

TREATY OAK BANCORP INC
Form 10KSB/A
February 13, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

FORM 10-KSB/A

Edgar Filing: TREATY OAK BANCORP INC - Form 10KSB/A

(Amendment No. 1)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

Edgar Filing: TREATY OAK BANCORP INC - Form 10KSB/A

For the fiscal year ended September 30, 2006

Commission File Number: 333-112325

Treaty Oak Bancorp, Inc.

Edgar Filing: TREATY OAK BANCORP INC - Form 10KSB/A

(Exact name of registrant as specified in its charter)

Texas

(State or other jurisdiction of corporation or organization)

20-0413144

(I.R.S. Employer Identification Number)

101 Westlake Drive, Austin, Texas
(Address of Principal Executive Offices)

78746
(Zip Code)

(512) 617-3600

(Registrant's telephone number, including area code)

Securities registered under Section 12(b) of the Exchange Act: **None.**

Securities registered under Section 12(g) of the Exchange Act: **None.**

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

Yes o No x

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

Yes x No o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Yes x No 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 x

The issuer's revenues for its most recent fiscal year were approximately \$5,227,000.

The aggregate market value of the common stock held by non-affiliates, based upon the last reported sales price at which the common stock was sold as of December 1, 2006, was \$17,069,512.

The number of shares outstanding of common stock, par value \$0.01 per share, as of the close of business on December 1, 2006 was 2,730,187.

Transitional Small Business Disclosure Format (Check One): **Yes o; No x**

EXPLANATORY NOTE

This Annual Report on Form 10-KSB/A (Form 10-KSB/A) is being filed as Amendment No. 1 to our Annual Report on Form 10-KSB for the fiscal year ended September 30, 2006, which was filed with the Securities and Exchange Commission on December 29, 2006 (the Original Filing). This Form 10-KSB/A is a technical amendment to add the conformed signature of our independent registered public accounting firm to their audit report which appears in Part II. Item 7. The conformed signature was previously inadvertently omitted from the electronically filed document. The addition of this conformed signature is the only change to Item 7, which is filed herein in its entirety in accordance with the SEC's rules and regulations.

In addition to the above amendment, this Form 10-KSB/A corrects information regarding a vote of security holders on October 24, 2006 in Part I. Item 4 which was inadvertently reported incorrectly in the Original Filing. The addition of the corrected voting information is the only change to Item 4, which is filed herein in its entirety in accordance with the SEC's rules and regulations.

This Form 10-KSB/A includes the list of exhibits in Part III. Item 13 that were previously filed with the Original Filing on December 29, 2006 and updated versions of Exhibits 23.1, 31.1, 31.2, 32.1 and 32.2.

The following sections in this report have been amended as a result of this restatement:

Part I. Item 4. Submission of Matters to a Vote of Security Holders;

Part II. Item 7. Financial Statements; and

Part III. Item 13. Exhibits.

This Form 10-KSB/A only amends the Items described above, and we have not modified or updated other disclosures presented in our Original Filing. Accordingly, this Form 10-KSB/A does not reflect events occurring after the filing of our Original Filing and does not modify or update those disclosures affected by subsequent events, except as specifically referenced herein. Information not affected by this amendment is unchanged and reflects the disclosures made at the time of the Original Filing on December 29, 2006.

PART I.

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

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year ended September 30, 2006; however, a Special Meeting of Shareholders was held on October 24, 2006. Of the 2,636,926 shares of common stock outstanding and entitled to vote at the meeting, 1,838,685 shares were present, either in person or by proxy. The following proposals were submitted to a vote of the shareholders at the meeting:

1. To approve and adopt an Agreement and Plan of Merger between the Company and Treaty Oak Holdings, Inc.
2. To elect Bill F. Schneider to serve on the Company's Board of Directors as a Class II director until his successor is duly elected and qualified.

The above proposals were approved and the results of the voting are summarized in the following table:

Proposal	For	Against	Withheld	Abstain
Approve the merger	1,823,379	12,005		3,301
Elect Bill F. Schneider to the Board of Directors	1,835,384		3,301	

2

PART II.

Item 7.

Financial Statements

Reference is made to the financial statements, the report thereon, and the notes thereto commencing at page F-1 of this Form 10-KSB/A, which financial statements, report and notes are included herein.

3

PART III.

Item 13. Exhibits

The following exhibits are filed herewith or are incorporated by reference to exhibits previously filed with the SEC.

Exhibit Number	Exhibit Title
2.1(1)	Agreement and Plan of Merger, dated October 3, 2006, between Treaty Oak Holdings, Inc. and the Company
3.1(2)	Amended and Restated Articles of Incorporation
3.2(3)	By-laws
4.1(3)	Specimen Common Stock Certificate, \$.01 par value per share
4.2(3)	See Exhibits 3.1 and 3.2 for provisions of the Articles of Incorporation and By-laws defining rights of holders of Common Stock
10.1(3)	Amended and Restated Building Lease between PGI Equity Partners, L.P. and Treaty Oak Bank
10.2(3)	Expense Reimbursement Agreement between Treaty Oak Holdings, Inc. and Treaty Oak Bancorp, Inc.
10.3(3)	Form of Promotional Shares Lock-In Agreement
10.4(3)	Form of Escrow Agreement between Treaty Oak Bancorp, Inc. and TIB The Independent Bankers Bank
10.5(3)	Form of Treaty Oak Bancorp Shareholders Warrant Agreement
10.6(2)*	Treaty Oak Bancorp, Inc. 2004 Stock Incentive Plan (amended and restated as of May 20, 2004)
10.7(3)*	Form of Indemnification Agreement between Treaty Oak Bancorp, Inc. and its directors and officers, and those of the Bank
10.8(3)	Registration Rights Agreement between Treaty Oak Bancorp, Inc. and Treaty Oak Holdings, Inc.
10.9(4)*	Employment Agreement, dated September 27, 2006, between Treaty Oak Bancorp, Inc. and Jeffrey L. Nash
10.10(5)	Form of Warrant
10.11(5)	Form of Registration Rights Agreement with former shareholders of Treaty Oak Holdings, Inc.
10.12(5)	Form of Registration Rights Agreement with former warrant holders of Treaty Oak Holdings, Inc.
21(5)	Subsidiaries
23.1	Consent of McGladrey & Pullen LLP**
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a)/15d-14(a) under the Exchange Act**

Edgar Filing: TREATY OAK BANCORP INC - Form 10KSB/A

- 31.2 Certification of Chief Financial Officer required by Rule 13a-14(a)/15d-14(a) under the Exchange Act**
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002**
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002**

* Indicates management contract or compensatory plan or arrangement.

