SECURITIES AND EXCHANGE COMMISSION

FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

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FIRST OTTAWA BANCSHARES INC

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Mailing Address
701-705 LASALLE STREET
P O BOX 657
OTTAWA IL 61350

Business Address
701-705 LASALLE STREET
P O BOX 657
OTTAWA IL 61350
8154340044X291

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2004

OR

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

For transition period from to

Commission file number 005-57237

FIRST OTTAWA BANCSHARES, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**36-4331185**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
701-705 LaSalle Street **Ottawa, Illinois**	**61350**
(Address of principal executive offices)	(ZIP Code)

(815) 434-0044
(Registrant' s telephone number, including area code)

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

Yes ☐ No ☒

Indicate by check mark whether the Registrant is an accelerated filer (as defined by Rule 12b-2 of the Exchange Act)

Yes ☐ No ☒

Indicate the number of shares outstanding of each of the Registrant' s classes of common stock as of the latest practicable date: As of August 12, 2004, the Registrant had outstanding 651,627 shares of common stock, $1.00 par value per share.

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FIRST OTTAWA BANCSHARES, INC. AND SUBSIDIARIES

Form 10-Q Quarterly Report

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FIRST OTTAWA BANCSHARES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

	(Unaudited) June 30, 2004	December 31, 2003
ASSETS		
Cash and cash equivalents	$ 14,751	$ 11,477
Federal funds sold	12,500	6,400
Cash and cash equivalents	27,251	17,877
Certificates of deposit	21,612	13,190
Securities available-for-sale	118,421	113,433
Loans held for sale	1,545	1,644
Loans, less allowance for loan losses of $1,077 and $1,049	127,843	129,255
Bank premises and equipment, net	7,656	7,537
Interest receivable and other assets	9,779	11,554
Total assets	$ 314,107	$ 294,490
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits		
Demand - non-interest-bearing	$ 30,440	$ 29,933

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NOW accounts	72,149	64,050
Money market accounts	52,357	28,828
Savings	30,167	27,826
Time, $100,000 and over	25,426	26,425
Other time	77,371	87,859
Total deposits	287,910	264,921
Federal funds purchased	–	–
Securities sold under agreements to repurchase	–	–
Borrowings	489	490
Interest payable and other liabilities	2,821	4,424
Total liabilities	291,220	269,835
Commitments and contingent liabilities		
Shareholders' equity		
Preferred stock - $1 par value, 20,000 shares Authorized; none issued	–	–
Common stock - $1 par value, 750,000 shares authorized and issued	750	750
Additional paid-in capital	4,013	4,008
Retained earnings	24,394	23,988
Treasury stock, at cost, 94,673 shares	(5,585)	(5,585)
Accumulated other comprehensive income (loss)	(685)	1,494
Total shareholders' equity	22,887	24,655
Total liabilities and shareholders' equity	$ 314,107	$ 294,490

See accompanying notes to condensed consolidated financial statements.

FIRST OTTAWA BANCSHARES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except share and per share data)
(Unaudited)

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2004	**2003**	**2004**	**2003**
Interest income				
Loans (including fee income)	$ 2,045	$ 2,003	$ 4,109	$ 3,968
Securities				
Taxable	940	839	1,943	1,748
Exempt from federal income tax	249	190	432	386
Certificates of deposit	127	96	232	201
Federal funds sold	12	–	26	–
Total interest income	3,373	3,128	6,742	6,303
Interest expense				
NOW account deposits	97	118	200	241
Money market deposit accounts	205	32	377	61

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Savings deposits	44	57	93	119
Time deposits	693	828	1,461	1,734
Repurchase agreements	0	1	–	8
Borrowings	1	1	5	4
Federal funds purchased	1	74	2	131
Total interest expense	1,041	1,111	2,138	2,298
NET INTEREST INCOME	2,332	2,017	4,604	4,005
Provision for loan losses	75	30	150	60
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	2,257	1,987	4,454	3,945
Noninterest income				
Service charges on deposit accounts	275	194	508	383
Trust and farm management fee income	114	114	228	228
Gain on loan sales	132	273	205	493
Gain on investment sales	72	–	183	–
Other income	189	147	296	250
Total noninterest income	782	728	1,420	1,354
Noninterest expenses				
Salaries and employee benefits	1,183	1,055	2,367	2,022
Occupancy and equipment expense	299	229	584	455
Data processing expense	97	106	183	220
Supplies	45	26	86	57
Advertising and promotions	11	18	23	35
Professional fees	134	88	240	153
Other expenses	515	300	1,015	634
Total noninterest expenses	2,284	1,822	4,498	3,576
INCOME BEFORE INCOME TAXES	755	893	1,376	1,723
Provision for income taxes	177	241	319	457
NET INCOME	$ 578	$ 652	$ 1,057	$ 1,266
Earnings per share-basic and diluted	$ 0.88	$ 0.99	$ 1.62	$ 1.93
Average shares outstanding-basic and diluted	651,627	656,429	651,627	656,691

See accompanying notes to condensed consolidated financial statements.

