MID-STATE BANCSHARES
Form 10-Q
August 08, 2006

United States
Securities and Exchange Commission

Washington, D.C. 20429

FORM 10-Q

ý **Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934.**
For the quarterly period ended June 30, 2006.

o **Transition report under Section 13 or 15(d) of the Securities Exchange Act of 1934**
for the transition period from N/A to N/A

Commission File Number 000-23925

MID-STATE BANCSHARES

(Exact name of registrant as specified in its charter)

California (State or Other Jurisdiction of Incorporation or Organization)	**77-0442667** (I.R.S. Employer Identification No.)
1026 Grand Ave. Arroyo Grande, CA (Address of Principal Executive Offices)	**93420-0580** (Zip Code)

Registrant s Telephone Number: **(805) 473-7700**

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

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

Large Accelerated Filer o Accelerated Filer ý Non-accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No ý

Number of shares of common stock of the Company outstanding as of July 25, 2006: 22,039,378 shares.

Mid-State Bancshares

June 30, 2006

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PART I - FINANCIAL INFORMATION

Item 1 - Financial Statements

Mid-State Bancshares
Consolidated Statements of Financial Position
(Unaudited - figures in 000 s)

	June 30, 2006	**Dec. 31, 2005**	**June 30, 2005**
ASSETS			
Cash and Due From Banks	$ 97,563	$ 109,791	$ 116,891
Fed Funds Sold	11,878		26,400
Securities Available For Sale	510,213	619,332	580,062
Loans Held for Sale	8,933	10,176	10,871
Loans, net of unearned income	1,564,169	1,519,014	1,490,366
Allowance for Loan Losses	(11,855)	(11,896)	(13,403)
Net Loans	1,552,314	1,507,118	1,476,963
Premises and Equipment, Net	25,933	24,772	24,055
Accrued Interest Receivable	12,718	13,947	12,136
Goodwill	47,840	47,840	47,840
Core Deposit Intangibles, net	6,047	6,483	7,045
Senior Housing Crime Prevention Foundation Investment	30,000	30,000	30,000
Other Assets	24,221	22,040	18,833
Total Assets	$ 2,327,660	$ 2,391,499	$ 2,351,096
LIABILITIES AND SHAREHOLDERS EQUITY			
Non Interest Bearing Demand	$ 521,469	$ 567,782	$ 561,435
NOW Accounts, Money Market and Savings Deposits	998,444	1,067,486	1,049,143
Time Deposits Under $100	250,604	232,275	229,784
Time Deposits $100 or more	215,735	202,063	185,366
Total Deposits	1,986,252	2,069,606	2,025,728
Other Borrowings	49,726	25,903	25,331
Allowance for Losses Unfunded Commitments	1,880	1,761	1,759
Accrued Interest Payable and Other Liabilities	22,693	21,667	23,623
Total Liabilities	2,060,551	2,118,937	2,076,441
Commitments and Contingencies			
Shareholders Equity:			
Common Stock and Surplus (Shares outstanding of 22,121, 22,520 and 22,810 respectively)	31,014	42,343	51,149
Retained Earnings	239,507	229,824	218,380
Accumulated Other Comprehensive Income net of tax (benefit)/provision of ($ 2,538), $ 264, and $3,417 respectively	(3,412)	395	5,126
Total Equity	267,109	272,562	274,655
Total Liabilities and Equity	$ 2,327,660	$ 2,391,499	$ 2,351,096

The accompanying notes are an integral part of these consolidated statements.

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Mid-State Bancshares

Consolidated Statements of Income

(Unaudited - figures in 000 s except earnings per share data)

	Three Month Period Ended June 30, 2006	2005	Six Month Period Ended June 30, 2006	2005
Interest Income:				
Interest and fees on loans	$ 30,425	$ 25,812	$ 59,174	$ 49,753
Interest on investment securities -				
U.S. Treasury securities	209	194	400	305
U.S. Government agencies and corporations	1,442	1,434	3,104	3,007
Obligations of states and political sub-divisions and other securities	3,739	3,995	7,524	7,725
Interest on fed funds sold and other	215	219	563	346
Total Interest Income	36,030	31,654	70,765	61,136
Interest Expense:				
Interest on NOW, money market and savings	1,763	1,206	3,159	1,930
Interest on time deposits less than $100	2,183	1,251	3,923	2,274
Interest on time deposits of $100 or more	1,985	1,002	3,651	1,783
Interest other	647	235	1,111	420
Total Interest Expense	6,578	3,694	11,844	6,407
Net Interest Income before provision	29,452	27,960	58,921	54,729
Provision (Benefit) for loan losses			-	
Net Interest Income after provision	29,452	27,960	58,921	54,729
Other Operating Income:				
Service charges and fees	2,562	2,375	5,049	4,720
Commissions, fees and other service charges	2,337	2,090	4,494	4,259
Gain on sale of securities	29	80	(142)	88
Gain on sale of loans held for sale	136	139	105	238
Other non-interest income	895	694	1,433	1,468
Total Other Operating Income	5,959	5,378	10,939	10,773
Other Operating Expense:				
Salaries and employee benefits	12,599	10,668	24,680	21,656
Occupancy and furniture	3,192	3,089	6,354	6,041
Other operating expenses	5,798	5,454	11,517	9,849
Total Other Operating Expense	21,589	19,211	42,551	37,546
Income Before Taxes	13,822	14,127	27,309	27,956
Provision for income taxes	4,899	4,615	9,612	9,354
Net Income	$ 8,923	$ 9,512	$ 17,697	$ 18,602
Earnings per share:				
basic	$ 0.40	$ 0.42	$ 0.79	$ 0.81
diluted	$ 0.39	$ 0.41	$ 0.78	$ 0.79
Dividends per share	$ 0.18	$ 0.16	$ 0.36	$ 0.32
Average shares used in earnings per share calculations:				
basic	22,246	22,884	22,344	22,951
diluted	22,706	23,381	22,828	23,468

