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# 2007 Annual Report

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**First Capital, Inc.**

Corydon, Indiana 47112

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# FIRST CAPITAL, INC.

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## BUSINESS OF THE COMPANY

First Capital, Inc. ("First Capital" or the "Company") is the thrift holding company of First Harrison Bank ("First Harrison" or the "Bank"). The Bank is the primary business of the Company.

The Company's principal executive office is located at 220 Federal Drive, N.W., Corydon, Indiana, and the telephone number at that address is (812) 738-2198.

First Harrison's deposit accounts are insured up to applicable legal limits by the Federal Deposit Insurance Corporation. The Bank is a member of the Federal Home Loan Bank System. The Bank, with its main office located in Corydon, Indiana, conducts business from twelve locations in Harrison, Floyd, Clark and Washington Counties of southern Indiana. This includes a new office in Salem, Indiana, that was opened in November 2007. The Bank will also be relocating its Edwardsville, Indiana office to within that town during 2008.

First Harrison is a community-oriented financial institution providing a wide range of banking services with a focus on building customer relationships through a commitment to customer service and community involvement. The Bank's primary business is attracting deposits from the general public and using those funds to originate one-to-four-family residential mortgage loans, multi-family and commercial real estate loans secured by properties located in southern Indiana, commercial business and consumer loans. Non-deposit investment products are sold through an agreement with Great American Advisors. The Bank also 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 securities portfolio.



Dear Shareholders:

Most bankers would agree that this past year has been one of the most challenging years for the banking industry during the past decade. Despite all the sobering news about sub-prime mortgage loans and continued difficult economic conditions we were able to weather the rough times last year and we are confident in our ability to weather any rough times in the future.

We continue to rely on our experience and our core values as the cornerstones of our business plan for enhancing profitability. We did not venture into the sub-prime lending market and we avoided the 100% financing schemes. Our core values have served us well in the past and should continue to serve us well in the future. As in the past we strive to operate your company on strong, safe, and sound banking principals for the long term.

Our relocation for the Edwardsville, Indiana office is under way and should be complete by early Fall. This new location will offer us more visibility to customers and prospects as we anticipate continued growth in this area. Our Salem, Indiana office opened in November. The staff there has done an excellent job and the community has come through with business that we are confident will keep us on target with our growth plans for that location.

We have seen excellent growth in all of our Internet delivery methods, as well as increased growth in our technology for servicing business accounts. These methods of doing business save time for customers and the Bank. We continue to focus on growing personal and business checking accounts and related services.

The Board of Directors and management appreciate your continued support and hope you take every opportunity to use our Bank and refer your friends and family. We take pride in being a community bank that continues to support the communities in which we have branches. Our team has given their time and talent to coaching local youth baseball and basketball. Your company took the lead in sponsoring programs for Relay for Life, United Way, Habitat for Humanity, school partnerships and many others. These are the core values that make us different from other banks in the area. Please take time to review the annual report and call us with any questions.

A handwritten signature in black ink, appearing to read "Wm Harrod", is located below the main body of text.

William W. Harrod  
President and CEO

## SELECTED FINANCIAL AND OTHER DATA

The financial data presented below is qualified in its entirety by the more detailed financial data appearing elsewhere in this report, including the Company's audited consolidated financial statements. The following tables set forth certain information concerning the financial position and results of operations of the Company at the dates and for the periods indicated.

### FINANCIAL CONDITION DATA:

At December 31,

	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
	<i>(In thousands)</i>				
Total assets	\$ 453,179	\$ 457,105	\$ 438,354	\$ 425,302	\$ 409,138
Cash and cash equivalents (1)	15,055	24,468	14,673	17,425	13,561
Securities available for sale	72,991	71,362	75,721	65,192	66,244
Securities held to maturity	1,050	1,118	1,194	1,258	1,507
Net loans	334,463	333,575	322,453	317,086	304,200
Deposits	328,151	331,143	317,264	316,462	302,468
Retail repurchase agreements	15,562	19,228	10,704	635	520
Advances from Federal Home Loan Bank	60,694	59,461	65,947	65,099	60,242
Total stockholders' equity	45,736	44,089	41,957	40,714	43,895

### OPERATING DATA:

For the Year Ended  
December 31,

	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
	<i>(In thousands)</i>				
Interest income	\$ 27,085	\$ 26,211	\$ 23,659	\$ 22,109	\$ 21,303
Interest expense	13,699	12,741	10,343	9,117	8,715
Net interest income	13,386	13,470	13,316	12,992	12,588
Provision for loan losses	558	810	563	510	725
Net interest income after provision for loan losses	12,828	12,660	12,753	12,482	11,863
Noninterest income	3,524	3,471	3,001	2,707	2,337
Noninterest expense (2)	11,349	10,551	10,152	9,959	8,797
Income before income taxes	5,003	5,580	5,602	5,230	5,403
Income tax expense	1,591	1,872	1,914	1,799	1,870
<b>Net Income</b>	<b>\$ 3,412</b>	<b>\$ 3,708</b>	<b>\$ 3,688</b>	<b>\$ 3,431</b>	<b>\$ 3,533</b>

### PER SHARE DATA (3):

Net income - basic	\$ 1.21	\$ 1.31	\$ 1.31	\$ 1.13	\$ 1.19
Net income - diluted	1.20	1.30	1.29	1.11	1.17
Dividends	0.68	0.68	0.62	0.60	0.56

(1) Includes cash and due from banks, interest-bearing deposits in other depository institutions and federal funds sold.

(2) Includes merger-related expenses of \$97,000 in 2003.

(3) Per share data for 2003 through 2005 has been restated for the 10% stock dividend declared on June 19, 2006.

## SELECTED FINANCIAL AND OTHER DATA - CONTINUED

SELECTED FINANCIAL RATIOS:	At or For the Year Ended December 31,				
	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
<i>Performance Ratios:</i>					
Return on assets (1)	0.76%	0.84%	0.86%	0.82%	0.93%
Return on average equity (2)	7.74%	8.64%	8.91%	7.75%	8.70%
Dividend payout ratio (3)	56.00%	49.31%	43.05%	47.65%	43.03%
Average equity to average assets	9.87%	9.66%	9.61%	10.60%	10.68%
Interest rate spread (4)	2.82%	2.90%	3.02%	3.06%	3.25%
Net interest margin (5)	3.31%	3.34%	3.39%	3.42%	3.62%
Non-interest expense to average assets	2.54%	2.38%	2.36%	2.38%	2.30%
Average interest earning assets to average interest bearing liabilities	114.94%	114.25%	114.11%	115.03%	115.02%
<i>Regulatory Capital Ratios (Bank only):</i>					
Tier I - adjusted total assets	8.25%	7.95%	7.94%	7.74%	8.70%
Tier I - risk based	12.63%	12.57%	12.86%	12.47%	13.42%
Total risk-based	13.20%	13.15%	13.39%	12.92%	14.35%
<i>Asset Quality Ratios:</i>					
Nonperforming loans as a percent of net loans (6)	1.70%	1.31%	0.99%	1.12%	1.74%
Nonperforming assets as a percent of total assets (7)	1.44%	1.16%	0.90%	0.94%	1.35%
Allowance for loan losses as a percent of gross loans receivable	0.65%	0.68%	0.64%	0.76%	0.77%

(1) Net income divided by average assets.

(2) Net income divided by average equity.

(3) Dividends declared per share divided by net income per share.

(4) Difference between weighted average yield on interest-earning assets and weighted average cost of interest-bearing liabilities.

(5) Net interest income as a percentage of average interest-earning assets.

(6) Nonperforming loans consist of loans accounted for on a nonaccrual basis and accruing loans 90 days or more past due.

(7) Nonperforming assets consist of nonperforming loans and real estate acquired in settlement of loans, but exclude restructured loans.

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

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## 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 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 to be 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; and other factors disclosed periodically in the Company's filings with the Securities and Exchange Commission.

Because of the risks and uncertainties inherent in forward-looking statements, readers are cautioned not to place undue reliance on them, whether included in this report or made elsewhere from time to time by the Company or on its behalf by its authorized officers. Except as may be required by applicable law and regulation, the Company assumes no obligation to update or revise any forward-looking statements subsequent to the date on which they are made.

## General

As the holding company for the Bank, the Company conducts its business primarily through the Bank. The Bank's results of operations depend primarily on net interest income, which is the difference between the income earned on its interest-earning assets, such as loans and investments, and the cost of its interest-bearing liabilities, consisting primarily of deposits, retail repurchase agreements and borrowings from the Federal Home Loan Bank of Indianapolis. The Bank's net income is also affected by, among other things, fee income, provisions for loan losses, operating expenses and income tax provisions. The Bank's results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government legislation and policies concerning monetary and fiscal affairs, housing and financial institutions and the intended actions of the regulatory authorities.

Management's discussion and analysis of financial condition and results of operations is intended to assist in understanding the financial condition and results of operations of the Company and the Bank. The information contained in this section should be read in conjunction with the consolidated financial statements and the accompanying notes to consolidated financial statements included elsewhere in this report.

## Operating Strategy

The Company is the parent company of an independent community-oriented financial institution that delivers quality customer service and offers a wide range of deposit, loan and investment products to its customers. The commitment to customer needs, the focus on providing consistent customer service, and community service and support are the keys to the Bank's past and future success. The Company has no other material income other than that generated by the Bank and its subsidiaries.

The Bank's primary business strategy is attracting deposits from the general public and using those funds to originate one-to-four-family residential mortgage loans, multi-family residential loans, commercial real estate and business loans and consumer loans. The Bank invests excess liquidity primarily in interest-bearing deposits with the Federal Home Loan Bank of Indianapolis and other financial institutions, federal funds sold, U.S. government and agency securities, local municipal obligations and mortgage-backed securities.

In recent years, the Company's operating strategy has also included strategies designed to enhance profitability by increasing sources of noninterest income and improving operating efficiency while managing its capital and limiting its credit risk and interest rate risk exposures. To accomplish these objectives, the Company has focused on the following:

- Control credit risk by focusing on the origination of one-to-four-family residential mortgage loans and consumer loans, consisting primarily of home equity loans and lines of credit, while increasing the market share of commercial real estate and small business loans.
- Focus on growth at the branch offices in commercial deposit and loan relationships.
- Capitalize on our branch locations to further expand our market share in Southern Indiana.
- Increase fee income from secondary market mortgage originations by having dedicated originators serving each office.
- Continue to invest in technology to increase productivity and efficiency, increase growth of our Internet banking service, bill payment service, and the Company's ability to provide customer information at our teller lines in minutes versus days.
- Engage in a capital management strategy to repurchase Company stock and pay dividends to enhance shareholder value.

## Critical Accounting Policies and Estimates

The accounting and reporting policies of the Company comply with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. The financial position and results of operations can be affected by these estimates and assumptions, which are integral to understanding reported results. Critical accounting policies are those policies that require management to make assumptions about matters that are highly uncertain at the time an accounting estimate is made; and different estimates that the Company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the Company's financial condition, changes in financial condition or results of operations. Most accounting policies are not considered by management to be critical accounting policies. Several factors are considered in determining whether or not a policy is critical in the preparation of financial statements. These factors include, among other things, whether the estimates are significant to the financial statements, the nature of the estimates, the ability to readily validate the estimates with other information including third parties or available prices, and sensitivity of the estimates to changes in economic conditions and whether alternative accounting methods may be utilized under generally accepted accounting principles.

Significant accounting policies, including the impact of recent accounting pronouncements, are discussed in Note 1 of the Notes to Consolidated Financial Statements. Those policies considered to be critical accounting policies are described below.

**Allowances for Loan Losses.** Management's evaluation of the adequacy of the allowance for loan losses is the most critical of accounting estimates for a financial institution. The methodology for determining the allowance for loan losses and the related provision for loan losses is described below in "Allowance for Loan Losses." This accounting estimate is highly subjective and requires a significant amount of judgment because a multitude of factors can influence the ultimate collection of a loan. The methodology for determining the allowance for loan losses attempts to identify the amount of probable losses in the loan portfolio. However, there can be no assurance that the methodology will successfully identify all probable losses as the factors and conditions that influence the estimate are subject to significant change and management's judgments. As a result, additional provisions for loan losses may be required that would adversely impact earnings in future periods.

**Valuation Methodologies.** In the ordinary course of business, management applies various valuation methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when active markets do not exist for the items being valued. Generally, in evaluating various assets for potential impairment, management compares the fair value to the carrying value. Quoted market prices are referred to when estimating fair values for certain assets, such as investment securities. However, for those items for which market-based prices do not exist, management utilizes significant estimates and assumptions to value such items. Examples of these items include goodwill and other intangible assets, estimated present value of impaired loans, deferred compensation plans, value ascribed to stock-based compensation and certain other financial investments. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on the Company's results of operations.

## Comparison of Operating Results

### Year Ended December 31, 2007 Compared to Year Ended December 31, 2006

**Net Income.** Net income was \$3.4 million (\$1.20 per share diluted; weighted average common shares outstanding of 2,836,601, as adjusted) for the year ended December 31, 2007 compared to \$3.7 million (\$1.30 per share diluted; weighted average common shares outstanding of 2,848,229, as adjusted) for the year ended December 31, 2006.

**Net Interest Income.** Net interest income decreased \$84,000, or 0.6%, from \$13.5 million in 2006 to \$13.4 million in 2007 primarily due to a decrease in the interest rate spread.

