First Business Financial Services, Inc.
Form 10-K
March 19, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
ANNUAL REPORT PURSUANT TO
SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2007
Commission file number 0-51028

FIRST BUSINESS FINANCIAL SERVICES, INC.

WISCONSIN	39-1576570
(State or jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
401 Charmany Drive Madison, WI	53719
(Address of Principal Executive Offices)	(Zip Code)

(608) 238-8008
Registrant s telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, $0.01 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. o Yes þ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. o Yes þ No

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. þ Yes o No

Indicate by check mark if the disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this From 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer o		Accelerated filer o
Non-accelerated filer o	(Do not check if a smaller reporting company)	Smaller Reporting Company þ

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

The aggregate market value of the common equity held by non-affiliates computed by reference to the closing price of such common equity, as of the last business day of the registrant s most recently completed second fiscal quarter was approximately $51.2 million.

As of March 5, 2008, 2,510,657 shares of common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III Portions of the Proxy Statement for the Annual Meeting of Stockholders to be held on May 5, 2008 are incorporated by reference into Part III hereof.

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PART I.

Item 1. Business

General

First Business Financial Services, Inc. (FBFS or the Corporation) is a registered bank holding company incorporated under the laws of the State of Wisconsin and is engaged in the commercial banking business through its wholly-owned banking subsidiaries First Business Bank and First Business Bank Milwaukee (referred to as the Banks). All of the operations of FBFS are conducted through the Banks and certain subsidiaries of First Business Bank. The Corporation operates as a business bank focusing on delivering a full line of commercial banking products and services tailored to meet the specific needs of small and medium size businesses, business owners, executives, professionals and high net worth individuals. The Corporation does not utilize its locations to attract retail customers. The Corporation generally targets businesses with sales between $2 million and $50 million. For a more detailed discussion of loans, leases and the underwriting criteria of the Banks, see **Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations.** To supplement its business banking deposit base, the Corporation utilizes wholesale funding alternatives to fund a portion of the Corporation s assets.

First Business Bank (FBB) is a state bank that was chartered in 1909 under the name Kingston State Bank. In 1990, FBB relocated its home office to Madison, Wisconsin, opened a banking facility in University Research Park, and began focusing on providing high-quality banking services to small and medium-sized businesses located in Madison and the surrounding area. FBB offers a full line of commercial banking products and services in the greater Madison, Wisconsin area, tailored to meet the specific needs of businesses, business owners, executives, professionals and high net worth individuals. FBB s product lines include cash management services, commercial lending, commercial real estate lending and equipment leasing. FBB also offers trust and investment services through First Business Trust & Investments (FBTI), a division of FBB. In addition, FBB offers business owners, executives, professionals and high net worth individuals consumer services including a variety of deposit accounts, personal lines of credit and personal loans. FBB has two loan production offices in the Northeast Region of Wisconsin to serve Oshkosh, Wisconsin and Appleton, Wisconsin and their surrounding areas. The Appleton, Wisconsin location opened in December 2007.

FBB has two wholly owned subsidiaries that are complementary to the Corporation s business banking services. First Business Capital Corp. (FBCC) is a wholly-owned subsidiary of FBB operating as an asset-based commercial lending company specializing in providing secured lines of credit as well as term loans on equipment and real estate assets primarily to manufacturers and wholesale distribution companies located throughout the United States. First Business Equipment Finance, LLC (FBEF), formerly known as First Business Leasing, LLC, is a commercial equipment finance company specializing in financing of general equipment to small and middle market companies throughout the United States.

First Madison Investment Corp. (FMIC) and FMCC Nevada Corp. (FMCCNC) are operating subsidiaries located in and formed under the laws of the state of Nevada. FMIC was organized for the purpose of managing a portion of the Bank s investment portfolio. FMIC invests in marketable securities and loans purchased from FBB. FMCCNC, a wholly-owned subsidiary of FBCC, invests in loans purchased from FBCC.

First Business Bank Milwaukee (FBB Milwaukee) is a state bank that was chartered in 2000 in Wisconsin. FBB Milwaukee also offers a wide range of commercial banking products and services tailored to meet the specific needs of businesses, business owners, executives, professionals and high net worth individuals in the greater Milwaukee, Wisconsin area through a single location in Brookfield, Wisconsin. Like FBB, FBB Milwaukee s product lines include cash management services, commercial lending and commercial real estate lending for similar sized businesses as FBB. FBB Milwaukee also offers trust and investment services through a trust service office agreement with FBB. FBB Milwaukee also offers business owners, executives, professionals and high net worth individuals consumer services which include a variety of deposit accounts, personal lines of credit, and personal loans.

In June 2000, FBFS purchased a 51% interest in The Business Banc Group Ltd. (BBG), a corporation formed to act as a bank holding company owning all the stock of a Wisconsin chartered bank to be newly organized and headquartered in Brookfield, a suburb of Milwaukee, Wisconsin. In June 2004

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all shares of BBG stock were successfully exchanged for FBFS stock pursuant to a conversion option. Subsequent to this transaction, BBG was dissolved. This transaction resulted in FBB Milwaukee becoming a wholly-owned subsidiary of the Corporation.

In December 2001, FBFS formed FBFS Statutory Trust I (Trust), a statutory trust organized under the laws of the State of Connecticut and a wholly-owned financing subsidiary of FBFS. In December 2001, the Trust issued $10.0 million in aggregate liquidation amount of floating rate trust preferred securities in a private placement offering. These securities mature 30 years after issuance and are callable at face value after five years. The Trust used the proceeds from the offering to purchase $10.3 million of 3 month LIBOR plus 3.60% Junior Subordinated Debentures (the Debentures) of the Corporation. In December 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51, Revised* (FIN 46R) to provide guidance on how to identify a variable interest entity and determine when an entity needs to be included in a company s consolidated financial statements. As a result of the adoption of FIN 46R in 2004, the Trust was no longer consolidated by FBFS. On December 18, 2006 the Corporation exercised its right to redeem the Debentures purchased by the Trust. The Trust subsequently redeemed the preferred securities and the Trust was closed. See **Note 11** to the consolidated financial statements.

Available Information

The Corporation maintains a web site at www.firstbusiness.com. This Form 10-K and all of the Corporation s filings under the Exchange Act are available through that web site, free of charge, including copies of annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports, on the date that the Corporation files those materials with, or furnishes them to, the Securities and Exchange Commission.

Employees

At December 31, 2007, FBFS had 142 employees which include 121.5 full-time equivalent employees. No employee is covered by a collective bargaining agreement, and we believe our relationship with our employees to be excellent.

Supervision and Regulation

Below is a brief description of certain laws and regulations that relate to the Corporation and the Banks. This narrative does not purport to be complete and is qualified in its entirety by reference to applicable laws and regulations.

General.

The Banks are chartered in the State of Wisconsin and are subject to regulation and supervision by the Division of Wisconsin Banking Review Board (the Division), and more specifically the Wisconsin Department of Financial Institutions (WDFI), and are subject to periodic examinations. Review of fiduciary operations is included in the periodic examinations. The Banks deposits are insured by the Deposit Insurance Fund (DIF). The DIF is administered by the Federal Deposit Insurance Corporation (FDIC), and therefore the Banks are also subject to regulation by the FDIC. Periodic examinations of both Banks are also conducted by the FDIC. The Banks must file periodic reports with the FDIC concerning their activities and financial condition and must obtain regulatory approval prior to entering into certain transactions such as mergers with or acquisitions of other depository institutions and opening or acquiring branch offices. This regulatory structure gives the regulatory authorities extensive direction in connection with their supervisory and enforcement activities and examination policies, including policies regarding the classification of assets and the establishment of adequate loan and lease loss reserves.

Wisconsin banking laws restrict the payment of cash dividends by state banks by providing that (i) dividends may be paid only out of a bank s undivided profits, and (ii) prior consent of the Division is required for the payment of a dividend which exceeds current year income if dividends declared have exceeded net profits in either of the two immediately preceding years. The various bank regulatory agencies have authority to prohibit a bank regulated by them from engaging in an unsafe or unsound practice; the payment of a dividend by a bank could, depending upon the circumstances, be considered as

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such. In the event that (i) the FDIC or the Division should increase minimum required levels of capital; (ii) the total assets of the Banks increase significantly; (iii) the income of the Banks decrease significantly; or (iv) any combination of the foregoing occurs, then the Boards of Directors of the Banks may decide or be required by the FDIC or the Division to retain a greater portion of the Banks earnings, thereby reducing dividends.

The Banks are subject to certain restrictions imposed by the Federal Reserve Act on any extensions of credit to their parent holding company, FBFS. Also included in this Act are restrictions on investments in stock or other securities of FBFS and on taking of such stock or securities as collateral for loans to any borrower. Under this Act and regulations of the Federal Reserve Board, FBFS and its Banks are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit or any property or service.

The Corporation

FBFS is a financial holding company registered under the Bank Holding Company Act of 1956, as amended (the BHCA), and is subject to regulation, supervision, and examination by the Board of Governors of the Federal Reserve System (the FRB). The Corporation is required to file an annual report with the FRB and such other reports as the FRB may require. Prior approval must be obtained before the Corporation may merge with or consolidate into another bank holding company, acquire substantially all the assets of any bank or bank holding company, or acquire ownership or control of any voting shares of any bank or bank holding company if after such acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of such bank or bank holding company.

In reviewing applications for such transactions, the FRB considers managerial, financial, capital and other factors, including financial performance of the bank or banks to be acquired under the Community Reinvestment Act of 1977, as amended (the CRA). Also, under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, as amended, state laws governing interstate banking acquisitions subject bank holding companies to some limitations in acquiring banks outside of their home state without regard to local law.

The Gramm-Leach Bliley Act of 1999 (the GLB) eliminates many of the restrictions placed on the activities of bank holding companies. Bank holding companies such as FBFS can expand into a wide variety of financial services, including securities activities, insurance, and merchant banking without the prior approval of the FRB.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act (SOX) was enacted by the United States Congress to improve the accuracy and reliability of corporate disclosures made pursuant to securities laws, and for other purposes. A primary focus of SOX is to improve the quality and transparency in financial reporting and independent auditor services for public companies. As directed by SOX, the Securities and Exchange Commission (SEC) adopts rules that require conformance with specific sections of SOX. Section 302 of SOX and relating SEC rules require the Corporation s CEO and CFO to certify that they (i) are responsible for establishing, maintaining, and regularly evaluating the effectiveness of the Corporation s internal controls; (ii) have made certain disclosures to the Corporation s auditors and the audit committee of the Corporation s board of directors about the Corporation s internal controls; and (iii) have included information in the Corporation s quarterly and annual reports about their evaluation and whether there have been significant changes in the Corporation s internal controls over financial reporting that has materially affected, or is reasonably likely to materially affect the Corporation.

Section 404 of SOX requires public companies annual reports to (i) include the company s own assessment of internal control over financial reporting, and (ii) include an auditor s attestation regarding the company s internal control over financial reporting. The primary purpose of internal control over financial reporting is to foster the preparation of reliable and accurate financial statements. Since SOX was enacted, however, both requirements of SOX 404 have been postponed for smaller public companies such as the Corporation. The Corporation is subject to the first part of Section 404 of SOX beginning with this annual report. Refer to **Item 9A(T). Controls and Procedures** for the

Corporation s assessment. The requirement of an auditor s attestation per the second part of Section 404 of SOX continues to be postponed per temporary Item 308T of SEC Regulation S-K. Consequently, no auditor attestation accompanies Management s Annual Report on Internal Control Over Financial Reporting in this annual report.

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The Banks

As state-chartered DIF-insured banks, the Banks are subject to extensive regulation by the WDFI and the FDIC. Lending activities and other investments must comply with federal statutory and regulatory requirements. This federal regulation establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the DIF, the FDIC, and depositors.

Insurance of Deposits. The Banks deposits are insured under the DIF of the FDIC. The basic insurance coverage is up to $100,000. Depositors may qualify for additional coverage if the deposit accounts are in different ownership categories. In addition, federal law provides up to $250,000 in coverage for self-directed retirement accounts. The FDIC assigns institutions to a particular capital group based on the levels of the Banks capital well-capitalized, adequately capitalized, or undercapitalized. These three groups are then divided into three subgroups reflecting varying levels of supervisory concern, ranging from those institutions considered to be healthy to those that represent substantial supervisory concern. The result is nine assessment risk classifications, with well-capitalized, financially sound institutions paying lower rates than those paid by undercapitalized institutions that pose a risk to the insurance fund.

The Banks assessment rate depends on the capital category to which they are assigned. Assessment rates for deposit insurance currently range from 0 to 27 basis points. The Banks are well capitalized. The supervisory subgroup to which the Banks are assigned by the FDIC is confidential and may not be disclosed. The Banks rate of deposit insurance assessments will depend upon the category or subcategory to which the Banks are assigned. Any increase in insurance assessments could have an adverse affect on the earnings of the Banks.

Regulatory Capital Requirements. The FRB monitors the capital adequacy of the Banks because on a consolidated basis they have assets in excess of $500.0 million. A combination of risk-based and leverage ratios are determined by the FRB. Failure to meet these capital guidelines could result in supervisory or enforcement actions by the FRB. Under the risk-based capital guidelines, different categories of assets, including certain off-balance sheet items, such as loan commitments in excess of one year and letters of credit, are assigned different risk weights, with perceived credit risk of the asset in mind. These risk weighted assets are calculated by assigning risk-weights to corresponding asset balances to determine the risk-weight of the entire asset base. Total capital, under this definition, is defined as the sum of Tier 1 and Tier 2 capital elements, with Tier 2 capital being limited to 100% of Tier 1 capital. Tier 1 capital, with some restrictions, includes common stockholders equity, any perpetual preferred stock, qualifying trust preferred securities, and minority interests in any unconsolidated subsidiaries. Tier 2 capital, with certain restrictions, includes any perpetual preferred stock not included in Tier 1 capital, subordinated debt, any trust preferred securities not qualifying as Tier 1 capital, specific maturing capital instruments and the allowance for loan and lease losses (limited to 1.25% of risk-weighted assets). The regulatory guidelines require a minimum total capital to risk-weighted assets of 8%, of which at least 4% must be in the form of Tier 1 capital. The FRB also has a leverage ratio requirement which is defined as Tier 1 capital divided by average total consolidated assets. The minimum leverage ratio required is 3%.

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The Corporation and the Banks actual capital amounts and ratios are presented in the table below and reflect the Banks well-capitalized positions.