The accompanying notes are an integral part of these consolidated statements.

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Mid-State Bancshares

Consolidated Statements of Comprehensive Income

(Unaudited - figures in 000 s)

	Three Month Period Ended June 30, 2006	2005	Six Month Period Ended June 30, 2006	2005
Net Income	$ 8,923	$ 9,512	$ 17,697	$ 18,602
Other Comprehensive Income Before Taxes:				
Unrealized gains (losses) on securities available for sale:				
Unrealized holding (losses) gains arising during period	(3,516)	5,878	(6,487)	(2,802)
Reclassification adjustment for (gains) losses included in net income	(29)	(80)	142	(88)
Other comprehensive (loss) income, before tax	(3,545)	5,798	(6,345)	(2,890)
Income tax (credit) expense related to items in comprehensive income	(1,418)	2,319	(2,538)	(1,156)
Other Comprehensive (Loss) Income, Net of Taxes	(2,127)	3,479	(3,807)	(1,734)
Comprehensive Income	$ 6,796	$ 12,991	$ 13,890	$ 16,868

The accompanying notes are an integral part of these consolidated statements.

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Mid-State Bancshares

Consolidated Statements of Changes in Capital Accounts
(Unaudited - figures in 000 s except share amounts)

	Number of Shares	**Capital Stock**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Total**
BALANCE, December 31, 2005	22,520,434	$ 42,343	$ 229,824	$ 395	$ 272,562
Cash dividend			(8,014)		(8,014)
Exercise of stock options	124,470	1,696			1,696
Tax Benefit from exercise of options		695			695
Net income			17,697		17,697
Change in net unrealized gain on available for sale securities, net of taxes of ($2,538)				(3,807)	(3,807)
Common stock issued under employee plans and related tax benefits		913			913
Stock repurchased	(524,082)	(14,633)			(14,633)
BALANCE, June 30, 2006	**22,120,822**	**$ 31,014**	**$ 239,507**	**$ (3,412)**	**$ 267,109**
BALANCE, December 31, 2004	23,099,159	$ 61,439	$ 206,328	$ 6,860	$ 274,627
Cash dividend			(7,321)		(7,321)
Exercise of stock options	220,340	3,226			3,226
Tax Benefit from exercise of options			771		771
Net income			18,602		18,602
Change in net unrealized gain on available for sale securities, net of taxes of ($3,475)				(1,734)	(1,734)
Stock repurchased	(509,557)	(13,516)			(13,516)
BALANCE, June 30, 2005	22,809,942	$ 51,149	$ 218,380	$ 5,126	$ 274,655

The accompanying notes are an integral part of these consolidated statements.

Mid-State Bancshares

Consolidated Statements of Cash Flows

(Unaudited - figures in 000 s)

	Six Month Period Ended June 30, 2006	2005
OPERATING ACTIVITIES		
Net Income	$ 17,697	$ 18,602
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses		
Depreciation and amortization	2,550	2,758
Net amortization of prem./dicounts-investments	1,483	1,859
Gain on sale of loans held for sale	(105)	(238)
Net decrease in loans held for sale	1,348	2,356
Loss (gain) on sale of securities, net	142	(88)
Change in deferred loan fees	456	(202)
Share based compensation	913	
Tax benefit for equity awards	(108)	
Changes in assets and liabilities:		
Accrued interest receivable	1,229	(218)
Core deposit intangible	436	687
Other assets, net	357	1,403
Other liabilities, net	1,145	5,050
Net cash provided by operating activities	27,543	31,969
INVESTING ACTIVITIES		
Proceeds from sales and maturities of investments	123,224	116,100
Purchases of investments	(22,075)	(86,007)
Increase in loans	(45,652)	(68,666)
Purchases of premises and equipment, net	(3,711)	(1,866)
Net cash used in investing activities	51,786	(40,439)
FINANCING ACTIVITIES		
(Decrease) increase in deposits	(83,354)	31,183
Increase in other borrowings	23,823	18,749
Exercise of stock options and related tax benefit	2,499	3,997
Cash dividends paid	(8,014)	(7,321)
Repurchase of company stock	(14,633)	(13,516)
Net cash (used in) provided by financing activities	(79,679)	33,092
(Decrease) increase in cash and cash equivalents	(350)	24,622
Cash and cash equivalents, beginning of period	109,791	118,669
Cash and cash equivalents, end of period	$ 109,441	$ 143,291
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$ 10,497	$ 6,194
Cash paid during the period for taxes on income	8,800	9,257
Supplemental disclosure of non-cash investing activities:		
Transfer of security investment for other assets		30,000

The accompanying notes are an integral part of these consolidated statements.

