FIRST MERCHANTS CORP
Form 10-Q
August 09, 2006

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2006

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from _______ to _______

Commission File Number 0-17071

First Merchants Corporation

(Exact name of registrant as specified in its charter)

Indiana	35-1544218
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
200 East Jackson Street Muncie, IN	47305-2814
(Address of principal executive offices)	(Zip code)

(765) 747-1500

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

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

Large accelerated filer [ ]   Accelerated filer [X]   Non-accelerated filer [ ]

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

As of July 21, 2006, there were 18,267,487 outstanding common shares, without par value, of the registrant.

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PART I. FINANCIAL INFORMATION
Item 1. FINANCIAL STATEMENTS
CONSOLIDATED CONDENSED BALANCE SHEETS
(Dollars in thousands, except per share amounts)

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS:		
Cash and due from banks	$ 71,275	$ 70,417
Interest-bearing deposits....	8,529	8,748
Investment securities available for sale	456,499	422,627
Investment securities held to maturity	10,383	11,639
Mortgage loans held for sale....	5,338	4,910
Loans, net of allowance for loan losses of $25,884 and $25,188.	2,565,556	2,432,239
Premises and equipment	41,122	39,417
Federal Reserve and Federal Home Loan Bank stock....	23,889	23,200
Interest receivable	19,539	19,690
Core deposit intangibles	16,043	17,567
Goodwill	121,386	121,266
Cash surrender value of life insurance....	44,358	43,579
Other assets	24,346	21,780
Total assets	$ 3,408,263	$ 3,237,079
LIABILITIES:		
Deposits:		
Noninterest-bearing	$ 340,046	$ 314,335
Interest-bearing	2,195,354	2,068,241
Total deposits	2,535,400	2,382,576
Borrowings	527,347	508,236
Interest payable	6,927	5,874
Other liabilities....	25,585	26,997
Total liabilities	3,095,259	2,923,683
COMMITMENTS AND CONTINGENT LIABILITIES		
STOCKHOLDERS' EQUITY:		
Preferred stock, no-par value:		
Authorized and unissued - 500,000 shares		
Common Stock, $.125 stated value:		

Authorized --- 50,000,000 shares		
Issued and outstanding - 18,259,256 and 18,416,714 shares....	2,282	2,302
Additional paid-in capital	142,037	145,682
Retained earnings	181,042	174,717
Accumulated other comprehensive loss	(12,357)	(9,305)
Total stockholders' equity	313,004	313,396
Total liabilities and stockholders' equity	$ 3,408,263	$ 3,237,079

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(Dollars in thousands, except per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six M
	2006	2005	2006
Interest Income:			
Loans receivable			
Taxable	$45,658	$38,831	$ 88,73
Tax exempt	231	189	39
Investment securities			
Taxable	3,082	2,376	5,80
Tax exempt	1,613	1,554	3,26
Federal funds sold	11	112	2
Deposits with financial institutions	132	166	24
Federal Reserve and Federal Home Loan Bank stock	320	285	63
Total interest income	51,047	43,513	99,10
Interest expense:			
Deposits	16,914	10,829	31,33
Borrowings	6,367	4,763	12,42
Total interest expense	23,281	15,592	43,75
Net Interest Income	27,766	27,921	55,35
Provision for loan losses	1,729	1,948	3,45
Net Interest Income After Provision for Loan Losses	26,037	25,973	51,90
Other Income:			
Net realized gains on sales of available-for-sale securities.	(9)	6	
Other income	8,420	8,756	17,00

Total other income	8,411	8,762	17,00
Other expenses:			
Salaries and benefits	13,543	13,258	27,93
Other expenses	10,351	9,941	19,74
Total other expenses	23,894	23,199	47,68
Income before income tax	10,554	11,536	21,22
Income tax expense	3,263	3,615	6,42
Net Income	$ 7,291	$ 7,921	$14,80
Per share:			
Basic	$ .39	$ .43	$ .80
Diluted	.39	.43	.80
Dividends	.23	.23	.46

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands)
(Unaudited)

	Three Months E June 30	
	2006	
Net Income	$ 7,291	$
Other comprehensive income (loss), net of tax:		
Unrealized gains (losses) on securities available for sale:		
Unrealized holding gains (losses) arising during the period, net of income tax benefit of $1,631, ($916), $2,035, and $1,606	(2,446)	
Less: Reclassification adjustment for gains (losses) included in net income, net of income tax expense of ($4), $2, $0 and $2	(5)	
	(2,441)	
Comprehensive income	$ 4,850	$