Total interest income increased 3.3% from \$26.2 million in 2006 to \$27.1 million in 2007. This increase was primarily a result of higher yields due to higher market interest rates. Interest on loans increased \$544,000 as a result of the average tax-equivalent yield on those loans increasing from 6.82% in 2006 to 7.03% in 2007. Interest on investment securities increased \$181,000 during 2007 due to the average tax-equivalent yield of those investments increasing from 4.56% in 2006 to 4.81% in 2007. The average balance of interest-earning assets changed little, increasing from \$417.9 million in 2006 to \$419.0 million in 2007. The average tax equivalent yield on interest-earning assets increased from 6.38% in 2006 to 6.58% in 2007. Management has focused loan origination efforts on commercial and consumer loans. The majority of the new commercial loans are adjustable-rate loans. Adjustable-rate loans now comprise 38% of the total loan portfolio compared to 36% at the end of 2006. Market interest rates increased during 2006, resulting in scheduled upward repricing of variable-rate loans during 2007, increasing the overall yield on these loans in 2007.

Total interest expense increased \$958,000, from \$12.7 million for 2006 to \$13.7 million for 2007. This increase was primarily due to an increase in the average cost of funds from 3.48% in 2006 to 3.76% in 2007. The increase was primarily due to the average cost of time deposits which increased from 4.05% in 2006 to 4.54% in 2007 primarily due to low cost accounts maturing and repricing at higher current rates. The average balances of deposits and borrowed funds were \$291.7 million and \$72.9 million, respectively, for 2007. In 2006, those average balances were \$290.4 million and \$75.4 million. For further information, see "Average Balance Sheets" below. The changes in interest income and interest expense resulting from changes in volume and changes in rates for 2007 and 2006 are shown in the schedule captioned "Rate/Volume Analysis" included herein.

**Provision for Loan Losses.** The provision for loan losses was \$558,000 for 2007 compared to \$810,000 for 2006. The consistent application of management's allowance methodology resulted in a decrease in the provision for loan losses during 2007 due to the net loan portfolio growth of \$888,000, compared to \$11.1 million in 2006. Nonperforming loans increased from \$4.4 million at December 31, 2006 to \$5.7 million at December 31, 2007. Net charge offs increased slightly comparing the two periods, from \$594,000 during 2006 to \$646,000 during 2007. The provisions were recorded to bring the allowance to the level determined in applying the allowance methodology after reduction for net charge-offs during the year. See "Asset Quality."

Provisions for loan losses are charges to earnings to maintain the total allowance for loan losses at a level considered adequate 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.

**Noninterest income.** Noninterest income increased \$53,000 to \$3.5 million for 2007 compared to 2006. Service charges on deposit accounts and the cash surrender value of life insurance increased \$163,000 and \$108,000, respectively, when comparing the two periods. The increase in cash surrender value of life insurance was due to the purchase of \$3.6 million of bank-owned life insurance in May 2007. Other income and commission income decreased \$168,000 and \$140,000, respectively, primarily due to the sale of the Company's insurance agency in December 2006.

**Noninterest expense.** Noninterest expense increased \$798,000, or 7.6%, to \$11.3 million for 2007 compared to \$10.6 million in 2006. The increase resulted primarily from increases of \$361,000 in compensation and benefits and \$212,000 in other operating expenses. The increase in compensation and benefits is attributable to normal salary increases and the increased staff with the opening of the new office in Salem, Indiana during November 2007. The increase in other operating expenses is primarily due to losses on the sale of foreclosed assets and other expenses associated with those assets.

**Income tax expense.** Income tax expense for the year ended December 31, 2007 was \$1.6 million compared to \$1.9 million for the year ended December 31, 2006. The effective tax rate for 2006 was 33.5% compared to 31.8% for 2007. The decrease in the effective tax rates for 2007 compared to 2006 was primarily the result of an increase in tax-exempt income due to increases in municipal securities and bank-owned life insurance held in 2007 compared to 2006. See Note 12 in the accompanying Notes to Consolidated Financial Statements.

## **Year Ended December 31, 2006 Compared to Year Ended December 31, 2005**

**Net Income.** Net income was \$3.7 million (\$1.30 per share diluted; weighted average common shares outstanding of 2,848,229, as adjusted) for the year ended December 31, 2006 and \$3.7 million (\$1.29 per share diluted; weighted average common shares outstanding of 2,848,640, as adjusted) for the year ended December 31, 2005. The 2005 figures have been restated to account for the 10% stock dividend declared on June 19, 2006.

**Net Interest Income.** Net interest income increased \$154,000, or 1.2%, from \$13.3 million in 2005 to \$13.5 million in 2006 primarily due to an increase in average interest-earning assets during 2006 offset by an increase in average interest-bearing liabilities and a decrease in the interest rate spread.

Total interest income increased 10.8% from \$23.7 million in 2005 to \$26.2 million in 2006. This increase was primarily a result of higher yields due to higher market interest rates and an increase in loan balances. Interest on loans increased \$2.5 million as a result of the average yield and balance on those loans increasing from 6.41% and \$318.6 million, respectively, in 2005 to 6.82% and \$336.5 million, respectively, in 2006. Interest on investment securities increased \$89,000 during 2006 due to the average yield of those investments increasing from 4.34% in 2005 to 4.56% in 2006. The average balance of interest-earning assets increased 3.6% from \$403.5 million in 2005 to \$417.9 million in 2006. The average tax equivalent yield on interest-earning assets increased from 5.95% in 2005 to 6.38% in 2006. Management has continued to focus loan origination efforts on variable-rate loans. These loans comprised 36% of the total loan portfolio at the end of 2006, compared to 33% at the end of 2005. As market interest rates increased during 2006, the yield on variable-rate loans scheduled to reprice during the year increased.

Total interest expense increased from \$10.3 million for 2005 to \$12.7 million for 2006. This increase was primarily due to an increase in the average cost of interest-bearing liabilities from 2.93% in 2005 to 3.48% in 2006. The Federal Reserve Board increased target interest rates by 1.00% during 2006 which spurred an increase in the Bank's average cost on money market savings and interest-bearing demand deposits, from 1.28% in 2005 to 2.20% in 2006. The average cost of time deposits also increased from 3.53% in 2005 to 4.05% in 2006 primarily due to low cost accounts maturing and repricing at higher rates. The average balances of deposits and borrowed funds were \$290.4 million and \$75.4 million, respectively, for 2006. In 2005, those average balances were \$284.0 million and \$69.5 million. For further information, see "Average Balance Sheets" below. The changes in interest income and interest expense resulting from changes in volume and changes in rates for 2006 and 2005 are shown in the schedule captioned "Rate/Volume Analysis" that follows "Average Balance Sheets."

**Provision for Loan Losses.** The provision for loan losses was \$810,000 for 2006 compared to \$563,000 for 2005. During 2006, the net loan portfolio growth was \$11.1 million, primarily due to increases in commercial real estate, land and consumer loans. The consistent application of management's allowance methodology resulted in an increase in the provision for loan losses as nonperforming loans increased from \$3.2 million at December 31, 2005 to \$4.4 million at December 31, 2006. This increase was partially offset by a reduction in net charge offs, from \$937,000 during 2005 to \$594,000 during 2006. The provisions were recorded to bring the allowance to the level determined in applying the allowance methodology after reduction for net charge-offs during the year. See "Asset Quality."

**Noninterest income.** Noninterest income increased \$470,000, or 15.7%, to \$3.5 million for 2006 compared to \$3.0 million in 2005 primarily due to increases in service charges on deposit accounts and gains on the sale of mortgage loans of \$254,000 and \$184,000, respectively. The increase in service charges on deposit accounts was due to both the increased number of transaction accounts and an increase in some fees charged to depositors as the Bank increased fees for the first time since 2003. In 2006, the Bank continued its mortgage banking activities which began in 2003. The Bank was able to offer an increased number of mortgage products to borrowers while continuing to reduce the concentration of long-term fixed rate mortgage loans. For a discussion of our mortgage banking operations, see Note 1 in the accompanying Notes to Consolidated Financial Statements.

**Noninterest expense.** Noninterest expense increased \$399,000, or 3.9%, to \$10.6 million for 2006 compared to \$10.2 million in 2005. The increase results primarily from increases of \$284,000 in compensation and benefits and \$83,000 in other operating expenses. The increase in compensation and benefits is attributable to normal salary increases and higher employee insurance costs.

**Income tax expense.** Income tax expense for the years ended December 31, 2005 and December 31, 2006 was \$1.9 million. The effective tax rate for 2005 was 34.2% compared to 33.5% for 2006. See Note 12 in the accompanying Notes to Consolidated Financial Statements.

## AVERAGE BALANCE SHEETS

The following table sets forth certain information for the periods indicated regarding average balances of assets and liabilities, as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities and average yields and costs. Such yields and costs for the periods indicated are derived by dividing income or expense by the average historical cost balances of assets or liabilities, respectively, for the periods presented and do not give effect to changes in fair value that are included as a separate component of stockholders' equity. Average balances are derived from daily balances. Tax-exempt income on loans and investment securities has been adjusted to a tax equivalent basis using the federal marginal tax rate of 34%.

(Dollars in thousands)	Year ended December 31,								
	2007			2006			2005		
	<u>Average</u> <u>Balance</u>	<u>Interest</u>	<u>Average</u> <u>Yield/</u> <u>Cost</u>	<u>Average</u> <u>Balance</u>	<u>Interest</u>	<u>Average</u> <u>Yield/</u> <u>Cost</u>	<u>Average</u> <u>Balance</u>	<u>Interest</u>	<u>Average</u> <u>Yield/</u> <u>Cost</u>
<b>Interest-earning assets:</b>									
Loans (1) (2):									
Taxable (3)	\$331,077	\$23,282	7.03%	\$331,210	\$22,644	6.84%	\$318,165	\$20,372	6.40%
Tax-exempt	2,636	173	6.56%	5,276	314	5.95%	451	38	8.43%
Total loans	<u>333,713</u>	<u>23,455</u>	7.03%	<u>336,486</u>	<u>22,958</u>	6.82%	<u>318,616</u>	<u>20,410</u>	6.41%
Investment securities:									
Taxable (3)	57,193	2,509	4.39%	59,502	2,454	4.12%	62,092	2,421	3.90%
Tax-exempt	20,873	1,248	5.98%	18,046	1,080	5.98%	16,147	973	6.03%
Total investment securities	<u>78,066</u>	<u>3,757</u>	4.81%	<u>77,548</u>	<u>3,534</u>	4.56%	<u>78,239</u>	<u>3,394</u>	4.34%
Federal funds sold and interest-bearing deposits with banks									
	7,210	359	4.98%	3,913	192	4.91%	6,609	199	3.01%
Total interest-earning assets	<u>418,989</u>	<u>27,571</u>	6.58%	<u>417,947</u>	<u>26,684</u>	6.38%	<u>403,464</u>	<u>24,003</u>	5.95%
Noninterest-earning assets									
	27,919			26,119			27,420		
Total assets	<u>\$ 446,908</u>			<u>\$ 444,066</u>			<u>\$ 430,884</u>		
<b>Interest-bearing liabilities:</b>									
Interest-bearing demand deposits	\$ 92,843	\$ 2,242	2.41%	\$ 92,016	\$ 2,021	2.20%	\$ 91,177	\$ 1,171	1.28%
Savings accounts	30,440	242	0.80%	31,603	247	0.78%	34,261	263	0.77%
Time deposits	168,387	7,642	4.54%	166,810	6,751	4.05%	158,609	5,598	3.53%
Total deposits	<u>291,670</u>	<u>10,126</u>	3.47%	<u>290,429</u>	<u>9,019</u>	3.11%	<u>284,047</u>	<u>7,032</u>	2.48%
Retail repurchase agreements	13,137	632	4.81%	16,821	841	5.00%	7,986	273	3.42%
FHLB advances	59,722	2,941	4.92%	58,562	2,881	4.92%	61,535	3,038	4.94%
Total interest-bearing liabilities	<u>364,529</u>	<u>13,699</u>	3.76%	<u>365,812</u>	<u>12,741</u>	3.48%	<u>353,568</u>	<u>10,343</u>	2.93%
Noninterest-bearing liabilities:									
Noninterest-bearing deposits	35,026			33,015			33,265		
Other liabilities	3,250			2,323			2,656		
Total liabilities	<u>402,805</u>			<u>401,150</u>			<u>389,489</u>		
Stockholders' equity	44,103			42,916			41,395		
Total liabilities and stockholders' equity	<u>\$ 446,908</u>			<u>\$ 444,066</u>			<u>\$ 430,884</u>		
<b>Net interest income</b>									
		<u>\$ 13,872</u>			<u>\$ 13,943</u>			<u>\$ 13,660</u>	
<b>Interest rate spread</b>									
			<u>2.82%</u>			<u>2.90%</u>			<u>3.02%</u>
<b>Net interest margin</b>									
			<u>3.31%</u>			<u>3.34%</u>			<u>3.39%</u>
<b>Ratio of average interest-earning assets to average interest-bearing liabilities</b>									
			<u>114.94%</u>			<u>114.25%</u>			<u>114.11%</u>

(1) Interest income on loans includes fee income of \$485,000, \$480,000, and \$383,000 for the years ended December 31, 2007, 2006, and 2005, respectively.

(2) Average loan balances include loans held for sale and nonperforming loans.

(3) Includes taxable debt and equity securities and Federal Home Loan Bank stock.

## RATE/VOLUME ANALYSIS

The following table sets forth the effects of changing rates and volumes on net interest income and interest expense computed on a tax-equivalent basis. Information is provided with respect to (i) effects on interest income attributable to changes in volume (changes in volume multiplied by prior rate); (ii) effects attributable to changes in rate (changes in rate multiplied by prior volume); and (iii) effects attributable to changes in rate and volume (change in rate multiplied by changes in volume). Tax exempt income on loans and investment securities has been adjusted to a tax-equivalent basis using the federal marginal tax rate of 34%.