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Mid-State Bancshares

Notes to Consolidated Financial Statements

(Information with respect to interim periods is unaudited)

NOTE A - BASIS OF PRESENTATION AND MANAGEMENT REPRESENTATION

The accompanying consolidated financial statements include the accounts of Mid-State Bancshares and its wholly owned subsidiary Mid-State Bank & Trust and the Bank s subsidiaries, MSB Properties and Mid-Coast Land Company (collectively the Company, Bank or Mid-State). All significant inter-company transactions have been eliminated in consolidation. These consolidated financial statements should be read in conjunction with the Form 10-K Annual Report for the year ended December 31, 2005 of Mid-State Bancshares. A summary of the Company s significant accounting policies is set forth in the Notes to Consolidated Financial Statements contained therein.

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States on a basis consistent with the accounting policies reflected in the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2005. They do not, however, include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments including normal recurring accruals considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole.

NOTE B - EARNINGS PER SHARE

The following is a reconciliation of net income and shares outstanding to the income and number of shares used to compute Earnings Per Share (EPS). Figures are in thousands, except earnings per share data.

	Three Month Period Ended June 30, 2006			**Three Month Period Ended June 30, 2005**		
	Net Income	**Shares**	**EPS**	**Net Income**	**Shares**	**EPS**
Net Income as reported	$ 8,923			$ 9,512		
Basic Earnings Per Share:						
Income available to Common Shareholders	$ 8,923	22,246	$ 0.40	$ 9,512	22,884	$ 0.42
Effect of dilutive securities:						
Stock Options		460			497	
Diluted Earnings Per Share:						
Income available to Common Shareholders	$ 8,923	22,706	$ 0.39	$ 9,512	23,381	$ 0.41

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	Six Month Period Ended June 30, 2006 Net Income	Shares	EPS	Six Month Period Ended June 30, 2005 Net Income	Shares	EPS
Net Income as reported	$ 17,697			$ 18,602		
Basic Earnings Per Share:						
Income available to Common Shareholders	$ 17,697	22,344	$ 0.79	$ 18,602	22,951	$ 0.81
Effect of dilutive securities:						
Stock Options		484			517	
Diluted Earnings Per Share:						
Income available to Common Shareholders	$ 17,697	22,828	$ 0.78	$ 18,602	23,468	$ 0.79

NOTE C RECENT ACCOUNTING PRONOUNCEMENTS

In June 2004, the Emerging Issues Task Force of the Financial Accounting Standards Board (FASB) issued guidance on its Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. The guidance made recommendations regarding unrealized losses on available-for-sale debt and equity securities accounted for under Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities, and No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations. The guidance for evaluating whether an investment is other-than-temporarily impaired was to be applied in other-than-temporary impairment evaluations made in reporting periods beginning after June 15, 2004. The disclosures were to be effective in annual financial statements for fiscal years ending after December 15, 2003, for investments accounted for under Statements 115 and 124. On September 30, 2004, the FASB Board directed the issuance of FASB Staff Position (FSP) EITF Issue 03-1-a, Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1. The proposed FSP would provide implementation guidance with respect to debt securities that are impaired solely due to interest rates and/or sector spreads and analyzed for other-than-temporary impairment under paragraph 16 of issue 03-1. The FASB asked constituents to comment on whether the application guidance with respect to minor impairments should also be applied to securities analyzed for impairment under paragraphs 10-15 of Issue 03-1. At the June 29, 2005 meeting, the Board decided not to provide additional guidance on the meaning of other-than-temporary impairment and directed the staff to finalize proposed FASB Staff Position (FSP) EITF 03-1-a, Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1. The final FSP, retitled as FSP FAS 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, would:

1. Replace the guidance in paragraphs 10 18 of EITF Issue 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, and refer to existing other-than-temporary impairment guidance for example, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* APB Opinion No. 18, *The Equity Method of Accounting for Investments in*

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Common Stock, and SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities

2. Supersede Issue 03-1 and EITF Topic No. D-44, Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value

3. Codify the guidance set forth in Topic D-44 and clarify that an investor should recognize an impairment loss no later than when the impairment is deemed other than temporary, even if a decision to sell has not been made

4. Be effective for other-than-temporary impairment analyses conducted in periods beginning after September 15, 2005.

At the September 7, 2005 meeting, the Board directed the staff to consider transition guidance for the proposed FSP. At the September 14, 2005 meeting, the Board decided to retain the paragraph in the proposed FSP pertaining to the accounting for debt securities subsequent to an other-than-temporary impairment and add a footnote to clarify that the proposed FSP does not address when a debt security should be designated as nonaccrual or how to subsequently report income on a nonaccrual debt security. In addition, the Board decided that (1) transition would be applied prospectively and (2) the effective date would be reporting periods beginning after December 15, 2005. Adoption of EITF Issue 03-1-a did not have a material impact on the Company s results of operations and its financial position.