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(In thousands)			
As of December 31, 2007						
Total capital (to risk-weighted assets)						
Consolidated	$ 87,018	10.22%	$ 68,119	8.00%	N/A	N/A
First Business Bank	79,072	10.45	60,528	8.00	$ 75,660	10.00%
First Business Bank Milwaukee	9,847	10.26	7,679	8.00	9,599	10.00
Tier 1 capital (to risk-weighted assets)						
Consolidated	$ 46,164	5.42%	$ 34,060	4.00%	N/A	N/A
First Business Bank	71,097	9.40	30,264	4.00	$ 45,396	6.00%
First Business Bank Milwaukee	8,639	9.00	3,840	4.00	5,759	6.00
Tier 1 capital (to average assets)						
Consolidated	$ 46,164	5.12%	$ 36,065	4.00%	N/A	N/A
First Business Bank	71,097	9.04	31,459	4.00	$ 39,324	5.00%
First Business Bank Milwaukee	8,639	7.39	4,678	4.00	5,848	5.00

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(In thousands)			
As of December 31, 2006						
Total capital (to risk-weighted assets)						
Consolidated	$ 73,241	10.40%	$ 56,360	8.00%	N/A	N/A
First Business Bank	64,443	10.49	49,144	8.00	$ 61,430	10.00%
First Business Bank Milwaukee	10,205	11.31	7,218	8.00	9,022	10.00
Tier 1 capital (to risk-weighted assets)						
Consolidated	$ 43,944	6.24%	$ 28,180	4.00%	N/A	N/A
First Business Bank	57,838	9.42	24,572	4.00	$ 36,858	6.00%

First Business Bank Milwaukee	9,070	10.05	3,609	4.00	5,413	6.00
Tier 1 capital (to average assets)						
Consolidated	$ 43,944	5.99%	$ 29,331	4.00%	N/A	N/A
First Business Bank	57,838	9.22	25,086	4.00	$ 31,358	5.00%
First Business Bank Milwaukee	9,070	8.50	4,269	4.00	5,336	5.00

Prompt Corrective Action. The Banks are also subject to capital adequacy requirements under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), whereby the Banks could be required to guarantee a capital restoration plan, should they become undercapitalized as defined by FDICIA. The maximum liability under such a guarantee would be the lesser of 5% of the Banks total assets at the time they became undercapitalized or the amount necessary to bring the Banks into compliance with the capital restoration plan. The Corporation is also subject to the source of strength doctrine per the FRB, which requires that holding companies serve as a source of financial and managerial strength to their subsidiary banks.

If banks fail to submit an acceptable restoration plan, they are treated under the definition of significantly undercapitalized and would thus be subject to a wider range of regulatory requirements and restrictions. Such restrictions would include activities involving asset growth, acquisitions, branch establishment, establishment of new lines of business and also prohibitions on capital distributions, dividends and payment of management fees to control persons, if such payments and distributions would cause undercapitalization.

The following table sets forth the FDIC s definition of the five capital categories, in the absence of a specific capital directive.

Category	Total Capital to Risk Weighted Assets	Tier 1 Capital to Risk Weighted Assets	Tier 1 Leverage Ratio
Well capitalized	³ 10%	³ 6%	³ 5%
Adequately capitalized	³ 8%	³ 4%	³ 4%*
Undercapitalized	< 8%	< 4%	< 4%*
Significantly undercapitalized	< 6%	< 3%	< 3%
Critically undercapitalized	Ratio of tangible equity to total assets £ 2%		

* 3% if the Banks receive the highest rating under the uniform system.

Limitations on Dividends and Other Capital Distributions. Federal and state regulations impose various restrictions or requirements on state-chartered banks with respect to their ability to pay dividends or make various other distributions of capital. Generally, such laws restrict dividends to undivided profits or profits earned during preceding periods. Also, FDIC insured institutions may not pay dividends while undercapitalized or if such a payment would cause undercapitalization. The FDIC also has authority to prohibit the payment of dividends if such a payment constitutes an unsafe or unsound practice in light of the financial condition of a particular bank. At December 31, 2007, subsidiary unencumbered retained earnings of approximately $37.1 million could be transferred to the Corporation in the form of cash dividends without prior regulatory approval, subject to the capital needs of each subsidiary.

Liquidity. The Banks are required by federal regulation to maintain sufficient liquidity to ensure safe and sound operations. We believe that our Banks have an acceptable liquidity percentage to match the balance of net withdrawable deposits and short-term borrowings in light of present economic conditions and deposit flows.

Federal Reserve System. The Banks are required to maintain non-interest bearing reserves at specified levels against their transaction accounts and non-personal time deposits. As of December 31, 2007, the Banks were in compliance with these requirements. Because required reserves must be maintained in the form of cash or non-interest bearing deposits at the FRB, the effect of this requirement is to reduce the Banks interest-earning assets.

Federal Home Loan Bank System. The Banks are members of the FHLB of Chicago (FHLB). The FHLB serves as a central credit facility for its members. The FHLB is funded primarily from proceeds from the sale of obligations of the FHLB system. It makes loans to member banks in the form of FHLB advances. All advances from the FHLB are required to be fully collateralized as determined by the FHLB.

As a member, each Bank is required to own shares of capital stock in the FHLB in an amount equal to the greatest of $500, 1% of its aggregate unpaid residential mortgage loans, home purchase contracts or similar obligations at the beginning of each year, or 20% of its outstanding advances. The FHLB also imposes various limitations on advances relating to the amount and type of collateral, the amount of advances and other items. At December 31, 2007, the Banks owned a total of $2.4 million in FHLB stock and were in compliance with their respective requirements. The Banks received combined dividends from the FHLB totaling $46,000 for the year ended December 31, 2007 as compared to $82,000 for the year ended December 31, 2006.

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On October 10, 2007, FHLB announced via Form 8-K that it has entered into a consensual cease and desist order with its regulator, the Federal Housing Finance Board. Under the terms of the order, capital stock repurchases and redemptions, including redemptions upon membership withdrawal or other termination, are prohibited unless FHLB has received approval of the Director of the Office of Supervision of the Finance Board. As a result of this consensual cease and desist order, the Banks do not expect dividend income from its holdings of FHLB stock to be a significant source of income for the foreseeable future. The Banks currently hold $2.4 million, at cost, of FHLB stock, of which $641,000 is deemed voluntary stock. At this time, we believe we will ultimately recover the value of this stock. Refer to **Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources** for further discussion relating to the impact of this order on our ability to obtain resources from the FHLB to meet the liquidity needs of the Banks.

Restrictions on Transactions with Affiliates. The Banks loans to their own and the Corporation s executive officers, directors and owners of greater than 10% of any of their respective stock (so-called insiders) and any entities affiliated with such insiders are subject to the conditions and limitations under Section 23A of the Federal Reserve Act and the Federal Reserve Bank s Regulation O. Under these regulations, the amount of loans to any insider is limited to the same limit imposed in the loans-to-one borrower limits of the respective Banks. All loans to insiders must not exceed the Banks unimpaired capital and unimpaired surplus. Loans to executive officers, other than loans for the education of the officers children and certain loans secured by the officers residence, may not exceed the greater of $25,000 or 2.5% of the Banks unimpaired capital and unimpaired surplus, and may never exceed $100,000. Regulation O also requires that loans to insiders must be approved in advance by a majority of the Board of Directors, at the bank level. Such loans, in general, must be made on substantially the same terms as, and with credit underwriting procedures no less stringent than those prevailing at the time for, comparable transactions with other persons.

The Banks can make exceptions to the foregoing procedures if they offer extensions of credit that are widely available to employees of the Banks and that do not give any preference to insiders over other employees of the Banks.

Community Reinvestment Act. The Community Reinvestment Act (CRA) requires each Bank to have a continuing and affirmative obligation in a safe and sound manner to help meet the credit needs of its entire community, including low and moderate income neighborhoods. Federal regulators regularly assess the Banks record of meeting the credit needs of their respective communities. Applications for additional acquisitions would be affected by the evaluation of the Banks effectiveness in meeting its CRA requirements.

Riegle Community Development and Regulatory Improvement Act of 1994. Federal regulators have adopted guidelines establishing general standards relating to internal controls, information and internal audit systems, loan documentation, credit underwriting, interest rate risk, asset growth, asset quality, earnings and compensation, fees, and benefits. These guidelines require, in general, that appropriate systems and practices are in place to identify and manage the risks and exposures specified by the guidelines. Such prohibitions include excessive compensation when amounts paid appear to be unreasonable or disproportionate to the services performed by executive officers, employees, directors or principal shareholders.

USA PATRIOT Act of 2001. The USA PATRIOT Act requires banks to establish anti-money laundering programs; to establish due diligence policies, procedures, and controls with respect to private banking accounts and correspondent banking accounts involving foreign individuals and specific foreign banks; and to avoid establishing, maintaining, administering or managing correspondent accounts in the United States for or on behalf of foreign banks that maintain no presence in any country. Additionally, the USA PATRIOT Act encourages cooperation among financial institutions, regulatory authorities, and law enforcement with respect to individuals or organizations that could reasonably be suspected of engaging in terrorist activities. Federal regulators have begun proposing and implementing regulations in efforts to interpret the USA PATRIOT Act. The Banks must comply with Section 326 of the Act which provides for minimum procedures in the verification of identification of new customers.

Commercial Real Estate Guidance. The FDIC s Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (CRE Guidance) provides supervisory criteria, including the following numerical indicators, to assist bank examiners in identifying banks with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny: (1) commercial real estate loans exceed 300% of capital and increased 50% or more in the preceding three years, or (2) construction and land development loans exceed 100% of capital. The CRE Guidance does not limit banks levels of commercial real estate lending activities but rather guides institutions in developing risk management practices and levels of capital that are commensurate with the level and nature of their commercial real estate concentrations. Based on our current loan portfolio, the CRE Guidance applies to the Banks. We believe that we have taken appropriate precautions to address the risks associated with our concentrations in commercial real estate lending. We do not expect the Guidance to adversely affect our operations or our ability to execute our growth strategy.

Fair and Accurate Transactions Act of 2003. In November 2007, the OCC, FDIC, OTS, NCUA and FTC (the Agencies) issued final rules and guidelines implementing section 114 of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act) and final rules implementing section 315 of the FACT Act. The rules implementing Section 114 require each financial institution or creditor to develop and implement a written identity theft prevention program to detect, prevent and mitigate identity theft in connection with opening of certain accounts or certain existing accounts. Certain events such as a change of address, returned mail, a request for replacement debit or credit card or efforts to reactivate dormant account may signal potential fraud. Additionally, the Agencies issued joint rules under Section 315 that provide guidance regarding reasonable policies and process that a user of consumer reports must employ when a consumer reporting agency sends us a notice of address discrepancy. Sections 114 and 315 of the FACT Act are effective January 1, 2008 with mandatory compliance required by November 1, 2008. The Banks will be in full compliance by this mandatory date.

Changing Regulatory Structure. Regulation of the activities of national and state banks and their holding companies imposes a heavy burden on the banking industry. The FRB, FDIC, and WDFI all have extensive authority to police unsafe or unsound practices and violations of applicable laws and regulations by depository institutions and their holding companies. These agencies can assess civil monetary penalties, issue cease and desist or removal orders, seek injunctions, and publicly disclose such actions. Moreover, the authority of these agencies has expanded in recent years, and the agencies have not yet fully tested the limits of their powers.

The laws and regulations affecting banks and financial or bank holding companies have changed significantly in recent years, and there is reason to expect changes will continue in the future, although it is difficult to predict the outcome of these changes. From time to time, various bills are introduced in the United States Congress with respect to the regulation of financial institutions. Certain of those proposals, if adopted, could significantly change the regulation of banks and the financial services industry.

Monetary Policy. The monetary policy of the FRB has a significant effect on the operating results of financial or bank holding companies and their subsidiaries. Among the means available to the FRB to affect the money supply are open market transactions in U.S. government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid on deposits.

Competition. The Banks encounter strong competition in attracting commercial loan, equipment finance and deposit clients as well as trust and investment clients. Such competition includes banks, savings institutions, mortgage banking companies, credit unions, finance companies, equipment finance companies, mutual funds, insurance companies, brokerage firms and investment banking firms. The Banks market areas include branches of several commercial banks that are substantially larger in terms of loans and deposits. Furthermore, tax exempt credit unions operate in most of the Banks market areas and aggressively price their products and services to a large portion of the market. The Banks also compete with regional and national financial institutions, many of which have greater liquidity, higher lending limits, greater access to capital, more established market recognition and more resources and collective experience than the Banks. Our profitability depends upon the Banks   continued ability to successfully maintain and increase market share.

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Executive Officers of the Registrant

The following contains certain information about the executive officers of FBFS. There are no family relationships between any directors or executive officers of FBFS.

Corey A. Chambas, age 45, has served as Chief Executive Officer of First Business Financial Services, Inc. since December, 2006, as President of the Corporation since February, 2005, and as a Director since July, 2002. He served as Chief Operating Officer of the Corporation from February, 2005 to September, 2006, and as Executive Vice President of the Corporation from July, 2002 to February, 2005. He served as Chief Executive Officer of First Business Bank from July, 1999 to September, 2006 and as President of First Business Bank from July, 1999 to February, 2005. He currently serves as a Director of First Business Bank-Milwaukee, First Business Equipment Finance, LLC, First Business Capital Corp., First Madison Investment Corp. and FMCC Nevada Corp.

James F. Ropella, age 48, has served as Senior Vice President and Chief Financial Officer of the Corporation since September, 2000. Mr. Ropella also serves as the Chief Financial Officer of the subsidiaries of the Corporation. He currently serves as a Director of First Madison Investment Corp. and FMCC Nevada Corp.

Joan A. Burke, age 56, has served as President of First Business Bank s Trust Division since September, 2001. Prior to that, from November, 1996 to May, 2001, Ms. Burke was the President, Chief Executive Officer and Chairperson of the Board of Johnson Trust Company and certain of its affiliates.

Mark J. Meloy, age 46, has served as Chief Executive Officer of First Business Bank since December 2007 and was elected President and a Director of First Business Bank in September, 2006. He served as Executive Vice President of First Business Bank from September, 2004 to September, 2006. He served as President and Chief Executive Officer of First Business Bank-Milwaukee from January, 2003 to October, 2004, and as a Director from November, 2002 to October, 2004. From November, 2002 to December 2002, he served as Executive Vice President and Chief Operating Officer of First Business Bank-Milwaukee. From April 2000, to November, 2002 he served as Senior Vice President and Senior Lending Officer at First Business Bank. He currently serves as a Director of First Business Equipment Finance, LLC and First Business Capital Corp.

Michael J. Losenegger, age 50, has served as Chief Operating Officer of the Corporation since September 2006. He has also served as Chief Executive Officer of First Business Bank from September 2006 December 2007. He was elected President and a Director of First Business Bank in February, 2005. He served as Chief Operating Officer of First Business Bank from September, 2004 to February, 2005. He served as Senior Vice President-Business Development from February, 2003 to September, 2004. Prior to that, from March, 1989 to January, 2003, Mr. Losenegger served as Assistant Vice President and Vice President and Senior Vice President of Lending at M&I Bank in Madison, Wisconsin. He currently serves as a Director of First Business Equipment Finance, LLC, First Business Capital Corp., First Madison Investment Corp. and FMCC Nevada Corp.

Charles H. Batson, age 54, joined the Corporation and was elected President and Chief Executive Officer of First Business Capital Corp. in January, 2006. Prior to joining the Corporation, from February 1986 to December, 2005, Mr. Batson served as Vice President and Business Development Manager for Wells Fargo Business Credit, Inc. He currently serves as a Director of First Business Capital Corp.

