unrecognized compensation expense related to nonvested stock options, which will be recognized over the remaining vesting period. The Black-Scholes option pricing model was used to determine the fair value of the options granted.

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 SFAS No. 123R to stock-based employee compensation in 2005.

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
	(In thousands, except per share data)	
Net Income, as reported	\$ 975	\$ 2,703
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(6)	(18)
Pro forma net income	\$ 969	\$ 2,685
Earnings per share:		
Basic as reported	\$ 0.35	\$ 0.96
Basic pro forma	\$ 0.34	\$ 0.95
Diluted as reported	\$ 0.34	\$ 0.95
Diluted pro forma	\$ 0.34	\$ 0.94

**5. Supplemental Disclosures of Cash Flow Information**

	<b>Nine Months Ended September 30, 2006      2005</b>	
	(In thousands)	
Cash payments for:		
Interest	\$ 9,078	\$ 7,556
Taxes	1,596	1,244
Noncash investing activities:		
Transfers from loans to real estate acquired through foreclosure	761	829

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**6. Recent Accounting Pronouncements**

The following are summaries of recently issued accounting pronouncements that impact the accounting and reporting practices of the Company:

In December 2004, FASB revised SFAS 123, *Share-Based Payment*. SFAS 123R requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements based on the grant date fair value of the award. This statement was effective for the Company's stock option plan awards effective January 1, 2006. (See Note 4) The adoption of this statement did not have a material impact on the Company's financial condition or results of operations.

In May 2005, FASB issued SFAS 154, *Accounting Changes and Error Corrections*. The statement replaces APB Opinion No. 20 (APB 20), *Accounting Changes*, and SFAS 3, *Reporting Accounting Changes in Interim Financial Statements*, and applies to all voluntary changes in accounting principles and changes required by an accounting pronouncement that does not include specific transition provisions. The statement requires retrospective application of most voluntary changes in accounting principles, so that those changes will be reflected in financial statements presented for comparative purposes. The statement carries forward the guidance contained in APB 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005 (January 1, 2006 for First Capital, Inc.). The adoption of this statement is not expected to have a material impact on the Company's financial condition or results of operations.

In March 2006, FASB issued SFAS 156, *Accounting for Servicing of Financial Assets*. The guidance in SFAS 156 amends the guidance in SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Specifically, the guidance in SFAS 156 addresses the recognition and measurement of separately-recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like accounting. The guidance clarifies when an obligation to service financial assets should be recognized separately as a servicing asset or a servicing liability and requires that a separately-recognized servicing asset or servicing liability initially be measured at fair value. The guidance further permits an entity with a separately-recognized servicing asset or servicing liability to choose either the amortization method or the fair value method for subsequent measurement. The statement is effective for all separately-recognized servicing assets and liabilities acquired or issued after the beginning of the fiscal year that begins after September 15, 2006 with early implementation permitted. The adoption of this statement is not expected to have a material impact on the Company's financial condition or results of operations.

In June 2006, FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS 109, *Accounting for Income Taxes*. The Interpretation prescribes a more-likely-than-not recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The provisions of the Interpretation are effective for fiscal years beginning after December 15, 2006. The application of this Interpretation is not expected to have a material impact on the Company's financial condition or results of operations.

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

In September 2006, FASB issued SFAS 157, *Fair Value Measurements*. The statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The statement does not require any new fair value measurements under existing accounting pronouncements. The definition of fair value retains the exchange price notion found in earlier definitions of fair value and clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact the sell or transfer. The statement further emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, the statement provides that fair value measurement should be determined based on the assumptions that market participants would use in pricing the assets or liability. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years with earlier implementation permitted. The application of this statement is not expected to have a material impact on the Company's financial condition or results of operations.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 108, entitled *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides guidance related to the consideration of the carryover or reversal effects of prior-year misstatements in quantifying current-year misstatements for purposes of materiality assessments. The SEC Staff concluded that registrants should quantify errors using both an income statement approach and a balance sheet approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, would be considered material. The guidance in SAB 108 is effective for evaluating the effect of prior-year misstatements on financial statements for the first fiscal year ending after November 15, 2006 and provides that the cumulative effect of misstatements considered material under this guidance should be reported as an adjustment to the opening balance of retained earnings as of the beginning of that first fiscal year with disclosure of the nature and amount of each individual error being corrected in the cumulative adjustment. The Company has applied the guidance in SAB 108 effective for this interim financial report. The application of the guidance in SAB 108 had no impact on the Company's financial condition or results of operations.