The FASB issued a revision to SFAS No. 123, Accounting for Stock-Based Compensation in December 2004. The revised Statement is SFAS No. 123R (revised 2004), Share-Based Payment and it supercedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. It is effective for the Company as of January 1, 2006. The Statement requires that the Company measures the cost of employee services received in exchange for an award of equity instruments (share based payment awards) based on the grant date fair value of the award and the estimated number of awards that are expected to vest. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award usually the vesting period. Compensation cost for awards that vest would not be reversed if the awards expire without being exercised. The Company previously applied APB Opinion No. 25, in accounting for its Plan. Accordingly, no compensation expense was recognized for grants under the Plan prior to 2006. Pro forma disclosures of net income and earnings per share were disclosed in Note 15 of the Company s Annual Report on Form 10K. The Company adopted the revised Statement for the first quarter of 2006. The impact of adopting the accounting treatment was to reduce earnings by approximately $408 thousand, after-tax, for the three months ended June 30, 2006. For the six months ended June 30, 2006, earnings were reduced by approximately $805 thousand, after-tax.

FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* on June 1, 2005, a replacement of APB No. 20 and SFAS No. 3. The Statement applies to all voluntary changes in accounting principle, and changes the requirements for accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods financial statements of a voluntary change in accounting principle unless it is impracticable. APB No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 improves financial reporting because its requirements enhance the consistency of financial information between periods. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Adoption of the Statement did not have a material effect on the Company s consolidated financial statements.

FASB issued SFAS No. 155, *Accounting for Certain Hybrid Instruments,* on February 16, 2006 as an amendment of FASB Statements No. 133 and 140. The standard allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. The standard also a) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, b) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, c) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and d) amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The Company expects to adopt the Statement for the first quarter of 2007 and expects it will not have a material effect on its consolidated financial statements.

The FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* on March 17, 2006 as an amendment to SFAS No. 140. The standard will simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, the new Standard addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting. The standard also clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability, requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable, permits an entity with a separately recognized servicing asset or servicing liability to choose either the amortization method or fair value method for subsequent measurement. SFAS No. 156 permits a servicer that uses derivative financial instruments to offset risks on servicing to report both the derivative financial instrument and related servicing asset or liability by using a consistent measurement attribute fair value. The Company expects to adopt the Statement for the first quarter of 2007 and expects it will not have a material effect on its consolidated financial statements.

NOTE D CORE DEPOSIT INTANGIBLES, NET

The following is a summary of the Company s core deposit intangibles. Figures are in thousands (unaudited).

	June 30, 2006			June 30, 2005		
	Gross Amount	**Accumulated Amortization**	**Net Carrying Amount**	**Gross Amount**	**Accumulated Amortization**	**Net Carrying Amount**
Core Deposit Intangible	$ 11,597	$ (5,550)	$ 6,047	$ 11,597	$ (4,552)	$ 7,045

	Dec. 31, 2005		
	Gross Amount	**Accumulated Amortization**	**Net Carrying Amount**
Core Deposit Intangible	$ 11,597	$ (5,114)	$ 6,483

<u>Aggregate Amortization Expense of Core Deposit Intangibles ($ in 000 s)</u>:

	Three Month Period Ended June 30,		**Six Month Period Ended June 30,**	
	2006	**2005**	**2006**	**2005**
Amortization of Core Deposit Intangible	$ 218	$ 344	$ 436	$ 687

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The amortization expense for core deposit intangibles is included within other operating expenses on the consolidated statements of income. Based on a review of the Company s core deposit intangible at September 30, 2005 in relation to the core deposits retained to which the intangible relates, it was determined that a downward adjustment in the amortization rate was appropriate under generally accepted accounting principles. The projected amortization expense for core deposit intangibles, assuming no further acquisitions or dispositions or changes in amortization rates, is approximately $872 thousand per year over the next five years.

NOTE E STOCK BASED COMPENSATION

On May 17, 2005, shareholders of the Company approved a new equity based compensation plan, the Mid-State Bancshares 2005 Equity Based Compensation Plan (the 2005 Plan) which reserves an additional 1,000,000 common shares for issuance in accordance with the terms of the Plan. The 2005 Plan provides for the grant of stock options, stock appreciation rights, restricted shares, restricted share units, performance based cash only awards, or any combination thereof. It replaced the 1996 Stock Option Plan which was limited in scope to the issuance of Stock Options. Shares available for issuance under the 1996 Plan are now included in the 2005 Plan, resulting in 933,061 shares currently being available to be issued (4.22% of current and issued outstanding common stock) as of June 30, 2006.