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY
(Dollars in thousands)
(Unaudited)

	2006	2005
Balances, January 1	$ 313,396	$ 314,603
Net income	14,800	14,488
Cash dividends on common stock	(8,449)	(8,495)
Cash dividends on restricted stock awards	(26)	
Other comprehensive income (loss), net of tax	(3,052)	(2,413)
Stock issued under dividend reinvestment and stock purchase plan	592	335
Stock options exercised	755	1,631
Tax benefit from stock options exercised	78	
Stock redeemed	(5,442)	(6,791)
Share-based compensation	352	
Balances, June 30	$ 313,004	$ 313,358

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Dollars in thousands)
(Unaudited)

	Si
	2006
Cash Flows From Operating Activities:	
Net income	$ 14,
Adjustments to reconcile net income to net cash provided by operating activities	

Provision for loan losses		3,
Depreciation and amortization		5,
Share-based compensation		
Tax benefits from stock options exercised		
Mortgage loans originated for sale		(57,
Proceeds from sales of mortgage loans		57,
Change in interest receivable		
Change in interest payable		1,
Other adjustments		(1,
Net cash provided by operating activities	$	23,
Cash Flows From Investing Activities:		
Net change in interest-bearing deposits	$	
Purchases of		
Securities available for sale		(66,
Proceeds from maturities of		
Securities available for sale		27,
Securities held to maturity		1,
Proceeds from sales of securities available for sale		
Purchase of Federal Reserve and		
Federal Home Loan Bank Stock		(
Net change in loans		(136,
Other adjustments		(7,
Net cash used by investing activities	$	(181,
Cash Flows From Financing Activities:		
Net change in		
Demand and savings deposits	$	11,
Certificates of deposit and other time deposits		140,
Borrowings		119,
Repayment of borrowings		(100,
Cash dividends on common stock		(8,
Cash dividends on restricted stock awards		
Stock issued under dividend reinvestment and stock purchase plans		
Stock options exercised		
Tax benefit from stock options exercised		
Stock redeemed		(5,
Net cash provided/(used) by financing activities		159,
Net Change in Cash and Cash Equivalents		
Cash and Cash Equivalents, January 1		70,
Cash and Cash Equivalents, June 30	$	71,
Additional cash flows information:		
Interest paid	$	42
Income tax paid		7

See notes to consolidated condensed financial statements.

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 1. General

Financial Statement Preparation

The significant accounting policies followed by First Merchants Corporation ("Corporation") and its wholly owned subsidiaries for interim financial reporting are consistent with the accounting policies followed for annual financial reporting, except as discussed below within the caption "Change in Accounting Principle". All adjustments, which are of a normal recurring nature and are in the opinion of management necessary for a fair statement of the results for the periods reported, have been included in the accompanying consolidated condensed financial statements.

The consolidated condensed balance sheet of the Corporation as of December 31, 2005 has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation's annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation's Form 10-K annual report filed with the Securities and Exchange Commission. The results of operations for the three and six month periods ended June 30, 2006 are not necessarily indicative of the results to be expected for the year.

Change in Accounting Principle

Effective January 1, 2006, the Corporation adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment ("SFAS 123(R)"). SFAS 123(R) addresses all forms of share-based payment awards, including shares under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. SFAS 123(R) requires all share-based payments to be recognized as expense, based upon their fair values, in the financial statements over the vesting period of the awards. The Corporation has elected the modified prospective application and, as a result, has recorded approximately $352,000 in compensation expense related to vested stock options, Employee Stock Purchase Plan options and restricted stock awards, less estimated forfeitures, for the six month period ended June 30, 2006.

NOTE 2. Share-Based Compensation

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1994 Stock Option Plan and The 1999 Long-term Equity Incentive Plan. The stock options, which have a ten year life, become 100 percent vested ranging from three months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after three years. The RSAs vest only if the employee is actively employed by the Corporation on the vesting date and, therefore, any unvested shares are forfeited.