**7. Stock Dividend**

On June 19, 2006, the Company declared a 10% stock dividend. The dividend was paid on August 8, 2006 to shareholders of record as of the close of business on July 19, 2006. Based on the number of common shares outstanding on the record date, the Company issued 258,779 shares from its available authorized but unissued shares. The fair market value of the additional shares issued, aggregating \$4.1 million, was charged to retained earnings, and common stock and additional paid-in capital were increased by \$3,000 and \$4.1 million, respectively. All references in the accompanying financial statements to the number of common shares and per share amounts are based on the increased number of shares giving retroactive effect to the stock dividend.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
ANALYSIS OF FINANCIAL CONDITION AND**

**RESULTS OF OPERATIONS**

**FIRST CAPITAL, INC.**

**Safe Harbor Statement for Forward-Looking Statements**

This report may contain forward-looking statements within the meaning of the federal securities laws. These statements are not historical facts; rather they are statements based on the Company's current expectations regarding its business strategies and their intended results and its future performance. Forward-looking statements are preceded by terms such as "expects," "believes," "anticipates," "intends" and similar expressions.

Forward-looking statements are not guarantees of future performance. Numerous risks and uncertainties could cause or contribute to the Company's actual results, performance and achievements being materially different from those expressed or implied by the forward-looking statements. Factors that may cause or contribute to these differences include, without limitation, general economic conditions, including changes in market interest rates and changes in monetary and fiscal policies of the federal government; legislative and regulatory changes; the quality and composition of the loan and investment securities portfolio; loan demand; deposit flows; competition; and changes in accounting principles and guidelines. Additional factors that may affect our results are discussed in our Annual Report on Form 10-K for the year ended December 31, 2005 under "Item 1A. Risk Factors." These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company assumes no obligation and disclaims any obligation to update any forward-looking statements.

**Critical Accounting Policies**

During the nine months ended September 30, 2006, there was no significant change in the Company's critical accounting policies or the application of critical accounting policies as presented in the annual report on Form 10-K for the year ended December 31, 2005.

**Financial Condition**

Total assets increased from \$438.4 million at December 31, 2005 to \$451.7 million at September 30, 2006, an increase of 3.1%.

Net loans receivable (excluding loans held for sale) increased \$18.2 million from \$322.5 million at December 31, 2005 to \$340.7 million at September 30, 2006. Installment loans increased \$9.7 million during the period while commercial and residential mortgages increased \$4.7 million and \$2.1 million, respectively. Adjustable rate loans increased \$7.1 million during the period.

Securities available for sale decreased \$6.6 million from \$75.7 million at December 31, 2005 to \$69.1 million at September 30, 2006. Maturities and principal repayments of these securities totaled \$8.1 million and \$3.0 million, respectively, during the period. Purchases of \$4.4 million of securities classified as available for sale were also made during the period.

Investment securities held-to-maturity decreased \$70,000 during the period primarily due to maturities of \$35,000 and principal repayments of \$34,000.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
ANALYSIS OF FINANCIAL CONDITION AND**

**RESULTS OF OPERATIONS**

**FIRST CAPITAL, INC.**

Cash and cash equivalents increased from \$14.7 million at December 31, 2005 to \$15.2 million at September 30, 2006. Interest bearing deposits with banks increased \$3.2 million during the period while cash and due from banks decreased \$3.1 million.