Through December 31, 2005, the Company accounted for its stock-based compensation in accordance with SFAS No. 123, Accounting for Stock Based Compensation. SFAS No. 123 allowed stock options to be valued using the intrinsic value method in accordance with APB No. 25, Accounting for Stock Issued to Employees. Effective January 1, 2006, the Company adopted SFAS No. 123R, Share Based Payment. This standard requires that all share-based compensation awards be measured at fair value at the date of grant and expensed over their vesting or service periods. The impact of adopting the new accounting treatment was to reduce income before tax and net income by approximately $473 and $408 thousand, respectively, for the three months ended June 30, 2006. On a per share basis, this amounted to two cents per share on both a basic and diluted basis. For the six months ended June 30, 2006, the impact was to reduce income before tax and net income by approximately $913 and $805 thousand, respectively. On a per share basis, this amounted to four cents per share on both a basic and diluted basis. Cash provided by operating activities and cash provided by financing activities related to stock option activity increased by $2.4 million for the six months ended June 30, 2006.

Prior to 2006, the Company accounted for stock options under the provisions of Accounting Principles Board (APB) Opinion No. 25 and provided proforma net income and proforma earnings per share disclosures for employee stock option grants as if the fair-value-based method, defined in SFAS No. 123R had been applied. A summary of the proforma disclosure as of June 30, 2005 was as follows:

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(dollars in 000 s except per share amounts)	Three Month Period Ended June 30, 2005	Six Month Period Ended June 30, 2005
Net income, as reported	$ 9,512	$ 18,602
Deduct: Total stock-based compensation expense determined under the fair value based method for all awards, net of related taxes	(584)	(1,163)
Proforma net income	$ 8,928	$ 17,439
Basic income per share, as reported	$ 0.42	$ 0.81
Proforma basic income per share	$ 0.39	$ 0.76
Diluted income per share, as reported	$ 0.41	$ 0.79
Proforma diluted income per share	$ 0.38	$ 0.74

In determining the pro forma disclosures in the previous table, the fair value of options granted was estimated on the date of grant using the Black-Scholes option pricing model and appropriate assumptions. The weighted average grant date fair values of the options granted during 2006 were based on the following assumptions:

- Risk Free Interest Rate = 4.6%
- Dividend Yield = 2.5%
- Stock Price Volatility = 34.9%
- Weighted Expected Lives of Option Grants = 8.5 years

Option awards are granted with an exercise price equal to the market price of the Company s common stock on the date of grant. While options are exercisable and expire as determined by the Board of Directors, they generally become exercisable over a five year period vesting 20% each year, and have a term of ten years. For purposes of determining the fair value of stock option awards, the Company uses the Black-Scholes option pricing model applied on a grant by grant basis. Risk free rates of interest were applied in the model as of the grant date based on data provided by the Federal Reserve Bank on its H.15 release. The dividend yield applied in the model was the dividend yield of the Company at time of grant. The expected volatility of the Company s stock price applied in the model was based on historical information from 1998 (when the Company was first listed on NASDAQ) through March 31, 2006. The expected average life applied in the model was estimated from historical information from 1998 through March 31, 2006 and was calculated by major employee groups. Compensation cost is recognized using a straight-line method over the vesting or service period and is net of estimated forfeitures.

The following tables show a summary of stock option activity:

	Options	Weighted Average Exercise Price	Per Share Price Ranges
Outstanding at December 31, 2005	**2,000,958**	**$ 19.20**	**$5.375 $30.61**
Granted from Jan. 1 to June 30, 2006	**77,503**	**$ 29.00**	**$29.00 $29.00**
Exercised from Jan. 1 to June 30, 2006	**(124,470)**	**$ 13.63**	**$5.375 $25.79**
Forfeited from Jan. 1 to June 30, 2006	**(8,862)**	**$ 18.33**	**$15.50 $24.64**
Outstanding at June 30, 2006	**1,945,129**	**$ 19.95**	**$12.125 $30.61**
Exercisable at June 30, 2006	**1,267,586**	**$ 17.15**	**$12.125 $30.61**
Range of Expiration Dates	**8/12/2008 to 2/16/2016**		

Range of Exercise Prices	Total Amount Outstanding	Weighted Average Remaining Contractual Years	Weighted Average Exercise Price	Amount Exercisable	Weighted Average Exercise Price
$9.183 - $12.244	12,000	3.8	$ 12.125	12,000	$ 12.125
$12.245 - $15.305	421,543	3.3	$ 14.529	421,543	$ 14.529
$15.306 - $18.366	792,875	4.5	$ 16.898	674,302	$ 16.875
$18.367 - $21.427	10,800	5.8	$ 19.620	6,800	$ 19.641
$21.428 - $24.488	72,400	7.7	$ 22.792	20,200	$ 22.647
$24.489 - $27.549	318,637	8.0	$ 25.882	88,873	$ 25.477
$27.550 - $30.610	316,874	8.9	$ 28.486	43,868	$ 28.145
Total	1,945,129	5.6	$ 19.949	1,267,586	$ 17.150

The weighted average fair value of grants issued in the first half of 2006 was $10.45. The weighted average fair value of all grants outstanding as of June 30, 2006 was $6.97. The aggregate intrinsic value for vested options exercisable at June 30, 2006 was $13,773,906 and the aggregate intrinsic value of unvested options not yet exercisable at June 30, 2006 was $2,109,254.