FIRST OTTAWA BANCSHARES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

Six Months ended June 30, 2004 and 2003

(In thousands, except per share data)

(Unaudited)

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	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Share-holders' Equity
Balance at January 1, 2004	$ 750	$ 4,008	$ 23,988	$ (5,585)	$ 1,494	$ 24,655
Net income	–	–	1,057	–	–	1,057
Unrealized net gain on securities available-for-sale, net of reclassi-fications and tax effects	–	–	–	–	(2,179)	(2,179)
Comprehensive loss						(1,122)
Cash dividends declared ($1 per share)	–	–	(651)	–	–	(651)
Options vested	–	5	–	–	–	5
Balance at June 30, 2004	$ 750	$ 4,013	$ 24,394	$ (5,585)	$ (685)	$ 22,887
Balance at January 1, 2003	$ 750	$ 4,000	$ 23,491	$ (5,270)	$ 2,212	$ 25,183
Net income	–	–	1,266	–	–	1,266
Unrealized net gain on securities available-for-sale, net of reclassi-fications and tax effects	–	–	–	–	400	400
Comprehensive income						1,666
Cash dividends declared ($1 per share)	–	–	(657)	–	–	(657)
Purchase of 1,629 Treasury shares	–	–	–	(91)	–	(91)
Balance at June 30, 2003	$ 750	$ 4,000	$ 24,100	$ (5,361)	$ 2,612	$ 26,101

See accompanying notes to condensed consolidated financial statements.

FIRST OTTAWA BANCSHARES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
Six Months ended June 30, 2004 and 2003
(In thousands)
(Unaudited)

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	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 1,057	$ 1,266
Adjustments to reconcile net income to net cash from operating activities		
Change in deferred loan fees	–	(3)
Provision for loan losses	150	60
Depreciation and amortization	433	164
Premium amortization on securities, net	260	96
Derivative valuation adjustment	(69)	–
Net change in loans held for sale	304	1,296
Gain on loan sales	(205)	(493)
Gain on sales of securities	(183)	–
(Gain) Loss on sale of other real estate owned	(23)	13
Change in interest receivable and other assets	1,568	55
Change in interest payable and other liabilities	174	(224)
Net cash from operating activities	3,466	2,230
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of securities available-for-sale	6,087	–
Proceeds from maturities of securities	12,050	10,204
Purchases of securities available-for-sale	(26,504)	(180)
Proceeds from maturities of certificates of deposit	1,096	3,062
Purchases of certificates of deposit	(9,449)	(400)
Net change in loans receivable	1,196	(4,177)
Proceeds from sale of other real estate owned	89	166
Property and equipment expenditures	(345)	(1,357)
Net cash from investing activities	(15,780)	7,318
CASH FLOWS FROM FINANCING ACTIVITIES		
Change in deposits	22,989	4,164
Change in federal funds purchased	–	(7,700)
Change in other borrowings	(1)	(385)
Change in securities sold under agreements to repurchase	–	(1,488)
Vested stock options	5	–
Purchase of treasury shares	–	(91)
Dividends paid	(1,305)	(1,316)
Net cash from financing activities	21,688	(6,816)
Change in cash and cash equivalents	9,374	2,732
Cash and cash equivalents at beginning of period	17,877	8,606
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 27,251	$ 11,338

See accompanying notes to condensed consolidated financial statements.

FIRST OTTAWA BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINACIAL STATEMENTS

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NOTE 1 – BASIS OF PRESENTATION

The accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent with those used in the preparation of annual consolidated financial statements. The interim condensed consolidated financial statements reflect all normal and recurring adjustments, which are necessary, in the opinion of management, for a fair statement of results for the interim periods presented. Results for the three months and six months ended June 30, 2004 are not necessarily indicative of the results that may be expected for the year ended December 31, 2004.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for the interim financial period and with the instructions to Form 10-Q. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company' s annual report on Form 10-K for 2003 filed with the U.S. Securities and Exchange Commission. The condensed consolidated balance sheet of the Company as of December 31, 2003 has been derived from the audited consolidated balance sheet as of that date.

The Company' s wholly-owned subsidiary, First Ottawa Financial Corporation, sells insurance and investment products.