Total deposits increased 2.0% from \$317.3 million at December 31, 2005 to \$323.6 million at September 30, 2006. Time deposits increased \$10.4 million during the period as customers took advantage of increased market rates by moving funds into certificates of deposit. Interest-bearing checking and savings accounts decreased \$3.9 million primarily due to a local municipality withdrawing \$5.0 million from a money market account held at the bank.

Federal Home Loan Bank borrowings decreased from \$65.9 million at December 31, 2005 to \$61.9 million at September 30, 2006. New advances of \$30.0 million were offset by principal repayments of \$34.0 million.

Retail repurchase agreements increased from \$10.7 million at December 31, 2005 to \$19.7 million at September 30, 2006. This increase was primarily due to the Bank's successful efforts to acquire local municipal funds which are held in retail repurchase accounts due to sweep agreements.

Total stockholders' equity increased from \$42.0 million at December 31, 2005 to \$43.5 million at September 30, 2006. This increase was primarily the result of retained net income of \$1.4 million.

**Results of Operations**

**Net Income for the nine-month periods ended September 30, 2006 and 2005.** Net income was \$2.7 million (\$0.96 per share diluted) for the nine months ended September 30, 2006 compared to \$2.7 million (\$0.95 per share diluted) for the nine months ended September 30, 2005. The earnings per share figures for 2005 have been restated to reflect the ten percent (10%) stock dividend the Company declared on June 19, 2006. The Company experienced increases in net interest income after the provision for loan losses and noninterest income offset by an increase in noninterest expenses.

**Net Income for the three-month periods ended September 30, 2006 and 2005.** Net income was \$852,000 (\$0.30 per share diluted) for the three months ended September 30, 2006 compared to \$975,000 (\$0.34 per share diluted) for the same period in 2005. Again, the earnings per share figure for 2005 reflects the stock dividend discussed above. A decrease in net interest income after the provision for loan losses and an increase in noninterest expense were partially offset by an increase in noninterest income.

**Net interest income for the nine-month periods ended September 30, 2006 and 2005.** Net interest income increased \$255,000 to \$10.2 million in 2006 compared to \$9.9 million in 2005.

Total interest income increased \$1.9 million during the nine months ended September 30, 2006 compared to the same period in 2005. The average balance of interest-earning assets and their tax-equivalent yield increased from \$402.4 million and 5.89% in 2005 to \$415.5 million and 6.34% in 2006. This increase in yield is due to the general increase in market interest rates, as well as the increase in loans as a component of the Bank's earning assets.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND**

**ANALYSIS OF FINANCIAL CONDITION AND**

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**FIRST CAPITAL, INC.**

Total interest expense increased \$1.6 million during the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005. The average balance of interest-bearing liabilities increased from \$352.7 million in 2005 to \$363.8 million in 2006 while the average rate on these liabilities increased from 2.87% in 2005 to 3.39% in 2006. A major factor behind this increase was the transfer of deposit balances from interest-bearing checking and money market accounts to higher costing certificates of deposits. As a result, the Bank's tax-equivalent interest rate spread decreased from 3.02% during the first nine months of 2005 to 2.95% for the same period in 2006.

**Net interest income for the three-month periods ended September 30, 2006 and 2005.** Net interest income decreased from \$3.4 million for the three months ended September 30, 2005 to \$3.3 million for the same period in 2006 primarily due to the increased cost of funds.

Total interest income increased \$589,000 for the three months ended September 30, 2006 compared to the same period in 2005. This increase was caused by increases in the average balance of interest-earning assets and in the tax-equivalent yield on those assets. For the quarter ended September 30, 2005, the average balance totaled \$405.3 million and the tax-equivalent yield was 6.05%, and increased during the same period in 2006 to \$419.9 million and 6.44%, respectively.