	2007 Compared to 2006 Increase (Decrease) Due to				2006 Compared to 2005 Increase (Decrease) Due to			
	<u>Rate</u>	<u>Volume</u>	<u>Rate/ Volume</u>	<u>Net</u>	<u>Rate</u>	<u>Volume</u>	<u>Rate/ Volume</u>	<u>Net</u>
	(In thousands)							
Interest-earning assets:								
Loans:								
Taxable	\$ 647	\$ (9)	\$ -	\$ 638	\$ 1,390	\$ 825	\$ 57	\$ 2,272
Tax-exempt	32	(157)	(16)	(141)	(11)	407	(120)	276
Total loans	<u>679</u>	<u>(166)</u>	<u>(16)</u>	<u>497</u>	<u>1,379</u>	<u>1,232</u>	<u>(63)</u>	<u>2,548</u>
Investment securities:								
Taxable	161	(100)	(6)	55	139	(100)	(6)	33
Tax-exempt	-	168	-	168	(7)	115	(1)	107
Total investment securities	<u>161</u>	<u>68</u>	<u>(6)</u>	<u>223</u>	<u>132</u>	<u>15</u>	<u>(7)</u>	<u>140</u>
Federal funds sold and interest-bearing deposits with banks	<u>3</u>	<u>162</u>	<u>2</u>	<u>167</u>	<u>126</u>	<u>(81)</u>	<u>(51)</u>	<u>(6)</u>
Total net change in income on interest-earning assets	<u>843</u>	<u>64</u>	<u>(20)</u>	<u>887</u>	<u>1,637</u>	<u>1,166</u>	<u>(121)</u>	<u>2,682</u>
Interest-bearing liabilities:								
Interest-bearing deposits	1,059	44	4	1,107	1,789	158	40	1,987
Retail repurchase agreements	(32)	(184)	7	(209)	126	302	140	568
FHLB advances	1	59	-	60	(11)	(147)	1	(157)
Total net change in expense on interest-bearing liabilities	<u>1,028</u>	<u>(81)</u>	<u>11</u>	<u>958</u>	<u>1,904</u>	<u>313</u>	<u>181</u>	<u>2,398</u>
Net change in net interest income	<u>\$ (185)</u>	<u>\$ 145</u>	<u>\$ (31)</u>	<u>\$ (71)</u>	<u>\$ (267)</u>	<u>\$ 853</u>	<u>\$ (302)</u>	<u>\$ 284</u>

## Comparison of Financial Condition at December 31, 2007 and 2006

Total assets decreased 0.9% from \$457.1 million at December 31, 2006 to \$453.2 million at December 31, 2007 primarily due to a decrease in cash and cash equivalents. Those funds were used to offset decreases in deposits and retail repurchase agreements.

Net loans increased 0.3% from \$333.6 million at December 31, 2006 to \$334.5 million at December 31, 2007. The largest area of loan growth was in commercial real estate loans which increased \$16.4 million, or 33.7%, to \$64.9 million at December 31, 2007. Commercial lending, which is generally considered to carry greater risk of loss than residential mortgage lending, has been a key focus of management for the last several years and is expected to remain so for 2008. Consumer loans also increased \$2.6 million during 2007. Residential mortgage loans decreased \$12.3 million during 2007 as the Bank continued to expand its mortgage banking activities and retained fewer residential mortgage loans in the loan portfolio. The Bank originated \$34.1 million in new residential mortgages for sale in the secondary market during 2007 compared to \$24.5 million in 2006. These loans were either originated and funded by the Bank and sold in the secondary market or originated as an agent for a third-party mortgage company. Of this total, \$14.6 million paid off existing loans in the Bank's portfolio. Originating mortgage loans for sale or serving as an agent for a third-party mortgage company allows the Bank to better manage its interest rate risk, while offering a full line of mortgage products to prospective customers. Residential construction loans decreased \$4.5 million during 2007 as the Bank sought to limit speculative construction lending during the increasingly volatile housing market.

Securities available for sale, at fair value, consisting primarily of U. S. agency and private mortgage-backed obligations, U. S. agency notes and bonds, and municipal obligations increased \$1.6 million, from \$71.4 million at December 31, 2006 to \$73.0 million at December 31, 2007. Purchases of securities available for sale totaled \$14.2 million in 2007. These purchases were offset by maturities of \$9.2 million and principal repayments of \$4.1 million. The Bank invests excess cash in securities that provide safety, liquidity and yield. Accordingly, the Bank purchases mortgage-backed securities to provide cash flow for loan demand and deposit changes, federal agency notes for short-term yield and low credit risk, and municipals to improve the tax equivalent yield focusing on longer term profitability.

The investment in securities held to maturity, consisting of federal agency mortgage-backed securities and municipal obligations, totaled \$1.1 million at December 31, 2007 and December 31, 2006. During 2007, the Bank had maturities of \$48,000 and principal repayments of \$19,000.

Cash and cash equivalents decreased from \$24.5 million at December 31, 2006 to \$15.1 million at December 31, 2007. Excess funds, which came to the Bank late in 2006, were invested in early 2007.

Total deposits decreased 0.9%, from \$331.1 million at December 31, 2006 to \$328.2 million at December 31, 2007. Noninterest-bearing demand deposits decreased 2.6% to \$35.3 million at December 31, 2007. Time deposits decreased \$5.1 million during 2007 while interest-bearing demand deposits, money market and savings accounts increased a total of \$3.0 million during the period. As market rates decreased during the latter part of 2007, many customers chose to let their certificates of deposit mature and transfer those funds to interest-bearing demand deposit accounts to wait for rates to rebound.

Federal Home Loan Bank borrowings increased \$1.2 million from \$59.5 million at December 31, 2006 to \$60.7 million at December 31, 2007. New advances of \$46.0 million were drawn during the year, primarily to meet short-term liquidity needs and lock in at lower fixed rates. Principal payments on advances totaled \$44.8 million during 2007.

Retail repurchase agreements decreased from \$19.2 million at December 31, 2006 to \$15.6 million at December 31, 2007. This decrease was primarily due to a decrease in public funds which can vary significantly during the year.

Total stockholders' equity increased from \$44.1 million at December 31, 2006 to \$45.7 million at December 31, 2007 primarily as a result of retained net income of \$1.5 million and a \$528,000 unrealized gain on available for sale securities. During 2007, the Company also repurchased 39,043 shares of its stock at a weighted average price of \$17.42 per share. As of December 31, 2007, the Company had repurchased 310,924 shares of the 345,000 authorized by the Board of Directors under the current stock repurchase program.

## Asset Quality

At December 31, 2007, nonperforming assets, consisting of nonaccrual loans, loans 90 days past due and still accruing and real estate owned, totaled \$6.5 million, or 1.44% of total assets compared to a total of \$5.3 million, or 1.16% of total assets, at December 31, 2006. At December 31, 2007 and 2006, impaired loans totaled \$5.7 million and \$4.4 million, respectively, as defined by Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*. Impaired loans at December 31, 2007 and 2006 included nonaccrual loans of \$4.9 million and \$3.2 million, respectively, and loans 90 days past due still accruing interest of \$816,000 and \$1.1 million, respectively. The increase in nonaccrual loans primarily relates to four loans secured by residential real estate developments in Floyd County, Indiana totaling \$1.2 million. Loans 90 days past due may continue to accrue interest as long as the estimated value of the collateral and collection efforts are deemed sufficient to ensure full recovery. The related allowance for loan losses on impaired loans was \$555,000 at December 31, 2007 and \$516,000 at December 31, 2006. The average carrying value of impaired loans was \$5.2 million and \$3.7 million during the years ended December 31, 2007 and 2006, respectively, and interest income of \$281,000 and \$132,000 was recognized on impaired loans during the period of impairment under the cash receipts method during 2007 and 2006, respectively. The Bank's net charge-offs were \$646,000, or 0.19% of average loans outstanding for the year ended December 31, 2007, compared to \$594,000, or 0.18% of average loans outstanding for the year ended December 31, 2006. The allowance for loan losses was \$2.2 million, or 0.65% of total loans, at December 31, 2007 compared to \$2.3 million, or 0.68% of total loans, at December 31, 2006. The decrease in the ratio of the allowance for loan losses to total loans primarily results from the decrease in the loss provision recorded during 2007 compared to 2006 due to the slowed growth rate in net loans receivable. Foreclosed real estate decreased to \$833,000 at December 31, 2007 compared to \$941,000 at December 31, 2006. Foreclosed real estate consists of residential properties held for sale. During 2007 and 2006, foreclosure losses included in net charge-offs to the allowance for loan losses amounted to \$241,000 and \$102,000, respectively.

The following table presents an analysis of nonperforming assets as of December 31, 2007 and 2006:

*(Dollars in thousands)*

	<u>2007</u>	<u>2006</u>
Nonaccrual loans:		
Residential real estate	\$ 1,684	\$ 797
Commercial real estate	2,674	2,192
Commercial business	397	48
Consumer	<u>124</u>	<u>208</u>
Total	<u>4,879</u>	<u>3,245</u>
Loans 90 days past due still accruing interest:		
Residential real estate	633	776
Commercial real estate	-	-
Commercial business	23	144
Consumer	<u>160</u>	<u>205</u>
Total	<u>816</u>	<u>1,125</u>
Total nonperforming loans	5,695	4,370
Foreclosed real estate, net	<u>833</u>	<u>941</u>
Total nonperforming assets	<u>\$ 6,528</u>	<u>\$ 5,311</u>
Nonperforming loans to net loans	1.70%	1.31%
Nonperforming loans to total assets	1.26%	0.96%
Nonperforming assets to total assets	1.44%	1.16%
Allowance for loan losses as a percentage of:		
Outstanding loans	0.65%	0.68%
Nonperforming loans	39.19%	53.09%
Net charge-offs	345.51%	390.57%

Regulations require that the Bank classify its assets on a regular basis. There are three regulatory classifications for problem assets: substandard, doubtful and loss. Management regularly reviews the loan portfolio to determine whether any loans require classification or a change in classification. At December 31, 2007, the Bank had \$4.9 million in doubtful loans and \$3.9 million in substandard loans, of which all but \$3.3 million are included in total nonperforming loans reported above. In addition to regulatory classifications, the Bank also classifies loans as "special mention" or "watch" when they are currently performing in accordance with their contractual terms but exhibit potential weaknesses that must be monitored by management on an ongoing basis. At December 31, 2007, the Bank identified \$5.1 million in loans as special mention or watch loans.

## **Allowance for Loan Losses**

Loans are the Bank's largest concentration of assets and continue to represent the most significant potential risk. In originating loans, the Bank recognizes that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the collateral. The Bank maintains an allowance for loan losses to absorb losses inherent in the loan portfolio. The allowance for loan losses represents management's estimate of probable loan losses based on information available as of the date of the financial statements. The allowance for loan losses is based on management's evaluation of the loan portfolio, including historical loan loss experience, delinquencies, known and inherent risks in the nature and volume of the loan portfolio, information about specific borrower situations, estimated collateral values, and economic conditions.

The loan portfolio is reviewed quarterly by management to evaluate the adequacy of the allowance for loan losses to determine the amount of any adjustment required after considering the loan charge-offs and recoveries for the quarter. Management applies a systematic methodology that incorporates its current judgments about the credit quality of the loan portfolio. In addition, the Office of Thrift Supervision (OTS), as an integral part of its examination process, periodically reviews the Bank's allowance for loan losses and may require the Bank to make additional provisions for estimated losses based on their judgments about information available to them at the time of their examination.

The methodology used in determining the allowance for loan losses includes segmenting the loan portfolio by identifying risk characteristics common to pools 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 pools of loans with similar characteristics by applying loss factors that consider the qualitative factors which may affect the loss rates.

Specific allowances related to impaired loans and other classified loans are established where management has identified significant conditions or circumstances related to a loan that management believes indicate that a probable loss has been incurred. The identification of these loans results from the loan review process that identifies and monitors credits with weaknesses or conditions which call into question the full collection of the contractual payments due under the terms of the loan agreement. Factors considered by management include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due.

For loans evaluated on a pool basis, management applies loss factors to pools of loans with common risk characteristics (i.e., residential mortgage loans, home equity loans, credit card loans). The loss factors are derived from the Bank's historical loss experience or, where the Bank does not have loss experience, the peer group historical loss experience. Peer group historical loss experience is used after evaluating the attributes of the Bank's loan portfolio as compared to the peer group which is considered to be community banks located in the central region of the United States. Loss factors are adjusted for significant qualitative factors that, in management's judgment, affect the collectibility of the loan portfolio segment. The significant qualitative factors include the levels and trends in charge-offs and recoveries, trends in volume and terms of loans, levels and trends in delinquencies, the effects of changes in underwriting standards and other lending practices or procedures, the experience and depth of the lending management and staff, effects of changes in credit concentration, changes in industry and market conditions and national and local economic trends and conditions. Management evaluates these conditions on a quarterly basis and evaluates and modifies the assumptions used in establishing the loss factors.

## Off-Balance-Sheet Arrangements

The Company is a party to financial instruments with off-balance-sheet risk including commitments to extend credit under existing lines of credit and commitments to originate loans. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements.

Off-balance-sheet financial instruments whose contract amounts represent credit and interest rate risk are summarized as follows:

	<u>At December 31,</u>	
	<u>2007</u>	<u>2006</u>
	<i>(In thousands)</i>	
Commitments to originate new loans	\$ 9,821	\$ 12,943
Undisbursed portion of construction loans	6,431	6,029
Unfunded commitments to extend credit under existing commercial and personal lines of credit	35,007	40,891
Standby letters of credit	2,002	4,104

The Company does not have any special purpose entities, derivative financial instruments or other forms of off-balance-sheet financing arrangements.