The Company issued 26,229 restricted stock shares during the second quarter of 2006. These restricted shares will vest three years from the date of grant and vesting is subject to continued employment at the Company through the vesting date. Holders of restricted shares will have the right to receive dividends and vote the shares, but may not sell, assign, transfer, pledge or otherwise encumber the stock until after the shares are fully vested. The aggregate intrinsic value of these awards was $718,760 as of June 30, 2006. A summary of restricted shares outstanding is as follows:

	Number of Restricted Shares	Aggregate Average Intrinsic Value Per Share
Outstanding at December 31, 2005	**0**	
Granted from Jan. 1 to June 30, 2006	**26,229**	**$ 28.00**
Vested from Jan. 1 to June 30, 2006	**0**	
Forfeited from Jan. 1 to June 30, 2006	**(559)**	**$ 28.00**
Outstanding at June 30, 2006	**25,670**	**$ 28.00**

Compensation expense on restricted stock shares is accounted for using the straight-line method over the vesting or service period and is net of estimated forfeitures. The amount recognized was $57 thousand, pre-tax, for the three months and six months ended June 30, 2006.

Unamortized compensation expense at June 30, 2006 amounted to approximately $4.4 million related to stock options outstanding and $0.7 million on restricted stock awards. The expense associated with stock options is expected to be recognized over a weighted average life of 1.74 years, assuming an estimated 5% forfeiture rate. The expense associated with restricted stock awards is expected to be recognized over a weighted average life of 2.75 years, assuming an estimated 2% forfeiture rate.

NOTE F SENIOR HOUSING CRIME PREVENTION FOUNDATION INVESTMENT

During the second quarter of 2005, the Company made an investment in the amount of $30.0 million in a security of a U.S. government agency. That security was exchanged for an interest bearing investment in the Senior Housing Crime Prevention Foundation Investment Corporation (SHCPF-I) with the U.S. government agency held in safekeeping reflecting ownership by SHCPF-I and the pledge of that Security in favor of Mid-State Bank & Trust. The investment provides funding for the Senior Housing Crime Prevention Foundation in its efforts to prevent elder abuse in nursing homes throughout the Company s service area. This investment is displayed separately within the Company s Consolidated Statements of Financial Position.

NOTE G REPORTABLE BUSINESS SEGMENTS

Below is a summary statement of income for the three months and six months ended June 30, 2006 and 2005 for each reportable business segment.

Three Months Ended June 30,

(unaudited dollars in 000 s)	Community Banking 2006	Community Banking 2005	Mid Coast Land Company 2006	Mid Coast Land Company 2005	Trust Services 2006	Trust Services 2005	Mid-State Bancshares 2006	Mid-State Bancshares 2005
Interest Income	$ 36,030	$ 31,654	$	$	$	$	$ 36,030	$ 31,654
Interest Expense	6,578	3,694					6,578	3,694
Net Interest Income	29,452	27,960					29,452	27,960
Provision for Loan Losses								
Non Interest Income	5,588	4,772	1	336	370	270	5,959	5,378
Non Interest Expense	21,228	18,975	7	3	354	233	21,589	19,211
Pre-Tax Income	$ 13,812	$ 13,757	$ (6)	$ 333	$ 16	$ 37	$ 13,822	$ 14,127

Six Months Ended June 30,

(unaudited dollars in 000 s)	Community Banking 2006	Community Banking 2005	Mid Coast Land Company 2006	Mid Coast Land Company 2005	Trust Services 2006	Trust Services 2005	Mid-State Bancshares 2006	Mid-State Bancshares 2005
Interest Income	$ 70,765	$ 61,136	$	$	$	$	$ 70,765	$ 61,136
Interest Expense	11,844	6,407					11,844	6,407
Net Interest Income	58,921	54,729					58,921	54,729
Provision for Loan Losses								
Non Interest Income	10,027	9,854	205	350	707	569	10,939	10,773
Non Interest Expense	41,911	37,092	12	6	628	448	42,551	37,546
Pre-Tax Income	$ 27,037	$ 27,491	$ 193	$ 344	$ 79	$ 121	$ 27,309	$ 27,956

NOTE H GUARANTEES

The Company has guarantees outstanding under performance standby letter of credit accommodations made to its customers in the ordinary course of business totaling $37.5 million at June 30, 2006, down from $44.4 million one year earlier.

Letters of credit are issued in connection with agreements made by customers to counterparties. Terms of these letters of credit are generally for one year and may or may not be collateralized by receivables or other assets. If the customer fails to comply with the agreement, the counterparty may enforce the letter of credit as a remedy. Credit risk arises from the possibility that the customer may not be able to repay the Company. The notional amount of the letter of credit accommodations represents the maximum amount of future cash payments.