Total interest expense increased \$686,000 for the three months ended September 30, 2006 compared to the same period in 2005. While the average balance of interest-bearing liabilities increased from \$356.1 million in 2005 to \$367.6 million in 2006, the average cost of these liabilities increased from 2.99% in 2005 to 3.65% in 2006. A primary factor in this increase was an increase in money market rates which caused an immediate increase to the entire money market portfolio. As a result, the tax-equivalent interest rate spread decreased from 3.06% in the three-month period ended September 30, 2005 to 2.79% during the same period in 2006.

**Provision for loan losses.** The provision for loan losses was \$215,000 for the three-month period ended September 30, 2006 as compared to \$150,000 for the same period in 2005. Net charge offs amounted to \$242,000 and \$85,000 for the three-month periods ended September 30, 2006 and 2005, respectively. The provision for loan losses was \$585,000 for the nine-month period ended September 30, 2006 as compared to \$463,000 for the same period in 2005. During the nine-month period ended September 30, 2006, gross loans receivable increased \$18.4 million while net charge offs amounted to \$427,000. Net charge offs totaled \$767,000 for the nine-month period ended September 30, 2005. As stated earlier in this report, installment loans increased \$9.7 million during the nine-month period ended September 30, 2006, while commercial and residential mortgages increased \$4.7 million and \$2.1 million, respectively. The consistent application of management's allowance methodology resulted in an increase in the provision for loan losses due to growth in the loan portfolio.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
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**FIRST CAPITAL, INC.**

Provisions for loan losses are charges to earnings to maintain the total allowance for loan losses at a level considered reasonable by management to provide for probable known and inherent loan losses based on management's evaluation of the collectibility of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specified impaired loans and economic conditions. Although management uses the best information available, future adjustments to the allowance may be necessary due to changes in economic, operating, regulatory and other conditions that may be beyond the Bank's control. While the Bank maintains the allowance for loan losses at a level that it considers adequate to provide for estimated losses, there can be no assurance that further additions will not be made to the allowance for loan losses and that actual losses will not exceed the estimated amounts.

The methodology used in determining the allowance for loan losses includes segmenting the loan portfolio by identifying risk characteristics common to groups of loans, determining and measuring impairment of individual loans based on the present value of expected future cash flows or the fair value of collateral, and determining and measuring impairment for groups of loans with similar characteristics by applying loss factors that consider the qualitative factors which may affect the loss rates.

The allowance for loan losses was \$2.3 million at September 30, 2006 compared to \$2.1 million at December 31, 2005. Management has deemed these amounts as adequate on those dates based on its best estimate of probable known and inherent loan losses. At September 30, 2006, nonperforming loans amounted to \$4.0 million compared to \$3.2 million at December 31, 2005. Included in nonperforming loans are loans over 90 days past due secured by residential mortgages in the amount of \$899,000, consumer loans of \$103,000, commercial mortgages amounting to \$89,000, and commercial loans of \$74,000. These loans are accruing interest as the estimated value of the collateral and collection efforts are deemed sufficient to ensure full recovery. At September 30, 2006, nonaccrual loans amounted to \$2.8 million compared to \$1.9 million at December 31, 2005. Of the nonaccrual loans at September 30, 2006, \$2.2 million were secured by commercial mortgages and the remainder by residential mortgages.

**Noninterest income for the nine-month periods ended September 30, 2006 and 2005.** Noninterest income increased 4.8% to \$2.4 million for the nine months ended September 30, 2006 compared to \$2.3 million for the nine months ended September 30, 2005. Service charges on deposit accounts increased \$194,000 when comparing the two periods which was offset by decreases in mortgage brokerage fees and commission income of \$63,000 and \$44,000, respectively.

**Noninterest income for the three-month periods ended September 30, 2006 and 2005.** Noninterest income for the quarter ended September 30, 2006 increased to \$830,000 compared to \$727,000 for the quarter ended September 30, 2005. Gains on the sale of mortgage loans and service charges on deposit accounts increased \$90,000 and \$68,000, respectively.