David J. Vetta, age 53, joined the Corporation and was elected President and Chief Executive Officer of First Business Bank-Milwaukee in January 2007. Prior to joining the Corporation he was Managing Director at Fifth Third Bank and Managing Director at JP Morgan Chase for nearly 30 years. He currently serves as a Director of First Business Bank Milwaukee.

Item 1a. Risk Factors

You should carefully read and consider the following risks and uncertainties because they could materially and adversely affect our business, financial condition, results of operations and prospects.

Competition. The Banks encounter strong competition in attracting commercial loan, equipment finance and deposit clients as well as trust and investment clients. Such competition includes banks, savings institutions, mortgage banking companies, credit unions, finance companies, equipment finance companies, mutual funds, insurance companies, brokerage firms and investment banking firms.

The Banks market areas include branches of several commercial banks that are substantially larger in terms of loans and deposits. Furthermore, tax exempt credit unions operate in most of the Banks market areas and aggressively price their products and services to a large portion of the market. The Banks also compete with regional and national financial institutions, many of which have greater liquidity, higher lending limits, greater access to capital, more established market recognition and more resources and collective experience than the Banks. Our profitability depends upon the Banks continued ability to successfully maintain and increase market share.

We believe the principal factors that are used to attract core deposit accounts and that distinguish one financial institution from another include rates of return, types of accounts, service fees, convenience of office locations and hours and quality of service to the depositors. We believe the primary factors in competing for commercial loans are interest rates, loan fee charges, loan structure and timeliness and quality of service to the borrower.

Government Regulation and Monetary Policy. Our businesses are subject to extensive state and federal government supervision, regulation, and control. Existing state and federal banking laws subject us to substantial limitations with respect to loans, purchases of securities, payment of dividends and many other aspects of our businesses. See **Item 1. Business Supervision and Regulation.** There can be no assurance that future legislation or government policy will not adversely affect the banking industry or our operations. In addition, economic and monetary policy of the Federal Reserve may increase our cost of doing business and affect its ability to attract deposits and make loans.

Key Personnel. Our success has been and will be greatly influenced by our continuing ability to retain the services of our existing senior management and, as it expands, to attract and retain additional qualified senior and middle management. If we unexpectedly lose any of the key management personnel, or we are unable to recruit and retain qualified personnel in the future, that could have an adverse effect on our business and financial results.

Technology. The banking industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving clients, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend in part on our ability to address the needs of our clients by using technology to provide products and services that will satisfy client demands for convenience as well as create additional efficiencies in our operations. A number of our competitors have substantially greater resources to invest in technological improvements. There can be no assurance that we will be able to implement new technology-driven products and services to our clients.

Market Area. The origination of loans secured by real estate and business assets of those businesses is the Banks primary business and the principal source of profits. Most of the Banks loans are to businesses located in or adjacent to Dane, Waukesha and Outagamie Counties in Wisconsin. Client demand for loans could be reduced by a weaker economy, an increase in unemployment, a decrease in real estate values, or an increase in interest rates in these areas. Any general adverse change in the economic conditions, including real estate values, prevailing in these areas could reduce the Banks growth rate, impair their ability to collect loans or attract deposits, and generally have an adverse impact on our results of operations and financial condition. If this region experienced adverse economic, political or business conditions, the Banks would likely experience higher rates of loss and delinquency on their loans than if their loans were geographically more diverse.

Loan Portfolio Risk. The Banks originate commercial mortgage, construction, multi-family, 1-4 family, commercial, asset-based, consumer loans, and leases, all of which are primarily within their respective market areas. Such loans expose the Banks to greater credit risk than home mortgages which form a greater part of the business of many commercial banks, because the collateral securing these loans may not be sold as easily as residential real estate. These loans also have greater credit risk than residential real estate for the following reasons:

Commercial mortgage loan repayment is dependent upon cash flow generation sufficient to cover operating expenses and debt service.

Commercial loan repayment is dependent upon the successful operation of the borrower s business.

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Consumer loans such as credit card loans and vehicle loans are collateralized, if at all, with assets that may not provide an adequate source of payment of the loan due to depreciation, damage or loss.

Environmental Risk. The Banks encounter certain environmental risks in their lending activities. Under federal and state law, Banks may become liable for costs of cleaning up hazardous materials found on secured properties. Certain states may also impose liens with higher priorities than first mortgages on properties to recover funds used in such efforts. The Banks attempt to control their exposure to environmental risks with respect to loans secured by larger properties by monitoring available information on hazardous waste disposal sites and occasionally requiring environmental inspections of such properties prior to closing a loan, as warranted. No assurance can be given, however, that the value of properties securing loans in the Banks portfolio will not be adversely affected by the presence of hazardous materials or that future changes in federal or state laws will not increase the Banks exposure to liability for environmental cleanup.

Loan and Lease Loss Allowance Risk. The Banks are exposed to the risk that their loan and lease clients may not repay their loans and leases according to their terms and that the collateral securing the payment of these loans and leases may be insufficient to assure repayment. The Banks may experience significant loan and lease losses which could have a material adverse impact on operating results. There is a risk that various assumptions and judgments about the collectibility of the loan and lease portfolios made by us could be formed from inaccurately assessed conditions leading to and related to such judgments and assumptions. Those assumptions and judgments are based, in part, on assessment of the following conditions:

Current economic conditions and their estimated effects on specific borrowers;

An evaluation of the existing relationships among loans and leases, probable loan and lease losses and the present level of the allowance for loan and lease losses;

Results of examinations of the Banks loan and lease portfolios by regulatory agencies;

Management s internal review of the loan and lease portfolios.

The Banks maintain an allowance for loan and lease losses to cover probable losses inherent in the loan and lease portfolios. Additional loan and lease losses will likely occur in the future and may occur at a rate greater than that experienced to date. An analysis of the loan and lease portfolios, historical loss experience and an evaluation of general economic conditions are all utilized in determining the size of the allowance. Additional adjustments may be necessary to allow for unexpected volatility or deterioration in the local or national economy. If significant additions are made to the allowance for loan and leases losses, this would materially decrease net income. Additionally, regulators periodically review the allowance for loan and lease losses or identify further loan or lease charge-offs to be recognized based on judgments different from ours. Any increase in the loan or lease allowance or loan or lease charge-offs as required by regulatory agencies could have a material adverse impact on net income.

Interest Rate Risk. We are subject to interest rate risk. Changes in the interest rate environment may reduce our profits. Net interest spreads are affected by the difference between the maturities and repricing characteristics of interest-earning assets and interest-bearing liabilities. They are also affected by the proportion of interest-earning assets that are funded by interest-bearing liabilities. Loan volume and yield are affected by market interest rates on loans, and increasing interest rates are generally associated with a lower volume of loan originations. There is no assurance that we can minimize our interest rate risk. In addition, an increase in the general level of interest rates may adversely affect the ability of certain borrowers to pay their obligations if the reason for that increase in rates is not a result of a general expansion of the economy. Accordingly, changes in levels of market interest rates could materially and adversely affect our net interest spread, asset quality, loan origination volume and overall profitability.

Trust Operations Risk. We are subject to trust operations risk related to performance of fiduciary responsibilities. Clients may make claims and take legal action pertaining to our performance of our fiduciary responsibilities. Whether client claims and legal action related to our performance of our fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to us, they may result in significant financial liability and/or adversely affect the market perception of us and our products and services, as well as impact client demand for those products and services. Any financial liability or reputation damage could have a material adverse affect on our

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business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Economic Conditions. Our success depends on the economic conditions in the US and general economic conditions in the specific local markets in which the Banks and subsidiaries operate, principally in Dane County, Wisconsin area and to a lesser extent, Waukesha County, Wisconsin. The Banks invest in collateralized mortgage obligations as a part of their asset portfolios due to the liquidity, favorable returns and flexibility with these instruments. In recent months, structured investments, such as collateralized mortgage obligations, have been subject to significant market volatility due to the uncertainty of their credit ratings, deterioration in credit quality occurring within certain types of residential mortgages, changes in prepayments of the underlying collateral and the lack of transparency related to the credit quality of the underlying collateral. In addition, the Banks use brokered certificates of deposit as a component of their deposit accounts due to favorable pricing and range of maturities available. A decline in the US economy or an extended disruption in the credit markets could have an adverse affect on the pricing, terms, liquidity and/or availability of these instruments.

Adverse economic conditions in our market area, including depressed real estate values, could reduce our growth rate, affect borrowers ability to repay their loans, and cause loans to become inadequately collateralized which could have an adverse affect on our financial condition and results of operations.

Item 1b. Unresolved Staff Comments

None

Item 2. Properties

At December 31, 2007, the Banks conducted business from their full service offices located in Madison, Wisconsin at 401 Charmany Drive and in Brookfield, Wisconsin located at 18500 W. Corporate Drive. The Banks lease their full-service offices and these leases expire in 2016 and 2010, respectively. FBB opened a loan production office at 3919 West Prospect Avenue, Appleton, Wisconsin in December 2007 and this lease expires in 2017. FBB conducts trust and investment business from a limited purpose branch located at 3500 University Avenue, Madison, Wisconsin. Office space is also leased in Burnsville, Minnesota, Independence, Ohio, St. Louis, Missouri, Chicago, Illinois, and Oshkosh, Wisconsin under short-term lease agreements which have terms of less than one year. See **Note 7** to the Consolidated Financial Statements for more information regarding leasehold improvements and equipment. See **Note 14** to the Consolidated Financial Statements for more information regarding the operating lease agreements.

Item 3. Legal Proceedings

We believe that no litigation is threatened or pending in which we face potential loss or exposure which could materially affect our consolidated financial position, consolidated results of operations or cash flows. Since our subsidiaries act as depositories of funds and trust agents, they could occasionally be named as defendants in lawsuits involving claims to the ownership of funds in particular accounts. This and other litigation is incidental to our business.

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

No matters were submitted to a vote of security holders during the fourth quarter of 2007.

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PART II.

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The common stock of the Corporation is traded on the Nasdaq National Market under the symbol FBIZ . At February 29, 2008, there were approximately 501 shareholders of record of FBFS common stock.

The following table presents the range of high and low closing sale prices of our common stock for each quarter within the two most recent fiscal years, according to information available, and cash dividends declared for the years ended December 31, 2007 and 2006, respectively.

	High	Low	Dividend Declared
2007			
1st Quarter	$ 22.67	$ 21.26	$ 0.065
2nd Quarter	22.50	19.80	0.065
3rd Quarter	20.93	17.70	0.065
4th Quarter	19.05	17.50	0.065
2006			
1st Quarter	$ 24.00	$ 21.50	$ 0.06
2nd Quarter	24.84	22.76	0.06
3rd Quarter	24.50	22.02	0.06
4th Quarter	23.00	21.51	0.06

The timing and amount of future dividends are at the discretion of the Board of Directors of the Corporation (the Board) and will depend upon the consolidated earnings, financial condition, liquidity and capital requirements of the Corporation and its subsidiaries, the amount of cash dividends paid to the Corporation by its subsidiaries, applicable government regulations and policies and other factors considered relevant by the Board. The Board anticipates it will continue to pay quarterly dividends in amounts determined based on the above factors.

Equity Compensation Plan Information

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants, and Rights. (a)	Weighted-average Exercise Price of Outstanding Options, Warrants, and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	159,540	$ 22.10	431,129

On November 20, 2007, the Corporation publicly announced a stock repurchase program whereby the Corporation would repurchase up to approximately $1,000,000 of the Corporation s outstanding stock.

Issuer Purchases of Securities

Period	**Total Number of Shares Purchased**	**Average Price Paid Per Share**	**Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs**	**Maximum Number that May Yet be Purchased Under the Plans or Programs**
October 1 31, 2007	-	-	-	-
November 1 30, 2007	30,000	$ 19.00	30,000	23,691
December 1 31, 2007	14,000	$ 18.06	14,000	10,122

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Item 6. Selected Consolidated Financial Data

Three Year Comparison of Selected Consolidated Financial Data

	As of and For the Year Ended December 31,		
	2007	2006	2005
	(Dollars in Thousands, Except Share Data)		
FOR THE YEAR:			
Interest income	$ 59,488	$ 47,660	$ 36,509
Interest expense	36,280	28,689	18,733
Net interest income	23,208	18,971	17,776
Provision for loan and lease losses	2,904	1,519	400
Gain on sale of 50% owned joint venture	-	-	973
Non-interest income	4,416	3,674	3,266
Non-interest expense	19,657	15,698	14,403
Income tax expense	1,807	1,681	2,455
Net income	$ 3,256	$ 3,747	$ 4,757
Yield on earning assets	7.36%	7.21%	6.22
Cost of funds	4.91	4.77	3.59
Interest rate spread	2.45	2.44	2.62
Net interest margin	2.87	2.87	3.03
Return on average assets	0.39	0.54	0.78
Return on average equity	6.86	8.65	11.79
ENDING BALANCE SHEET:			
Total Assets	$ 918,438	$ 788,323	$ 669,249
Securities	97,378	100,008	92,055
Loans and leases, net	771,633	639,867	532,716
Deposits	776,060	640,266	567,464
Borrowed funds	81,986	92,970	39,758
Junior subordinated debentures	-	-	10,310
Stockholders equity	48,552	45,756	41,843
FINANCIAL CONDITION ANALYSIS:			
Allowance for loan losses to year-end loans	1.26%	1.28%	1.25%
Allowance to non-accrual loans	111.17	748.06	438.67
Net charge-offs to average loans	0.19	-	-
Non-accrual loans to gross loans	1.13	0.17	0.29
Average equity to average assets	5.64	6.26	6.61
STOCKHOLDERS DATA:			
Basic earnings per share	$ 1.33	$ 1.53	$ 1.96
Diluted earnings per share	1.32	1.52	1.93
Book value per share at end of period	19.35	18.36	17.18
Dividend declared per share	0.26	0.24	0.175

Dividend payout ratio	19.55%	15.68%	8.93%
Shares outstanding	2,509,213	2,493,578	2,435,008

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

When used in this report, and in any oral statements made with the approval of an authorized executive officer, the words or phrases may, could, should, hope, might, believe, expect, plan, assume, intend, estima likely, or similar expressions are intended to identify forward-looking statements. Such statements are subject to risks and uncertainties, including, without limitation, changes in economic conditions in the market area of FBB or FBB Milwaukee, changes in policies by regulatory agencies, fluctuation in interest rates, demand for loans in the market area of FBB or FBB Milwaukee, borrowers defaulting in the repayment of loans and competition. These risks could cause actual results to differ materially from what FBFS has anticipated or projected. These risk factors and uncertainties should be carefully considered by potential investors. See **Item 1A, Risk Factors** for discussion relating to risk factors impacting the Corporation. Investors should not place undue reliance on any such forward-looking statements, which speak only as of the date made. The factors described within this Form 10-K could affect the financial performance of FBFS and could cause actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods.