NOTE 2 – EARNINGS PER SHARE

The number of shares used to compute basic and diluted earnings per share were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net income (in thousands)	$ 578	$ 652	$ 1,057	$ 1,266
Weighted Average Shares outstanding	651,627	656,429	651,627	656,691
Effect of dilutive securities:				
Stock options	–	–	–	–
Shares used to compute diluted earnings per share	651,627	656,429	651,627	656,691
Earnings per share:				
Basic	$ 0.88	$ 0.99	$ 1.62	$ 1.93
Diluted	0.88	0.99	1.62	1.93

Options to purchase 14,500 shares at June 30, 2004 were not included in the earnings per share calculation as they were anti-dilutive.

NOTE 3 – CAPITAL RATIOS

At the end of the period, the Company' s and Bank' s capital ratios were materially the same and were:

June 30, 2004		December 31, 2003	
Amount	Ratio	Amount	Ratio

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Total capital (to risk-weighted assets)	$ 20,268	11.8%	$ 19,661	11.9%
Tier I capital (to risk-weighted assets)	19,191	11.2%	18,612	11.3%
Tier I capital (to average assets)	19,191	6.4%	18,612	7.2%

At June 30, 2004, the Company and the Bank were categorized as well capitalized and management is not aware of any conditions or events since the most recent notification that would change the Company' s or Bank' s categories.

NOTE 4 - DERIVATIVES

The Company uses derivatives to fix future cash flows for interest payments on some of its floating rate certificates of deposit. In this regard, the Company has entered into an interest rate swap with the Federal Home Loan Bank of Chicago to fix the interest rate on a specific certificate of deposit product. At June 30, 2004, the Company had $2.6 million of certificates of deposit, which mature in 2006, 2007, 2008 and 2009, in which it pays the Federal Home Loan Bank a weighted average interest rate of 3.05% and will receive an interest rate from the Federal Home Loan Bank based on the appreciation of the S&P 500 Index. This interest received from the Federal Home Loan Bank will be paid to the customer. The assets and liabilities in this transaction are being netted and the expense recorded in interest expense on deposits.

In addition to the above, the Company also purchased $6.3 million of certificates of deposit, which are included in the certificates of deposit caption on the consolidated balance sheet. These investments mature throughout 2006, 2007, 2008 and 2009. The investments that individually do not exceed $100,000 are secured by the FDIC. Investments that do individually exceed $100,000 are guaranteed by a standby letter of credit issued by the Federal Home Loan Bank of Pittsburgh with an interest rate of 0%. The initial investment is not at risk, but the return on the investment is based on a calculation of the appreciation in the S&P 500 Index. The fair value of this embedded derivative is recorded in investment certificates of deposit and the fair value adjustment is included in other income. At June 30, 2004, the Bank had allocated $582,000 to this asset and recorded a valuation expense of $42,000 for the current year.

FIRST OTTAWA BANCSHARES, INC. AND SUBSIDIARY
MANAGEMENT' S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

ITEM 2. MANAGEMENT' S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis is intended as a review of significant factors affecting the financial condition and results of operations of the Company for the periods indicated. The discussion should be read in conjunction with the Condensed Consolidated Financial Statements and Notes. In addition to historical information, the following Management' s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve risks and uncertainties. The Company' s actual results could differ significantly from those anticipated in these forward-looking statements as a result of certain factors discussed elsewhere in this report.

Overview

First Ottawa Bancshares, Inc. is the holding company for First National Bank of Ottawa. The Company is headquartered in Ottawa, Illinois and operates four offices in Ottawa, a new branch in Morris and purchased two branches in Streator during the fourth quarter of 2003. The Company has purchased real estate in Yorkville, Illinois with the intention of establishing a full service branch facility in that community in early 2005. The Company continues to explore expansion opportunities within its existing market area and in surrounding areas.

The Company' s principal business is conducted by the Bank and consists of a full range of community-based financial services, including commercial and retail banking. The profitability of the Company' s operations depends primarily on its net interest income, provision for loan

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losses, other income, and other expenses. Net interest income is the difference between the income the Company receives on its loan and securities portfolios and its cost of funds, which consists of interest paid on deposits and borrowings. The provision for loan losses reflects the cost of credit risk in the Company's loan portfolio. Other income consists of service charges on deposit accounts, trust and farm management fee income, securities gains (losses), gains (losses) on sales of loans, and other income. Other expenses include salaries and employee benefits, as well as occupancy and equipment expenses and other noninterest expenses.

Net interest income is dependent on the amounts and yields of interest-earning assets as compared to the amounts of and rates on interest-bearing liabilities. Net interest income is sensitive to changes in market rates of interest and the Company's asset/liability management procedures in coping with such changes. The provision for loan losses is dependent upon management's assessment of the collectibility of the loan portfolio under current economic conditions.

The Company's net income for the six months ended June 30, 2004, was $1.06 million, or $1.62 per common share, compared to net income of $1.27 million, or $1.93 per common share for the six months ended June 30, 2003. The decrease in net income was due primarily to increases in noninterest expenses related to the opening of an additional branch in Morris and the acquisition of two branches in Streator after June 30, 2003.