**Noninterest expense for the nine-month periods ended September 30, 2006 and 2005.** Noninterest expense increased 3.4% to \$7.9 million for the nine months ended September 30, 2006 compared to the same period in 2005. The majority of that increase was in compensation and benefit expenses, which increased \$228,000 when comparing the two periods. This was due to an increase in lending personnel, as well as normal salary and benefit increases.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
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Data processing expenses decreased \$92,000 during the nine months ended September 30, 2006 as compared to the same period in 2005 due to decreases in equipment depreciation and lower fees associated with electronic banking.

**Noninterest expense for the three-month periods ended September 30, 2006 and 2005.** Noninterest expense for the quarter ended September 30, 2006 increased 7.3% to \$2.6 million compared to \$2.5 million for the quarter ended September 30, 2005. This increase was primarily due to an increase in compensation and benefits.

**Income tax expense.** Income tax expense for the nine-month period ended September 30, 2006 was \$1.3 million, compared to \$1.4 million for the same period in 2005. The effective tax rate decreased from 33.8% in 2005 to 33.1% in 2006. Income tax expense for the three-month period ended September 30, 2006 was \$402,000, compared to \$518,000 for the same quarter in 2005. The effective tax rate was 34.7% for the third quarter in 2005 compared to 32.1% for the same period in 2006. The decrease in the tax rate for 2006 was due to the increased investment of municipal securities at the Nevada investment subsidiary during 2006.

**Liquidity and Capital Resources**

The Bank's primary sources of funds are customer deposits, proceeds from loan repayments, maturing securities and FHLB advances. While loan repayments and maturities are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by market interest rates, general economic conditions and competition. At September 30, 2006, the Bank had cash and cash equivalents of \$15.2 million and securities available-for-sale with a fair value of \$69.1 million. If the Bank requires funds beyond its ability to generate them internally, it has additional borrowing capacity with the FHLB of Indianapolis and additional collateral eligible for repurchase agreements.

The Bank's primary investing activity is the origination of one-to-four family mortgage loans and, to a lesser extent, consumer, multi-family, commercial real estate and residential construction loans. The Bank also invests in U.S. Government and agency securities and mortgage-backed securities issued by U.S. Government agencies.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to support loan growth and deposit withdrawals, to satisfy financial commitments and to take advantage of investment opportunities. Historically, the Bank has been able to retain a significant amount of its deposits as they mature.

The Bank is required to maintain specific amounts of capital pursuant to OTS regulatory requirements. As of September 30, 2006, the Bank was in compliance with all regulatory capital requirements, which were effective as of such date with tangible, core and risk-based capital ratios of 8.4%, 8.4% and 13.5%, respectively. The regulatory requirements at that date were 1.5%, 3.0% and 8.0%, respectively. At September 30, 2006, the Bank was considered "well-capitalized" under applicable regulatory guidelines.

**PART I - ITEM 2**

**MANAGEMENT'S DISCUSSION AND  
ANALYSIS OF FINANCIAL CONDITION AND**

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**FIRST CAPITAL, INC.**

**Off-Balance Sheet Arrangements**

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with generally accepted accounting principles, are not recorded on the Company's financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are primarily used to manage customers' requests for funding and take the form of loan commitments and letters of credit. A further presentation of the Company's off-balance sheet arrangements is presented in the Company's 2005 Annual Report to Stockholders, filed as an exhibit to the Form 10-K for the year ended December 31, 2005.

For the nine months ended September 30, 2006, the Company did not engage in any off-balance sheet transactions reasonably likely to have a material effect on the Company's financial condition, results of operations or cash flows.

**PART I - ITEM 3**

**QUANTITATIVE AND QUALITATIVE DISCLOSURES**

**ABOUT MARKET RISK**

**FIRST CAPITAL, INC.**

**Qualitative Aspects of Market Risk.** The Bank's principal financial objective is to achieve long-term profitability while reducing its exposure to fluctuating market interest rates. The Bank has sought to reduce the exposure of its earnings to changes in market interest rates by attempting to manage the mismatch between asset and liability maturities and interest rates. In order to reduce the exposure to interest rate fluctuations, the Bank has developed strategies to manage its liquidity, shorten its effective maturities of certain interest-earning assets and decrease the interest rate sensitivity of its asset base. Management has sought to decrease the average maturity of its assets by emphasizing the origination of short-term commercial and consumer loans, all of which are retained by the Bank for its portfolio. The Bank relies on retail deposits as its primary source of funds. Management believes retail deposits, compared to brokered deposits, reduce the effects of interest rate fluctuations because they generally represent a more stable source of funds.