Where any such forward-looking statement includes a statement of the assumptions or bases underlying such forward-looking statement, FBFS cautions that, while its management believes such assumptions or bases are reasonable and are made in good faith, assumed facts or bases can vary from actual results, and the differences between assumed facts or bases and actual results can be material, depending on the circumstances. Where, in any forward-looking statement, an expectation or belief is expressed as to future results, such expectation or belief is expressed in good faith and believed to have a reasonable basis, but there can be no assurance that the statement of expectation or belief will result in, or be achieved or accomplished.

FBFS does not intend to, and specifically disclaims any obligation to, update any forward-looking statements.

The following discussion and analysis is intended as a review of significant events and factors affecting the financial condition and results of operations of FBFS for the periods indicated. The discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto and the Selected Consolidated Financial Data presented in this Form 10-K.

Overview

The principal business of FBFS is conducted by FBB and FBB Milwaukee and certain subsidiaries of FBB and consists of a full range of commercial banking products and services tailored to meet the financial service needs of small and medium size businesses, business owners, executives, professionals, and high net worth individuals. Products include commercial lending, asset-based lending, equipment financing, trust and investment services and a broad range of deposit products. Our profitability depends on our ability to execute our established growth strategy and on the outcome of efforts in controlling the areas of net interest income, provision for loan and lease losses, non-interest income, and non-interest expenses.

The operating philosophy of FBFS is focused on local decision making and local client service from each of our primary banking locations in Madison, Brookfield and Appleton, Wisconsin combined with the efficiency of centralized administrative functions such as support for information technology, finance and accounting and human resources. We have a unique niche business banking model and we consistently operate within this niche. This allows us to provide a great deal of expertise in providing financial solutions to our clients with an experienced staff to serve our clients on an ongoing basis. In 2007, our primary strategy was to focus on organic growth. We have made a substantial investment in our business development team throughout our entire company to allow us to execute this organic growth strategy in both on balance sheet assets and liabilities, including growth in our loan and lease portfolios and in-market deposit portfolios as well as in our off-balance sheet assets, which include our assets under management within our trust division of FBB. The increase in the off-balance sheet trust assets under management drives a significant portion of our fee income and is a key component to achieving our Top Line Revenue growth targets which is discussed in further detail elsewhere in this document.

Net interest income is the difference between the income we receive on our loans, leases and investment securities, and the interest we pay on our deposits and borrowings. The provision for loan and lease losses reflects the cost of credit risk in the loan and lease portfolio. Non-interest income consists of service charges on deposit accounts, securities gains, loan and lease fees, trust and investment services fee income, and other income. Non-interest expenses include salaries and employee benefits, occupancy, equipment expenses, professional services, marketing expenses, and other non-interest expenses.

Recent Developments

Tax Audit. Like the majority of financial institutions located in Wisconsin, FBB transferred investment securities and loans to out-of-state investment subsidiaries. FBB s Nevada investment subsidiaries now hold and manage these assets. The investment subsidiaries have not filed returns with, or paid income or franchise taxes to, the State of Wisconsin. The Wisconsin Department of Revenue (the Department) implemented a program to audit Wisconsin financial institutions which formed investment subsidiaries located outside of Wisconsin, and the Department has generally indicated that it intends to assess income or franchise taxes on the income of the out-of-state investment subsidiaries of Wisconsin financial institutions. FBB received a Notice of Audit from the Department that would cover years 1999 through 2005 and would relate primarily to the issue of income of the Nevada subsidiaries. During 2007, FBCC received a Notice of Audit from the Department that would cover the years 2001 through 2005. During 2004, the Department offered a blanket settlement agreement to most banks in Wisconsin having Nevada investment subsidiaries. The Department has not issued an assessment to FBB or FBCC, but the Department has stated that it intends to do so if the matter is not settled.

Prior to the formation of the investment subsidiaries FBB obtained private letter rulings from the Department regarding the non-taxability of income generated by the investment subsidiaries in the State of Wisconsin. FBB believes it complied with Wisconsin law and the private rulings received from the Department. Should an assessment be forthcoming, FBB intends to defend its position vigorously through the normal administrative appeals process in place at the Department and through other judicial channels should they become necessary. Although FBB will vigorously oppose any such assessment, there can be no assurance that the Department will not be successful in whole or in part in its efforts to tax the income of FBB s Nevada investment subsidiary. FBB and FBCC have accrued, as a component of current state income tax expense, an estimated liability including interest which is the most likely amount within a range of probable settlement amounts. We do not expect the resolution of this matter to materially affect its consolidated results of operations and financial position beyond the amounts accrued.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. By their nature, changes in these assumptions and estimates could significantly affect the financial position or results of operations for FBFS. Actual results could differ from those estimates. Please refer to **Note 1** to the Consolidated Financial Statements for a discussion of the most significant accounting policies followed by the Corporation. Discussed below are certain policies that are critical to FBFS. We view critical accounting policies to be those which are highly dependent on subjective or complex judgments, estimates, and assumptions, and where changes in those estimates and assumptions could have a significant impact on the financial statements.

Allowance for Loan and Lease Losses. The allowance for loan and lease losses represents our recognition of the risks of extending credit and its evaluation of the quality of the loan and lease portfolio and as such, requires the use of judgment as well as other systematic objective and quantitative methods. The risks of extending credit and the accuracy of our evaluation of the quality of the loan and lease portfolio are neither static nor mutually exclusive and could result in a material impact on our consolidated financial statements. We could over-estimate the quality of the loan and lease portfolio resulting in a lower allowance for loan and lease losses than necessary, overstating net income and equity. Conversely, we could under-estimate the quality of the loan and lease portfolio, resulting in a higher allowance for loan and lease losses than necessary, understating net income and equity. The allowance for loan and lease losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan and lease losses and decreased by charge-offs, net of recoveries. We estimate the allowance balance required and the related provision for loan and lease losses based on quarterly evaluations of the loan and lease portfolio, with particular attention paid to loans and leases that have been specifically identified as needing additional management analysis because of the potential for further problems. During these evaluations, consideration is also given to such factors as the level and composition of impaired and other non-performing loans and leases, historical loss experience, results of examinations by regulatory agencies, independent loan and lease reviews, the market value of collateral, the strength and availabilities of guarantees, concentration of credits and other factors. Allocations of the allowance may be made for specific loans or leases, but the entire allowance is available for any loan or lease that, in our judgment, should be charged off. Loan and lease losses are charged against the allowance when we believe that the uncollectibility of a loan or lease balance is confirmed. See **Note 6** to the Consolidated Financial Statements for further discussion of the allowance for loan and lease losses.

We also continue to pursue all practical and legal methods of collection, repossession and disposal, and adheres to high underwriting standards in the origination process in order to continue to maintain strong asset quality. Although we believe that the allowance for loan and lease losses is adequate based upon current evaluation of loan and lease delinquencies, non-performing assets, charge-off trends, economic conditions and other factors, there can be no assurance that future adjustments to the allowance will not be necessary. Should the quality of loans or leases deteriorate, then the allowance for loan and lease losses would generally be expected to increase relative to total loans and leases. When loan or lease quality improves, then the allowance would generally be expected to decrease relative to total loans and leases.

Income Taxes. FBFS and its wholly owned subsidiaries file a consolidated federal income tax return and separate state tax returns. Deferred income taxes are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. The determination of current and deferred income taxes is based on complex analyses of many factors, including the interpretation of federal and state income tax laws, the difference between the tax and financial reporting basis of assets and liabilities (temporary differences), estimates of amounts currently due or owed, such as the timing of reversals of temporary differences and current accounting standards. Prior to January 1, 2007, we accrued through our current income tax provision, the amounts it deems probable of assessment related to federal and state income tax expenses. Such accruals would be reduced when such taxes are paid or reduced by way of a credit to the current income tax provision when it is no longer probable that such taxes will be paid. Beginning January 1, 2007, we apply a more likely than not approach to each of our tax positions when determining the amount of tax benefit to record in our consolidated financial statements. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates on deferred taxes is recognized in income in the period that includes the enactment date.

FBFS and its subsidiaries have State of Wisconsin net operating loss (NOL) carryforwards as of December 31, 2007 of approximately $43.0 million, which expire in years 2007 through 2022. See **Note 15** to the Consolidated Financial Statements for further discussion of income taxes. The federal and state taxing authorities who make assessments based on their determination of tax laws periodically review our interpretation of federal and state income tax laws. Tax liabilities could differ significantly from the estimates and interpretations used in determining the current and deferred income tax liabilities based on the completion of taxing authority examinations.

We have made our best estimate on valuation allowances needed for deferred tax assets on certain net operating loss carryforwards and other temporary differences and have made our best estimate of the probable loss related to a state tax exposure matter. These estimates are subject to changes. Changes in these estimates could adversely affect future consolidated results of operations.

As noted elsewhere herein, in June 2004, Business Banc Group LTD (BBG) shareholders completed the exchange of their 49% minority ownership in BBG to FBFS for shares of FBFS. This event resulted in FBFS owning 100% of BBG shares. BBG was subsequently dissolved and as a result, FBB Milwaukee became a direct wholly-owned subsidiary of FBFS. Since 2004, FBFS has filed a consolidated federal tax return with FBB Milwaukee enabling the usage of FBB Milwaukee s NOL carryforwards to offset consolidated federal taxable income, subject to certain IRS annual limitations. This event increases further the probability that all of the benefits related to these NOL carryforwards will be fully realized. We will continue to evaluate the probability of the usage of the NOL carryforwards and if in the future it is no longer deemed more likely than not that the benefit of the NOL carryforwards will be realized, then a valuation allowance will be established through a charge to income tax expense. At December 31, 2007, $447,000 of the BBG Federal NOL remains.

Lease Residuals. We lease machinery and equipment to clients under leases which qualify as direct financing leases for financial reporting and as operating leases for income tax purposes. Under the direct financing method of accounting, the minimum lease payments to be received under the lease contract, together with the estimated unguaranteed residual value (approximating 3 to 20% of the property cost of the related equipment), are recorded as lease receivables when the lease is signed and the lease property is delivered to the client. Residual value is the estimated fair market value of the equipment on lease at lease termination. In estimating the equipment s fair value, we rely on historical experience by equipment type and manufacturer published sources of used equipment prices, internal evaluations and, where available, valuations by independent appraisers, adjusted for known trends. Our estimates are reviewed regularly to ensure reasonableness; however, the amounts we will ultimately realize could differ from the estimated amounts. Where declines in residual amounts are estimated to be other-than-temporary, the residual amount is reduced and a loss is recorded. See **Note 6** to the Consolidated Financial Statements for further discussion of leases and lease residuals.

Goodwill and Other Intangible Assets. Goodwill was recorded as a result of the acquisition of the 49% interest in BBG on June 1, 2004, the purchase price of which exceeded the fair value of the net assets acquired. Goodwill is reviewed at least annually for impairment. Because of adverse changes in the business climate, the Corporation performed an additional goodwill impairment test as of December 31, 2007. This review requires judgment. If goodwill is determined to be impaired, a reduction in value would be expensed in the period in which it became impaired. No impairments has been recognized for the years ended December 31, 2007 and 2006. See **Note 1 and Note 8** to the Consolidated Financial Statements for further discussion of goodwill and other intangibles.

Judgment is also used in the valuation of other intangible assets consisting of a core deposit intangible and a client list from a purchased brokerage/investment business. Core deposit intangibles were recorded for core deposits acquired in the BBG acquisition which was accounted for as a purchase business combination. The core deposit intangible assets were recorded under the presumption that they provide a more favorable source of funding than wholesale borrowings. An intangible asset was recorded for the present value of the difference between the expected interest to be incurred on these deposits and interest expense that would be expected if these deposits were replaced by wholesale borrowings, over the expected lives of the core deposits. The current estimate of the underlying lives of core deposits is fifteen years and ten years for the client list. If it is determined that the deposits or the client list have shorter lives, the assets will be adjusted and an expense will be recorded for the amount that is impaired.

Results of Operations

Comparison of the Years Ended December 31, 2007 and 2006

Overview. Net income for the year ended December 31, 2007 was $3.3 million, a decline of 13.1%, or $491,000, from $3.7 million for the year ended December 31, 2006. The principal factors that contributed to this decline include an increase in the provision for loan and lease losses and an increase in non-interest expenses. Provision for loan and lease losses increased $1.4 million which is associated with an increase in inherent risk directly related to a growing loan portfolio coupled with an increase in our non-performing loans and leases. Non-interest expenses increased $4.0 million primarily in our compensation expense category. Positive factors offsetting the decline in net income include increase in net interest income of $4.2 million caused by volume increases associated with our organic growth and $742,000 increase in non-interest income which is primarily driven by the increase in our trust and investment services fee income. Basic earnings per share were $1.33 and $1.53 for the years ended December 31, 2007 and 2006, respectively. Diluted earnings per share were $1.32 and $1.52 for the years ended December 31, 2007 and 2006, respectively. The decline in both basic and diluted earnings per share was directly related to the 13.1% decline in net income for the year ended December 31, 2007. Return on average assets and average return on equity are 0.39% and 6.86%, respectively for the year ended December 31, 2007 compared to 0.54% and 8.65%, respectively, for the year ended December 31, 2006.

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Top Line Revenue. Top line revenue is comprised of net interest income and non-interest income. This measurement is also commonly referred to as operating revenue. We use this measure to monitor our revenue growth and as one half of the performance measurements used for our non-equity incentive plan that covers substantially all employees within our Corporation. The growth in top line revenue exceeded our target of 12.5% growth over the prior year. The components of top line revenue were as follows:

	For the Year Ended December 31, 2007	2006	Change
	(In Thousands)		
Net interest income	$ 23,208	$ 18,971	22.3%
Non-interest income	4,416	3,674	20.2
Total top line revenue	$ 27,624	$ 22,645	22.0

Adjusted Net Income. Adjusted net income is comprised of our net income as presented under generally accepted accounting principles (GAAP) adjusted for the after tax effects of the provision for loan and lease losses and actual net charge-offs incurred during the year. We use this measure to monitor the growth of net income after the effect of actual net charge-offs and as the other half of the performance measurements used for our non-equity incentive plan that covers substantially all employees within our Corporation. Our target growth of adjusted net income is 12.5% growth over the prior year. A reconciliation of net income to adjusted net income is as follows:

	For the Year Ended December 31, 2007	2006	Change
Net income, presented under US GAAP	$ 3,256	$ 3,747	(13.1)%
Add back:			
Provision for loan and lease losses, after tax	1,765	923	91.2%
Less:			
Net (charge-offs) recoveries, after tax	(818)	2	*
Adjusted net income	$ 4,203	$ 4,672	(10.0)%

* Not meaningful

Net Interest Income. Net interest income depends on the amounts of and yields on 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 asset/liability management procedures used by management in responding to such changes. The dollar volume of loans, leases and investments compared to the dollar volume of deposits and borrowings, combined with the interest rate spread, produces the changes in net interest income between periods. The table below provides information with respect to (1) the effect on interest income attributable to changes in rate (changes in rate multiplied by prior volume), (2) the effect on interest income attributable to changes in volume (changes in volume multiplied by prior rate) and (3) the changes in rate/volume (changes in rate multiplied by changes in volume) for the year ended December 31, 2007 compared to the year ended December 31, 2006.