Commitments to originate new loans or to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Loan commitments generally expire within 30 to 45 days. Most equity line commitments are for a term of 5 to 10 years and commercial lines of credit are generally renewable on an annual basis. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amounts of collateral obtained, if deemed necessary by the Company upon extension of credit, are based on management's credit evaluation of the borrower.

## Contractual Obligations

The following table summarizes information regarding the Company's contractual obligations as of December 31, 2007:

<u>Contractual Obligations</u>	<u>Payments due by period</u>				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1-3 years</u>	<u>3-5 years</u>	<u>More than 5 years</u>
	<i>(In thousands)</i>				
Deposits	\$ 328,151	\$ 273,067	\$ 47,950	\$ 6,483	\$ 651
Federal Home Loan Bank advances	60,694	12,864	32,101	10,629	5,100
Retail repurchase agreements	15,562	15,562	-	-	-
Operating lease obligations	<u>106</u>	<u>39</u>	<u>67</u>	<u>-</u>	<u>-</u>
Total contractual obligations	<u>\$ 404,513</u>	<u>\$ 301,532</u>	<u>\$ 80,118</u>	<u>\$ 17,112</u>	<u>\$ 5,751</u>

## Liquidity and Capital Resources

Liquidity refers to the ability of a financial institution to generate sufficient cash flow to fund current loan demand, meet deposit withdrawals and pay operating expenses. The Bank's primary sources of funds are new deposits and proceeds from loan repayments and prepayments and from the maturity of securities. The Bank may also borrow from the Federal Home Loan Bank of Indianapolis. While loan repayments and maturities of securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by market interest rates, general economic conditions and competition. At December 31, 2007, the Bank had cash and interest-bearing deposits with banks of \$15.1 million and securities available for sale with a fair value of \$73.0 million. If the Bank requires funds beyond its ability to generate them internally, it has additional borrowing capacity with the Federal Home Loan Bank of Indianapolis and collateral eligible for repurchase agreements.

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. At December 31, 2007, the Bank had total commitments to extend credit of \$51.3 million. See Note 16 in the accompanying Notes to Consolidated Financial Statements. At December 31, 2007, the Bank had certificates of deposit scheduled to mature within one year of \$111.7 million. 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 regulations. As of December 31, 2007, 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 8.3%, 8.3% and 13.2%, respectively. See Note 20 in the accompanying Notes to Consolidated Financial Statements.

## Effect of Inflation and Changing Prices

The consolidated financial statements and related financial data presented in this report have been prepared in accordance with generally accepted accounting principles, which generally require the measurement of financial position and operating results in terms of historical dollars, without considering the changes in relative purchasing power of money over time due to inflation. The primary impact of inflation is reflected in the increased cost of the Bank's operations. Unlike most industrial companies, virtually all the assets and liabilities of the financial institution are monetary in nature. As a result, interest rates generally have a more significant impact on the financial institutions performance than do general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

## Market Risk Analysis

**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 200 basis point decrease to a 300 basis point increase 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. This procedure for measuring interest rate risk was developed by the OTS to replace the "gap" analysis (the difference between interest-earning assets and interest-bearing liabilities that mature or reprice within a specific time period).

The following tables are provided by the OTS and set forth the change in the Bank's NPV at December 31, 2007 and 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.

At December 31, 2007					
Change In Rates	Net Portfolio Value			Net Portfolio Value as a Percent of Present Value of Assets	
	Dollar Amount	Dollar Change	Percent Change	NPV Ratio	Change
	<i>(Dollars in thousands)</i>				
300bp	\$ 38,799	\$ (13,312)	(26)%	8.71%	(249)bp
200bp	44,362	(7,749)	(15)	9.80	(140)bp
100bp	49,195	(2,916)	(6)	10.70	(50)bp
--bp	52,111	-	-	11.20	--bp
(100)bp	53,705	1,594	3	11.43	23 bp
(200)bp	53,914	1,803	3	11.40	20 bp

At December 31, 2006					
Change In Rates	Net Portfolio Value			Net Portfolio Value as a Percent of Present Value of Assets	
	Dollar Amount	Dollar Change	Percent Change	NPV Ratio	Change
	<i>(Dollars in thousands)</i>				
300bp	\$ 36,549	\$ (15,911)	(30)%	8.22%	(301)bp
200bp	42,490	(9,970)	(19)	9.39	(184)bp
100bp	48,196	(4,264)	(8)	10.47	(76)bp
--bp	52,460	-	-	11.23	--bp
(100)bp	54,725	2,265	4	11.58	35 bp
(200)bp	55,166	2,706	5	11.58	35 bp

The preceding tables indicate that the Bank's NPV would be expected to decrease in the event of a sudden and sustained increase in prevailing market interest rates, but would be expected to increase in the event of a sudden and sustained decrease in rates. The expected decrease in the Bank's NPV given an increase in rates is primarily attributable to the relatively high percentage of fixed-rate loans in the Bank's loan portfolio. At December 31, 2007, approximately 62% of the 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 tables. These assumptions relate to interest rates, loan prepayments, 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 tables. 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 tables.



# MONROE SHINE

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## Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders  
**First Capital, Inc.**  
Corydon, Indiana

We have audited the accompanying consolidated balance sheets of **First Capital, Inc. and Subsidiaries** as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2007. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of **First Capital, Inc. and Subsidiaries** as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America.

*Monroe Shine*

New Albany, Indiana  
January 11, 2008

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**DECEMBER 31, 2007 AND 2006**

*(Dollars in thousands, except share and per share data)*

	<u>2007</u>	<u>2006</u>
<b>ASSETS</b>		
Cash and due from banks	\$ 10,010	\$ 14,002
Interest bearing deposits with banks	4,646	10,155
Federal funds sold	399	311
Total cash and cash equivalents	15,055	24,468
Securities available for sale, at fair value	72,991	71,362
Securities-held to maturity (fair value \$1.139; \$1,214 in 2006)	1,050	1,118
Loans held for sale	258	2,275
Loans, net of allowance for loan losses of \$ 2,232 in 2007 and \$2,320 in 2006	334,463	333,575
Federal Home Loan Bank stock, at cost	3,551	3,551
Foreclosed real estate	833	941
Premises and equipment	10,612	9,224
Accrued interest receivable	2,549	2,497
Cash surrender value of life insurance	5,124	1,349
Goodwill	5,386	5,386
Core deposit intangibles	317	390
Other assets	990	969
	\$ 453,179	\$ 457,105
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing	\$ 35,292	\$ 36,218
Interest-bearing	292,859	294,925
Total Deposits	328,151	331,143
Retail repurchase agreements	15,562	19,228
Advances from Federal Home Loan Bank	60,694	59,461
Accrued interest payable	1,902	1,863
Accrued expenses and other liabilities	1,134	1,321
Total Liabilities	407,443	413,016
<b>Commitments and contingencies</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 3,125,563 shares (3,113,705 shares in 2006)	31	31
Additional paid-in capital	23,863	23,647
Retained earnings-substantially restricted	28,284	26,783
Accumulated other comprehensive income	(53)	(581)
Unearned ESOP shares	(121)	(203)
Less treasury stock, at cost - 310,924 shares (271,881 shares in 2006)	(6,268)	(5,588)
Total Stockholders' Equity	45,736	44,089
	\$ 453,179	\$ 457,105

See notes to consolidated financial statements.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**YEARS ENDED DECEMBER 31, 2007, 2006, AND 2005**

*(Dollars in thousands, except per share data)*

	<u>2007</u>	<u>2006</u>	<u>2005</u>
<b>INTEREST INCOME</b>			
Loans, including fees	\$ 23,396	\$ 22,852	\$ 20,397
Securities			
Taxable	2,347	2,276	2,258
Tax-exempt	823	713	642
Federal Home Loan Bank dividends	162	178	163
Interest-bearing deposits in banks	357	192	199
Total interest income	<u>27,085</u>	<u>26,211</u>	<u>23,659</u>
<b>INTEREST EXPENSE</b>			
Deposits	10,126	9,019	7,032
Retail repurchase agreements	632	841	273
Advances from Federal Home Loan Bank	2,941	2,881	3,038
Total interest expense	<u>13,699</u>	<u>12,741</u>	<u>10,343</u>
Net interest income	13,386	13,470	13,316
Provision for loan losses	558	810	563
Net interest income after provision for loan losses	<u>12,828</u>	<u>12,660</u>	<u>12,753</u>
<b>NONINTEREST INCOME</b>			
Service charges on deposit accounts	2,538	2,375	2,121
Commission income	172	312	336
Gain on sale of mortgage loans	448	399	215
Mortgage brokerage fees	125	84	158
Increase in cash surrender value of life insurance	149	41	40
Other income	92	260	131
Total noninterest income	<u>3,524</u>	<u>3,471</u>	<u>3,001</u>
<b>NONINTEREST EXPENSE</b>			
Compensation and benefits	6,387	6,026	5,742
Occupancy and equipment	1,078	1,015	953
Data processing	907	841	913
Professional fees	460	417	369
Advertising	373	320	326
Other expenses	2,144	1,932	1,849
Total noninterest expense	<u>11,349</u>	<u>10,551</u>	<u>10,152</u>
Income before income taxes	5,003	5,580	5,602
Income tax expense	1,591	1,872	1,914
Net Income	<u>\$ 3,412</u>	<u>\$ 3,708</u>	<u>\$ 3,688</u>
Net income per common share, basic	<u>\$ 1.21</u>	<u>\$ 1.31</u>	<u>\$ 1.31</u>
Net income per common share, diluted	<u>\$ 1.20</u>	<u>\$ 1.30</u>	<u>\$ 1.29</u>

See notes to consolidated financial statements.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
**YEARS ENDED DECEMBER 31, 2007, 2006, AND 2005**

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Stock	Treasury Stock	Total
<i>(Dollars in thousands, except share and per share data)</i>							
Balances at January 1, 2005	\$ 28	\$ 19,278	\$ 26,888	\$ 29	\$ (331)	\$ (5,178)	\$ 40,714
<b>COMPREHENSIVE INCOME</b>							
Net income	-	-	3,688	-	-	-	3,688
Other comprehensive income:							
Change in unrealized gain on securities available for sale, net of deferred income tax benefit of \$473	-	-	-	(795)	-	-	(795)
Less: Reclassification adjustment	-	-	-	-	-	-	-
<b>Total comprehensive income</b>	-	-	-	-	-	-	<u>2,893</u>
Cash dividends (\$0.62 per share)	-	-	(1,587)	-	-	-	(1,587)
Stock options exercised	1	68	-	-	-	-	69
Shares released by ESOP trust	-	57	-	-	82	-	139
Stock compensation expense	-	-	-	-	1	-	1
Purchase of 14,656 treasury shares	-	-	-	-	-	(272)	(272)
Balances at December 31, 2005	29	19,403	28,989	(766)	(248)	(5,450)	41,957
<b>COMPREHENSIVE INCOME</b>							
Net income	-	-	3,708	-	-	-	3,708
Other comprehensive income:							
Change in unrealized gain on securities available for sale, net of deferred income tax expense of \$105	-	-	-	185	-	-	185
Less: Reclassification adjustment	-	-	-	-	-	-	-
<b>Total comprehensive income</b>	-	-	-	-	-	-	<u>3,893</u>
10% stock dividend	2	4,118	(4,081)	-	(39)	-	-
Cash dividends (\$0.68 per share)	-	-	(1,833)	-	-	-	(1,833)
Stock options exercised	-	25	-	-	-	-	25
Shares released by ESOP trust	-	69	-	-	82	-	151
Stock compensation expense	-	32	-	-	2	-	34
Purchase of 7,483 treasury shares	-	-	-	-	-	(138)	(138)
Balances at December 31, 2006	\$ 31	\$ 23,647	\$ 26,783	\$ (581)	\$ (203)	\$ (5,588)	\$ 44,089

See notes to consolidated financial statements.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY - CONTINUED**  
**YEARS ENDED DECEMBER 31, 2007, 2006, AND 2005**

<i>(Dollars in thousands, except share and per share data)</i>	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Stock Compensation and ESOP	Treasury Stock	Total
Balances at December 31, 2006	\$ 31	\$ 23,647	\$ 26,783	\$ (581)	\$ (203)	\$ (5,588)	\$ 44,089
<b>COMPREHENSIVE INCOME</b>							
Net income	-	-	3,412	-	-	-	3,412
Other comprehensive income:							
Change in unrealized gain on securities available for sale, net of deferred income tax expense of \$308	-	-	-	528	-	-	528
Less: Reclassification adjustment	-	-	-	-	-	-	-
<b>Total comprehensive income</b>							<u>3,940</u>
Cash dividends (\$0.68 per share)	-	-	(1,911)	-	-	-	(1,911)
Stock options exercised	-	125	-	-	-	-	125
Shares released by ESOP trust	-	59	-	-	82	-	141
Stock compensation expense	-	32	-	-	-	-	32
Purchase of 39,043 treasury shares	-	-	-	-	-	(680)	(680)
Balances at December 31, 2007	<u>\$ 31</u>	<u>\$ 23,863</u>	<u>\$ 28,284</u>	<u>\$ (53)</u>	<u>\$ (121)</u>	<u>\$ (6,268)</u>	<u>\$ 45,736</u>

See notes to consolidated financial statements.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**YEARS ENDED DECEMBER 31, 2007, 2006, AND 2005**