- (1) Incorporated by reference to the Company's Current Report on Form 8-K filed October 10, 2006.
- (2) Incorporated by reference to the Company's Registration Statement on Form S-8 filed October 22, 2004.
- (3) Incorporated by reference to the same numbered exhibit to the Company's Registration Statement on Form SB-2.
- (4) Incorporated by reference to the Company's Current Report on Form 8-K filed November 1, 2006.
- (5) Incorporated by reference to the Company's Original Filing on Form 10-KSB filed December 29, 2006.

** Filed herewith.

5

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TREATY OAK BANCORP, INC.

Dated: February 13, 2007

By: /s/ Jeffrey L. Nash
 Jeffrey L. Nash, President and Chief Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Charles T. Meeks Charles T. Meeks	Chairman of the Board	February 13, 2007
/s/ Jeffrey L. Nash Jeffrey L. Nash	Chief Executive Officer, President, and Director (Principal Executive Officer)	February 13, 2007
/s/ William J. McLellan William J. McLellan	Director	February 13, 2007
/s/ Elias F. Lee Urbina Elias F. Lee Urbina	Director	February 13, 2007
/s/ Carl J. Stolle Carl J. Stolle	Director	February 13, 2007
/s/ Marvin L. Schragger Marvin L. Schragger	Director	February 13, 2007
/s/ Hayden D. Watson Hayden D. Watson	Director	February 13, 2007
/s/ Arthur H. Coleman Arthur H. Coleman	Director	February 13, 2007
/s/ Bill F. Schneider Bill F. Schneider	Director	February 13, 2007

Contents

<u>Report of Independent Registered Public Accounting Firm</u>	<u>F-1</u>
<u>Consolidated Balance Sheets</u>	<u>F-2</u>
<u>Consolidated Statements of Operations</u>	<u>F-3</u>
<u>Consolidated Statements of Changes In Shareholders' Equity</u>	<u>F-4</u>
<u>Consolidated Statements of Cash Flows</u>	<u>F-5</u>
<u>Notes to Consolidated Financial Statements</u>	<u>F-7</u>

Report of Independent Registered Public Accounting Firm

The Board of Directors

Treaty Oak Bancorp, Inc.

Austin, Texas

We have audited the accompanying consolidated balance sheets of Treaty Oak Bancorp, Inc. and Subsidiaries (the Company) as of September 30, 2006, and 2005, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits 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 consolidated 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 Treaty Oak Bancorp, Inc. and Subsidiaries as of September 30, 2006, and 2005, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ McGladrey & Pullen,
LLP

Dallas, Texas

December 28, 2006

F-1

Treaty Oak Bancorp, Inc.

Consolidated Balance Sheets

September 30, 2006 and 2005

(Dollars In Thousands, Except Shares and Par Value Amounts)

	September 30, 2006	September 30, 2005
ASSETS		
Cash and cash items	\$ 267	\$ 230
Due from banks	2,312	9,271
Federal funds sold	23,775	3,606
Total cash and cash equivalents	26,354	13,107
Securities available for sale	16	427
Securities held to maturity, fair value of \$2,001 and \$3,472, respectively	2,006	3,501
Investment in Federal Home Loan Bank, at cost	224	217
Investment in Independent Banker's Financial Corporation stock, at cost	102	100
Loans, net	59,620	35,683
Premises and equipment, net	5,593	5,819
Notes receivable from affiliate	2,821	
Accrued interest receivable	484	348
Due from affiliates	192	34
Goodwill and other intangibles, net	1,205	1,215
Other assets	474	298
Total assets	\$ 99,091	\$ 60,749
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	\$ 28,091	\$ 17,057
NOW, money market and savings	32,401	13,413
Time deposits	20,526	15,076
Total deposits	81,018	45,546
Accounts payable and accrued expenses	352	109
Accrued interest payable	160	116
Property mortgage	2,667	2,727
Notes payable	2,483	74
Minority interest - PGI Equity Partners, LP	1,106	1,109
Other liabilities	33	35
Total liabilities	87,819	49,716
Shareholders' equity:		
Preferred stock, \$0.01 par value; 1,000,000 shares authorized; none issued		
Common stock, \$0.01 par value; 20,000,000 shares authorized; 2,640,226 and 2,635,746, respectively, issued	26	26
Paid-in capital	14,989	14,949
Accumulated deficit	(3,693)	(3,888)
Accumulated other comprehensive loss	(4)	(4)
Less shares held in treasury, at cost (6,003 shares)	(50)	(50)
Total shareholders' equity	11,272	11,033
Total liabilities and shareholders' equity	\$ 99,091	\$ 60,749

See Notes to the Consolidated Financial Statements

Treaty Oak Bancorp, Inc.

Consolidated Statements of Operations

Year Ended September 30, 2006 and 2005

(Dollars In Thousands, Except Shares and Per Share Amounts)

	Year Ended September 30, 2006	Year Ended September 30, 2005
Interest income:		
Loans, including fees	\$ 4,184	\$ 1,700
Taxable securities	93	131
Interest on deposits with other banks	93	70
Federal funds sold	340	160
Total interest income	4,710	2,061
Interest expense:		
Deposits	1,019	482
Other borrowings	183	146
Total interest expense	1,202	628
Net interest income	3,508	1,433
Provision for loan losses	295	130
Net interest income after provision for loan losses	3,213	1,303
Noninterest income:		
Service charges on deposit accounts	103	80
Other noninterest income	414	247
Total noninterest income	517	327
Noninterest expense:		
Salaries and employee benefits	1,728	1,793
Occupancy and equipment expenses	398	296
Accounting and other professional fees	294	291
Other noninterest expense	1,089	1,015
Income (losses) allocated to minority interests	26	(28)
Total noninterest expense	3,535	3,367
Net income (loss)	\$ 195	\$ (1,737)
Earnings (loss) per common share - basic	\$ 0.07	\$ (0.66)
Earnings (loss) per common share - diluted	\$ 0.07	\$ (0.66)
Weighted average shares outstanding - basic	2,630,720	2,619,411
Weighted average shares outstanding - dilutive	2,633,953	2,619,411

See Notes to the Consolidated Financial Statements

F-3

Treaty Oak Bancorp, Inc.