CRITICAL ACCOUNTING POLICIES

The accounting and reporting policies of the Company are in accordance with accounting principles generally accepted in the United States and conform to general practices within the banking industry. The Company's significant accounting policies are described in detail in the notes to the Company's consolidated financial statements for the year ended December 31, 2003. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. The financial position and results of operations can be affected by these estimates and assumptions and are integral to the understanding of reported results. Critical accounting policies are those policies that management believes are the most important to the portrayal of the Company's financial condition and results, and they require management to make estimates that are difficult, subjective, or complex.

Allowance for Credit Losses- The allowance for credit losses provides coverage for probable losses inherent in the Company's loan portfolio. Management evaluates the adequacy of the allowance for credit losses each quarter based on changes, if any, in underwriting activities, the loan portfolio composition (including product mix and geographic, industry or customer-specific concentrations), trends in loan performance, regulatory guidance and economic factors. This evaluation is inherently subjective, as it requires the use of significant management estimates. Many factors can affect management's estimates of specific and expected losses, including volatility of default probabilities, rating migrations, loss severity and economic and political conditions. The allowance is increased through provisions charged to operating earnings and reduced by net charge-offs.

The Company determines the amount of the allowance based on relative risk characteristics of the loan portfolio. The allowance recorded for commercial loans is based on reviews of individual credit relationships and an analysis of the migration of commercial loans and actual loss experience. The allowance recorded for homogeneous consumer loans is based on an analysis of loan mix, risk characteristics of the portfolio, fraud loss and bankruptcy experiences, and historical losses, adjusted for current trends, for each homogeneous category or group of loans. The allowance for credit losses relating to impaired loans is based on the loan's observable market price, the collateral for certain collateral-dependent loans, or the discounted cash flows using the loan's effective interest rate.

Regardless of the extent of the Company's analysis of customer performance, portfolio trends or risk management processes, certain inherent but undetected losses are probable within the loan portfolio. This is due to several factors including inherent delays in obtaining information regarding a customer's financial condition or changes in their unique business conditions, the judgmental nature of individual loan evaluations, collateral assessments and the interpretation of economic trends. Volatility of economic or customer-specific conditions affecting the identification and estimation of losses for larger non-homogeneous credits and the sensitivity of assumptions utilized to establish allowances for homogenous groups of loans are among other factors. The Company estimates a range of inherent losses related to the existence of these exposures. The estimates are based upon the Company's evaluation of imprecise risk

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associated with the commercial and consumer allowance levels and the estimated impact of the current economic environment.

Mortgage Servicing Rights- Mortgage servicing rights ("MSRs") associated with loans originated and sold, where servicing is retained, are capitalized and included in other intangible assets in the consolidated balance sheet. The value of the capitalized servicing rights represents the present value of the future servicing fees arising from the right to service loans in the portfolio. Critical accounting policies for MSRs relate to the initial valuation and subsequent impairment tests. The methodology used to determine the valuation of MSRs requires the development and use of a number of estimates, including anticipated principal amortization and prepayments of that principal balance. Events that may significantly affect the estimates used are changes in interest rates, mortgage loan prepayment speeds and the payment performance of the underlying loans. The carrying value of the MSRs is periodically reviewed for impairment based on a determination of fair value. For purposes of measuring impairment, the servicing rights are compared to a valuation prepared based on a discounted cash flow methodology, utilizing current prepayment speeds and discount rates. Impairment, if any, is recognized through a valuation allowance and is recorded as amortization of intangible assets.

Derivatives- As a part of the Company' s funding strategy, derivative financial instruments, all of which are interest rate swap arrangements, are used to reduce exposure to changes in interest rates for certain financial instruments. These derivatives are accounted for by recognizing the fair value of the contracts on the balance sheet. The valuation of these derivatives is considered critical because carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for the interest rate swaps and related deposit products are provided by third parties.

Additionally, the Company has purchased certificate of deposits which contain an equity related embedded derivative component. The initial investment in the certificate of deposit is not at risk but the return on the investment is based on appreciation in the S&P 500 Index.

Accordingly, the fair value of the embedded derivative is recorded at fair value as an adjustment to the certificate of deposit and other income.

Stock Compensation- Grants under the Company' s stock incentive plan are accounted for under the provisions of Statement of Accounting Standards (SFAS) No. 123, applying the fair value method and the use of an option pricing model to estimate the value of the options granted. The stock options are granted with an exercise price equal to the market price at the date of grant. Resulting compensation expense, under the stock options is measured and recorded based on the estimated value of the options.