Many of the commitments are expected to expire without being drawn upon. Accordingly, the total outstanding commitment amount does not necessarily represent future cash requirements. The Company does not anticipate any significant losses as a result of these transactions. Provision has been made for losses which may be sustained in the fulfillment of, or from an inability to fulfill, any commitments. The provision at June 30, 2006 was $1.9 million, compared to $1.8 million one year earlier, and is reflected on the Consolidated Statements of Financial Position as Allowance for Losses Unfunded Commitments.

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

The following is management s discussion and analysis of the major factors that influenced our financial performance for the three months and six months ended June 30, 2006. This analysis should be read in conjunction with our 2005 Annual Report as filed on Form 10-K and with the unaudited financial statements and notes as set forth in this report. *Unless the context requires otherwise, the terms Company, us, we, and our refers to Mid-State Bancshares on a consolidated basis.*

Certain statements contained in this Quarterly Report of Form 10-Q (Report), including, without limitation, statements containing the words estimate, believes, anticipates, intends, may, expects, could, and words of similar import, constitute forward-looking statements wit meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements relate to, among other things, our current expectations regarding future operating results, net interest margin, strength of the local economy, our loan mix, cost of deposits and the recovery of unrealized losses in the investment portfolio and allowance for credit losses. These forward looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others, those concerning (i) the Company s strategies, objectives and plans for expansion of its operations, products and services, and growth of its portfolio of loans, investments and deposits, (ii) the Company s beliefs and expectations regarding actions that may be taken by regulatory authorities having oversight of its operation and interest rates, (iii) the Company s beliefs as to the adequacy of its existing and anticipated allowances for loan and real estate losses and its expectations about the loss potential in its non-performing loans, (iv) the Company s beliefs and expectations concerning future operating results, (v) the growth of its loan portfolio, changes in its loan mix and changes in its net interest margin and (vi) the strength of the economy and the increasing levels of competition in its service area. Additional information on these and other factors that could affect financial results may be found in the Company s 2005 Annual Report as filed on form 10-K, including in Item 1A. Risk Factors. When relying on forward-looking statements to make decisions with respect to our Company, investors and others are cautioned to consider these and other risks and uncertainties. We disclaim any obligation to update any such factors or to publicly announce the results of any revisions to any of the forward-looking statements contained herein to reflect future events or developments.

Critical Accounting Policies and Estimates This Management s Discussion and Analysis of Financial Condition and Results of Operations, as well as, disclosures included elsewhere in this Form 10-Q, are based upon the Company s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements require Management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingencies. A summary of the more significant accounting policies of the Company can be found in Footnote One to the financial statements which is included in Item 8 of the Company s Annual Report on Form 10-K and in the Management s Discussion and Analysis included in Item 7 of that same report entitled Critical Accounting Policies and Estimates.

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Selected Financial Data - Summary. The following table provides certain selected consolidated financial data as of and for the three months ending June 30, 2006 and 2005 (unaudited in 000 s, except per share data).

(In 000 s, except per share data)	Quarter Ended June 30, 2006	June 30, 2005	At or for the 6 months ended June 30, 2006	June 30, 2005
Interest Income	$ 36,030	$ 31,654	$ 70,765	$ 61,136
Interest Expense	6,578	3,694	11,844	6,407
Net Interest Income	29,452	27,960	58,921	54,729
Provision for Loan Losses				
Net Interest Income after provision for loan losses	29,452	27,960	58,921	54,729
Non-interest income	5,959	5,378	10,939	10,773
Non-interest expense	21,589	19,211	42,551	37,546
Income before income taxes	13,822	14,127	27,309	27,956
Provision for income taxes	4,899	4,615	9,612	9,354
Net Income	$ 8,923	$ 9,512	$ 17,697	$ 18,602
Per share:				
Net Income - basic	$ 0.40	$ 0.42	$ 0.79	$ 0.81
Net Income - diluted	$ 0.39	$ 0.41	$ 0.78	$ 0.79
Weighted average shares used in Basic E.P.S. calculation	22,246	22,884	22,344	22,951
Weighted average shares used in Diluted E.P.S. calculation	22,706	23,381	22,828	23,468
Cash dividends	$ 0.18	$ 0.16	$ 0.36	$ 0.32
Book value at period-end			$ 12.08	$ 12.04
Tangible book value at period end			$ 9.64	$ 9.63
Ending Shares			22,121	22,810
Financial Ratios				
Return on assets (annualized)	1.52 %	1.63 %	1.51 %	1.61 %
Return on tangible assets (annualized)	1.56 %	1.67 %	1.55 %	1.65 %
Return on equity (annualized)	13.17 %	13.87 %	12.97 %	13.60 %
Return on tangible equity (annualized)	16.44 %	17.34 %	16.14 %	17.00 %
Net interest margin	5.61 %	5.37 %	5.61 %	5.30 %
Net interest margin (taxable equivalent yield)	6.00 %	5.79 %	6.01 %	5.72 %
Net loan losses to avg. loans	0.02 %	0.06 %	0.01 %	0.06 %
Efficiency ratio	61.0 %	57.6 %	60.9 %	57.3 %
Period Averages				
Total Assets	$ 2,347,097	$ 2,339,887	$ 2,361,014	$ 2,323,193
Total Tangible Assets	2,293,114	2,284,853	2,306,924	2,267,989
Total Loans (includes loans held for sale)	1,560,602	1,460,506	1,540,413	1,447,401
Total Earning Assets	2,107,590	2,088,566	2,118,473	2,084,110
Total Deposits	1,998,463	2,022,691	2,014,818	2,007,110
Common Equity	271,704	275,100	275,179	275,842
Common Tangible Equity	217,721	220,067	221,089	220,638