Consolidated Statements of Changes In Shareholders Equity
Year Ended September 30, 2006 and 2005
(Dollars In Thousands)

	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Subscribed for but not paid for and not issued	Accumulated Deficit	Accumulated other comprehensive income (loss)	Treasury Stock	Total
Balances at October 1, 2004	2,169,814	\$ 22	\$ 11,067	\$ 3,379	\$ (2,151)	\$ 2	\$	12,319
Sale of common stock subscribed as of September 30, 2004	405,663	4	3,375	(3,379)				
Sale of common stock, net of costs of issuance	47,510		393					393
Shares repurchased and held in treasury							(50)	(50)
Non-cash stock based compensation	11,199		98					98
Shares issued through the exercise of common stock warrants	1,560		16					16
Comprehensive loss:								
Net loss					(1,737)			(1,737)
Change in unrealized depreciation on securities available for sale						(6)		(6)
Total comprehensive loss								(1,743)
Balances at September 30, 2005	2,635,746	\$ 26	\$ 14,949	\$	\$ (3,888)	\$ (4)	\$ (50)	\$ 11,033
Shares issued through the exercise of common stock warrants	1,480		15					15
Non-cash stock based compensation	3,000		25					25
Comprehensive income:								
Net income					195			195
Change in unrealized appreciation on securities available for sale						4		4
Total comprehensive income								199
Balances at September 30, 2006	2,640,226	\$ 26	\$ 14,989	\$	\$ (3,693)	\$	\$ (50)	\$ 11,272

See Notes to Consolidated Financial Statements

F-4

Treaty Oak Bancorp, Inc.

Consolidated Statements of Cash Flows
Years Ended September 30, 2006 and 2005
(Dollars In Thousands)

	September 30, 2006	September 30, 2005
Cash flows from operating activities:		
Net income (loss)	\$ 195	\$ (1,737)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Minority interests in partnership income (loss)	26	(28)
Provision for loan losses	295	130
Non-cash stock based compensation	25	98
Write-off of loan acquisition costs in connection with refinancing		100
Depreciation and amortization, net	362	321
Changes in other operating assets and liabilities:		
Accrued interest receivable	(136)	(204)
Other assets	(144)	(59)
Accrued interest payable	44	101
Other liabilities	241	12
Net cash provided by (used in) operating activities	908	(1,266)
Cash flows from investing activities:		
Proceeds from maturities and principal repayments on securities - available for sale	416	31
Proceeds from maturities and principal repayments on securities - held to maturity	1,490	2,000
Purchases of securities - held to maturity		(5,494)
Cash paid for acquisitions		(926)
Purchase of minority interest	(80)	
Purchases of correspondent bank stock	(7)	(106)
Net increase in loans	(24,273)	(25,860)
Advances to affiliates	(158)	(128)
Repayments of advances to affiliates		163
Purchases of premises and equipment	(64)	(623)
Net cash used in investing activities	(22,676)	(30,943)
Cash flows from financing activities:		
Net increase in deposits	35,472	32,353
Proceeds from the sale of common stock		3,772
Payments of principal on mortgage	(60)	(364)
Proceeds from notes payable	2,409	
Proceeds from exercise of warrants	15	16
Proceeds from note payable - PGI Equity Partners, LP		150
Notes payable to affiliates	(2,821)	
Repurchase of common stock		(50)
Increase in minority interest - PGI Equity Partners, LP		155
Net cash provided by financing activities	35,015	36,032
Net increase in cash and cash equivalents	13,247	3,823
Cash and cash equivalents at beginning of year	13,107	9,284
Cash and cash equivalents at end of year	\$ 26,354	\$ 13,107

See Notes to the Consolidated Financial Statements

Treaty Oak Bancorp, Inc.**Consolidated Statements of Cash Flows
Years Ended September 30, 2006 and 2005
(Dollars In Thousands)**

	2006	2005
Supplemental disclosures of cash flow information:		
Non-cash investing and financing information:		
Cash interest received	\$ 4,574	\$ 1,857
Cash interest paid	\$ 1,158	\$ 527
Assets acquired through foreclosure	\$ 41	\$ 15
Acquisition of PGI Equity Partners, LP		
Assets acquired		\$ 4,943
Liabilities assumed		(3,015)
Minority interests		(1,002)
Cash paid, net of cash acquired		\$ 926

See Notes to the Consolidated Financial Statements

F-6

Treaty Oak Bancorp, Inc.

**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**

Note 1. Organization and Nature of Operation

Treaty Oak Bancorp, Inc. (the Company) is a bank holding company incorporated on November 18, 2003, and organized December 8, 2003 for the purpose of holding the common stock of Treaty Oak Bank (formerly Texline State Bank, the Bank). The Company acquired the Bank on March 9, 2004, and began conducting banking operations in Texline, Texas. The Bank commenced operations in Austin, Texas, on September 10, 2004. Prior to the commencement of operations in Austin, the Company was considered to be in the development stage. Since opening the Austin, Texas offices, the Company has pursued its business model of movement toward a more diversified lending strategy with an emphasis on commercial and real estate lending. The Company, through Treaty Oak Bank, provides a full range of commercial and consumer banking services to individuals and businesses in the commercial sector in Austin, Texas, and in the agriculture, cattle and commercial sectors in the community of Texline, Texas.

The Company acquired a 47.5% interest in PGI Equity Partners, LP (the Partnership) on December 30, 2004. The Partnership owns and operates the building in which the Company offices. On February 23, 2006, the Company acquired additional 2.5% Class A and 1.25% Class B interests in the Partnership from the sole remaining minority shareholder for \$80,000 cash, bringing the Company's total ownership interest in the Partnership to 51.25% at September 30, 2006. As of November 15, 2006, following the Company's merger with Treaty Oak Holdings, Inc., the Company now controls 100% of the limited partnership interests in the Partnership as well as the 5.5% interest held by PGI Capital, Inc., the Partnership's general partner. The Partnership has been consolidated in the Company's financial statements since December 31, 2004.

The Company (through its Bank subsidiary) acquired a 50% interest in Treaty Oak Mortgage, LLC, on June 27, 2005 for \$1,000. Treaty Oak Mortgage provides mortgage brokerage services in 38 states. The Company does not have a controlling financial interest in Treaty Oak Mortgage, LLC.

On June 29, 2006, the Company (through its Bank subsidiary) acquired a 50% interest in Treaty Oak Commercial Group, LLC (TOCG) for \$100,000. The Company does not have a controlling interest in TOCG and it is accounted for on the equity method of accounting. TOCG is a commercial real estate brokerage firm providing medium and long term mortgages on commercial real estate. Aside from its initial investment, the Company has no risk associated with operating expenditures or other liabilities of TOCG.

Note 2. Summary of Significant Accounting Policies

A summary of the significant accounting policies applied in the preparation of the accompanying consolidated financial statements follows. The accounting principles followed and the methods of applying them are in conformity with both accounting principles generally accepted in the United States of America and prevailing practices of the Banking industry.