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Rate/Volume Analysis

	Increase (Decrease) For the Year Ended December 31, 2007 Compared to 2006			
	Rate	Volume	Rate/ Volume	Net
	(In Thousands)			
Interest-Earning Assets				
Commercial real estate and other mortgage loans	$ 655	$ 7,688	$ 188	$ 8,531
Commercial and industrial loans	(296)	3,201	(63)	2,842
Leases	(136)	399	(41)	222
Consumer loans	(9)	19	(1)	9
Total loans and leases receivable	214	11,307	83	11,604
Mortgage-related securities	261	(15)	(1)	245
Investment securities	11	(55)	(6)	(50)
Other investments	(32)	(8)	3	(37)
Fed funds sold and other	-	66	(12)	54
Short-term investments	1	11	-	12
Total net change in income on interest-earning assets	455	11,306	67	11,828
Interest-Bearing Liabilities				
NOW accounts	(17)	687	(5)	665
Money market	(123)	801	(14)	664
Certificates regular	1,133	4,036	330	5,499
Certificates large	166	358	30	554
Total deposits	1,159	5,882	341	7,382
Junior subordinated debentures	(1,241)	(1,241)	1,241	(1,241)
FHLB advances	9	324	3	336
Other borrowings	228	765	121	1,114
Total net change in expense on interest-bearing liabilities	155	5,730	1,706	7,591
Net change in net interest income	$ 300	$ 5,576	$ (1,639)	$ 4,237

Interest income was $59.4 million for the year ended December 31, 2007, an increase of $11.8 million, or 24.8%, from the year ended December 31, 2006. This increase was primarily due to the volume increases in the commercial real estate and other mortgage loan portfolio and the commercial and industrial loan portfolio. The average balance of the commercial real estate and other mortgage loan portfolio was $481.0 million with an average yield of 7.34% compared to an average balance of $373.7 million with an average yield of 7.16% for the year ended December 31, 2006. Yields on our commercial real estate and other mortgage loan portfolio increased 18 basis points. The majority of the loans in this portfolio are fixed rate in nature and are minimally impacted by a volatile interest rate market. The average balance of the commercial and industrial loan portfolio was $200.4 million with an average yield of 8.98% for the year ended December 31, 2007 compared to an average balance of $165.5 million with an average yield of 9.16% for the year ended December 31, 2006. The yields on our commercial and industrial portfolio dropped 18 basis points. This basis point decline is partially attributable to the volatility in the Prime and London Interbank Offer Rates (LIBOR) that has occurred during 2007 coupled with continued pressures to competitively price our commercial loans. Yields on commercial loans also reflect the recognition of asset-based loan fees collected including prepayment fees.

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Interest expense was $36.3 million for the year ended December 31, 2007, an increase of $7.6 million, or 26.5%, from the year ended December 31, 2006. The increase in interest expense was primarily caused by the increased average deposit liability balances needed to fund asset growth and the need to competitively price deposit products to attract local deposits. Shortfalls in attracting local deposits are supplemented with brokered deposits. Average deposit balances, including brokered deposits, were approximately $676.7 million with a weighted average cost of funds of 4.80% compared to an average balance of $548.0 million with a weighted average cost of funds of 4.58% for the year ended December 31, 2006. Average borrowings were $62.4 million with a weighted average cost of funds of 6.13% for the year ended December 31, 2007 compared to an average balance of $52.9 million with a weighted average cost of funds of 6.82% for the year ended December 31, 2006. During the fourth quarter of 2006, we repaid $10.3 million of junior subordinated debentures. The decrease in the weighted average cost of funds is directly related to this repayment and its replacement with subordinated notes payable at a lower rate.

During the third quarter of 2007, we decided to change the pricing index of our variable rate deposit liabilities, including NOW and money market accounts from the 91 day Treasury Bill (T-Bill) index to the Federal Funds rate. This was done at a time when the T-Bill rates were experiencing significant volatility and action was required to continue to competitively price our products while protecting our in-market deposits to maintain appropriate liquidity for the Banks. As a result of this pricing methodology change, we did not experience a significant decline in our weighted average cost of funds associated with our NOW and money market accounts as the Federal Funds average rate for the year 2007 and the average rate of the T-Bill for the same time period of 2006 are closely correlated. As discussed above, shortfalls in attracting local deposits are supplemented with brokered deposits. With the volatility in the interest rate markets over the last quarter of 2007, brokered deposit rates did not fall as quickly as the related indices due to significant demand for brokered deposits throughout the financial services industry caused by liquidity issues among larger financial institutions that were impacted by the challenges of the sub-prime residential real estate market. Interest rates on brokered deposits are fixed; however, purchases of brokered certificates are structured to match the repricing and maturity of the interest-earning portfolio.

Net interest margin was 2.87% for the year ended December 31, 2007 compared to 2.87% for the year ended December 31, 2006. Our net interest margin remained stable due to the market-based pricing of assets and liabilities because we managed the composition and duration of our interest-bearing liabilities to limit the exposure to changing rates and because the rate of increase in our net interest income kept pace with the growth in our interest earning assets. In addition, the change of the index of which we price our variable rate deposit products allows us to significantly mitigate basis risk or repricing mismatch inherent in our portfolios without implementing complicated hedging strategies to protect our net interest margin in volatile and changing rate environments.

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Net Interest Income Information

Average Interest-Earning Assets, Average Interest-Bearing Liabilities, Interest Rate Spread, and Net Interest Margin. The following table shows our average balances, interest, average rates, net interest margin, and the spread between combined average rates earned on the our interest-earning assets and cost of interest-bearing liabilities for the periods indicated. The average balances are derived from average daily balances.

	For the Year Ended December 31, 2007			2006		
	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
	(Dollars in Thousands)					
Interest-Earning Assets						
Commercial real estate and other mortgage loans[1]	$ 481,039	$ 35,307	7.34%	$ 373,731	$ 26,776	7.16%
Commercial and industrial loans	200,414	18,000	8.98	165,473	15,158	9.16
Leases	24,346	1,552	6.37	18,730	1,330	7.10
Consumer loans	3,106	198	6.37	2,823	189	6.70
Total loans and leases receivable[1]	708,905	55,057	7.77	560,757	43,453	7.75
Mortgage-related securities[2]	92,094	4,167	4.52	92,444	3,922	4.24
Investment securities[2]	1,640	60	3.66	3,297	110	3.34
Federal Home Loan Bank stock	2,230	45	2.02	2,474	82	3.31
Fed funds sold and other	1,118	56	5.01	33	2	6.06
Short-term investments	2,212	103	4.66	1,980	91	4.60
Total interest-earning assets	808,199	59,488	7.36	660,985	47,660	7.21
Non-interest-earning assets	32,539			31,292		
Total assets	$ 840,738			$ 692,277		
Interest-Bearing Liabilities						
NOW accounts	$ 67,189	2,838	4.22	$ 51,048	2,173	4.26
Money market	171,508	7,699	4.49	153,978	7,035	4.57
Certificates-regular	387,974	19,385	5.00	300,601	13,886	4.62
Certificates-large	50,025	2,536	5.07	42,377	1,982	4.68
Total deposits	676,696	32,458	4.80	548,004	25,076	4.58
Junior subordinated debentures	-	-	-	9,915	1,241	12.52
FHLB advances	25,776	1,256	4.87	19,059	920	4.83
Other borrowings	36,605	2,566	7.01	23,971	1,452	6.06
Total interest-bearing liabilities	739,077	36,280	4.91	600,949	28,689	4.77
Non-interest-bearing liabilities	54,204			47,992		

Total liabilities		793,281					648,941			
Stockholders equity		47,457					43,336			
Total liabilities and stockholders equity	$	840,738				$	692,277			
Net interest income/interest rate spread			$	23,208	2.45%			$	18,971	2.44%
Net interest-earning assets	$	69,122				$	60,036			
Net interest margin					2.87%					2.87%
Average interest-earning assets to average interest-bearing liabilities		109.35%					110.00%			
Return on average assets		0.39					0.54			
Return on average equity		6.86					8.65			
Average equity to average assets		5.64					6.26			
Non-interest expense to average assets		2.34					2.27			

(1) The average balances of loans and leases include non-performing loans and leases. Interest income related to non-performing loans and leases is recognized when collected.

(2) Includes amortized cost of basis of assets held and available for sale.

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Provision for Loan and Lease Losses. The provision for loan and lease losses totaled $2.9 million for the year ended December 31, 2007 compared to $1.5 million for the year ended December 31, 2006. The $1.4 million increase in the provision for loan and lease losses is primarily due to the increased inherent risk associated with a growing loan and lease portfolio coupled with both an increased amount of impaired loans and other factors prescribed by our allowance for loan and lease methodology. The provision for loan and lease losses is dependent upon the credit quality of loans and leases, the increased inherent risk associated with a larger portfolio, the risk inherent in specific loan types and our assessment of the collectibility of loans and leases under current economic conditions. While we have made no changes to our underwriting standards in 2007 and 2006, current economic conditions have caused us to add additional steps to our approval process. To establish the appropriate level of the allowance for loan and lease losses, we regularly reviews our historical charge-off migration analysis and an analysis of the current level and trend of several factors that we believe may indicate losses in the loan and lease portfolio. These factors include delinquencies, volume, average size, average risk rating, technical defaults, geographic concentrations, industry concentrations, loans and leases on the management attention watch list, experience in the credit granting functions and changes in underwriting standards, and level of non-performing assets and related fair value of underlying collateral. Refer to **Allowance for Loan and Lease Losses** for further information.

Non-Interest Income. Non-interest income, consisting primarily of fees earned for trust and investment services, service charges and fees on deposits and loans and income from bank-owned life insurance, increased $742,000, or 20.2%, to $4.4 million for the year ended December 31, 2007 from $3.7 million for the year ended December 31, 2006. Trust and investment services fee income increased $558,000, or 41.2% to $1.9 million for the year ended December 31, 2007 compared to $1.4 million for the year ended December 31, 2006. Trust and investment services fee income can be broken into two components: trust fee income and investment service commission income. Trust fee income was $1.5 million for the year ended December 31, 2007 compared to $1.1 million for the year ended December 31, 2006. Trust fee income is driven by the volume of assets under management and the market values associated with those assets. At December 31, 2007, we had $291.2 million of trust assets under management. This is an $86.9 million increase over the assets under management of $204.3 million at December 31, 2006. The increase in trust assets under management is a direct result of successful sales efforts. The second component of trust and investment services fee income relates to investment service commissions. Investment commissions are received on each transaction processed for our brokerage clients along with continued commissions received as long as our clients hold the investment in the product that was purchased. At December 31, 2007, the brokerage assets under administration increased $33.4 million, or 29.2%, to $147.8 million compared to $114.4 million at December 31, 2006. As a result of increased client activity and due to timing of commissions paid, investment service commissions increased approximately $158,000, or 53.4%, for the year ended December 31, 2007 compared to the year ended December 31, 2006.

Income associated with cash surrender value of life insurance policies increased $83,000, or 13.5%, to $697,000 for the year ended December 31, 2007 compared to $614,000 for the year ended December 31, 2006. The increase in cash surrender value is due to positive market performance of the policies. In addition, non-interest income increased due to the change in fair value of interest rate swaps and net cash settlement which decreased 2006 period revenue by approximately $163,000. A majority of our interest rate swaps were terminated during the first quarter of 2006. We did not enter into any new interest rate swaps in 2007.

Non-Interest Expense. Non-interest expense increased $4.0 million, or 25.2%, to $19.7 million for the year ended December 31, 2007 from $15.7 million for the year ended December 31, 2006. In general, non-interest expenses are influenced by the growth of operations, with additional employees necessary to staff such growth. Compensation expense was the primary driver of the increase in non-interest expenses during 2007. Compensation expense increased $2.8 million, or 30.6%, to $12.1 million for the year ended December 31, 2007 compared to $9.3 million for the year ended December 31, 2006. The increase in compensation expense is primarily due to an increased number of full-time equivalent employees which increases overall salary expense and bonus accruals, additional compensation expense associated with share-based compensation awards and increased healthcare costs. At December 31, 2007, we had 121.5 full-time equivalent employees compared to 112.0 full-time equivalent employees at December 31, 2006 with a primary emphasis in hiring additional business development officers in all

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areas of our Corporation as a means to execute our primary growth strategy. We believe this investment in our people provides a strong foundation to meet our growth initiatives in the future. Share-based compensation expense increased approximately $215,000 when comparing the years ended December 31, 2007 and 2006. We began issuing restricted share awards in 2006, and the increase in this expense represents the recognition in 2007 of twelve months of expense relating to 2006 awards that were granted periodically during fiscal year 2006. We expect that we will continue to award restricted shares. This expense will continue to increase through 2010, at which time the expense will reflect four years of awards of restricted shares, as our restricted shares generally vest over a four year period, then will only fluctuate due to other normal factors including number of shares granted and market price at which those shares are granted.

Marketing expense increased $140,000, or 15.0%, to $1.1 million for the year ended December 31, 2007 from $936,000 for the year ended December 31, 2006. The increase is due to the timing of planned advertising campaigns, including those campaigns associated with market expansion. Professional fees increased $112,000, or 8.6%, to $1.4 million for the year ended December 31, 2007 compared to $1.3 million for the year ended December 31, 2006. The increase is attributable to increased audit fees, directors fees and use of third party consultants. Other non-interest expense increased $780,000, or 46.5%, to $2.5 million for the year ended December 31, 2007 compared to $1.7 million for the year ended December 31, 2006. The increase was caused by several factors including increottom"> (28) (15)

Proceeds from stock option exercises	4,712	3,752	8,035
Net cash provided by (used in) financing activities	14,190	(6,276)	1,414
Net increase (decrease) in cash and cash equivalents	679	878	(482)
Cash and cash equivalents at beginning of year	4,054	3,176	3,658
Cash and cash equivalents at end of year	$4,733	$4,054	$3,176
Supplemental disclosures:			
Interest paid during the year	$772	$274	$681
Income taxes paid during the year	11,926	6,513	7,089

The following items are not included in the Consolidated Statement of Cash Flows:

Minimum pension liability adjustment	$(546)	$334	$(291)

See accompanying notes.

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Keystone Automotive Industries, Inc. (Keystone) and its wholly owned subsidiaries. Significant subsidiaries included in the consolidated financial statements include Keystone Automotive Industries MN, Inc. (formerly North Star Plating Co.), Keystone Automotive Industries FL, Inc. (formerly Inteuro Parts Distributors, Inc.) and Keystone Automotive Industries Resources, Inc. (formerly Republic Automotive Parts, Inc.) (collectively with Keystone, the Company). All significant intercompany transactions have been eliminated in consolidation.

Business Information

The Company operates in one business segment. The principal business of the Company is the distribution of collision replacement parts for automobiles and light trucks to collision repair shops through a network of distribution centers located within the United States and Canada.