(In 000 s, except per share data)	June 30, 2006	June 30, 2005
Balance Sheet - At Period-End		
Cash and due from banks	$ 97,563	$ 116,891
Investments and Fed Funds Sold	522,091	606,462
Loans held for sale	8,933	10,871
Loans, net of deferred fees, before allowance for loan losses	1,564,169	1,490,366
Allowance for Loan Losses	(11,855)	(13,403)
Goodwill and core deposit intangibles	53,887	54,885
Other assets	92,872	85,024
Total Assets	$ 2,327,660	$ 2,351,096
Non-interest bearing deposits	$ 521,469	$ 561,435
Interest bearing deposits	1,464,783	1,464,293
Other borrowings	49,726	25,331
Allowance for losses - unfunded commitments	1,880	1,759
Other liabilities	22,693	23,623
Shareholders equity	267,109	274,655
Total Liabilities and Shareholders equity	$ 2,327,660	$ 2,351,096
Asset Quality & Capital - At Period-End		
Non-accrual loans	$ 261	$ 5,152
Loans past due 90 days or more		
Other real estate owned		
Total non performing assets	$ 261	$ 5,152
Allowance for losses to loans, gross (1)	0.9 %	1.0 %
Non-accrual loans to total loans, gross	0.0 %	0.3 %
Non performing assets to total assets	0.0 %	0.2 %
Allowance for losses to non performing loans (1)	5262.5 %	294.3 %
Equity to average assets (leverage ratio)	9.4 %	9.4 %
Tier One capital to risk-adjusted assets	11.2 %	11.6 %
Total capital to risk-adjusted assets	11.9 %	12.5 %

(1) Includes allowance for loan losses and allowance for losses - unfunded commitments

Performance Summary. The Company posted net income of $8.9 million for the three months ended June 30, 2006 compared to $9.5 million in the like 2005 period. On a per share basis, diluted earnings per share were $0.39 in the 2006 period compared to $0.41 in the same quarter of 2005. These earnings represent an annualized return on assets (R.O.A.) of 1.52% in the 2006 period compared to 1.63% in the same quarter of 2005. The annualized return on equity was 13.17% for the second quarter of 2006 compared to 13.87% in the second quarter of 2005. For the six month period ended June 30, 2006, the Company posted net income of $17.7 million compared to $18.6 million in the like 2005 period. On a per share basis, diluted earnings per share were $0.78 in the 2006 period compared to $0.79 in the year earlier period. These results represented a R.O.A. of 1.51% in the 2006 period compared to 1.61% in the 2005 period. The annualized return on equity was 12.97% for the first half of 2006 compared to 13.60% in the year earlier period. Results in 2006 were influenced by increases in non-interest expense which increased $2.4 million and $5.0 million, respectively, for the three month and six month periods of 2006 compared to 2005. These increases related primarily to staffing increases for growth and compliance, benefit cost increases and adoption of SFAS No. 123R, Share-Based Payment discussed above. SFAS No. 123R requires that the Company measures the cost of employee services received in exchange for an award of equity instruments and recognizes the cost over the period during which the employee is required to

provide service. The adoption of the new statement alone resulted in an after-tax charge to earnings of approximately $408 thousand, or $0.02 per share in the second quarter of 2006 and $805 thousand for the six month period, or $0.04 per share.

The Company s leverage capital ratio was 9.4% at June 30, 2006, the same level as one year earlier. This ratio is substantially above regulatory requirements for well capitalized banks.

Net Interest Income. The following table delineates the impacts of changes in the volume of earning assets, changes in the volume of interest bearing liabilities, and changes in interest rates on net interest income for the three month periods ended June 30, 2006 and 2005.

	3 months ended June 30, 2006			**3 months ended June 30, 2005**			**2006 Compared to 2005 Composition of Change**		
		Interest	**Average**		**Interest**	**Average**			
	Average	**Income /**	**Yield /**	**Average**	**Income /**	**Yield /**	**Change Due To:**		**Total**
Dollars in 000 s	**Balance**	**Expense**	**Rate**	**Balance**	**Expense**	**Rate**	**Volume**	**Rate**	**Change**
EARNING ASSETS:									
Loans	$ 1,560,602	$ 30,425	7.82 %	$ 1,460,506	$ 25,812	7.09 %	$ 1,860	$	