**Quantitative Aspects of Market Risk.** The Bank does not maintain a trading account for any class of financial instrument nor does the Bank engage in hedging activities or purchase high-risk derivative instruments. Furthermore, the Bank is not subject to foreign currency exchange rate risk or commodity price risk.

The Bank uses interest rate sensitivity analysis to measure its interest rate risk by computing changes in net portfolio value ( NPV ) of its cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. NPV represents the market value of portfolio equity and is equal to the market value of assets minus the market value of liabilities, with adjustments made for off-balance sheet items. This analysis assesses the risk of loss in market risk sensitive instruments in the event of a sudden and sustained 100 to 300 basis point increase or decrease in market interest rates with no effect given to any steps that management might take to counter the effect of that interest rate movement. Using data compiled by the OTS, the Bank receives a report that measures interest rate risk by modeling the change in NPV over a variety of interest rate scenarios.

The following tables are provided by the OTS and set forth the change in the Bank's NPV at December 31, 2005 and June 30, 2006, based on OTS assumptions that would occur in the event of an immediate change in interest rates, with no effect given to any steps that management might take to counteract that change. Given the timing of the release of this information by the OTS, information as of September 30, 2006 is unavailable for inclusion in this report.

## PART I - ITEM 3

## QUANTITATIVE AND QUALITATIVE DISCLOSURES

## ABOUT MARKET RISK

## FIRST CAPITAL, INC.

At December 31, 2005

Change In Rates	Dollar	Net Portfolio Value Dollar	Percent Change	Net Portfolio Value as a Percent of Present Value of Assets	Change
	Amount	Change	(Dollars in thousands)	NPV Ratio	
300bp	\$39,849	\$(12,408)	(24)%	9.33%	(230)bp
200bp	44,647	(7,610)	(15)	10.27	(136)bp
100bp	49,055	(3,202)	(6)	11.09	(54)bp
Static	52,257			11.63	bp
(100)bp	52,955	698	1	11.66	3 bp
(200)bp	50,286	(1,971)	(4)	11.03	(60)bp

At June 30, 2006

Change In Rates	Dollar	Net Portfolio Value Dollar	Percent Change	Net Portfolio Value as a Percent of Present Value of Assets	Change
	Amount	Change	(Dollars in thousands)	NPV Ratio	
300bp	\$36,066	\$(16,630)	(32)%	8.37%	(320)bp
200bp	41,707	(10,989)	(21)	9.50	(207)bp
100bp	47,557	(5,139)	(10)	10.63	(94)bp
Static	52,696			11.57	bp
(100)bp	56,243	3,547	7	12.16	59 bp
(200)bp	56,904	4,208	8	12.18	61 bp

The preceding table presenting the Bank's NPV at June 30, 2006 indicates that in the event of a sudden and sustained increase in prevailing market interest rates, the Bank's NPV would be expected to decrease. The expected decrease in the Bank's NPV in a rising rate environment is primarily attributable to the relatively high percentage of fixed-rate loans in the Bank's loan portfolio. At September 30, 2006, approximately 66% of the Bank's loan portfolio consisted of fixed-rate loans.

Certain assumptions utilized by the OTS in assessing the interest rate risk of savings associations within its region were utilized in preparing the preceding table. These assumptions relate to interest rates, loan prepayment rates, deposit decay rates and the market values of certain assets under differing interest rate scenarios, among others.

As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in calculating the table.