The Company s product offerings, comprised of more than 19,000 stock keeping units, may be divided into four primary categories: (i) the Company s core business continues to be automotive body parts which consist primarily of fenders, hoods, headlight and taillight assemblies, radiators, condensers and grilles, (ii) the Company distributes new and remanufactured plastic bumper covers and steel bumpers manufactured by multiple domestic and foreign manufacturers, (iii) the Company distributes paint and other materials used in repairing a damaged vehicle primarily to repair shops and (iv) the Company distributes wheels and related products.

Fiscal Year

The Company uses a 52/53 week fiscal year. The Company s fiscal year ends on a Friday, usually the Friday closest to the last day of March. The fiscal year ended April 1, 2005 included 53 weeks and the fiscal years ended March 31, 2006 and March 26, 2004 each included 52 weeks.

Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

Concentrations of Risk

Accounts receivable subject the Company to a potential concentration of credit risk. Substantially all of the Company s customers are in the auto body repair business, none representing more than 1% of sales. The Company performs periodic credit evaluations of its customers financial condition and generally does not require collateral. Receivables are generally due within 30 days. Credit losses have consistently been within management s expectations.

During 2006 and 2005, by dollar amount, the Company imported 56% and 48% of its products directly or indirectly from Asia, respectively.

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fair Values of Financial Instruments

Fair values of cash and cash equivalents, accounts receivable, accounts payable, credit facility and other short-term obligations approximate cost due to the short period of time to maturity.

Cash Equivalents

The Company considers all highly liquid instruments with an original maturity of three months or less when purchased to be cash equivalents. Cash and cash equivalents are held by major financial institutions.

Allowance for Doubtful Accounts. The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The Company adjusts its allowance monthly based upon a formula relating to the aging of its receivables. If the financial condition of the Company s customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Inventories

The Company s inventories consist primarily of automotive aftermarket collision replacement parts, paint and related items. Inventories are stated at the lower of cost (weighted-average method) or market.

Long-Lived Assets

The Company reviews the recoverability of its long-lived assets as required by Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. The estimated future cash flows are based upon, among other things, assumptions about expected future operating performance, and may differ from actual cash flows. Long-lived assets evaluated for impairment are grouped with other assets to the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. If the sum of the projected undiscounted cash flows (excluding interest) is less than the carrying value of the assets, the assets will be written down to the estimated fair value in the period in which the determination is made. The Company has determined that no impairment of long-lived assets exists as of March 31, 2006.

Depreciation and Amortization

The Company uses the straight-line method for calculating depreciation and amortization of property, plant, and equipment over the following estimated useful lives:

Buildings	20 years
Machinery and equipment	5 12 years
Furniture and fixtures	5 7 years
Auto and truck	3 5 years
Leasehold improvements	Term of lease or life of the asset, whichever is shorter

The Company capitalized approximately $1.2 million, $2.5 million and $2.1 million incurred for the development of internal use computer software in accordance with the American Institute of Certified Public Accountant s Statement of Position 98-1, Accounting for the Cost of Computer Software Developed or

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Obtained for Internal Use during fiscal 2006, fiscal 2005 and fiscal 2004, respectively. These costs are included in the furniture, fixtures and equipment category above and are depreciated on the straight-line method over five to seven years.

Goodwill and Other Intangibles

The Company records goodwill as a result of acquisitions and analyzes its goodwill for impairment at least annually under SFAS No. 142, Goodwill and Other Intangible Assets. The determination of the value of goodwill requires it to make estimates and assumptions that affect its consolidated financial statements. In assessing the recoverability of our goodwill, the Company must make assumptions regarding estimated future cash flows and other factors to determine fair value of the respective assets. If these estimates or their related assumptions change in the future, the Company may be required to record impairment charges for these assets. The Company performs goodwill impairment tests on an annual basis and between annual tests whenever events may indicate that an impairment exists.

As of March 31, 2006, the Company had $39.4 million in goodwill that is subject to annual impairment tests. If the Company is required to recognize goodwill impairments in future periods, the Company would report those impairment losses as part of its operating results. The Company determined that no adjustments were necessary when it performed its annual impairment testing in the fourth quarter of fiscal 2006, 2005 and 2004, respectively.

Other intangibles are comprised of covenants not to compete. Covenants not to compete are amortized using the straight-line method over the terms of the agreements, generally 3 5 years. Amortization expense for other intangibles for the years ended March 31, 2006, April 1, 2005 and March 26, 2004 was $531,000, $403,000 and $525,000, respectively.

Leases and Leasehold Improvements. The Company leases certain distribution centers, office space, equipment and vehicles. The Company has over 200 leases and no one lease is material to the operations of the Company. The Company accounts for its leases under the provisions of SFAS No. 13, Accounting for Leases, and subsequent amendments, which require that leases be evaluated and classified as operating leases or capital leases for financial reporting purposes. Certain leases contain rent escalation clauses, which are recorded on a straight-line basis over the initial term of the lease with the difference between the rent paid and the straight-line rent recorded as a deferred rent liability. Lease incentive payments received from landlords are recorded as deferred rent liabilities and are amortized on a straight-line basis over the lease term as a reduction in rent. In addition, leasehold improvements associated with these operating leases are amortized over the shorter of their economic lives or the respective lease terms. The term of each lease is generally the initial term of the lease unless external economic factors were to exist such that renewals potentially provided for in the establishing an amortization period and determining if such lease qualified as a capital or operating lease.

Prior to fiscal 2005, the Company had been recording the actual rent expense for each year of the lease. As a result, the Company s 2005 statement of income includes an adjustment to correct its lease accounting of $0.7 million, net of tax, ($0.5 million, net of tax, related to fiscal years prior to 2005). Prior year s financial statements were not restated due to the immateriality of the amount to the statement of income and statement of cash flows for 2004 or any prior individual year. As the correction relates solely to accounting treatment, it did not affect the Company s historical or future cash flows.

Self-Insured Reserves. The Company is self-insured for general and automobile liability, workers compensation and the health care claims of its team members, although the Company maintains stop-loss

KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

coverage with third-party insurers to limit its total liability exposure. A reserve for liabilities associated with these losses is established for claims filed and claims incurred but not yet reported based upon our estimate of ultimate cost, which is calculated using analyses of historical data and valuations provided by third-party actuaries. Management monitors new claims and claim development as well as negative trends related to the claims incurred but not reported in order to assess the adequacy of our insurance reserves. While the Company does not expect the amounts ultimately paid to differ significantly from our estimates, our self-insurance reserves and corresponding selling, general and administrative expenses could be affected if future claim experience differs significantly from historical trends and actuarial assumptions.

Revenue Recognition

The Company recognizes revenue upon concluding that all of the fundamental criteria for product revenue recognition have been met. Such criteria are usually met at the time title passes to the customer, typically at the time of delivery or shipment. The costs related to shipping and handling fees are included in selling and distribution expenses. The Company provides its customers the right to return products that are damaged or defective. The effect of these programs is estimated and current period sales and costs of sales are reduced accordingly.

Other Income

The Company s other income primarily consists of revenue generated by the sales of scrap aluminum, a byproduct of the Company s wheel recycling business, and finance fee income from past due accounts receivable.

Stock-Based Compensation

The Company elected to continue to account for stock-based compensation plans using the intrinsic value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under the provisions of APB Opinion No. 25, compensation expense is measured at the grant date for the difference between the fair value of the stock and the exercise price. The Company has not granted stock options at less than the fair value of the stock at the date of grant.

New Accounting Standards

In December 2004, the Financial Accounting Standards Board (FASB) issued a revised Statement 123, *Share Based Payment* (Statement 123R), to address the accounting for stock-based employee plans. The statement eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25 and instead requires that such transactions be accounted for using a fair value based method of accounting. The impact of adoption of Statement 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had we adopted Statement 123R in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of proforma net income and earnings per share in Note 10 to our consolidated financial statements. Statement 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows in periods after adoption. Statement 123R, as recently amended, is effective the beginning of the first fiscal year which begins after June 15, 2005. Consequently, Statement 123R will not impact the Company until the beginning of fiscal 2007 and the adoption of Statement 123R is not expected to have a material adverse impact on the Company s consolidated financial position or cash flows.

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of APB No. 43, Chapter 4. SFAS 151 amends Accounting Research Bulletin No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overhead to inventory be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect that the adoption of this standard will have a material impact on its consolidated financial position or cash flows.

In June 2005, the FASB Emerging Issues Task Force reached a consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements (EITF 05-6). The guidance requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. The guidance is effective for periods beginning after June 29, 2005. The adoption of EITF 05-6 will not have an impact on the Company s consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections A Replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

2. ACQUISITIONS

In October 2005, the Company acquired substantially all of the assets of Veng USA LLC, a distributor of aftermarket collision replacement parts in the Northeast. Veng USA LLC had locations in Seekonk and Woburn, Massachusetts; Manchester and Milford, Connecticut; Manchester, New Hampshire and Auburn, Maine. The Company acquired these companies for approximately $36.5 million in cash, net of cash received. This acquisition was accounted for under the purchase method of accounting and accordingly the assets and liabilities have been recorded at their estimated fair value at the dates of acquisition. The excess of purchase price over the estimated fair values of the assets acquired was approximately $27.4 million and has been recorded as goodwill.

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the amounts assigned to assets acquired and liabilities assumed at the date of the acquisition of Veng USA LLC:

	October 2005 (in thousands)
Receivables	$ 2,582
Inventories	4,412
Other current assets	209
Property and equipment	1,372
Goodwill	27,372
Other intangibles	925
Total assets acquired	$ 36,872
Other accrued liabilities	(372)
Total liabilities assumed	(372)
Net assets acquired	$ 36,500

The following unaudited pro forma information presents the results of operations of the Company as if the acquisition of Veng USA LLC had taken place at the beginning of the applicable periods:

	March 31, 2006	April 1, 2005	March 26, 2004
	(in thousands, except per share amounts)		
Net sales	$ 648,605	$ 593,280	$ 532,073
Net income	22,840	16,041	19,238
Earnings per diluted share	$ 1.42	$ 1.02	$ 1.26

In June 2006, the Company acquired certain assets of S&E Auto Panels, LLC, a distributor of aftermarket collision replacement parts in Dexter, Missouri in June 2005. The results for fiscal 2006 and 2005, assuming that S&E Auto Panels, LLC had been made at the beginning of fiscal 2005, would not have been materially different from the results presented.

The consolidated financial statements include the results of operations for each business for all periods subsequent to the applicable purchase date.

During fiscal 2005, the Company acquired certain assets of Lincoln Bumper, Inc., a distributor of aftermarket collision replacement parts in Lincoln, Nebraska in June 2004 and of Royal Bumper Service, a recycler of plastic bumpers in Newberg, Oregon at the beginning of fiscal 2005. In November 2004, the Company acquired all of the outstanding capital stock of Chambers Parts Distributors, a distributor of after marked collision replacement parts with locations in Bangor, Manchester and Portland, Maine. The Company acquired these companies for approximately $2.6 million in cash, net of cash received. All of these acquisitions were accounted for under the purchase method of accounting and accordingly, the assets and liabilities of the acquired entities have been recorded at their estimated fair value at the dates of acquisition. The excess of purchase price over the estimated fair values of the assets acquired was approximately $1.6 million and has been recorded as goodwill. The consolidated financial statements include the results of operations for each business for all periods subsequent to the applicable purchase date. The results for fiscal 2005 and 2004, assuming that these acquisitions had been made at the beginning of fiscal 2004, would not have been materially different from the results presented.

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During fiscal 2004, the Company acquired certain assets of the following businesses: Landmark Auto Parts, a distributor of aftermarket collision replacement parts in Newport News, Virginia in May 2003; U.S. Crash Parts, a distributor of aftermarket collision parts in Lexington, Kentucky in June 2003; Kansas Bumper/Mokan, a distributor of aftermarket collision replacement parts in Kansas City, Lawrence, Topeka, Manhattan, Wichita and Liberal, Kansas in September 2003; and Sam s Nu-Chrome Bumper, a distributor of bumpers in New Orleans, Louisiana in December 2003. In addition, the Company acquired all of the outstanding capital stock of two Canadian distributors of aftermarket collision replacement parts. The Company acquired MultiPro in August 2003, with locations in Drummondville, Montreal, Quebec, Ottawa and Sherbrooke and Quinte, Canada and Quinte in January 2004, with locations in Trenton, Toronto, Ottawa and Montreal, Canada. The Company acquired these companies for approximately $15.9 million in cash, net of cash received. All of these acquisitions were accounted for under the purchase method of accounting and accordingly the assets and liabilities of the acquired entities have been recorded at their estimated fair value at the dates of acquisition. The excess of purchase price over the estimated fair values of the assets acquired was approximately $6.8 million and has been recorded as goodwill. The consolidated financial statements include the results of operations for each business for all periods subsequent to the applicable purchase date. The results for fiscal 2004 and 2003, assuming that these acquisitions had been made at the beginning of fiscal 2003, would not have been materially different from the results presented.

3. FINANCING ARRANGEMENTS

The Company has in place a $75.0 million revolving secured line of credit with commercial lenders that matures on October 14, 2010. The Company has the option to expand the credit facility to $100.0 million. Advances under the revolving line of credit bear interest either at LIBOR plus 0.75% or at the lender s prime rate. At March 31, 2006, $9.5 million had been drawn down under the line of credit. The line of credit is subject to certain restrictive covenants set forth in the loan agreement, which requires that the Company maintain certain financial ratios. The Company was in compliance with all such covenants at March 31, 2006. The Company has outstanding lines of credit in the aggregate amount of $13.1 million issued to its primary insurers to secure the Company s deductible reimbursement obligations. The amount of these letters of credit reduces the funds available under the Company s credit facility. At June 2, 2006, $58.2 million was available to the Company under the line of credit.

4. SHAREHOLDERS EQUITY

The Company maintains a stock repurchase plan as authorized by the Board of Directors, which at March 31, 2006, authorized the purchase of up to $4.1 million of its common stock at such times and at such prices as the President and Chief Financial Officer deemed appropriate. Repurchased shares were redeemed and treated as authorized but unissued shares. Since the inception of the plan, the Company has repurchased approximately 3.5 million shares for approximately $45.8 million, an average of $13.01 per share. No shares were repurchased during fiscal 2006, 2005 or 2004.

In February 2000, the Company issued 100,000 warrants to purchase the Company s stock at an exercise price of $6.50 to a vendor. The warrants are exercisable starting in February 2001 through 2005, or through the date of dissolution of the agreement. Using the intrinsic value method, the Company recorded the warrants in equity at $236,000 and amortized the expense over the period services were received from the vendor. The warrants were fully amortized in fiscal 2002. These warrants were exercised in March 2004.

The Company may pay dividends at the discretion of the Board of Directors. The Company has never paid dividends.