CONSOLIDATED FINANCIAL CONDITION

Total assets at June 30, 2004 were $314.1 million contrasted to $294.5 million at December 31, 2003, an increase of $19.6 million, or 6.7%. This increase was the result of an increase in cash and cash equivalents, securities available for sale, and certificates of deposits at other financial institutions. These increases were partially offset by decreases in loans, loans held for sale and other assets. Cash and cash equivalents increased as a result of a $6.1 million increase in federal funds sold. This increase, and increases of $5.0 million in investment securities and $8.4 million in certificates of deposit at other financial institutions were funded through deposit growth. Loans decreased $1.4 million, primarily due to decreases in the real estate and installment portfolios. Loans held for sale decreased modestly by $99,000 as mortgage loan refinancing demand slowed during the first six months of the year. Other assets decreased by $1.8 million due to amortization of purchase accounting adjustments and a $1.3 million reduction in dividends receivable.

The Company has purchased real estate in Yorkville, Illinois with the intention of establishing a full service branch facility in that community. Construction on the facility is anticipated to begin in late 2004, with an expected completion date in early 2005. The Bank anticipates additional capital expenditures of approximately $700,000 to complete the branch facility.

Total liabilities at June 30, 2004 were $291.2 million compared to $269.8 million at December 31, 2003, an increase of $21.4 million, or 7.9%. This increase was a result of an increase in transactional deposits. Deposits increased by $23.0 million, from $264.9 million at December 31, 2003, to $287.9 million at June 30, 2004, primarily due to increases in short term deposits of a local municipality and county

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funds resulting from real estate tax payments and deposit growth in the Morris, Illinois market area. Other liabilities decreased by $1.6 million, primarily due to the $1.1 million reduction in the deferred tax liability associated with the market value of the available for sale investment portfolio. In addition, dividends payable decreased from $1.3 million as of December 31, 2003, to $651,000 as of June 30, 2004.

Total equity declined to $22.9 million at June 30, 2004 compared to $24.6 million at December 31, 2003. This decrease was the result of $1.1 million of additional retained earnings from net income for the period ended June 30, 2004 and a decrease of $2.2 million, net of tax, in the Company' s investment portfolio due to increasing interest rates. In addition, dividends payable in July 2004 were declared and recorded.

CONSOLIDATED RESULTS OF OPERATIONS

Net income for the second quarter of 2004 was $578,000, or $.88 per share, an 11.3% decrease compared to $652,000, or $.99 per share, in the second quarter of 2003. The decrease in net income for the quarter was primarily the result of an increase in non interest expense of $462,000, and an increase in the provision for loan loss of $45,000. These changes were partially offset by an increase in net interest income of $315,000, and a $54,000 increase in non interest income. The decrease in income before taxes also resulted in a decrease in the income tax provision of $64, 000.

During the six months ended June 30, 2004, net income was $1.06 million, or $1.62 per share, compared to $1.27 million, or $1.93 per share during the first six months of 2003. This 16.5% decrease in net income for the six month period was primarily due to a $922,000 increase in non interest expense, or 25.8%, and an increase in the provision for loan loss of $90,000, or 150%. Increases in expenses were partially offset by an increase in net interest income of $599,000, or 15.0%, and an increase in non interest income of $66,000, or 4.9%. This decrease in the Company' s pretax income also resulted in a decrease in the tax provision of $138,000.

The annualized return on average assets was .70% for the six months ended June 30, 2004, compared to 1.08% in 2003. The annualized return on average equity decreased to 9.0% for the six months ended June 30, 2004, from 10.9% in 2003.

NET INTEREST INCOME

Net interest income increased by 15% to $2.3 million from $2.0 million for the three months ended June 30, 2004 and 2003. Total interest income increased to $3.4 million for the three months ended June 30, 2004 from $3.1 million for the same period ended June 30, 2003, a 7.8% increase. This increase was primarily the result of an increase in interest income from securities to $1.2 million for the three months ended June 30, 2004 from $1.0 million for the same period a year earlier. In addition, an increase in interest income from investment certificates of deposits of $31,000 and a decline in interest expense, to $1.0 million for the three months ended June 30, 2004 from $1.1 million for the same period ended June 30, 2003, a 6.3% decrease, contributed to the increase in net interest income for the three month period.

Net interest income for the six months ended June 30, 2004 and 2003 was $4.6 and $4.0 million, respectively. This increase was primarily the result of additional volume in interest earning assets compared to prior year. The Company' s tax equivalent net interest margin was 3.45% for the six months ended June 30, 2004 and 3.73% a year earlier. The yield on average earning assets decreased to 5.07% for the six months ended June 30, 2004 from 5.84% for the same period ended June 30, 2003, a decline of 77 basis points. This decrease was partially offset by a corresponding decrease in the cost of funds to 1.82% from 2.46% paid for the same period ended June 30, 2003, a 64 basis point decline. These decreases were a result of ongoing repricing of assets and liabilities as they matured in the low rate environment throughout 2003 and during the first six months of 2004.