**PART I - ITEM 4**

**CONTROLS AND PROCEDURES**

**FIRST CAPITAL, INC.**

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's disclosure controls and procedures, as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (the SEC) (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

## PART II

## OTHER INFORMATION

## FIRST CAPITAL, INC.

**Item 1. Legal Proceedings**

The Company is not a party to any legal proceedings. Periodically, there have been various claims and lawsuits involving the Bank, mainly as a plaintiff, such as claims to enforce liens, condemnation proceedings on properties in which the Bank holds security interests, claims involving the making and servicing of real property loans and other issues incident to the Bank's business. The Bank is not a party to any pending legal proceedings that it believes would have a material adverse affect on its financial condition or operations.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. There have been no material changes to the risk factors described in our Annual Report on Form 10-K, however these are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

Period	(a)	(b)	(c)	(d)
	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1 through July 31, 2006		\$		78,228
August 1 through August 31, 2006	29	\$ 18.30	29	78,199
September 1 through September 30, 2006				78,199
Total	29	\$ 18.30	29	78,199

**PART II**

**OTHER INFORMATION**

**FIRST CAPITAL, INC.**

On January 4, 2001, the Company announced a stock repurchase program to purchase up to 101,000 shares of its outstanding common stock. On September 30, 2002, the Board of Directors authorized an increase in the stock repurchase program in connection with the merger of Hometown Bancshares whereby the Company would purchase up to 345,000 shares of its outstanding common stock. The stock repurchase program expires upon the purchase of the maximum number of shares authorized under the program.

**Item 3. Defaults upon Senior Securities**

Not applicable.

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

Not applicable.

**Item 5. Other Information**

None.

**PART II**

**OTHER INFORMATION**

**FIRST CAPITAL, INC.**

**Item 6. Exhibits**

- 3.1 Articles of Incorporation of First Capital, Inc. (1)
- 3.2 Second Amended and Restated Bylaws of First Capital, Inc. (6)
- 10.1 Employment Agreement with J. Gordon Pendleton (3)
- 10.2 Employment Agreement with Samuel E. Uhl (2)
- 10.3 Employment Agreement with Michael C. Frederick (2)
- 10.4 Employment Agreement with Joel E. Voyles (2)
- 10.5 Employee Severance Compensation Plan (3)
- 10.6 First Federal Bank, A Federal Savings Bank 1994 Stock Option Plan (as assumed by First Capital, Inc. effective December 31, 1998) (4)
- 10.7 First Capital, Inc. 1999 Stock-Based Incentive Plan (5)
- 10.8 1998 Officers and Key Employees Stock Option Plan for HCB Bancorp (5)
- 10.9 Employment Agreement with William W. Harrod (2)
- 11.0 Statement Regarding Computation of Per Share Earnings (incorporated by reference to Note 4 of the Unaudited Consolidated Financial contained herein)
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
- 32.1 Section 1350 Certification of Chief Executive Officer
- 32.2 Section 1350 Certification of Chief Financial Officer

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(1) Incorporated by reference from the Exhibits filed with the Registration Statement on Form SB-2, and any amendments thereto, Registration No. 333-63515.

(2) Incorporated by reference to the Annual Report on Form 10-KSB for the year ended December 31, 1999.

(3) Incorporated by reference to the Quarterly Report on Form 10-QSB for the quarter ended December 31, 1998.

(4) Incorporated by reference from the Exhibits filed with the Registration Statement on Form S-8, and any amendments thereto, Registration Statement No. 333-76543.

(5) Incorporated by reference from the Exhibits filed with the Registration Statement on Form S-8, and any amendments thereto, Registration Statement No. 333-95987.

(6) Incorporated by reference to the Annual Report on Form 10-KSB for the year ended December 31, 2001.



**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.

FIRST CAPITAL, INC.

(Registrant)

**Dated** November 13, 2006

**BY:** /s/ William W. Harrod

William W. Harrod

President and CEO

**Dated** November 13, 2006

**BY:** /s/ Michael C. Frederick

Michael C. Frederick

Senior Vice President

and Treasurer