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. EARNINGS PER SHARE

The Company calculates basic and diluted earnings per share as required by SFAS No. 128, Earnings Per Share. Basic earnings per share excludes any dilutive effects of options, warrants and convertible securities. Diluted earnings per share is calculated including the dilutive effects of warrants, options, and convertible securities, if any. The income from continuing operations is used as the numerator to determine whether potential common shares are dilutive or antidilutive. The following table sets forth the computation of basic and diluted earnings per share:

	Year ended March 31, 2006	April 1, 2005	March 26, 2004
	(in thousands, except per share amounts)		
Numerator:			
Net income	$ 22,258	$ 14,260	$ 17,722
Denominator:			
Denominator for basic earnings per share weighted average shares	16,000	15,642	14,998
Effect of dilutive securities:			
Employee stock options and warrants	95	145	268
Denominator for dilutive earnings per share adjusted weighted average shares and assumed conversions	16,095	15,787	15,266
Basic earnings per share	$ 1.39	$ .91	$ 1.18
Diluted earnings per share	$ 1.38	$ .90	$ 1.16

There were 0, 110,000 and 0 antidilutive options for the fiscal years ended March 31, 2006, April 1, 2005 and March 26, 2008, respectively.

6. RELATED PARTY TRANSACTIONS

The Company has entered into various property lease agreements with related parties, including certain of the Company s officers and agreements with a corporation and an LLC which is owned by a family member of a Company officer. The leases contain terms up to 5 years. The Company believes that the terms and conditions of such leases with affiliated parties are no less favorable than could have been obtained from unaffiliated parties in arm s length transactions at the time such leases were entered into. Rent expense for related party lease agreements, included in the total rent expense, amounted to $629,000, $478,000 and $1,155,000 for the fiscal years 2006, 2005 and 2004, respectively, exclusive of the Company s obligation for property taxes and insurance.

7. SALES BY PRODUCT

	Fiscal Year Ended March 31, 2006	April 1, 2005	March 26, 2004
	(in millions)		

Automotive body parts(1)	$ 322.9	$ 284.3	$ 251.7
Bumpers	188.3	164.5	145.2
Paint and related materials	60.7	59.9	58.1
Wheels and related products	52.7	43.3	39.0
Other	3.7	5.7	7.1
Total Sales	$ 628.3	$ 557.7	$ 501.1

(1) Consists primarily of fenders, hoods, headlights and taillight assemblies, radiators, condensers and grilles.

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. INCOME TAXES

The liability method is used in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities. The provision for income taxes reflects the taxes to be paid for the period and the change during the period in the deferred tax assets and liabilities.

Significant components of the Company s deferred tax liabilities and assets are as follows:

	March 31, 2006	April 1, 2005
	(in thousands)	
Deferred tax assets:		
Inventories	$ 4,643	$ 3,876
Intangibles	3,979	4,889
Accrued expenses	5,320	3,619
Other	75	506
Total deferred tax assets	14,017	12,890
Valuation allowance	(382)	(377)
	13,635	12,513
Deferred tax liabilities:		
Prepaid expenses	(868)	(594)
Excess of book basis over tax basis of property and equipment	(2,174)	(2,280)
Total deferred tax liabilities	(3,042)	(2,874)
Net deferred tax assets	$ 10,593	$ 9,639

The Company recorded a valuation allowance related to a deferred tax asset recorded as a result of the write-off of its investment in an internet company.

Significant components of the provision for income taxes attributable to operations are as follows:

	Year ended		
	March 31, 2006	April 1, 2005	March 26, 2004
		(in thousands)	
Current:			
Federal	$ 13,783	$ 8,214	$ 7,397
State	1,544	805	763
Foreign	411	70	291
	15,738	9,089	8,451
Deferred:			
Federal	(878)	86	2,462

State	(98)	8	254
Foreign	22	113	
	(954)	207	2,716
	$ 14,784	$ 9,296	$ 11,167

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The reconciliation of income taxes at the U.S. federal statutory tax rate to reported income tax expense is as follows:

		Year ended	
	March 31, 2006	April 1, 2005	March 26, 2004
		(in thousands)	
Income taxes at statutory tax rate	$ 12,965	$ 8,245	$ 10,150
State income taxes, net of federal tax effect	1,404	787	981
Non-deductible expenses	215	180	203
Rate change and other	195	85	(161)
Valuation allowance	5	(1)	(6)
	$ 14,784	$ 9,296	$ 11,167

9. EMPLOYEE BENEFIT PLANS

The Company has suspended its defined benefit pension plan (the Plan) to provide pension benefits to all non-union team members. Plan benefits are based on an employee s years of service and the compensation during the five years of employment which would yield the highest average compensation. Effective in April 1997, the Company suspended the accrual of future benefits.

The net periodic pension cost for all the Company s benefit plans was as follows:

		Pension Benefits	
	March 31, 2006	April 1, 2005	March 26, 2004
		(in thousands)	
Service cost	$ 120	$ 118	$
Interest cost	293	316	306
Recognized losses	580	427	98
Expected return on assets	(349)	(344)	(251)
	$ 644	$ 517	$ 153

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of the status of the funding of the plans:

	Pension Benefits	
	March 31, 2006	April 1, 2005
	(in thousands)	
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 5,510	$ 5,250
Service cost	120	118
Interest cost	293	316
Actuarial losses	417	781
Benefits paid	(885)	(955)
Benefit obligation at end of year	$ 5,455	$ 5,510
Change in plan assets:		
Fair value of plan assets at beginning of year	$ 4,210	$ 3,942
Actual return on plan assets	1,081	155
Company contributions	872	1,068
Benefits paid	(885)	(955)
Fair value of plan assets at end of year	$ 5,278	$ 4,210
Funded status:		
Funded status of the plan (underfunded)	$ (177)	$ (1,300)
Unrecognized net actuarial (gain) losses	1,144	2,038
Net amount recognized	$ 967	$ 738
Amounts recognized in the statement of financial position:		
Accrued benefit liability	$ (177)	$ (1,300)
Accumulated other comprehensive loss	1,144	2,038
Net amount recognized	$ 967	$ 738

The weighted-average asset allocations of the Company s defined benefit plan at March 31, 2006 and April 1, 2005 by asset category, are as follows:

	Fiscal year ended	
	March 31, 2006	April 1, 2005
Plan Assets:		
Equity securities	95%	90%
Debt securities	4%	5%
Other	1%	5%

Total	100%	100%

The above asset allocations are in line with the Company s target asset allocation ranges, which are as follows: equity securities 70% to 90%, debt securities 0% to 20% and other securities of 0% to 10%. At March 31, 2006 and April 1, 2005, the plan held 31,200 shares of common stock of the Company with a market value of $1,317,000 and $721,000, respectively.

KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of benefit payments expected to be paid during the fiscal year ending in:

	Defined Benefit Plan (In thousands)
2007	$ 375
2008	308
2009	302
2010	347
2011	318
2012 2016	1,673

The Company s contribution for Company-sponsored retirement plans was as follows:

	Fiscal Year Ended		
	March 31, 2006	April 1, 2005	March 26, 2004
401(k) Plan	$ 1,523	$ 1,505	$ 1,411
Defined Benefit Plan	872	1,068	581
Total	$ 2,395	$ 2,573	$ 1,992

In accordance with the provisions of SFAS No. 87, Employers Accounting for Pensions, at March 31, 2006 the Company recorded a minimum pension liability representing the excess of the accumulated benefit obligation over the fair value of the plan assets. The balance of the liability of $1,144,000 was reported in accumulated comprehensive income (loss), net of applicable deferred income taxes of $699,000.

In determining the actuarial present value of projected benefit obligations at March 31, 2006 and April 1, 2005, a discount rate of 5.75% and 5.50%, respectively, was used. There are no future compensation increases due to the suspension of benefit accruals. The expected long-term annual rate of return on assets was 8% for the year ended March 31, 2006 and April 1, 2005. The Company does not expect to make any contribution to the defined benefit plan during fiscal year 2007.

The Company maintains a 401(k) plan, as amended, that covers substantially all of its employees. Employees who have completed more than one year of service are eligible and may contribute from 1% to 50% of their base pay. The Company matches 50% of the first 6% of employee contributions. Employee contributions vest immediately, while employer contributions vest based on years of service.

10. STOCK COMPENSATION PLANS

In 1996, the Board of Directors of the Company adopted a Stock Incentive Plan (the 1996 Plan). There were 2,700,000 shares of Common Stock reserved for issuance under the 1996 Plan, as amended. Effective August 3, 2005 (the Effective Date), the Company s stockholders adopted the 2005 Omnibus Incentive Plan (the 2005 Plan) replacing the 1996 Plan. No further grants can be made under the 1996 Plan as of the Effective Date. On the Effective Date, there were options outstanding with respect to 681,284 shares of Common Stock under the 1996 Plan.

The 2005 Plan has a share authorization of 1,850,000 shares of Common Stock plus that number of shares subject to awards under the 1996 Plan as of the Effective Date to the extent that such outstanding awards are forfeited, expire or otherwise terminate without the issuance of shares. Of the aggregate share authorization, no

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

more than 740,000 shares may be issued pursuant to full value awards (awards other than stock options or stock appreciation rights) and no more than 300,000 shares may be issued to Non-employee Directors. Under the 2005 Plan, subject to certain annual share or dollar limitations, both incentive and nonqualified stock options, restricted stock, stock appreciation rights, performance shares, restricted and performance share units and cash-based awards may be granted.

Stock options expire 10 years from the date of grant and generally vest over a period of three or four years. The restrictions on the sale or transfer of grants of restricted stock also generally expire over a period of three to four years.

In July 2005, the Compensation Committee of the Board of Directors authorized the Chief Executive Officer to allocate grants of up to an aggregate of 54,300 shares of restricted stock and restricted stock units under the 2005 Plan to non-officer employees of the Company. Grants of an aggregate of 54,300 shares were made to 173 employees with the restriction on sale or transfer lapsing on July 1, 2008.

In July 2005, the Compensation Committee of the Board of Directors authorized the granting of 196,000 nonqualified options under the 2005 Plan to nine officers of the Company. These grants vest in equal annual installments over a three-year period.

On August 3, 2005, the Board of Directors approved the granting of 1,087 restricted shares to each of the directors, except for the Chief Executive Officer. The restrictions on sale or transfer lapse the day before the 2006 annual meeting of stockholders.

Stock Option Plan	**Shares**	**Weighted Average Exercise Price**
Outstanding at March 28, 2003	1,619,143	$ 12.02
Granted	145,000	17.68
Exercised	(650,825)	11.31
Expired/Cancelled	(55,000)	14.19
Outstanding at March 26, 2004	1,058,318	13.13
Granted	120,000	25.75
Exercised	(349,181)	10.81
Expired/Cancelled	(102,200)	14.00
Outstanding at April 1, 2005	726,937	16.20
Granted	196,000	25.23
Exercised	(339,881)	13.79
Expired/Cancelled	(67,800)	23.17
Outstanding at March 31, 2006	515,256	$ 20.15

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following tabulation summarizes certain information concerning outstanding and exercisable options at March 31, 2006, April 1, 2005 and March 26, 2004.

	Price Range		
	$5.53-$9.00	**$10.00-$20.00**	**$20.375-$20.60**
Outstanding options as of March 26, 2004:			
Number outstanding	289,000	761,218	8,100
Weighted average exercise price	$ 5.93	$ 15.78	$ 20.38
Weighted average remaining contractual life in years	6.1	6.9	3.8
Exercisable options:			
Number exercisable	114,875	318,880	8,100
Weighted average exercise price	$ 6.45	$ 14.71	$ 20.38
Outstanding options as of April 1, 2005:			
Number outstanding	109,875	491,162	125,900
Weighted average exercise price	$ 5.67	$ 16.17	$ 25.49
Weighted average remaining contractual life in years	5.2	6.0	8.8
Exercisable options:			
Number exercisable	109,875	250,228	5,900
Weighted average exercise price	$ 5.67	$ 15.70	$ 20.38
Outstanding options as of March 31, 2006:			
Number outstanding	45,150	213,506	256,600
Weighted average exercise price	$ 5.53	$ 16.93	$ 25.40
Weighted average remaining contractual life in years	4.40	4.81	8.73
Exercisable options:			
Number exercisable	45,150	144,756	21,850
Weighted average exercise price	$ 5.53	$ 16.25	$ 24.63

The Company adopted SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amends SFAS No. 123, Accounting for Stock-Based Compensation, SFAS No. 148 which provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirement of SFAS No. 123 to require more prominent and more frequent disclosures in financial statements of the effects of stock-based compensation. If the Company had elected to recognize compensation cost based on the fair value of the options granted at the grant rate as prescribed by SFAS No. 148, net income and earnings per share would have been reduced to the pro forma amounts shown below:

	March 31, 2006	**April 1, 2005**	**March 26, 2004**
	(In thousands, except per share amounts)		
Pro forma:			
Net income as reported	$ 22,258	$ 14,260	$ 17,722
Stock-based compensation	418	216	64
Less: Fair value stock-based compensation	(937)	(604)	(553)
Net income pro forma	$ 21,739	$ 13,872	$ 17,233
Net income per share as reported:			
Basic	$ 1.39	$ .91	$ 1.18

Diluted	$	1.38	$	.90	$	1.16
Net income per share pro forma:						
Basic	$	1.36	$	.89	$	1.15
Diluted	$	1.35	$	.88	$	1.13

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The effects of applying SFAS No. 123 as amended by SFAS No. 148, for purposes of determining pro forma net income (loss) and net income (loss) per share are not likely to be representative of the effects on reported net income (loss) for future years. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model using the following weighted average assumptions:

	March 31, 2006	April 1, 2005	March 26, 2004
Risk free interest rate	4.46%	4.55%	4.76%
Expected life in years	4	4	4
Expected volatility	40.64%	39.52%	44.50%
Expected dividend yield	0.00%	0.00%	0.00%

11. COMMITMENTS AND CONTINGENCIES

The Company leases substantially all of its property and a portion of its plant and equipment. Certain of the leases contained renewal options from two to five years.

Future minimum lease payments, under non-cancelable operating leases with initial terms of one year or more, are approximately as follows at March 31, 2006:

	Related Party Leases	Other	Total Operating Leases
		(in thousands)	
2007	$ 572	$ 18,742	$ 19,314
2008	572	15,010	15,582
2009	512	10,934	11,446
2010	201	7,372	7,573
2011	63	5,055	5,118
Thereafter		11,650	11,650
Total minimum rental payments	$ 1,920	$ 68,763	$ 70,683

Total rent expense amounted to $22,773,000, $20,881,000 and $17,022,000 for fiscal 2006, 2005 and 2004, respectively, exclusive of the Company s obligation for property taxes and insurance.

The Company is subject to legal proceedings and claims which arise in the ordinary course of its business. Although occasional adverse decisions or settlements may occur, the Company believes that the final disposition of such matters will not have a material adverse effect on the financial position, results of operations or cash flow of the Company.

12. SUBSEQUENT EVENTS

Effective April 20, 2006, the Company entered into a 15-year lease commitment on a build-to-suit office complex comprising 52,000 square feet in Nashville, Tennessee. The aggregate base rent obligation for this complex totals $11,310,000 over the term and includes a purchase option for $9,200,000. Once completed, the Company s principal executive offices will be located in this facility.