PROVISION FOR LOAN LOSSES

The provision for loan losses was $75,000 during the second quarter of 2004 compared to $30,000 for the same period in 2003. Year to date provision for loan loss was $150,000 in 2004 compared to $60,000 in 2003. As of June 30, 2004, the allowance for loan losses totaled $1.1 million, or .84% of total loans, which was a slight increase from .80% as of December 31, 2003. Nonaccrual loans increased from $137,000 at December 31, 2003 to $148,000 at June 30, 2004. Nonperforming loans, including nonaccrual loans, increased $774,000 to $1.2 million over

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the same period due primarily to one commercial credit which is in the process of foreclosure. Management feels the Bank is well collateralized and expects no loss on the credit.

The amounts of the provision and allowance for loan losses are influenced by current economic conditions, actual loss experience, industry trends and other factors, including real estate values in the Company' s market area and management' s assessment of current collection risks within the loan portfolio. While the general economy shows signs of improvement, borrowers may continue to experience difficulty, and the level of non-performing loans, charge- offs, and delinquencies could rise and require increases in the provision. The allowance for loan losses represents management' s estimate of probable incurred losses based on information available as of the date of the financial statements. The allowance for loan losses is based on management' s evaluation of the collectibility of the loan portfolio, including past loan loss experience, known and inherent risks in the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, and economic conditions.

Management has concluded that the allowance for loan losses is adequate at June 30, 2004. However, there can be no assurance that the allowance for loan losses will be adequate to cover all losses.

NONINTEREST INCOME

The Company' s noninterest income totaled $782,000 for the three months ended June 30, 2004 compared to $728,000 for the same period in 2003, an increase of $54,000 or 7.4%. The increase in non interest income was primarily due to increases in service charges on deposit accounts of $81,000, and gains on the sale of investment securities of $72,000. Gains on loan sales to the secondary market decreased $141,000 to $132,000 in 2004 compared to 2003. This decrease was due to decreasing mortgage refinancing demand compared to prior year. Trust and farm management fee income remained constant at $114,000 in 2004 compared to the same period in 2003. Other income increased $42,000 to $189,000, largely due to an increase in income related to safe deposit box rents, index powered certificates of deposit, and gain on the sale of other real estate owned.

For the six months ended June 30, 2004, non-interest income increased by 4.9% or $66,000 to $1.4 million. Service charges on deposit accounts increased by $125,000, or 32.6%. Gains on the sale of investment securities increased $183,000 compared to prior year. Gains on loan sales to the secondary market decreased $288,000 due to decreased origination and refinancing volume. Other income increased $46,000 compared to prior year.

NONINTEREST EXPENSE

The Company' s non-interest expense was $2.3 and $1.8 million for the three months ended June 30, 2004 and 2003. Salaries and benefits, the largest component of non-interest expense, increased $128,000, or 12.1%, to $1.2 million. Increases in occupancy and equipment expense of $70,000, supplies expense of $19,000, professional fees of $46,000, and other expenses of $215,000 were offset to some extent by decreases in data expense of $9,000 and advertising expense of $7,000. The increase in salaries, supplies and occupancy and equipment expenses was due primarily to increased personnel, supplies and depreciation on capital expenditures related to additional facilities in Morris and Streator which were opened after June 30, 2003. The increase in professional fees was a result of anticipated increases in general legal expenses and audit expenses for the additional facilities, as well as an increase in one time consulting fees related to

strategic planning and the Streator acquisition paid in 2004. Increases in other expenses resulted from increased insurance and other costs related to the operation of additional facilities. In addition, amortization expense of $99,000 related to the core deposit intangible resulting from the purchase of the Streator branches was recorded in the second quarter of 2004.

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For the six months ended June 30, 2004, non-interest expense increased $922,000 to $4.5 million, or 25.8%, compared to the year earlier period. Salaries and benefits increased $345,000, or 17.1%, to $2.4 million. Professional fees, occupancy expense, and supplies expense increased $245,000 as a result of additional facilities. Other expenses increased $381,000 primarily due to amortization expense of $199,000 related to the core deposit intangible resulting from the purchase of the Streator branches and increases in other expenses related to operating three added facilities compared to prior year.

LIQUIDITY AND CAPITAL RESOURCES

The Company' s primary sources of funds are deposits, repurchase agreements, and proceeds from principal and interest payments on loans and securities. While maturities and scheduled amortization of loans and securities and calls of securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions, and competition. The Company generally manages the pricing of its deposits to be competitive and to increase core deposit relationships.