*(Dollars in thousands)*

	<u>2007</u>	<u>2006</u>	<u>2005</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income	\$ 3,412	\$ 3,708	\$ 3,688
Adjustments to reconcile net income to net cash and cash equivalents provided by operating activities:			
Amortization of premium and accretion of discount on securities, net	16	30	137
Depreciation and amortization expense	755	751	821
Deferred income taxes	(63)	(159)	182
ESOP and stock compensation expense	173	185	155
Increase in cash value of life insurance	(149)	(41)	(40)
Provision for loan losses	558	810	563
Proceeds from sale of mortgage loans	29,183	22,580	16,114
Mortgage loans originated for sale	(26,718)	(24,456)	(15,390)
Net gain on sale of mortgage loans	(448)	(399)	(215)
Stock dividends on Federal Home Loan Bank stock	-	-	(78)
Increase in accrued interest receivable	(52)	(35)	(358)
Increase in accrued interest payable	39	365	212
Net change in other assets/liabilities	(436)	334	(218)
<b>Net Cash Provided By Operating Activities</b>	<u>6,270</u>	<u>3,673</u>	<u>5,573</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Purchase of securities available for sale	(14,158)	(9,097)	(23,639)
Proceeds from maturities of securities available for sale	9,208	9,732	6,523
Proceeds from maturities of securities held to maturity	48	35	25
Principal collected on mortgage-backed obligations	4,160	4,025	5,221
Investment in cash surrender value of life insurance	(3,625)	-	-
Net increase in loans receivable	(2,225)	(12,669)	(7,083)
Proceeds from sale of Federal Home Loan Bank stock	-	195	-
Proceeds from sale of foreclosed real estate	887	545	846
Purchase of premises and equipment	(2,070)	(615)	(139)
<b>Net Cash Used In Investing Activities</b>	<u>(7,775)</u>	<u>(7,849)</u>	<u>(18,246)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Net increase (decrease) in deposits	(2,992)	13,879	802
Advances from Federal Home Loan Bank	46,000	32,450	30,000
Repayment of advances from Federal Home Loan Bank	(44,767)	(38,936)	(29,152)
Net increase (decrease) in retail repurchase agreements	(3,666)	8,524	10,069
Exercise of stock options	108	25	61
Purchase of treasury stock	(680)	(138)	(271)
Dividends paid	(1,911)	(1,833)	(1,588)
<b>Net Cash Provided By (Used In) Financing Activities</b>	<u>(7,908)</u>	<u>13,971</u>	<u>9,921</u>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	(9,413)	9,795	(2,752)
Cash and cash equivalents at Beginning of Year	<u>24,468</u>	<u>14,673</u>	<u>17,425</u>
<b>Cash and Cash Equivalents at End of Year</b>	<u>\$ 15,055</u>	<u>\$ 24,468</u>	<u>\$ 14,673</u>

See notes to consolidated financial statements.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(1) **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations**

First Capital, Inc. (the Company) is the thrift holding company of First Harrison Bank (the Bank), a wholly-owned subsidiary. The Bank is a federally-chartered savings bank which provides a variety of banking services to individuals and business customers through twelve locations in southern Indiana. The Bank's primary source of revenue is real estate mortgage loans. The Bank originates mortgage loans for sale in the secondary market and also serves as a broker. On December 28, 2006, the Bank sold its property and casualty insurance business, but the Bank continues to sell non-deposit investment products through a financial services division. The Bank also 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 securities portfolio.

**Basis of Consolidation**

The consolidated financial statements include the accounts of the Company and its subsidiaries and have been prepared in accordance with generally accepted accounting principles and conform to general practices in the banking industry. Intercompany balances and transactions have been eliminated. Certain prior year amounts have been reclassified to conform to the current year presentation.

**Statements of Cash Flows**

For purposes of the statements of cash flows, the Company considers all cash and amounts due from depository institutions, and federal funds sold to be cash and cash equivalents.

**Use of Estimates**

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.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowance for loan losses and foreclosed real estate, management obtains independent appraisals for significant properties.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Bank to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Investment Securities**

**Securities Available for Sale:** Securities classified as available for sale are reported at fair value. Unrealized gains and losses, net of tax, on securities available for sale are included in other comprehensive income and the accumulated unrealized holding gains and losses are reported as a separate component of equity until realized. Realized gains and losses on the sale of securities available for sale are determined using the specific identification method and are included in other noninterest income and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income. Amortization of premium and accretion of discount are recognized in interest income using methods approximating the interest method over the period to maturity.

**Securities Held to Maturity:** Debt securities for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premium and accretion of discount that are recognized in interest income using methods approximating the interest method over the period to maturity.

Declines in the fair value of individual available for sale and held to maturity securities below their amortized cost that are other than temporary result in write-downs of the individual securities to their fair value. The related write-downs are included in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than amortized cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment for a period of time sufficient to allow for any anticipated recovery in fair value.

**Loans and Allowance for Loan Losses**

The Bank grants real estate mortgage, commercial business and consumer loans. A substantial portion of the loan portfolio is represented by mortgage loans to customers in southern Indiana. The ability of the Bank's customers to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans are stated at unpaid principal balances, less net deferred loan fees and the allowance for loan losses.

Loan origination and commitment fees, as well as certain direct costs of underwriting and closing loans, are deferred and amortized as a yield adjustment to interest income over the lives of the related loans using the interest method. Amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

The recognition of income on a loan is discontinued and previously accrued interest is reversed, when interest or principal payments become ninety (90) days past due unless, in the opinion of management, the outstanding interest remains collectible. Past due status is determined based on contractual terms. Generally, by applying the cash receipts method, interest income is subsequently recognized only as received until the loan is returned to accrual status. The cash receipts method is used when the likelihood of further loss on the loan is remote. Otherwise, the Bank applies the cost recovery method and applies all payments as a reduction of the unpaid principal balance until the loan qualifies for return to accrual status. A loan is restored to accrual status when all principal and interest payments are brought current and the borrower has demonstrated the ability to make future payments of principal and interest as scheduled. The Bank's practice is to charge off any loan or portion of a loan when the loan is determined by management to be uncollectible due to the borrower's failure to meet repayment terms, the borrower's deteriorating or deteriorated financial condition, the depreciation of the underlying collateral, the loans classification as a loss by regulatory examiners, or for other reasons.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. The specific component relates to loans that are classified as doubtful, substandard, or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

#### **Foreclosed Real Estate**

Foreclosed real estate includes both formally foreclosed property and in-substance foreclosed property held for sale. In-substance foreclosed properties are those properties for which the institution has taken physical possession, regardless of whether formal foreclosure proceedings have taken place.

At the time of foreclosure, foreclosed real estate is recorded at the lower of fair value less estimated costs to sell or cost, which becomes the property's new basis. Any write-downs based on the property's fair value at date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and property held for sale is carried at the lower of the new cost basis or fair value less cost to sell. Costs incurred in maintaining foreclosed real estate and subsequent impairment adjustments to the carrying amount of a property, if any, are included in other noninterest expense.

#### **Premises and Equipment**

The Company uses the straight line method of computing depreciation at rates adequate to amortize the cost of the applicable assets over their estimated useful lives. Items capitalized as part of premises and equipment are valued at cost. Maintenance and repairs are expensed as incurred. The cost and related accumulated depreciation of assets sold, or otherwise disposed of, are removed from the related accounts and any gain or loss is included in earnings.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Goodwill and Other Intangibles**

Goodwill recognized in a business combination represents the excess of the cost of the acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. Goodwill is carried at its implied fair value and is evaluated for possible impairment at least annually or more frequently upon the occurrence of an event or change in circumstances that would more likely than not reduce the fair value of the reporting unit below its carrying amount. Such circumstances could include, but are not limited to: (1) a significant adverse change in legal factors or in business climate, (2) unanticipated competition, or (3) an adverse action or assessment by a regulator. If the carrying amount of the goodwill exceeds its implied fair value, an impairment loss is recognized in earnings equal to that excess amount. The loss recognized cannot exceed the carrying amount of goodwill. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill is its new accounting basis.

Other intangible assets consist of acquired core deposit intangibles. Core deposit intangibles are amortized over the estimated economic lives of the acquired core deposits. The carrying amount of core deposit intangibles and the remaining estimated economic life are evaluated annually or whenever events or circumstances indicate the carrying amount may not be recoverable or the remaining period of amortization requires revision. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset is its new accounting basis.

**Mortgage Banking Activities**

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or market value. Aggregate market value is determined based on the quoted prices under a "best efforts" sales agreement with a third party. Net unrealized losses are recognized through a valuation allowance by charges to income. Realized gains on sales of mortgage loans are included in noninterest income. Mortgage loans are sold with servicing released.

Commitments to originate mortgage loans held for sale are considered derivative financial instruments to be accounted for at fair value. The Bank's mortgage loan commitments subject to derivative accounting are fixed-rate mortgage loan commitments at market rates when initiated. At December 31, 2007, the Bank had commitments to originate \$1.4 million in fixed-rate mortgage loans intended for sale in the secondary market after the loans are closed. Fair value is estimated based on fees that would be charged on commitments with similar terms.

**Income Taxes**

Income taxes are provided for the tax effects of the transactions reported in the financial statements and consist of taxes currently due plus deferred taxes related primarily to differences between the basis of available-for-sale securities, allowance for loan losses, estimated losses on foreclosed real estate, accumulated depreciation, and accrued income and expenses for financial and income tax reporting. The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Stock-Based Compensation**

Effective January 1, 2006, the Company adopted the fair value based method of accounting for stock-based compensation prescribed in statement of Financial Accounting Standards (SFAS) 123R, *Share-Based Payment*, for its stock option plan.

**Advertising Costs**

Advertising costs are charged to operations when incurred.

**Recent Accounting Pronouncements**

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

In June 2006, the Financial Accounting Standards Board (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 provisions of the Interpretation are 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 federal income tax return and the Company and Bank file a combined unitary return in the state of Indiana. The Company's federal income tax returns have not been examined in the past five years and the 2004, 2005 and 2006 tax years are subject to federal examination. The Company's Indiana state income tax returns for the years 2003, 2004 and 2005 were examined, with no changes made. The only tax year subject to state examination is 2006. The Company has no unrecognized tax benefits and does not anticipate any increase in unrecognized tax benefits during 2007 relative to any tax positions taken after January 1, 2007. The Company believes that its income tax filing positions and deductions would be sustained upon examination and does not anticipate any adjustments that would result in a material change to its financial position or results of operations. Therefore, no reserves for uncertain income tax positions have been recorded nor did the Company record a cumulative effect adjustment related to the adoption of Interpretation No. 48.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

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. FASB has deferred the effective date in SFAS 157 for one year for certain nonfinancial assets and nonfinancial liabilities, except those that are recognized and disclosed in the financial statements on a recurring annual basis. The application of this statement is not expected to have a material impact on the Company's financial condition or results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured 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 differently without having to apply complex hedge accounting provisions. The statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This statement is effective as of the beginning of fiscal years beginning after November 15, 2007. Accordingly, the Company will adopt SFAS No. 159 on January 1, 2008. At the effective date, an entity may elect the fair value option for eligible items that exist at that date. The entity shall report the effect of the first remeasurement to fair value as a cumulative effect adjustment to the opening balance of retained earnings. 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 adoption will be material.

(2) **RESTRICTION ON CASH AND DUE FROM BANKS**

The Bank is required to maintain reserve balances on hand and with the Federal Reserve Bank which are noninterest bearing and unavailable for investment. The average amount of those reserve balances for the years ended December 31, 2007 and 2006 were approximately \$2.1 million and \$5.7 million, respectively.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(3) **INVESTMENT SECURITIES**

Debt and equity securities have been classified in the balance sheets according to management's intent. Investment securities at December 31, 2007 and 2006 are summarized as follows:

<i>(In thousands)</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 2007:</b>				
Securities available for sale:				
Federal agency and corporate mortgage-backed securities	\$ 24,356	\$ 119	\$ 132	\$ 24,343
Other debt securities:				
Federal agency notes or bonds	25,421	30	131	25,320
Municipal	<u>21,736</u>	<u>121</u>	<u>58</u>	<u>21,799</u>
Subtotal, debt securities	<u>71,513</u>	<u>270</u>	<u>321</u>	<u>71,462</u>
Mutual funds	<u>1,559</u>	-	30	1,529
Total securities available for sale	<u>\$ 73,072</u>	<u>\$ 270</u>	<u>\$ 351</u>	<u>\$ 72,991</u>
Securities held to maturity:				
Federal agency mortgage-backed securities	\$ 42	\$ -	\$ 1	\$ 41
Other debt securities:				
Municipal	<u>1,008</u>	<u>90</u>	-	<u>1,098</u>
Total securities held to maturity	<u>\$ 1,050</u>	<u>\$ 90</u>	<u>\$ 1</u>	<u>\$ 1,139</u>
<b>December 31, 2006:</b>				
Securities available for sale:				
Federal agency and corporate mortgage-backed securities	\$ 20,045	\$ 9	\$ 391	\$ 19,663
Other debt securities:				
Federal agency notes or bonds	32,936	-	504	32,432
Municipal	<u>17,821</u>	<u>100</u>	<u>109</u>	<u>17,812</u>
Subtotal, debt securities	<u>70,802</u>	<u>109</u>	<u>1,004</u>	<u>69,907</u>
Mutual funds	<u>1,478</u>	-	23	1,455
Total securities available for sale	<u>\$ 72,280</u>	<u>\$ 109</u>	<u>\$ 1,027</u>	<u>\$ 71,362</u>
Securities held to maturity:				
Federal agency mortgage-backed securities	\$ 62	\$ -	\$ 2	\$ 60
Other debt securities:				
Municipal	<u>1,056</u>	<u>98</u>	-	<u>1,154</u>
Total securities held to maturity	<u>\$ 1,118</u>	<u>\$ 98</u>	<u>\$ 2</u>	<u>\$ 1,214</u>

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(3 - continued)

The amortized cost and fair value of debt securities as of December 31, 2007, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities may differ from contractual maturities because the mortgages underlying the obligations may be prepaid without penalty.