Basis of Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States and include the accounts and operations of the Company, its wholly owned subsidiary, the Bank, entities that it owns more than a 50% and entities in which it has a controlling financial interest. Significant inter-company accounts and transactions have been eliminated. The investment in PGI Equity Partners, LP, in which it has been determined that the Company exerts significant influence, is also consolidated under Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51 (FIN 46). FIN 46 was adopted by the Company for the quarter ended December 31, 2004.

Treaty Oak Bancorp, Inc.

**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses for the period. Accordingly, actual results could differ from those estimates.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold. Federal funds are normally sold for one-day periods. The Company normally considers all highly liquid investments with an initial maturity of less than ninety days to be cash equivalents. Cash flows from loans, due from time deposits and deposits are reported net.

Securities

Securities classified as available for sale are those that the Company intends to hold for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available for sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations, and other similar factors. Securities available for sale are reported at fair value with unrealized gains or losses reported as a separate component of other comprehensive income, net of income taxes. Realized gains or losses, determined on the basis of the cost of specific securities sold, are included in earnings. Declines in the fair market value of individual securities to below cost result in the write-down to fair market value. Securities classified as held to maturity are those that the Company has the ability and intent to hold until the instrument matures under the terms of its issuance and are reported at amortized cost. Management determines the appropriate classification of securities at the time of purchase.

Interest income includes amortization of purchase premiums and discounts. Gains and losses on sales of securities are recorded on the trade date and are determined using the specific identification method. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected 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 cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal balance adjusted for the allowance for loan losses. Interest is accrued daily on the outstanding balances.

A loan is considered impaired when it is probable, based upon current information and events, the Company will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Impaired loans are accounted for at the net present value of expected future cash flows, discounted at the loan's effective interest rate, the observable market price of the loan or the fair value of the collateral if the loan is collateral dependent.

The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received.

Treaty Oak Bancorp, Inc.

**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**

Loan fees and direct loan origination costs are capitalized and amortized over the expected life of the loan.

Allowance for Loan Losses

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb estimated losses on existing loans, based on an evaluation of the collectibility of loans and prior loss experience. This evaluation also takes into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrower's ability to pay. While management uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses, and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

Premises and Equipment

Land is carried at cost. Buildings, leasehold improvements, furniture and equipment are carried at cost, less accumulated depreciation which is computed on the straight line method over the following estimated useful lives:

Building and improvements	10 - 25 years
Furniture and equipment	2 - 10 years

Leasehold improvements are amortized over the shorter of the lease term or their useful life.

Other Real Estate and Repossessed Assets

Assets acquired through or instead of loan foreclosures are initially recorded at fair value when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

Comprehensive Income (Loss)

Comprehensive income (loss) is included in the consolidated statement of changes in shareholders' equity and reported for all periods. Comprehensive income (loss) includes both net income (loss) and other comprehensive income (loss), which includes the change in unrealized gains and losses on securities available for sale.

Income Taxes

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Treaty Oak Bancorp, Inc.**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**Goodwill, Intangibles and Other Assets

Goodwill is not amortized but is instead reviewed at least annually for impairment, and more often when impairment indicators are present. The Company completed a test for impairment of its goodwill based upon the measurement of its fair value as provided under Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangibles* in September 2006. The Company has determined that its goodwill is not impaired.

Core deposit intangibles are amortized using the straight-line method, which approximates the interest method, over seven years, the estimated life of the related deposits.

Impairment of Long-Lived Assets

The Company evaluates and recognizes impairment of long-lived assets under the provisions of SFAS No. 144, *Accounting for the impairment of Long-Lived Assets*. The Company evaluates long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. An impairment loss is recognized when the sum of the undiscounted future cash flow is less than the carrying amount of the asset, in which case, a write-down is recorded to reduce the related asset to its estimated fair value.

Stock-Based Compensation

The Company accounts for stock-based compensation to employees using the intrinsic value method. Accordingly, compensation costs for employee stock options is measured as the excess, if any, of the fair value of the Company's common stock at date of grant over the exercise price.

The Company accounts for stock-based compensation to non-employees at fair value.

The Company will be required to adopt FASB Statement 123R, *Share-Based Payments* (Statement 123R) beginning on October 1, 2006. Statement 123R requires public entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award—the requisite service period (usually the vesting period).

Statement 123R applies to all awards granted after the required effective date and to awards modified, repurchased or cancelled after that date. Additionally, compensation cost for the portion of the awards for which the requisite service has not been rendered that are outstanding as of the required effective date shall be recognized as the requisite service is rendered on or after the effective date. Based on the options currently outstanding, the adoption of Statement 123R will reduce fiscal 2007 earnings by approximately \$165,000.

The weighted average fair value of the options granted during the years ended September 30, 2006 and 2005 have been estimated using the Black-Scholes option pricing model with the following assumptions:

	Years Ended September 30, 2006			September 30, 2005		
Dividend yield	0		%	0		%
Risk-free interest rate	4.25	5.15	%	3.86	4.42	%
Expected volatility	22		%	22		%
Expected life in years	6.85 Years			6.85 Years		

Treaty Oak Bancorp, Inc.**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**

The table below presents the pro forma effect on the Company's operations assuming the Company had accounted for its stock options issued to employees at fair value (in thousands, except per share amounts):

	Years Ended September 30, 2006	September 30, 2005
Net income (loss) as reported	\$ 195	\$ (1,737)
Net income (loss) pro forma	\$ 30	\$ (1,848)
Earnings (loss) per share as reported		
Basic	\$ 0.07	\$ (0.66)
Diluted	\$ 0.07	\$ (0.66)
Earnings (loss) per share pro forma		
Basic	\$ 0.01	\$ (0.71)
Diluted	\$ 0.01	\$ (0.71)

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Earnings (Loss) Per Share

Basic earnings (loss) per share is computed by dividing net earnings (loss) by the weighted-average number of common shares outstanding for the year. Diluted earnings (loss) per share is computed using the weighted-average number of common shares outstanding plus the number of additional common shares that would have been outstanding if dilutive common shares had been issued. For the year ended September 30, 2006, all potentially dilutive securities, except for stock options to purchase 250,100 shares of the Company's common stock at exercise prices ranging from \$8.33 to \$8.50 per share were anti-dilutive. For the year ended September 30, 2005, all potentially dilutive securities were anti-dilutive.

Statement of Cash Flows

The Company has chosen to report on a net basis its cash receipts and cash payments for time deposits and loans.

Fair Value of Financial Instruments

The Company provides disclosures regarding financial instruments as prescribed by accounting principles generally accepted in the United States of America. These disclosures do not purport to represent the aggregate net fair value of the Company. Further, the fair value estimates are based on various assumptions, methodologies and subjective considerations which vary widely among different financial institutions and which are subject to change. With the exception of the financial instruments described below, the estimated fair values of financial instruments approximate their carrying amounts. The following methods and assumptions were used by the Company in estimating financial instruments fair values:

Treaty Oak Bancorp, Inc.