Liquidity management is both a daily and long-term responsibility of management. The Company adjusts its investments in liquid assets based upon management' s assessment of (i) expected loan demand, (ii) expected deposit flows, (iii) yields available on interest-earning deposits and securities, and (iv) the objectives of its asset/liability management program. Excess liquid assets are invested generally in interest-earning overnight deposits and short- and intermediate-term U.S. government and agency obligations.

The Company' s most liquid assets are cash and short-term investments. The levels of these assets are dependent on the Company' s operating, financing, lending, and investing activities during any given year. At June 30, 2004, cash and short-term investments totaled $30.4 million. The Company has other sources of liquidity if a need for additional funds arises, including securities maturing within one year and the repayment of loans. The Company may also utilize the sale of securities available-for-sale, federal funds lines of credit from correspondent banks, and borrowings from the Federal Home Loan Bank of Chicago and Bank One.

The following table discloses contractual obligations and commercial commitments of the Company as of June 30, 2004:

	Total	Less Than 1 Year	1 - 3 Years	4 - 5 Years	After 5 Years
Note payable	$ 489	$ 489	$ –	$ –	$ –
Data processing Contract payable	958	192	404	362	–
Lines of credit(1)	$ 15,917	$ 10,253	$ 4,215	$ 585	$ 863
Standby letters of credit(1)	350	350	–	–	–
Other commitments to extend credit(1)	–	–	–	–	–
	$ 13,631	$ 5,490	$ 765	$ 1,122	$ 6,254

(1) Represents amounts committed to customers.

IMPACT OF INFLATION AND CHANGING PRICES

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

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RECENT REGULATORY DEVELOPMENTS

Bank Sales of Securities. On June 17, 2004, the Securities and Exchange Commission (the "SEC") issued a Proposed Rule in which it described the parameters under which banks may sell securities to their customers without having to register as broker-dealers with the SEC in accordance with Title II of the Gramm-Leach-Bliley Act of 1999. The proposal, which is designated as Regulation B, clarifies, among other things: (i) the limitations on the amount that unregistered bank employees may be compensated for making referrals in connection with a third-party brokerage arrangement; (ii) the manner by which banks may be compensated for effecting securities transactions for its customers in a fiduciary capacity; and (iii) the extent to which banks may engage in certain securities transactions as a custodian. At this time, it is not possible to predict the impact that this proposal would have on the Company and its subsidiaries.

SAFE HARBOR STATEMENT

This document contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company' s management and on information currently available to management, are generally identifiable by the use of words such as "believe," "expect," "anticipate," "plan," "intend," "estimate," "may," "will," "would," "could," "should" or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

The Company' s ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries include, but are not limited to, the following:

The strength of the United States economy in general and the strength of the local economies in which the Company conducts its operations which may be less favorable than expected and may result in, among other things, a deterioration in the credit quality and value of the Company' s assets.

The economic impact of past and any future terrorist attacks, acts of war or threats thereof and the response of the United States to any such threats and attacks.

The effects of, and changes in, federal, state and local laws, regulations and policies affecting banking, securities, insurance and monetary and financial matters.

The effects of changes in interest rates (including the effects of changes in the rate of prepayments of the Company' s assets) and the policies of the Board of Governors of the Federal Reserve System.

The ability of the Company to compete with other financial institutions as effectively as the Company currently intends due to increases in competitive pressures in the financial services sector.

The inability of the Company to obtain new customers and to retain existing customers.

The timely development and acceptance of products and services, including products and services offered through alternative delivery channels such as the Internet.

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Technological changes implemented by the Company and by other parties, including third party vendors, which may be more difficult or more expensive than anticipated or which may have unforeseen consequences to the Company and its customers.

The ability of the Company to develop and maintain secure and reliable electronic systems.

The ability of the Company to retain key executives and employees and the difficulty that the Company may experience in replacing key executives and employees in an effective manner.

Consumer spending and saving habits which may change in a manner that affects the Company' s business adversely.

Business combinations and the integration of acquired businesses which may be more difficult or expensive than expected.

The costs, effects and outcomes of existing or future litigation.

Changes in accounting policies and practices, as may be adopted by state and federal regulatory agencies and the Financial Accounting Standards Board.

The ability of the Company to manage the risks associated with the foregoing as well as anticipated.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Additional information concerning the Company and its business, including other factors that could materially affect the Company' s financial results, is included in the Company' s filings with the Securities and Exchange Commission.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company' s overall interest rate sensitivity is demonstrated by net income analysis and "Gap" analysis. Net income analysis measures the change in net income in the event of hypothetical changes in interest rates. This analysis assesses the risk of change in net income in the event of sudden and sustained 2.0% increases and decreases in market interest rates. The tables below present the Company' s projected changes in annualized net income for the various rate shock levels at June 30, 2004 and June 30, 2003.