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KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following is a summary of the quarterly results of operations for the years ended March 31, 2006 and April 1, 2005.

	Quarter Ended			
	July 1	September 30	December 30	March 31
	(In thousands, except per share amounts)			
2006:				
Net sales	$ 144,781	$ 139,221	$ 164,387	$ 179,939
Gross profit	64,153	61,544	74,244	82,025
Net income	4,722	2,865	7,108	7,563
Per Common Share:				
Net income per share:				
Basic	$ 0.30	$ 0.18	$ 0.44	$ 0.47
Diluted	$ 0.30	$ 0.18	$ 0.44	$ 0.46

	Quarter Ended(1)			
	July 2	October 1	December 31	April 1
	(In thousands, except per share amounts)			
2005:				
Net sales	$ 141,117	$ 127,408	$ 136,631	$ 152,549
Gross profit	61,205	55,010	59,812	66,886
Net income	3,510	2,392	4,012	4,346
Per Common Share:				
Net income per share:				
Basic	$ 0.23	$ 0.15	$ 0.26	$ 0.28
Diluted	$ 0.22	$ 0.15	$ 0.25	$ 0.27

Quarterly and year-to-date computations of per share amounts are made independently. Therefore, the sum of per share amounts for the quarters may not agree with per share amounts for the year shown elsewhere.

(1) Fiscal 2005 contained 53 weeks and fiscal 2006 contained 52 weeks. The additional week in fiscal 2005 was in the quarter ended July 2, 2004.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE
None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

In accordance with Exchange Act Rules 13a-15 and 15d-15, we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as such term is defined in Exchange Act Rules 13a-15(e), as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of March 31, 2006.

Design and Evaluation of Internal Control Over Financial Reporting

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we have included the following report of management s assessment of the design and effectiveness of our internal controls as part of this Annual Report on Form 10-K for the fiscal year ended March 31, 2006. Ernst & Young, LLP, our independent registered public accounting firm, also attested to, and reported on, management s assessment of the effectiveness of internal control over financial reporting.

Management s Report On Internal Control Over Financial Reporting

The Company s management is responsible for establishing and maintaining adequate internal controls over financial reporting. The Company has assessed the effectiveness of its internal control over financial reporting as of March 31, 2006 based on criteria established by *Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO Framework).* The Company s assessment of the effectiveness of its internal control over financial reporting included testing and evaluating the design and operating effectiveness of its internal controls. In management s opinion, the Company has maintained effective internal control over financial reporting as of March 31, 2006, based on criteria established in the COSO Framework.

In October 2005, the Company acquired Veng USA LLC. Due to the timing of the acquisition, Veng USA LLC was not included in management s 2006 assessment of and report on internal control over financial reporting.

The Company s independent registered public accountants that audited the Company s financial statements as of March 31, 2006 have issued an attestation report on management s assessment of the Company s internal control over financial reporting, which appears below.

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Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements. Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

There have been no changes in our internal control over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Board of Directors and Shareholders of Keystone Automotive Industries, Inc.

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, that Keystone Automotive Industries, Inc. maintained effective internal control over financial reporting as of March 31, 2006 based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Keystone Automotive Industries, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As indicated in the accompanying Management s Report on Internal Control over Financial Reporting, management s assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Veng USA LLC, acquired in October 2005, which is included in the 2006 consolidated financial statements of Keystone Automotive Industries, Inc. and constituted 1.5% and 1.1% of total assets and net assets, respectively, as of March 31, 2006 and 2.6% and 6.4% of net sales and net income, respectively, for the year then ended. Our audit of internal control over financial reporting of Keystone Automotive Industries, Inc. also did not include an evaluation of the internal control over financial reporting of Veng USA LLC.

In our opinion, management s assessment that Keystone Automotive Industries, Inc. maintained effective internal control over financial reporting as of March 31, 2006, is fairly stated, in all material respects, based on COSO criteria. Also, in our opinion, Keystone Automotive Industries, Inc. maintained, in all material respects, effective internal control over financial reporting as of March 31, 2006, based on COSO criteria.

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We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Keystone Automotive Industries, Inc. as of March 31, 2006 and April 1, 2005, and the related consolidated statements of income, stockholders equity and cash flows for each of the three years in the period ended March 31, 2006, and our report dated June 12, 2006 expressed an unqualified opinion on those consolidated financial statements.

Los Angeles, California	/s/ Ernst & Young LLP
June 12, 2006	

ITEM 9B. OTHER INFORMATION.

The Company s results of operations for the third quarter of fiscal 2006 were released publicly on January 26, 2006, but a Form 8-K with the release attached was not subsequently filed. The Company filed its Form 10-Q for that third quarter, containing the information set forth in the release, on February 8, 2006.

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PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this Item will be contained in the Company s definitive Proxy Statement for its 2006 Annual Meeting of Stockholders to be held August 9, 2006, which will be filed with the Securities and Exchange Commission within 120 days of March 31, 2006. Such information is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item will be contained in the Company s definitive Proxy Statement for its 2006 Annual Meeting of Stockholders to be held August 9, 2006, which will be filed with the Securities and Exchange Commission within 120 days of March 31, 2006. Such information is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Other than as set forth below, the information required by this Item will be contained in the Company s definitive Proxy Statement for its 2006 Annual Meeting of Stockholders to be held August 9, 2006, which will be filed with the Securities and Exchange Commission within 120 days of March 31, 2006. Such information is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item will be contained in the Company s definitive Proxy Statement for its 2006 Annual Meeting of Stockholders to be held August 9, 2006, which will be filed with the Securities and Exchange Commission within 120 days of March 31, 2006. Such information is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item will be contained in the Company s definitive Proxy Statement for its 2006 Annual Meeting of Stockholders to be held August 9, 2006, which will be filed with the Securities and Exchange Commission within 120 days of March 31, 2006. Such information is incorporated herein by reference.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULE AND REPORTS ON FORM 8-K

(a)(1) **Financial Statements:**

See the Index to Item 8 above.

(a)(2) **Financial Statement Schedule:**

See (d) below.

(a)(3) **Exhibits:**

The following exhibits are filed herewith or incorporated by reference herein:

Exhibit No.	Description
3.1(1)	Amended and Restated Bylaws of the Registrant. [3.4]*
3.1.1(2)	Amendment to Amended and Restated Bylaws of the Registrant. [3.1.1]*
3.1.2(3)	Amendment to Amended and Restated Bylaws of the Registrant. [3.1.2]*
3.1.3(4)	Amendment to Amended and Restated Bylaws of the Registrant. [3.1.3]*
3.2(1)	Restated Articles of Incorporation of the Registrant. [3.5]*
3.2.1(5)	Amendment to Restated Articles of Incorporation of Registrant. [3.2.1]*
3.2.2(3)	Amendment to Restated Articles of Incorporation of Registrant. [3.2.2]*
3.2.3(6)	Certificate of Determination of Series A Junior Participating Preferred Stock. [4.2(A)]*
4.1(1)	Form of stock certificate. [4.1]*
4.2(6)	Rights Agreement dated as of February 10, 2000. [4.2]*
4.2.1(7)	First Amendment to Rights Agreement dated as of January 8, 2003.
10.9(8)(A)	Keystone Automotive Industries, Inc. 1996 Stock Incentive Plan, together with forms of incentive stock option, non-qualified stock option and restricted stock agreements. [10.10]*
10.10(9)(A)	Amendment to Registrant s 1996 Stock Incentive Plan.
10.11(10)(A)	Amendment to Registrant s 1996 Stock Incentive Plan
10.12(11)(A)	Amendment to Registrant s 1996 Stock Incentive Plan
10.13(11)(A)	Amendment to Registrant s 1996 Stock Incentive Plan
10.14(12)(A)	2005 Omnibus Incentive Plan
10.29(8)	The Registrant s Employee Defined Benefit Pension Plan, as amended. [10.11]*
10.37(13)	Credit Agreement dated as of October 14, 2005 among Registrant, Wells Fargo Bank, National Association and J P Morgan Chase Bank, N.A.
10.37.1(14)	Amendment No. 1 to the Credit Agreement dated October 14, 2005.
10.38(15)	Credit Agreement dated as of February 1, 2002 between Registrant and Wells Fargo Bank, National Association [10.29]*.

10.38.1(11)	First Amendment to Credit Agreement dated as of February 1, 2003 between Registrant and Wells Fargo Bank, National Association

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Exhibit No.	Description
10.38.2(16)	Second Amendment to Credit Agreement dated as of August 1, 2003 between Registrant and Wells Fargo Bank, National Association [10.38.2]*
10.38.3(17)	Third Amendment to Credit Agreement dated as of December 1, 2004 between Registrant and Wells Fargo Bank, National Association [10.38.3]*
10.39(18)(A)	Form of Key Employee Salary Continuation Agreement dated as of April 2002 with Charles J. Hogarty, D. Currey Hall, Christopher Northup, Carl Hartman and James C. Lockwood.
10.40(18)	Proprietary Brand Purchase Agreement between Registrant and Genera Corporation; dated August 8, 2000.
10.41(16)(A)	Consulting Agreement between Charles J. Hogarty and Registrant dated September 1, 2003. [10.41(A)]*
10.42(19)	Form of Officer and Director indemnification agreement. [10.42]*
10.43(A)	Restricted Stock Agreement between Richard L. Keister and the Registrant.
10.44(14)(A)	Form of Nonqualified Stock Option Award Agreement.
14.1(20)	Code of Business Conduct and Ethics. [14.1]*
21.1	Subsidiaries
23.1	Consent of Ernst & Young LLP, independent registered Public Accountants.
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the 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 the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Indicates the exhibit number of the document in the original filing.

(1) Filed as an exhibit to Amendment No. 2 to the Registration Statement on Form S-1 filed with the Securities and Exchange Commission on June 17, 1996.

(2) Filed as an exhibit to the Registration Statement on Form S-1 filed with the Securities and Exchange Commission on June 6, 1997 (File No. 333-28709).

(3) Filed as an exhibit to Registrant s Form 10-K filed with the Securities and Exchange Commission on June 24, 1999.

(4) Filed in a Form 8-K filed with the Securities and Exchange Commission on February 1, 2005.

(5) Filed as an Exhibit to Registrant s Form 10-K filed with the Securities and Exchange Commission on June 24, 1998.

(6) Filed as an exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on February 23, 2000.

(7) Filed as an Exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on January 14, 2003.

(8) Filed as an exhibit to the Registration Statement on Form S-1 filed with the Securities and Exchange Commission on April 18, 1996 (File No. 333-3994).

(9) Filed as an exhibit to Registrant s Registration Statement on Form S-4 filed with the Securities and Exchange Commission on May 18, 1998 (File No. 333-52969).

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(10) As described in Registrant s Proxy Statement filed with the Securities and Exchange Commission on July 19, 2000.
(11) Filed as an Exhibit to Registrant s Form 10-Q filed with the Securities and Exchange Commission on February 10, 2003.
(12) Filed as an Exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on August 5, 2005. [10.44]*
(13) Filed as an Exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on October 21, 2005 [10.44]*.
(14) Filed as an Exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on March 24, 2006.
(15) Filed as an Exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on February 19, 2002.
(16) Filed as an Exhibit to Registrant s Form 10-Q filed with the Securities and Exchange Commission on November 10, 2003.
(17) Filed as an Exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on December 3, 2004.
(18) Filed as an Exhibit to Registrant s Form 10-K filed with the Securities and Exchange Commission on June 27, 2002.
(19) Filed as an Exhibit to Registrant s Form 8-K filed with the Securities and Exchange Commission on December 3, 2004.
(20) Filed as an Exhibit to Registrant s Form 10-K filed with the Securities and Exchange Commission on June 15, 2005.
(A) A management contract or compensatory plan or arrangement as defined in Item 601 of Regulation S-K.
(b) **Exhibits:**

See (a)(3) above.

(c) **Financial Statement Schedules:**

Schedule II Valuation and Qualifying Accounts

All other schedules are omitted because they are not applicable or the required information is shown in the Registrant s financial statements or the related notes thereto.

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KEYSTONE AUTOMOTIVE INDUSTRIES

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

(in thousands)

Description	Balance at Beginning of Year	Additions: Charged to Costs and Expenses	Additions: Charged to Other Accounts	Deductions(1)	Balance at End of Year
Year ended March 31, 2006					
Allowance for uncollectible accounts	$ 1,270	$ 1,065	$	$ 1,400	$ 935
Year ended April 1, 2005					
Allowance for uncollectible accounts	$ 887	$ 962	$	$ 579	$ 1,270
Year ended March 26, 2004					
Allowance for uncollectible accounts	$ 1,291	$ 756	$	$ 1,160	$ 887

(1) Uncollectible accounts written-off, net of recoveries.

Description	Balance at Beginning of Year	Additions: Charged to Costs and Expenses	Additions: Charged to Other Accounts	Deductions	Balance at End of Year
Year ended March 31, 2006					
Allowance for slow-moving inventory	$ 5,000	$ 2,975	$	$ 2,243	$ 5,732
Year ended April 1, 2005					
Allowance for slow-moving inventory	$ 3,666	$ 3,749	$	$ 2,415	$ 5,000
Year ended March 26, 2004					
Allowance for slow-moving inventory	$ 4,460	$ 1,400	$	$ 2,194	$ 3,666

Description	Balance at Beginning of Year	Additions: Charged to Costs and Expenses	Additions: Charged to Other Accounts	Deductions and Disbursements	Balance at End of Year
Year ended March 31, 2006					
Reserve for self-insurance	$ 4,654	$ 17,163	$	$ 14,941	$ 6,876
Year ended April 1, 2005					
Reserve for self-insurance	$ 3,547	$ 14,229	$	$ 13,122	$ 4,654
Year ended March 26, 2004					
Reserve for self-insurance	$ 3,326	$ 8,806	$	$ 8,585	$ 3,547

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Annual Report to be signed on its behalf by the undersigned, thereunto duly authorized.

KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

By: /s/ RICHARD L. KEISTER
Richard L. Keister
President

Dated: June 13, 2006

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this Annual Report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ RICHARD L. KEISTER **Richard L. Keister**	President, Chief Executive Officer and Director	June 13, 2006
/s/ JEFFREY T. GRAY **Jeffrey T. Gray**	Vice President and Treasurer (Principal Financial and Accounting Officer)	June 13, 2006
/s/ RONALD G. FOSTER **Ronald G. Foster**	Director	June 13, 2006
/s/ JAMES ROBERT GERRITY **James Robert Gerrity**	Director	June 13, 2006
/s/ TIMOTHY C. MCQUAY **Timothy C. McQuay**	Director	June 13, 2006
/s/ JOHN R. MOORE **John R. Moore**	Director	June 13, 2006
/s/ STEPHEN A. RHODES **Stephen A. Rhodes**	Director	June 13, 2006
/s/ KEITH M. THOMPSON **Keith M. Thompson**	Director	June 13, 2006