	<u>Securities Available for Sale</u>		<u>Securities Held to Maturity</u>	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<i>(In thousands)</i>				
Due in one year or less	\$ 12,385	\$ 12,325	\$ 43	\$ 44
Due after one year through five years	20,441	20,451	144	150
Due after five years through ten years	4,191	4,225	216	236
Due after ten years	<u>10,140</u>	<u>10,118</u>	<u>605</u>	<u>668</u>
	47,157	47,119	1,008	1,098
Mortgage-backed securities	<u>24,356</u>	<u>24,343</u>	<u>42</u>	<u>41</u>
	<u>\$ 71,513</u>	<u>\$ 71,462</u>	<u>\$ 1,050</u>	<u>\$ 1,139</u>

Investment securities with a carrying amount of \$500,000 were pledged to secure public deposits at December 31, 2007. Also see notes 9 and 10 regarding investment securities pledged for other purposes.

Information pertaining to securities with gross unrealized losses at December 31, 2007, aggregated by investment category and the length of time that individual securities have been in a continuous loss position, follows:

	Number of Investment Positions	Fair Value	Gross Unrealized Losses
<i>(Dollars in thousands)</i>			
<b>Securities available for sale:</b>			
Continuous loss position less than twelve months:			
Federal agency and corporate mortgage-backed securities	3	\$ 1,647	\$ 4
Federal agency notes or bonds	9	6,483	11
Municipal obligations	14	5,122	33
Mutual fund	<u>1</u>	<u>1,238</u>	<u>1</u>
Total less than twelve months	<u>27</u>	<u>14,490</u>	<u>49</u>
Continuous loss position more than twelve months:			
Federal agency and corporate mortgage-backed securities	25	9,777	128
Federal agency notes or bonds	20	16,314	119
Municipal obligations	14	4,182	26
Mutual fund	<u>1</u>	<u>291</u>	<u>29</u>
Total more than twelve months	<u>60</u>	<u>30,564</u>	<u>302</u>
Total securities available for sale	<u>87</u>	<u>\$ 45,054</u>	<u>\$ 351</u>

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(3 - continued)

	Number Of Investment Positions	Fair Value	Gross Unrealized Losses
<i>(Dollars in thousands)</i>			
<b>Securities held to maturity:</b>			
Continuous loss position more than twelve months:			
Federal agency mortgage-backed securities	2	\$ 37	\$ 1

At December 31, 2007, the 85 debt securities in the available for sale classification in a loss position had depreciated approximately 1% from the amortized cost basis. All of the debt securities in a loss position at December 31, 2007 were backed by federal or state governments or secured by mortgage loans. These unrealized losses related principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government, its agencies or other governments, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. As management has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available for sale, no declines are deemed to be other-than-temporary.

**(4) LOANS**

Loans at December 31, 2007 and 2006 consisted of the following:

<i>(In thousands)</i>	<u>2007</u>	<u>2006</u>
Real estate mortgage loans:		
Residential	\$ 161,554	\$ 173,806
Land	12,032	12,581
Residential construction	12,963	17,435
Commercial real estate	58,606	47,756
Commercial real estate construction	6,272	764
Commercial business loans	24,210	24,730
Consumer loans:		
Home equity and second mortgage loans	41,035	39,483
Automobile loans	15,645	15,637
Loans secured by savings accounts	2,406	2,263
Unsecured loans	2,848	2,895
Other consumer loans	5,349	4,406
Gross loans	342,920	341,756
Less:		
Deferred loan origination fees, net	(205)	(168)
Undisbursed portion of loans in process	6,430	6,029
Allowance for loan losses	2,232	2,320
Loans, net	\$ 334,463	\$ 333,575

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

At December 31, 2007, residential mortgage loans secured by one-to-four family residential properties without private mortgage insurance or government guarantee and with loan-to-value ratios exceeding 90% amounted to approximately \$4.7 million.

Mortgage loans serviced for the benefit of others amounted to \$552,000 and \$798,000 at December 31, 2007 and 2006, respectively.

An analysis of the allowance for loan losses is as follows:

<i>(In thousands)</i>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Beginning balances	\$ 2,320	\$ 2,104	\$ 2,478
Provision for loan losses	558	810	563
Recoveries	136	110	124
Loans charged-off	<u>(782)</u>	<u>(704)</u>	<u>(1,061)</u>
Ending balances	<u>\$ 2,232</u>	<u>\$ 2,320</u>	<u>\$ 2,104</u>

At December 31, 2007 and 2006, the total recorded investment in loans on nonaccrual amounted to approximately \$4.9 million and \$3.2 million, respectively. The total recorded investment in loans past due ninety days or more and still accruing interest amounted to approximately \$816,000 and \$1.1 million at December 31, 2007 and 2006, respectively. Information about impaired loans and the related allowance for loan losses is presented below.

<i>(In thousands)</i>	<u>2007</u>	<u>2006</u>	<u>2005</u>
At end of year:			
Impaired loans with related allowance	\$ 2,678	\$ 1,657	\$ 784
Impaired loans with no allowance	<u>3,017</u>	<u>2,713</u>	<u>2,415</u>
Total	<u>\$ 5,695</u>	<u>\$ 4,370</u>	<u>\$ 3,199</u>
Allowance related to impaired loans	\$ 555	\$ 516	\$ 290
Average balance of impaired loans during the year	5,184	3,678	2,906
Interest income recognized in the statements of income during the periods of impairment	65	91	81
Interest income recognized during the periods of impairment - cash method	281	132	99

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

The Bank has entered into loan transactions with certain directors, officers and their affiliates (i.e., related parties). In the opinion of management, such indebtedness was incurred in the ordinary course of business on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with unrelated persons.

The following table represents the aggregate activity for related party loans during the year ended December 31, 2007:

*(In thousands)*

Beginning balance	\$ 2,964
New loans	1,745
Payments	<u>(2,957)</u>
Ending balance	<u>\$ 1,752</u>

The Bank has purchased commercial paper from a corporation where a director is considered a related party. In the opinion of management, these transactions were made in the ordinary course of business on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with unrelated parties. During the year ended December 31, 2007, the Bank purchased approximately \$1.1 million of loans to customers of the corporation and the aggregate outstanding balance of all loans purchased from the corporation was approximately \$1.9 million at both December 31, 2007 and 2006.

(5) **PREMISES AND EQUIPMENT**

Premises and equipment as of December 31 consisted of the following:

<i>(In thousands)</i>	<u>2007</u>	<u>2006</u>
Land and land improvements	\$ 3,190	\$ 2,530
Leasehold improvements	159	159
Office buildings	8,367	7,485
Furniture, fixtures and equipment	<u>4,224</u>	<u>4,025</u>
	15,940	14,199
Less accumulated depreciation	<u>5,328</u>	<u>4,975</u>
Totals	<u>\$ 10,612</u>	<u>\$ 9,224</u>

Depreciation expense was \$682,000, \$678,000 and \$748,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**(6) FORECLOSED REAL ESTATE**

At December 31, 2007 and 2006, the Bank had foreclosed real estate held for sale of \$833,000 and \$941,000, respectively. During the years ended December 31, 2007, 2006 and 2005, foreclosure losses in the amount of \$241,000, \$102,000 and \$235,000, respectively, were charged off to the allowance for loan losses. Losses on subsequent write downs of foreclosed real estate of \$35,000 for 2007 are aggregated with realized gains and losses from the sale of foreclosed real estate. No losses on subsequent write downs of foreclosed real estate were recognized in 2006 and 2005. The net gain or loss on foreclosed real estate is reported in other noninterest income or noninterest expense. Real estate taxes and other expenses of holding foreclosed real estate are included in other noninterest expenses and amounted to \$131,000, \$93,000 and \$61,000 in 2007, 2006 and 2005, respectively.

**(7) GOODWILL AND OTHER INTANGIBLES**

The Company acquired goodwill in the acquisition of Hometown Bancshares, Inc. during 2003. Goodwill is evaluated for impairment at least annually or more frequently upon the occurrence of an event or when circumstances indicate that the carrying amount is greater than its fair value. No impairment of goodwill was recognized during 2007, 2006 or 2005.

The following is a summary of other intangible assets subject to amortization as of December 31, 2007 and 2006:

<i>(In thousands)</i>	<u>2007</u>	<u>2006</u>
Core deposit intangibles:		
Acquired in branch acquisition	\$ 181	\$ 181
Acquired in Hometown merger	<u>566</u>	<u>566</u>
Gross carrying amount	747	747
Accumulated amortization	<u>(430)</u>	<u>(357)</u>
	<u>\$ 317</u>	<u>\$ 390</u>

Amortization expense was \$73,000, \$73,000 and \$73,000 for each year during the three year period ended December 31, 2007. Estimated amortization expense for each of the ensuing five years is as follows:

Year ending December 31:	<i>(In thousands)</i>
2008	\$ 73
2009	73
2010	73
2011	66
2012	32

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**(8) DEPOSITS**

The aggregate amount of time deposit accounts with balances of \$100,000 or more was approximately \$49.2 million and \$50.4 million at December 31, 2007 and 2006, respectively. Deposit account balances in excess of \$100,000 are not federally insured.

At December 31, 2007, scheduled maturities of time deposits were as follows:

Year ending December 31:	<i>(In thousands)</i>
2008	\$ 111,697
2009	31,887
2010	16,063
2011	1,849
2012 and thereafter	<u>5,285</u>
Total	\$ <u>166,781</u>

The Bank held deposits of approximately \$5.5 million and \$6.1 million for related parties at December 31, 2007 and 2006, respectively.

**(9) RETAIL REPURCHASE AGREEMENTS**

Retail repurchase agreements represent overnight borrowings from deposit customers and the debt securities sold under the repurchase agreements are under the control of the Bank. Information concerning borrowings under repurchase agreements is summarized as follows:

<i>(Dollars in thousands)</i>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Weighted average interest rate during the year	4.81%	5.00%	3.42%
Average daily balance	\$ 13,137	\$ 16,821	\$ 7,986
Maximum month-end balance during the year	\$ 18,071	\$ 24,346	\$ 13,276

Debt securities underlying the agreements at December 31:

Amortized cost	\$ 22,584	\$ 26,567	\$ 16,964
Fair value	\$ 22,491	\$ 25,118	\$ 16,952

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(10) **ADVANCES FROM FEDERAL HOME LOAN BANK**

At December 31, 2007 and 2006, advances from the Federal Home Loan Bank were as follows:

<i>(Dollars in thousands)</i>	2007		2006	
	Weighted Average Rate	Amount	Weighted Average Rate	Amount
Fixed rate advances	4.73%	\$ <u>60,694</u>	4.88%	\$ <u>59,461</u>

At December 31, 2007, advances from the Federal Home Loan Bank totaling \$23.0 million carried a put option whereby the Federal Home Loan Bank will automatically convert the fixed rate advance to a variable rate should the market interest rate exceed a pre-determined strike rate.

The following is a schedule of maturities for advances outstanding as of December 31, 2007:

*(In thousands)*

Due in:

2008	\$ 12,864
2009	15,054
2010	17,047
2011	3,379
2012	7,250
Thereafter	<u>5,100</u>
Total	\$ <u>60,694</u>

The advances are secured under a blanket collateral agreement. At December 31, 2007, the carrying value of residential mortgage loans and investment securities pledged as security for the advances was \$126.7 million and \$1.2 million, respectively.

(11) **LEASE COMMITMENTS**

During 2005, the Bank extended a noncancelable lease agreement for branch office space which expires in 2010. The Bank also has a noncancelable sub-lease agreement for branch office space which expires in 2010.

The subsidiary companies headquartered in Nevada lease office space under sublease agreements that automatically renew for one year periods each October.

The following is a schedule by years of future minimum rental payments required under operating leases that have initial or remaining noncancelable lease terms in excess of one year as of December 31, 2007 for each of the next five years and in the aggregate:

Year ending December 31:	<i>(In thousands)</i>
2008	\$ 39
2009	39
2009	<u>28</u>
Total minimum payments required	\$ <u>106</u>

Total rental expense for all operating leases for the years ended December 31, 2007, 2006 and 2005 amounted to \$49,000, \$49,000 and \$44,000, respectively.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(12) **INCOME TAXES**

The components of income tax expense were as follows:

<i>(In thousands)</i>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Current	\$ 1,654	\$ 2,031	\$ 1,725
Tax benefit allocated to additional paid-in capital related to exercise of options	-	-	7
Deferred	<u>(63)</u>	<u>(159)</u>	<u>182</u>
Totals	<u>\$ 1,591</u>	<u>\$ 1,872</u>	<u>\$ 1,914</u>

Significant components of the deferred tax assets and liabilities as of December 31, 2007 and 2006 were as follows:

<i>(In thousands)</i>	<u>2007</u>	<u>2006</u>
Deferred tax assets (liabilities):		
Depreciation	\$ (437)	\$ (505)
Deferred loan fees and costs	(120)	(113)
Deferred compensation plans	170	175
Federal Home Loan Bank stock dividends	(127)	(127)
Allowance for loan losses	876	910
Unrealized gain on securities available for sale	28	336
Acquisition purchase accounting adjustments	(106)	(132)
Other	<u>47</u>	<u>32</u>
Net deferred tax asset	<u>\$ 331</u>	<u>\$ 576</u>

The reconciliation of income tax expense with the amount which would have been provided at the federal statutory rate of 34% follows:

<i>(In thousands)</i>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Provision at federal statutory tax rate	\$ 1,701	\$ 1,897	\$ 1,905
State income tax-net of federal tax benefit	184	233	245
Tax-exempt interest income	(265)	(266)	(199)
Increase in cash value of life insurance	(51)	(14)	(13)
Other	<u>22</u>	<u>22</u>	<u>(24)</u>
Totals	<u>\$ 1,591</u>	<u>\$ 1,872</u>	<u>\$ 1,914</u>
<b>Effective tax rate</b>	<u>31.8%</u>	<u>33.5%</u>	<u>34.2%</u>

Prior to July 1, 1996, the Bank was permitted by the Internal Revenue Code to deduct from taxable income an annual addition to a statutory bad debt reserve subject to certain limitations. Retained earnings at December 31, 2007 includes approximately \$1.0 million of cumulative deductions for which no deferred federal income tax liability has been recorded. Reduction of these reserves for purposes other than tax bad debt losses or adjustments arising from carryback of net operating losses would create income for tax purposes subject to the then current corporate income tax rate. The unrecorded deferred liability on these amounts was approximately \$354,000 at December 31, 2007.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(12 - continued)

Federal legislation enacted in 1996 repealed the use of the qualified thrift reserve method of accounting for bad debts for tax years beginning after December 31, 1995. As a result, the Bank discontinued the calculation of the annual addition to the statutory bad debt reserve using the percentage-of-taxable-income method and adopted the experience reserve method for banks. Under this method, the Bank computes its federal tax bad debt deduction based on actual loss experience over a period of years. The legislation also provided that the Bank will not be required to recapture its pre-1988 statutory bad debt reserves if it ceases to meet the qualifying thrift definitional tests as provided under prior law and if the Bank continues to qualify as a "bank" under existing provisions of the Internal Revenue Code.