**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**

Loans: The fair values estimated for fixed-rate loans are estimated using a discounted cash flow calculation based on the interest rates currently being charged compared to average market rates being charged for loans of similar amounts and maturities.

Securities: The fair value of investment securities, excluding FHLB and IBFC stock, are the quoted market value for those securities on the balance sheet date.

Deposits: The fair values estimated for demand deposits (interest and non-interest bearing accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). Fair values of fixed rate certificates of deposit are estimated using a discounted cash flow calculation based on interest rates currently being offered.

Notes Payable: The fair values for notes payable are estimated using discounted cash flow calculation based on the interest rates currently being charged in the market compared to similar types of borrowings.

New Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the impact of FIN 48. The Company will adopt this Interpretation in the first quarter of fiscal 2008.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 addresses the views of the SEC staff regarding the process of quantifying financial statement misstatements. SEC registrants are expected to reflect the effects of initially applying the guidance in SAB 108 in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year and the offsetting adjustment should be made to the opening balance of retained earnings for that year. We will be required to adopt the interpretations in SAB 108 in the first quarter of fiscal 2007. We do not anticipate this interpretation will have any impact on the financial statements.

Note 3. Common Stock Offering

The Company issued 1,582,987 shares of its common stock at \$8.33 per share, resulting in gross proceeds of approximately \$13,186,282 and incurred offering costs of \$910,000 in an offering that closed on September 30, 2004. The stock subscription receivable at September 30, 2004 (the date the offering closed), represents stock subscription agreements that were received on or before September 30, 2004, and collected during the period from October 1, 2004 to December 3, 2004. The final stock subscription was paid in full on March 11, 2005; accordingly, there was no stock subscription receivable balance as of September 30, 2005. All of the stock subscriptions have been accounted for and that activity has been closed.

In addition, the Company issued warrants to purchase one share of common stock for every five shares of common stock purchased, up to a maximum of 280,000 warrants. This amount was increased to approximately 318,000 warrants in conjunction with the over-subscription of the offering. The warrants have an exercise price of \$10.00 per share and are exercisable at any time prior to June 30, 2007, subject to certain corporate transactions. 3,040 of the warrants had been exercised as of September 30, 2006.

Treaty Oak Bancorp, Inc.**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005****Note 4. Consolidation of Variable Interest Entity**

The Company has determined that it is the consolidating parent of the Partnership for financial reporting purposes based upon its investment in the Partnership combined with its lessee relationship with the Partnership. The Partnership owns and operates the premises located at 101 Westlake Drive where the Company and Bank offices are located. The Partnership has no other significant activities.

The assets and liabilities of the Partnership have been included in the consolidated balance sheet of the Company at September 30, 2006. The balance sheet of the Partnership as of September 30, 2006, was as follows (in thousands):

Cash	\$ 50
Premises and equipment, net	4,546
Other assets	285
Total Assets	\$ 4,881
Mortgage payable	\$ 2,667
Other liabilities	139
Partners' capital	2,075
Total Liabilities and Partners' Capital	\$ 4,881

The operations of the Partnership were included in the Company's statement of operations commencing on December 31, 2004. Because of the Company's status as a limited partner of the Partnership, the creditors of the Partnership do not have recourse against the Company with respect to the obligations of the Partnership in excess of the Company's investment in the Partnership.

Note 5. Securities

Securities consisted of the following (in thousands):

	As of September 30, 2006		As of September 30, 2005	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities Available for Sale:				
U.S. Government Agencies	\$ 14	\$ 14	\$ 401	\$ 396
Other mortgage backed securities	2	2	30	31
Total Securities Available for Sale	\$ 16	\$ 16	\$ 431	\$ 427
Securities Held to Maturity:				
U.S. Government Agencies	\$ 2,000	\$ 1,996	\$ 3,495	\$ 3,467
Other mortgage backed securities	6	5	6	5
Total Securities Held to Maturity	\$ 2,006	\$ 2,001	\$ 3,501	\$ 3,472

Treaty Oak Bancorp, Inc.

Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005

At September 30, 2006, there were no holdings of securities of any one issuer, other than the U.S. government and its agencies, in an amount greater than 10% of shareholders' equity.

Mortgage-backed securities are backed by pools of mortgages that are insured or guaranteed by the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA) or the Government National Mortgage Association (GNMA).

There were no mortgage-backed-securities or agency notes and bonds classified as available-for-sale in an unrealized loss position for a period greater than one year as of September 30, 2006. For securities which were in an unrealized loss position for a period less than one year as of September 30, 2006, the unrealized losses were approximately \$4,000 at September 30, 2006. For those securities with unrealized losses at September 30, 2006, the losses are generally due to changes in interest rates and, as such, are considered by management to be temporary.

The table below reflects the securities which were in a loss position on September 30, 2006, and the length of time they have been so positioned (in thousands).

	Continuous unrealized losses existing for less than 12 months		Continuous unrealized losses existing for more than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities Held to Maturity:						
Agency notes and bonds	\$ 1,996	\$ 4	\$ -	\$ -	\$ 1,996	\$ 4
Other mortgage backed securities	-	-	5	1	5	1
Total	\$ 1,996	\$ 4	\$ 5	\$ 1	\$ 2,001	\$ 5

The table below reflects the securities which were in a loss position on September 30, 2005, and the length of time they have been so positioned (in thousands).

	Continuous unrealized losses existing for less than 12 months		Continuous unrealized losses existing for more than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities Available for Sale:						
Agency notes and bonds	\$ 198	\$ 2	\$ 198	\$ 3	\$ 396	\$ 5
Mortgage backed securities	-	-	3	-	3	-
	\$ 198	\$ 2	\$ 201	\$ 3	\$ 399	\$ 5
Securities Held to Maturity:						
Agency notes and bonds	\$ 3,467	\$ 4	\$ -	\$ -	\$ 3,467	\$ 28
Mortgage backed securities	-	-	5	1	5	1
	\$ 3,467	\$ 4	\$ 5	1	\$ 3,472	\$ 29
Total	\$ 3,665	\$ 6	\$ 206	\$ 4	\$ 3,871	\$ 34

Edgar Filing: TREATY OAK BANCORP INC - Form 10KSB/A

For those securities with unrealized losses at September 30, 2005, the losses are generally due to changes in interest rates and, as such are considered by management to be temporary.

F-14

Treaty Oak Bancorp, Inc.

Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005

The amortized cost and estimated fair value of securities at September 30, 2006, by contractual maturity, are shown below (in thousands). Expected maturities for mortgage backed securities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Mortgage-backed securities are shown separately since they are not due at a single maturity date.

September 30, 2006	Amortized Cost		Estimated Fair Value	
Available for Sale				
Due in one year or less	\$	-	\$	-
Due from one year to five years		14		14
Mortgage-backed securities		2		2
	\$	16	\$	16
Held to Maturity				
Due in one year or less	\$	2,000	\$	1,996
Due from one year to five years		-		-
Mortgage-backed securities		6		5
	\$	2,006	\$	2,001

At September 30, 2006, \$2,017,000 of the Company's securities was pledged to the State of Texas (\$200,000), Texline Independent School District (\$1,014,000) and to the City of Texline (\$802,000). At September 30, 2005, \$1,218,000 of the Company's securities was pledged to the Texline Independent School District (\$1,016,000) and to the City of Texline (\$202,000).

Note 6. Loans and Allowance for Loan Losses

The Company grants real estate, commercial and agribusiness loans to customers primarily in the Austin and Northwest Texas markets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their obligations is dependent upon the general economic conditions of the area.

Loans at September 30, 2006 and 2005, were as follows (in thousands):

	As of September 30, 2006	As of September 30, 2005
Agriculture	\$ 2,989	\$ 3,261
Commercial	19,068	12,887
Commercial real estate	18,582	8,619
Residential real estate	8,221	4,524
Construction real estate	4,329	4,152
Consumer and other	6,981	2,517
Gross Loans	60,170	35,960
Less: allowance for loan losses	(550)	(277)
Net Loans	\$ 59,620	\$ 35,683

Treaty Oak Bancorp, Inc.**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**

Activity in the allowance for loan losses for the years ended September 30, 2006, and 2005, was as follows (in thousands):

	As of September 30, 2006	As of September 30, 2005
Balance at beginning of period	\$ 277	\$ 217
Provisions for loan losses	295	130
Loans charged off	(29)	(85)
Recoveries on loans previously charged off	7	15
Balance at end of period	\$ 550	\$ 277

The Company had no impaired loans at September 30, 2006, or September 30, 2005. At September 30, 2006 and September 30, 2005, the Company had approximately \$123,000 and \$91,000, respectively, in nonperforming loans consisting of \$123,000 and \$85,000, respectively, in non-accruing loans and \$0 and \$6,000, respectively, in loans 90 days or more past due, still accruing interest. If interest on non-accrual loans had been accrued, such income would have amounted to approximately \$9,000 and \$3,000 for the years ended September 30, 2006 and 2005, respectively.

Note 7. Premises and Equipment

Premises and equipment at September 30, 2006, and 2005, were as follows (in thousands):

	As of September 30, 2006	As of September 30, 2005
Land	\$ 959	\$ 949
Building and leasehold improvements	4,568	4,520
Furniture, fixtures and equipment	778	718
	6,305	6,187
Less accumulated depreciation and amortization	(712)	(368)
Total	\$ 5,593	\$ 5,819

Note 8. Notes Payable

On September 30, 2006, the Company had notes payable of \$5,150,000 which included the mortgage on the premises of \$2,667,000, a note payable to a third party bank of \$2,425,000 and other notes payable of \$58,000. The property mortgage bears interest at 5.92% and is due in 9 years. The \$2,425,000 note payable bears interest at the prime rate (8.25% at September 30, 2006) and is due in full on February 24, 2007. This note was paid in full on November 15, 2006. A schedule of contractual maturities of these notes as of September 30, 2006, is as follows (in thousands):

F-16

Treaty Oak Bancorp, Inc.

Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005

Years Ending September 30,			As of September 30, 2006
2007			\$ 2,505
2008			85
2009			89
2010			79
2011			80
Thereafter			2,312
			\$ 5,150

Note 9. Deposits

Time deposits of \$100,000 or more totaled \$8,989,000 and \$7,797,000 at September 30, 2006 and at September 30, 2005, respectively. At September 30, 2006, the scheduled maturities of time deposits were as follows (in thousands):

Years Ending September 30,			As of September 30, 2006
2007			\$ 20,197
2008			329
			\$ 20,526

Note 10. Goodwill and Other Intangibles

In conjunction with the acquisition of Texline State Bank, the Company recorded Goodwill of \$1,161,000 and core deposit intangibles of \$70,000. The following table reflects the net carrying amount of core deposit intangibles at September 30, 2006 and at September 30, 2005 (in thousands).

	As of September 30, 2006	As of September 30, 2005
Gross core deposit intangibles	\$ 70	\$ 70
Less accumulated amortization	(26)	(16)
Net core deposit intangibles	\$ 44	\$ 54

Core deposit intangibles will continue to be amortized over the next five (5) years at the rate of approximately \$10,000 per year.

Treaty Oak Bancorp, Inc.

Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005

Note 11. Stock Based Compensation and 2004 Stock Incentive Plan

On January 19, 2004, the Company and its shareholders approved the Company's 2004 Stock Incentive Plan (the "Plan"). The Plan authorizes incentive stock option grants, non-statutory stock option grants, direct stock issuances, stock appreciation rights, salary investment option grants, and director fee option grants. Eligible participants are employees, non-employee board members, and independent consultants or advisors.

500,000 shares of common stock were initially reserved under the Plan, and the share reserve increases on the 1st business day in January each year (beginning in 2005) by an amount equal to 2% of the number of outstanding shares of the Company on the last business day in December of the preceding year, subject to a maximum annual increase of 100,000 shares. For the year ending September 30, 2005, the increase in the number of shares available to the plan was 52,177. No person may receive stock option grants, stock issuances, or stock appreciation rights for more than 100,000 shares in the aggregate in any calendar year under the Plan.

In February 2005, the Company awarded share issuances for an aggregate of 10,803 shares of common stock under its 2004 incentive plan in connection with services that were rendered to the Company. These shares were fully vested. The Company recorded compensation expense in February of \$95,000 related to this transaction. During May 2005, the Company issued 396 shares of common stock for services provided by an outside consultant at \$8.83 per share. As a result, the Company recognized compensation expense in the amount of \$3,500 in May, 2005. An additional 38,300 options were granted to board members and employees in the last quarter of fiscal 2005. The options expire in ten (10) years and vest over three (3) years.

During the fiscal year ended September 30, 2006, no shares of common stock were issued in exchange for services rendered to the Company. In December 2005, 52,595 additional shares were added to the Plan's share reserves. During the fiscal year ended September 30, 2006, 121,000 options were granted to board members and employees. The options expire in ten (10) years and vest over (3) years. During the fiscal year ended September 30, 2006, 23,450 options were forfeited prior to vesting by individuals no longer employed by the Company.