	2004		
	Amount	Net Income Change	Change
	(Dollars in Thousands)		
+200 bp	$ 2,347	$ (159)	(6.33)%
Base	2,506	–	–
-200 bp	2,479	(27)	(1.07)%

	2003		
	Amount	Net Income Change	Change
	(Dollars in Thousands)		

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+200 bp	$ 2,194	$ (59)	(2.62)%
Base	2,253	–	–
-200 bp	2,049	(204)	(9.03)%

As shown above, at June 30, 2004, the effect of an immediate 200 basis point increase in interest rates would decrease the Company' s net income by 6.33% or approximately $159,000. The effect of an immediate 200 basis point decrease in rates would decrease the Company' s net interest income by 1.07% or approximately $27,000. However, the Company does not anticipate market interest rates decreasing an additional 200 basis points, so these results may not be acheivable.

ITEM 4: CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of the Company' s management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company' s disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of June 30, 2004. Based on that evaluation, the Company' s management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company' s disclosure controls and procedures were effective. There have been no significant changes in the Company' s internal controls or in other factors that could significantly affect internal controls.

PART II

ITEM 1. LEGAL PROCEEDINGS

There are no material pending legal proceedings to which the Company or its subsidiaries are a party other than ordinary routine litigation incidental to their respective businesses.

ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Election of Directors

At the Annual Meeting of Stockholders on May 19, 2004 , Joachim J. Brown, John L. Cantlin and Patty Godfrey were elected to serve as Class II directors until the 2007 Annual Meeting of Stockholders. Bradley J. Armstrong, Donald J. Harris, and Thomas P. Rooney continue to serve as Class I directors with a term expiring in 2006 and Thomas E. Haeberle, Erika L. Schmidt and William J. Walsh continue to serve as Class III directors with a term expiring in 2005. The voting for each Class II director was as follows:

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	Votes For	Votes Withheld
Joachim J. Brown	492,796	7,643
John L. Cantlin	493,236	7,203
Patty P. Godfrey	491,905	8,534

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)
31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the 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 the Sarbanes-Oxley Act of 2002.

Reports on Form 8-K

A report on form 8-K/A was filed on April 13, 2004, pursuant to Item 7, which reported amendment number 1 to the Form 8-K filed with the Securities and Exchange Commission on November 19, 2003.

A report on Form 8-K was filed on April 23, 2004 pursuant to Item 12, which reported, in the form of a press release, the Company' s financial results for the quarter ended March 31, 2004.

A report on Form 8-K was filed on July 23, 2004 pursuant to Item 12, which reported, in the form of a press release, the Company' s financial results for the quarter ended June 30, 2004.

SIGNATURES

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

FIRST OTTAWA BANCSHARES, INC.
(Registrant)

/S/ JOACHIM J. BROWN
Joachim J. Brown
President (Chief Executive Officer)

/S/ VINCENT G. EASI

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Vincent G. Easi
Chief Financial Officer

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Exhibit 31.1

I, Joachim J. Brown, certify that:

1. I have reviewed this quarterly report on Form 10-Q of First Ottawa Bancshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant' s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-15(e)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Evaluated the effectiveness of the registrant' s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

   c) Disclosed in this report any change in the registrant' s internal control over financial reporting that occurred during the registrant' s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant' s internal control over financial reporting, and;

5. The registrant' s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant' s auditors and the audit committee of registrant' s board of directors (or persons performing the equivalent function):

   a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant' s ability to record, process, summarize, and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant' s internal control over financial reporting.

Date: August 12, 2004

/s/ Joachim J. Brown
Joachim J. Brown
President and Chief Executive Officer

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Exhibit 31.2

I, Vincent G. Easi, certify that:

1. I have reviewed this quarterly report on Form 10-Q of First Ottawa Bancshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant' s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-15(e)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Evaluated the effectiveness of the registrant' s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

   c) Disclosed in this report any change in the registrant' s internal control over financial reporting that occurred during the registrant' s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant' s internal control over financial reporting, and;

5. The registrant' s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant' s auditors and the audit committee of registrant' s board of directors (or persons performing the equivalent function):

   a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant' s ability to record, process, summarize, and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant' s internal control over financial reporting.

Date: August 12, 2004

/s/ Vincent G. Easi
Vincent G. Easi
Chief Financial Officer

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Exhibit 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of First Ottawa Bancshares, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report), I, Joachim J. Brown, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Joachim J. Brown

Joachim J. Brown
Chief Executive Officer
August 12, 2004

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Exhibit 32.2

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of First Ottawa Bancshares, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report), I, Vincent G. Easi, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Vincent G. Easi

Vincent G. Easi
Chief Financial Officer
August 12, 2004

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