(13) **EMPLOYEE BENEFIT PLANS**

**Defined Contribution Plan:**

The Bank has a qualified contributory defined contribution plan available to all eligible employees. The plan allows participating employees to make tax-deferred contributions under Internal Revenue Code Section 401(k). The Bank contributed \$214,000, \$195,000 and \$188,000 to the plan for the years ended December 31, 2007, 2006 and 2005, respectively.

**Employee Stock Ownership Plan:**

On December 31, 1998, the Company established a leveraged employee stock ownership plan (ESOP) covering substantially all employees. The ESOP trust acquired 61,501 shares of Company common stock financed by a term loan with the Company. The employer loan and the related interest income are not recognized in the consolidated financial statements as the debt is serviced from Company contributions. Dividends payable on allocated shares are charged to retained earnings and are satisfied by the allocation of cash dividends to participant accounts. Dividends payable on unallocated shares are not considered dividends for financial reporting purposes. Shares held by the ESOP trust are allocated to participant accounts based on the ratio of the current year principal and interest payments to the total of the current year and future year's principal and interest to be paid on the employer loan.

Compensation expense is recognized based on the average fair value of shares released for allocation to participant accounts during the year with a corresponding credit to stockholders' equity. Compensation expense recognized for the years ended December 31, 2007, 2006 and 2005 amounted to \$142,000, \$151,000 and \$153,000, respectively.

Company common stock held by the ESOP trust at December 31 was as follows, as restated for the stock dividend declared on June 19, 2006 (see Note 19):

<i>(Dollars in thousands)</i>	<u>2007</u>	<u>2006</u>
Allocated shares	50,176	44,030
Unearned shares	10,661	18,861
Total ESOP shares	<u>60,837</u>	<u>62,891</u>
Fair value of unearned shares	\$ <u>176</u>	\$ <u>350</u>

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**(14) DEFERRED COMPENSATION PLANS**

The Bank has a deferred compensation plan whereby certain officers will be provided specific amounts of income for a period of fifteen years following normal retirement. The benefits under the agreements become fully vested after four years of service beginning with the effective date of the agreements. The Bank accrues the present value of the benefits so the amounts required will be provided at the normal retirement dates and thereafter.

Assuming normal retirement, the benefits under the plan are paid in varying amounts between 1999 and 2022. The Bank is the owner and beneficiary of insurance policies on the lives of these officers which may provide funds for a portion of the required payments. The agreements also provide for payment of benefits in the event of disability, early retirement, termination of employment or death. Deferred compensation expense for this plan was \$32,000, \$36,000 and \$36,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

The Bank also has a directors' deferred compensation plan whereby a director defers into a retirement account a portion of his monthly director fees for a specified period to provide a specified amount of income for a period of fifteen years following normal retirement. The Bank also accrues the interest cost on the deferred obligation so the amounts required will be provided at the normal retirement dates and thereafter.

Assuming normal retirement, the benefits under the plan are paid in varying amounts between 1995 and 2037. The agreements also provide for payment of benefits in the event of disability, early retirement, termination of service or death. Deferred compensation expense for this plan was \$15,000, \$14,000 and \$13,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

**(15) STOCK-BASED COMPENSATION PLANS**

At December 31, 2007, the Company has two stock-based compensation plans, which are described below. The compensation cost that has been charged against income for those plans was \$32,000, \$34,000 and \$1,000 for 2007, 2006 and 2005, respectively. The total income tax benefit for stock options exercised was \$17,000 and \$7,000 for 2007 and 2005, respectively. No income tax benefit was realized in 2006 for stock options exercised.

**Stock Option Plan**

The Company's stock option plan provides for issuance of up to 209,192 shares of the Company's authorized but unissued common stock to all employees, including any officer or employee-director. Under the plan, the Company may grant both non-qualified and qualified (i.e., incentive) stock options. In the case of incentive stock options, the aggregate fair value of the stock (determined at the time the incentive stock option is granted) for which any optionee may be granted incentive options which are first exercisable during any calendar year shall not exceed \$100,000. Option prices may not be less than the fair market value of the underlying stock at the date of the grant.

Options granted generally vest ratably over five years and are exercisable in whole or in part for a period up to ten years from the date of the grant. Certain stock options provide for accelerated vesting if there is a change in control (as defined in the plan).

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(15 - continued)

The fair market value of stock options granted was determined at the date of grant using the Black-Scholes-Merton option pricing model. Expected volatilities are based on historical volatility of the Company's stock. The expected term of options granted represents the period of time that options are expected to be outstanding and is based on historical trends. The risk free rate for the expected life of the options is based on the U.S. Treasury yield curve in effect at the time of grant. The following assumptions were used for grants during the year ended December 31, 2005. No options were granted during the years ended December 31, 2007 and 2006.

	<u>2005</u>
Expected dividend yields	3.30%
Risk-free interest rate	3.72%
Expected volatility	10.01%
Expected life of options	7 years

A summary of option activity under the plan as of December 31, 2007, and changes during the year then ended is presented below:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
<i>(Dollars in thousands except per share data)</i>				
Outstanding at beginning of year	106,152	\$ 14.70		
Granted	-	-		
Exercised	11,858	\$ 9.10		
Forfeited or expired	<u>3,685</u>	\$ 20.91		
Outstanding at end of year	<u>90,609</u>	\$ 15.18	4.1	\$ 307
Exercisable at end of year	<u>73,658</u>	\$ 13.89	3.5	\$ 307

The weighted average grant-date fair value of options granted during 2005 was \$1.75. No options were granted during 2007 or 2006. The total intrinsic value of options exercised during the years ended December 31, 2007, 2006 and 2005, was \$91,000, \$28,000 and \$53,000, respectively.

Effective January 1, 2006, the Company adopted SFAS 123R, *Share-Based Payment*, 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 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. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(15 - continued)

The Company recognized compensation expense of \$32,000 for the year ended December 31, 2007 related to the stock option plan as expense is recognized ratably over the five-year vesting period of the options. At December 31, 2007, there was \$46,000 of unrecognized compensation expense related to nonvested stock options, which will be recognized over the remaining vesting period.

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.

<i>(In thousands, except per share data)</i>	<b>Year Ended December 31, <u>2005</u></b>
Net income, as reported	\$ 3,688
Deduct: Total stock-based employee determined under fair value based method for all awards, net of related tax effects	<u>(19)</u>
Pro forma net income	<b>\$ <u>3,669</u></b>
Earnings per share:	
Basic - as reported	\$ 1.31
Basic pro forma	\$ 1.30
Diluted - as reported	\$ 1.29
Diluted - pro forma	\$ 1.29

**Restricted Stock Compensation Plan**

The Company has a restricted stock compensation plan as an encouragement for directors, officers and key employees to remain in the employment or service of the Bank. The plan provides for grants of up to 30,750 shares of the Company's authorized but unissued common stock and all shares have been granted. The shares granted under the plan are in the form of restricted stock vesting over a five-year period beginning one year after the date of grant of the award. Since the stock issued is held in escrow by the Company before some or all of the services are performed, unearned compensation is recorded as a reduction of stockholders' equity. Compensation expense is recognized over the requisite service period with a corresponding credit to stockholders' equity. The requisite service period for restricted shares is the vesting period. The terms of the restricted stock compensation plan include a provision whereby all unearned shares become fully vested upon a "change in control" as defined in the plan.

A summary of the status of the Company's nonvested restricted shares as of December 31, 2007, and changes during the year ended December 31, 2007, is presented below:

	<b>Number of Shares</b>	<b>Weighted Average Grant-Date Fair Value</b>
Nonvested at beginning of year	110	\$ 14.25
Granted	-	-
Vested	110	\$ 14.25
Forfeited	<u>-</u>	-
Nonvested at end of year	<u>-</u>	\$ -

The total fair value of shares vested during the years ended December 31, 2007, 2006 and 2005, was \$2,000, \$2,000 and \$124,000, respectively.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**(16) COMMITMENTS AND CONTINGENCIES**

In the normal course of business, there are outstanding various commitments and contingent liabilities, such as commitments to extend credit and legal claims, which are not reflected in the financial statements.

Commitments under outstanding standby letters of credit totaled \$2.0 million at December 31, 2007.

The following is a summary of the commitments to extend credit at December 31, 2007 and 2006:

<i>(In thousands)</i>	<u>2007</u>	<u>2006</u>
Loan commitments:		
Fixed rate	\$ 7,372	\$ 9,774
Adjustable rate	2,449	3,169
Unused lines of credit on credit cards	2,308	2,340
Undisbursed commercial and personal lines of credit	14,822	20,206
Undisbursed portion of construction loans in process	6,431	6,029
Undisbursed portion of home equity lines of credit	<u>17,877</u>	<u>18,345</u>
Total commitments to extend credit	<u>\$ 51,259</u>	<u>\$ 59,863</u>

At December 31, 2006, the Company had two commitments totaling approximately \$633,000 to acquire land for future branch sites. Both transactions were consummated in 2007.

**(17) FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK**

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

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments (see Note 16). The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount and type of collateral obtained, if deemed necessary by the Bank upon extension of credit, varies and is based on management's credit evaluation of the counterparty.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Standby letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit.

The Bank has not been required to perform on any financial guarantees and did not incur any losses on its commitments during the years ended December 31, 2007, 2006 and 2005.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**(18) DIVIDEND RESTRICTION**

As an Indiana corporation, the Company is subject to Indiana law with respect to the payment of dividends. Under Indiana law, the Company may pay dividends so long as it is able to pay its debts as they become due in the usual course of business and its assets exceed the sum of its total liabilities, plus the amount that would be needed, if the Company were to be dissolved at the time of the dividend, to satisfy any rights that are preferential to the rights of the persons receiving the dividend. The ability of the Company to pay dividends depends primarily on the ability of the Bank to pay dividends to the Company.

The payment of dividends by the Bank is subject to regulation by the Office of Thrift Supervision (OTS). The Bank may not declare or pay a cash dividend or repurchase any of its capital stock if the effect thereof would cause the regulatory capital of the Bank to be reduced below regulatory capital requirements imposed by the OTS or below the amount of the liquidation account established upon completion of the conversion of the Bank's former mutual holding company (First Capital, Inc., MHC) from mutual to stock form on December 31, 1998.

**(19) STOCK DIVIDEND**

On June 19, 2006, the Company declared a 10% stock dividend payable on or about 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 258,476 new shares. The fair market value of the additional shares issued, aggregating \$4.1 million, was charged to retained earnings with corresponding increases in common stock and additional paid-in capital. 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.

**(20) REGULATORY MATTERS**

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total risk-based capital and Tier I capital to risk-weighted assets (as defined in the regulations) Tier I capital to adjusted total assets (as defined) and tangible capital to adjusted total assets (as defined). Management believes, as of December 31, 2007, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2007, the most recent notification from the OTS categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the institution's categories.

The actual capital amounts and ratios are also presented in the table. No amounts were deducted from capital for interest-rate risk in either year.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(20 - continued)

<i>(Dollars in thousands)</i>	<b>Actual</b>		<b>Minimum For Capital Adequacy Purposes:</b>		<b>Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions:</b>	
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
<b>As of December 31, 2007:</b>						
Total capital (to risk weighted assets)	\$ 38,562	13.20%	\$ 23,363	8.00%	\$ 29,203	10.00%
Tier I capital (to risk weighted assets)	\$ 36,885	12.63%	N/A		\$ 17,522	6.00%
Tier I capital (to adjusted total assets)	\$ 36,885	8.25%	\$ 17,894	4.00%	\$ 22,367	5.00%
Tangible capital (to adjusted total assets)	\$ 36,885	8.25%	\$ 6,710	1.50%	N/A	
<b>As of December 31, 2006:</b>						
Total capital (to risk weighted assets)	\$ 37,578	13.15%	\$ 22,862	8.00%	\$ 28,577	10.00%
Tier I capital (to risk weighted assets)	\$ 35,922	12.57%	N/A		\$ 17,146	6.00%
Tier I capital (to adjusted total assets)	\$ 35,922	7.95%	\$ 18,082	4.00%	\$ 22,602	5.00%
Tangible capital (to adjusted total assets)	\$ 35,922	7.95%	\$ 6,781	1.50%	N/A	

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(21) **DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS**

The following table summarizes the carrying value and estimated fair value of financial instruments at December 31, 2007 and 2006:

	<u>2007</u>		<u>2006</u>	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<i>(In thousands)</i>				
Financial assets:				
Cash and cash equivalents	\$ 15,055	\$ 15,055	\$ 24,468	\$ 24,468
Securities available for sale	72,991	72,991	71,362	71,362
Securities held to maturity	1,050	1,139	1,118	1,214
Loans held for sale	258	258	2,275	2,275
Loans, net of allowance for loan losses	334,463	326,274	333,575	321,902
Federal Home Loan Bank stock	3,551	3,551	3,551	3,551
Accrued interest receivable	2,549	2,549	2,497	2,497
Financial liabilities:				
Deposits	328,151	332,786	331,143	333,289
Retail repurchase agreements	15,562	15,562	19,228	19,228
Advances from Federal Home Loan Bank	60,694	61,894	59,461	59,106
Accrued interest payable	1,902	1,902	1,863	1,863
Off-balance-sheet financial instruments:				
Asset related to commitments to extend credit	-	18	-	61

The carrying amounts in the preceding table are included in the consolidated balance sheets under the applicable captions. The contractual or notional amounts of financial instruments with off-balance-sheet risk are disclosed in Note 16.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate that value:

**Cash and Cash Equivalents**

For cash and cash equivalents, including cash and due from banks, interest-bearing deposits with banks, and federal funds sold, the carrying amount is a reasonable estimate of fair value.