	Year Ended September 30, 2006		Year Ended September 30, 2005	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of the year	203,800	\$ 8.42	165,500	\$ 8.33
Granted	121,000	\$ 8.53	38,300	\$ 8.82
Forfeited/expired	(23,450)	\$ 8.40		
Outstanding, end of the year	301,350	\$ 8.47	203,800	\$ 8.42
Exercisable at the end of the year	120,950	\$ 8.38		
Weighted-average fair value of options granted during the year		\$ 1.87		\$ 1.77
Weighted-average remaining contractual life (months)	101		103	

F-18

Treaty Oak Bancorp, Inc.

**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**

Note 12. Other Related Party Transactions

Transactions with Our Organizing Shareholder

On August 30, 2006, Treaty Oak Holdings, Inc., the Company's largest shareholder, repurchased all of its stock owned by certain principals of our formerly affiliated services firms, including the Company's former CEO Terry W. Hamann. Concurrent with this stock redemption, those formerly affiliated firms relocated from the headquarters building. At that time, Mr. Hamann resigned his remaining positions with the Company including all committee assignments and his seat on the board of directors. Mr. Hamann had previously resigned his role as Chairman, CEO and President of the Company in February 2006.

PGI Capital, Inc.

The Company loaned \$200,000 to PGI Capital, Inc., a wholly owned subsidiary of Treaty Oak Holdings, Inc., on March 10, 2005, in conjunction with the refinance of the premises. The loan was renewed on September 26, 2005. PGI Capital, Inc. is the general partner in PGI Equity Partners, LP. The funds were partially loaned to, and partially contributed to the capital of, PGI Equity Partners, LP. The original loan bore interest at 5.05% and was due in full on March 8, 2006. At that time, the loan was renewed and extended to March 8, 2007 and the interest rate was increased to 5.90%.

Accounting and Tax Services

The Company receives tax planning advice and general tax and accounting services from Hamann, Ernstmeyer & Williamson, P.C., formerly Hamann & Associates, P.C. (HEW), a professional corporation of certified public accountants in which Mr. Hamann (the former Chief Executive Officer of the Company) owned an 80% interest until June 30, 2005 when his ownership interest became 5%. As of November 1, 2005, Mr. Hamann has no ownership interest in HEW. For the years ended September 30, 2006 and 2005, the Company paid approximately \$35,000 and \$ 123,000, respectively, for these services primarily with respect to assistance in the preparation of the Company's monthly and periodic reporting, tax planning and reporting, and other advisory services including public reporting matters. None of the fees paid for services during the years ended September 30, 2006, and 2005, were related to the efforts of Mr. Hamann, and Mr. Hamann is not currently compensated by the firm.

Other Transactions

The Company has a \$192,000 due from affiliate balance as of September 30, 2006 which represents amounts due from Treaty Oak Holdings, Inc. to PGI Equity Partners, LP for occupancy costs.

On October 11, 2005, the Company made a \$355,000 loan to Treaty Oak Holdings, Inc. (TOHI) with monthly interest payments due on the first of each month beginning November 1, 2005. The purpose of the loan was to enable TOHI to pay off certain obligations, and to provide sufficient liquidity to TOHI until the proposed merger with the Company has been completed. On April 26, 2006, the obligation was renewed and increased to \$373,000 at the then current prime rate. The loan was renewed and increased to \$400,000 on September 1, 2006. The principal balance (\$396,000 as of September 30, 2006), along with any accrued interest, is due and payable in full on November 1, 2006. On November 15, 2006, in connection with the merger of TOHI and the Company, the loan was paid in full.

On August 24, 2006, the Company made a \$2,425,000 loan to TOHI with monthly interest payments at the current prime rate (8.25% at September 30, 2006) due on the 24th day of each month. The purpose of the loan was to enable TOHI to redeem shares of common and preferred stock from certain of its shareholders. The loan was due and payable on February 24, 2007 but was paid-off in full on November 15, 2006 in connection with the Company's acquisition of TOHI.

F-19

Treaty Oak Bancorp, Inc.

Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005

Note 13. Other Non-interest Expense

Other non-interest expense consists of operating expenses such as data processing, advertising and marketing expenses, office supplies and general administrative and operating expenses. Also included in non-interest expense is the depreciation of the building owned by PGI Equity Partners, LP. The following table represents major categories of other non-interest expense for the fiscal years ended September 30, 2006 and 2005 (in thousands):

	Years Ended	
	September 30, 2006	September 30, 2005
Data processing, IT security and software maintenance	\$ 233	\$ 148
Depreciation and amortization	362	291
Write-off of loan acquisition fees on refinance, gross	-	100
Advertising, marketing, business development	118	84
Director and committee fees	49	50
Other operating expenses	327	342
	\$ 1,089	\$ 1,015

Note 14. Federal Income Taxes

	As of September 30, 2006	As of September 30, 2005
Deferred tax assets:		
Net operating loss carryforward	\$ 1,088	\$ 1,200
Other	92	51
	1,180	1,251
Less valuation allowance	(1,180)	(1,251)
	\$	\$

At September 30, 2006, the Company had approximately \$3,200,000 of federal net operating loss carry-forwards which expire in 2021 to 2026.

Although the Company became profitable during fiscal 2006, the Company's operating history is limited and, therefore, management has determined that the realization of the deferred tax assets was not more likely than not and accordingly such deferred tax assets have been fully reserved.

A reconciliation of the income tax benefit at the U.S. federal statutory income tax rate of 34% to actual income tax benefit for the years presented is as follows (in thousands):

Treaty Oak Bancorp, Inc.

Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005

	Years Ended	
	September 30, 2006	September 30, 2005
Income tax benefit (expense) at statutory rate	\$ 66	\$ (591)
Non-cash compensation	9	1
Increase (decrease) in valuation allowance	(71)	468
Other	(4)	122
	\$	\$

For the year ended September 30, 2005, other consists of items not deductible for tax purposes of \$12,000 and the effect of changes in tax estimates resulting from completion of the 2005 tax return of \$110,000.

Note 15. Financial Instruments with Off-Balance Sheet Risk

In the normal course of business, the Company is a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers, through the use of commitments to extend credit. Those instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the consolidated balance sheet. The contract or notional amounts of those instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

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

The following table summarizes the Company's off-balance sheet financial instruments as of September 30, 2006, and September 30, 2005 (in thousands):

	As of September 30, 2006	As of September 30, 2005
Commitments to extend credit	\$ 21,277	\$ 14,043
Standby letters of credit	\$ 1,935	\$ 269

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

Standby letters of credit are written conditional commitments used by the Company to guarantee the performance of a customer to a third party. The Company's policies generally require that letter of credit arrangements contain security and debt covenants similar to those contained in loan arrangements. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is

Treaty Oak Bancorp, Inc.**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**

represented by the contractual amount shown in the table above. If the commitment is funded, the Company would be entitled to seek recovery from the customer. As of September 30, 2006 and at September 30, 2005, no amounts had been recorded as liabilities for the Bank's potential obligations under these guarantees.

The Company periodically is subject to litigation as a part of normal business operations. As of September 30, 2006 and 2005, there was no material, or potentially material, ongoing litigation.

Note 16. Fair Value of Financial Instruments

	As of September 30, 2006		As of September 30, 2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets:				
Cash and cash equivalents	\$ 26,354	\$ 26,354	\$ 13,107	\$ 13,107
Securities available for sale	16	16	427	427
Securities held to maturity	2,006	2,001	3,501	3,472
Investment in Federal Home Loan Bank stock	224	224	217	217
Investment in Independent Banker's Financial Corporation stock	102	102	100	100
Loans, net	59,620	59,362	35,683	35,792
Notes receivable from affiliate	2,821	2,821	-	-
Accrued interest receivable	484	484	348	348
Due from affiliates				
Financial Liabilities:				
Deposits	\$1,018	\$1,064	45,546	45,507
Accrued interest payable	160	160	116	116
Notes payable	5,150	5,150	2,801	2,428

Note 17. Dividend Restrictions and Regulatory Matters

Banks and Bank holding companies are subject to regulatory capital requirements administered by state and federal Banking regulatory agencies. Capital adequacy guidelines and, additionally for Banks, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings and other factors. Failure to meet capital requirements can initiate regulatory action. As of September 30, 2006, and at September 30, 2005, management believes the Bank is in compliance with all regulatory capital requirements to which it is subject.

The following table sets forth the capital levels for the Bank in addition to the requirements under prompt corrective action regulations (in thousands):

Treaty Oak Bancorp, Inc.

Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005

	Actual			For Capital Adequacy Purposes			To Be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
As of September 30, 2006									
Tier 1 capital (to average assets)	\$ 8,213	11.07	%	\$ 2,967	4	%	3,709	5	%
Tier 1 capital (to risk-weighted assets)	8,213	11.39	%	2,885	4	%	4,328	6	%
Total Capital (to risk-weighted assets)	8,763	12.15	%	5,771	8	%	7,213	10	%

	Actual			For Capital Adequacy Purposes			To Be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
As of September 30, 2005									
Tier 1 capital (to average assets)	\$ 7,617	14.71	%	\$ 2,071	4	%	2,589	5	%
Tier 1 capital (to risk-weighted assets)	7,617	18.12	%	1,654	4	%	2,481	6	%
Total Capital (to risk-weighted assets)	7,894	19.09	%	3,307	8	%	4,134	10	%

As of September 30, 2006 and September 30, 2005, the Bank met the level of capital required to be categorized as well capitalized under prompt corrective action regulations. Management is not aware of any conditions subsequent to September 30, 2006 that would change the Bank's capital category.

The Bank is a state chartered Banking association and is subject to regulation, supervision and examination by the Texas Department of Banking (TDB) and the Federal Deposit Insurance Corporation (FDIC). In addition, upon making certain determinations with respect to the condition of any insured Bank, the FDIC may begin proceedings to terminate a Bank's federal deposit insurance.

From its initial acquisition of Texline State Bank, the Company's banking operations had been subject to a Memorandum of Understanding (MOU) with the FDIC. The MOU had been entered in for the purpose of ensuring that bank management appropriately and adequately addressed certain deficiencies identified by the FDIC and the Texas Department of Banking (TDB) during previous regulatory examinations prior to the Company's acquisition of Texline State Bank on March 9, 2004. Following the FDIC examination of the Bank in November, 2004, the FDIC terminated the MOU and proposed a new MOU that was more limited in scope. In February 2005, the Bank agreed to become subject to the new MOU which was subsequently executed effective March 3, 2005 by the FDIC. The Bank addressed all of the issues identified in the new MOU by March 31, 2005. At a subsequent follow-up review of the Bank conducted jointly by the FDIC and the TDB, the on-site examiners deemed the Bank's actions to date with regard to the new MOU to be satisfactory. The Bank was later advised to discontinue the submission of quarterly responses to the MOU based upon the Bank's affirmative actions in a letter dated April 25, 2005 from the FDIC.

The TDB and the FDIC conducted a joint safety and soundness examination of the Company during December, 2005 and reported their findings to the board of directors on January 10, 2006. The final written report was received by management in March, 2006, at which time the bank was advised of the official termination of the MOU.

Certain restrictions exist regarding the ability of the Bank to pay cash dividends. Regulatory approval is required in order to pay dividends until such time as the accumulated deficit is eliminated and certain other conditions are met. Further, the Company has been notified by its Banking regulators that no approval will be received in the first three years of operations.

Treaty Oak Bancorp, Inc.

**Notes to Consolidated Financial Statements
Years Ended September 30, 2006 and 2005**

Note 18. Subsequent Events

On November 15, 2006, the Company completed its previously announced acquisition of Treaty Oak Holdings, Inc. (TOHI) pursuant to the Agreement and Plan of Merger, dated October 3, 2006 (the Merger Agreement). The merger was approved by the Company s Board of Directors and also by the Company s shareholders at a Special Meeting of Shareholders held on October 24, 2006. Prior to the consummation of the merger, TOHI held approximately 39% of the issued and outstanding shares of our common stock. Pursuant to the Merger Agreement, (1) each issued and outstanding share of TOHI s common stock, par value \$0.01 per share was converted into the right to receive 0.8121 shares of the Company s common stock, par value \$0.01 per share, and (2) each issued and outstanding share of TOHI s preferred stock, par value \$10.00 per share, was converted into the right to receive 1.2034 shares of the Company s common stock.

TOHI had options to acquire 40,000 shares of common stock outstanding as of the date of the merger, which options were assumed by the Company and, pursuant to the conversion ratio, now represent options to acquire 32,484 shares of the Company s common stock. Also, at the closing of the merger, certain TOHI warrant holders were issued new warrants to acquire, in the aggregate, 450,000 shares of the Company s common stock. The Company granted the TOHI shareholders certain limited registration rights pursuant to a Registration Rights Agreement executed at the closing of the merger. Pursuant to the Registration Rights Agreement these former TOHI shareholders can request that the Company register their shares of the Company s common stock on a Registration Statement on Form S-3 if such form is available for use by the Company, but only once during any 12-month period. The former TOHI warrant holders were also granted similar S-3 registration rights.

F-24