**Debt and Equity Securities**

For debt and marketable equity securities, the fair values are based on quoted market prices. For Federal Home Loan Bank stock, a restricted equity security, the carrying amount is a reasonable estimate of fair value because it is not marketable.

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(21 - continued)

**Loans**

The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The carrying amount of accrued interest receivable approximates its fair value.

**Deposits**

The fair value of demand deposits, savings accounts, money market deposit accounts and other transaction accounts is the amount payable on demand at the balance sheet date. The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

**Borrowed Funds**

The carrying amount of retail repurchase agreements approximate its fair value. The fair value of advances from Federal Home Loan Bank is estimated by discounting the future cash flows using the current rates at which similar loans with the same remaining maturities could be obtained.

**Commitments to Extend Credit**

The majority of commitments to extend credit would result in loans with a market rate of interest if funded. The fair value of these commitments are the fees that would be charged to customers to enter into similar agreements. For fixed rate loan commitments, the fair value also considers the difference between current levels of interest rates and the committed rates.

(22) **PARENT COMPANY CONDENSED FINANCIAL INFORMATION**

Condensed financial information for First Capital, Inc. (parent company only) follows:

	<b>Balance Sheets</b>	
	<i>(In thousands)</i>	
	<u>As of December 31,</u>	
	<u>2007</u>	<u>2006</u>
<b>Assets:</b>		
Cash and interest bearing deposits	\$ 3,010	\$ 2,809
Other assets	198	160
Investment in subsidiaries	<u>42,538</u>	<u>41,123</u>
	<u>\$ 45,746</u>	<u>\$ 44,092</u>
<b>Liabilities and Equity:</b>		
Accrued Expenses	\$ 9	\$ 4
Stockholders' equity	<u>45,737</u>	<u>44,088</u>
	<u>\$ 45,746</u>	<u>\$ 44,092</u>

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(22 - continued)

**Statements of Income**  
*(In thousands)*

	<u>Years Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Interest income	\$ 15	\$ 14	\$ 13
Dividend income	2,813	2,516	2,006
Other operating expenses	<u>(452)</u>	<u>(402)</u>	<u>(332)</u>
Income before income taxes and equity in undistributed net income of subsidiaries	2,376	2,128	1,687
Income tax credit	<u>149</u>	<u>125</u>	<u>146</u>
Income before equity in undistributed net income of subsidiaries	2,525	2,253	1,833
Equity in undistributed net income of subsidiaries	<u>887</u>	<u>1,455</u>	<u>1,855</u>
Net income	<u>\$ 3,412</u>	<u>\$ 3,708</u>	<u>\$ 3,688</u>

**Statements of Cash Flows**  
*(In thousands)*

	<u>Years Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
<b>Operating Activities:</b>			
Net income	\$ 3,412	\$ 3,708	\$ 3,688
Adjustments to reconcile net income to cash provided by operating activities:			
Equity in undistributed net income of subsidiaries	(887)	(1,455)	(1,855)
ESOP and stock compensation expense	173	185	155
Net change in other assets and liabilities	<u>(14)</u>	<u>39</u>	<u>11</u>
Net cash provided by operating activities	<u>2,684</u>	<u>2,477</u>	<u>1,999</u>
<b>Financing Activities:</b>			
Exercise of stock options	108	25	61
Purchase of treasury stock	(680)	(138)	(272)
Cash dividends paid	<u>(1,911)</u>	<u>(1,833)</u>	<u>(1,588)</u>
Net cash used in financing activities	<u>(2,483)</u>	<u>(1,946)</u>	<u>(1,799)</u>
Net increase in cash	201	531	200
Cash at beginning of year	<u>2,809</u>	<u>2,278</u>	<u>2,078</u>
Cash at end of year	<u>\$ 3,010</u>	<u>\$ 2,809</u>	<u>\$ 2,278</u>

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(23) **SUPPLEMENTAL DISCLOSURE FOR EARNINGS PER SHARE**  
**(As restated for stock dividend declared on June 19, 2006)**

<i>(In thousands, except for share and per share data)</i>	<u>Years Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
<b>Basic:</b>			
Earnings:			
Net income	\$ 3,412	\$ 3,708	\$ 3,688
Shares:			
Weighted average common shares outstanding	2,814,691	2,823,372	2,821,772
Net income per common share, basic	\$ 1.21	\$ 1.31	\$ 1.31
<b>Diluted:</b>			
Earnings:			
Net income	\$ 3,412	\$ 3,708	\$ 3,688
Shares:			
Weighted average common shares outstanding	2,814,691	2,823,372	2,821,772
Add: Dilutive effect of outstanding options	21,902	24,779	26,642
Dilutive effect of restricted stock	8	78	226
Weighted average common shares outstanding, as adjusted	2,836,601	2,848,229	2,848,640
Net income per common share, diluted	\$ 1.20	\$ 1.30	\$ 1.29

Unearned ESOP shares are not considered as outstanding for purposes of computing weighted average common shares outstanding.

(24) **SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION**

<i>(In thousands)</i>	<u>Years Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
<b>Cash payments for:</b>			
Interest	\$ 13,660	\$ 12,376	\$ 10,131
Income taxes	1,873	1,995	1,852
<b>Noncash investing activities:</b>			
Transfers from loans to real estate acquired through foreclosure	\$ 1,074	\$ 917	\$ 1,348
Proceeds from sales of foreclosed real estate financed through loans	69	49	85

**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(25) **SELECTED QUARTERLY FINANCIAL INFORMATION (UNAUDITED)**

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b><u>2007</u></b>	<i>(In thousands, except per share data)</i>			
Interest income	\$ 6,764	\$ 6,747	\$ 6,789	\$ 6,785
Interest expense	<u>3,445</u>	<u>3,398</u>	<u>3,456</u>	<u>3,400</u>
Net interest income	3,319	3,349	3,333	3,385
Provision for loan losses	<u>225</u>	<u>35</u>	<u>118</u>	<u>180</u>
Net interest income after provision for loan losses	3,094	3,314	3,215	3,205
Noninterest income	814	908	899	903
Noninterest expenses	<u>2,802</u>	<u>2,933</u>	<u>2,812</u>	<u>2,802</u>
Income before income taxes	1,106	1,289	1,302	1,306
Income tax expense	<u>357</u>	<u>420</u>	<u>409</u>	<u>405</u>
Net income	<u>\$ 749</u>	<u>\$ 869</u>	<u>\$ 893</u>	<u>\$ 901</u>
Net income per common share, basic	<u>\$ 0.27</u>	<u>\$ 0.31</u>	<u>\$ 0.32</u>	<u>\$ 0.31</u>
Net income per common share, diluted	<u>\$ 0.26</u>	<u>\$ 0.31</u>	<u>\$ 0.32</u>	<u>\$ 0.31</u>
<b><u>2006</u></b>				
Interest income	\$ 6,291	\$ 6,494	\$ 6,635	\$ 6,791
Interest expense	<u>2,863</u>	<u>3,023</u>	<u>3,351</u>	<u>3,504</u>
Net interest income	3,428	3,471	3,284	3,287
Provision for loan losses	<u>170</u>	<u>200</u>	<u>215</u>	<u>225</u>
Net interest income after provision for loan losses	3,258	3,271	3,069	3,062
Noninterest income	737	809	830	1,054
Noninterest expenses	<u>2,583</u>	<u>2,677</u>	<u>2,645</u>	<u>2,605</u>
Income before income taxes	1,412	1,403	1,254	1,511
Income tax expense	<u>478</u>	<u>467</u>	<u>402</u>	<u>525</u>
Net income	<u>\$ 934</u>	<u>\$ 936</u>	<u>\$ 852</u>	<u>\$ 986</u>
Net income per common share, basic	<u>\$ 0.33</u>	<u>\$ 0.33</u>	<u>\$ 0.30</u>	<u>\$ 0.35</u>
Net income per common share, diluted	<u>\$ 0.33</u>	<u>\$ 0.33</u>	<u>\$ 0.30</u>	<u>\$ 0.34</u>

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## DIRECTORS AND OFFICERS

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### Board of Directors

James G. Pendleton  
Chairman of the Board and retired Chief Executive  
Officer of First Harrison Bank

Dennis L. Huber  
Retired President and Publisher of O'Bannon  
Publishing Company, Inc.

Kenneth R. Saulman  
Supervisor for Clark County REMC

Gerald L. Uhl  
Business Manager and Controller for Jacobi Sales, Inc.

James E. Nett  
Accountant for Koetter Woodworking, Inc.

Mark D. Shireman  
President of James L. Shireman, Inc.

Michael L. Shireman  
President of Uhl Truck Sales, Inc.

John W. Buschemeyer  
Retired President of Hurst Lumber Company

James S. Burden  
Retired owner of Tracy's Mobile Home Park

Kathryn W. Ernstberger  
Professor of Business Administration  
at Indiana University Southeast

William W. Harrod  
Executive Officer of First Capital, Inc. and  
First Harrison Bank

Samuel E. Uhl  
Executive Officer of First Capital, Inc. and  
First Harrison Bank

### Executive Officers

William W. Harrod  
President and Chief Executive Officer of First  
Capital, Inc. and Chief Operating Officer of First  
Harrison Bank

Samuel E. Uhl  
President and Chief Executive Officer of First  
Harrison Bank and Chief Operating Officer of  
First Capital, Inc.

M. Chris Frederick  
Senior Vice President, Chief Financial Officer  
and Treasurer

Dennis L. Thomas  
Senior Vice President, Lending  
Processing and Servicing

Joel E. Voyles  
Senior Vice President, Retail Banking  
Operations and Corporate Secretary

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## CORPORATE INFORMATION

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### General Counsel

Simpson, Thompson & Colin, LLC  
303 N. Capitol Avenue  
Corydon, Indiana 47112

### Independent Registered Public Accounting Firm

Monroe Shine & Co., Inc.  
222 East Market Street  
New Albany, Indiana 47150

### Special Counsel

Muldoon Murphy & Aguggia LLP  
5101 Wisconsin Ave., N.W.  
Washington, D.C. 20016

### Transfer Agent

Registrar and Transfer Company  
10 Commerce Drive  
Cranford, New Jersey 07016  
1-800-368-5948

### Common Shares and Dividend Information

The common shares of the Company are traded on the NASDAQ Capital Market under the symbol "FCAP." As of December 31, 2007, the Company had 1,311 stockholders of record and 3,125,563 common shares outstanding. This does not reflect the number of persons whose shares are in nominee or "street" name accounts through brokers.

The following table lists quarterly market price and dividend information per common share for the years ended December 31, 2007 and 2006 as reported by NASDAQ and as restated for the 10% stock dividend declared on June 19, 2006.

	High Sale	Low Sale	Dividends	Market price end of period
<b>2007:</b>				
First Quarter	\$ 17.15	\$ 15.16	\$ 0.17	\$ 16.50
Second Quarter	18.17	16.04	0.17	16.99
Third Quarter	18.20	17.52	0.17	18.00
Fourth Quarter	18.65	17.57	0.17	17.98
<b>2006:</b>				
First Quarter	\$ 18.77	\$ 15.68	\$ 0.17	\$ 18.77
Second Quarter	18.77	15.94	0.17	16.82
Third Quarter	20.65	16.77	0.17	18.75
Fourth Quarter	18.95	18.06	0.17	18.55

Dividend payments by the Company depend primarily on dividends received by the Company from the Bank. See Note 18 to Consolidated Financial Statements for information regarding the dividend restrictions applicable to the Company and the Bank.

## **Annual Meeting**

The Annual Meeting of Stockholders will be held at 12:00 Noon, local time, Wednesday, May 14, 2008, at the main office of the Bank, 220 Federal Drive, N.W., Corydon, Indiana 47112.

## **General Inquiries and Reports**

The Company is required to file an Annual Report on Form 10-K for its fiscal year ended December 31, 2007 with the Securities and Exchange Commission. Copies of this Annual Report and the Company's annual reports on Form 10-K (without exhibits) and quarterly reports on Form 10-Q (without exhibits) may be obtained without charge by writing:

William W. Harrod  
President and CEO  
First Capital, Inc.  
220 Federal Drive, N.W.  
Corydon, Indiana 47112  
(812) 738-2198

The Company's Annual Reports and Quarterly Reports are also available through the Company's internet website ([www.firstharrison.com](http://www.firstharrison.com)) and the Securities and Exchange Commission's internet website ([www.sec.gov](http://www.sec.gov)).







P.O. Box 130 • Corydon, IN 47112-0130  
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