The Corporation's 2004 Employee Stock Purchase Plan ("ESPP") provides eligible employees of the Corporation and its subsidiaries an opportunity to purchase shares of common stock of the Corporation through annual offerings financed by payroll deductions. The price of the stock to be paid by the employees may not be less than 85 percent of the lesser of the fair market value of the Corporation's common stock at the beginning or at the end of the offering period. Common stock purchases are made annually and are paid through advance payroll deductions of up to 20 percent of eligible compensation.

(Table dollars in thousands)

SFAS 123(R) requires the Corporation to begin recording compensation expense in 2006 related to unvested share-based awards outstanding as of December 31, 2005, by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards granted after December 31, 2005 are valued at fair value in accordance with provisions of SFAS 123(R) and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. At June 30, 2006, share-based compensation for the three and six months ended June 30, 2006 totaled $158,000 and $352,000, respectively, and has been recognized as a component of salaries and benefits expense in the accompanying Consolidated Condensed Statements of Income.

NOTE 2. Share-Based Compensation continued

Prior to 2006, the Corporation accounted for share-based compensation in accordance with APB 25 using the intrinsic value method, which did not require that compensation expense be recognized for the Corporation's stock and ESPP options; however, under APB 25, the Corporation was required to record compensation expense over the vesting period for the value of RSAs granted, if any.

The Corporation provided pro forma disclosure amounts in accordance with SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" (SFAS No. 148), as if the fair value method defined by SFAS No. 123 had been applied to its share-based compensation. The Corporation's net income and net income per share for the six months ended June 30, 2005 would have been reduced if compensation expense related to stock and ESPP options had been recorded in the financial statements, based on fair value at the grant dates.

The estimated fair value of the stock options granted during 2006 and in prior years was calculated using a Black Scholes option pricing model. The following summarizes the assumptions used in the 2006 Black Scholes model:

Risk-free interest rate	4.59%
Expected price volatility	29.84%
Dividend yield	3.54%
Forfeiture rate	4.00%
Weighted-average expected life, until exercise	5.75 years

The Black Scholes model incorporates assumptions to value share-based awards. The risk-free rate of interest, for periods equal to the expected life of the option, is based on a zero-coupon U.S. government instrument over a similar contractual term of the equity instrument. Expected price volatility is based on historical volatility of the Corporation's common stock. In addition, the Corporation generally uses historical information to determine the dividend yield and weighted-average expected life of the options, until exercise.

Separate groups of employees that have similar historical exercise behavior with regard to option exercise timing and forfeiture rates are considered separately for valuation and attribution purposes.

Share-based compensation expense recognized in the Consolidated Condensed Statements of Income is based on awards ultimately expected to vest and is reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately 4 percent for the six months ended June 30, 2006, based on historical experience. In the Corporation's pro forma disclosures required under SFAS 123(R) for the periods prior to fiscal 2006, the Corporation accounted for forfeitures as they occurred.

As a result of adopting SFAS 123(R), net income of the Corporation for the six months ended June 30, 2006 was $274,000 lower (net of $78,000 in tax benefits), than if it had continued to account for share-based compensation under APB 25. The impact on both basic and diluted earnings per share for the six months ended June 30, 2006 was $.01 per share.

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(Table dollars in thousands)
(Unaudited)

NOTE 2. Share-Based Compensation continued

Pro forma net income, as if the fair value based method had been applied to all awards, is as follows:

(In thousands, except for per share amounts)

	Three Month June 2006	
Net income as reported	$ 7,291	$
Add: Share-based compensation awards recorded as expense, net of income taxes	113	
Less: Share-based compensation cost, determined under the fair value based method, net of income taxes	(113)	
Pro forma net income	$ 7,291	$
Earnings per share:		
Basic - as reported	$ .39	$
Basic - pro forma	.39	
Diluted - as reported	.39	
Diluted - pro forma	.39	

The following table summarizes the components of the Corporation's share-based compensation awards recorded as expense:

(Table dollars in thousands)

	Three Months Ended June 30, 2006
Stock and ESPP Options:	
Pre-tax compensation expense	$ 116
Income tax benefit	(8)
Stock and ESPP option expense, net of income taxes	$ 108
Restricted Stock Awards:	
Pre-tax compensation expense	$ 42
Income tax benefit	(37)
Restricted stock awards expense, net of income taxes	$ 5
Total Share-Based Compensation:	
Pre-tax compensation expense	$ 158
Income tax benefit	(45)
Total share-based compensation expense, net of income taxes	$ 113

NOTE 2. Share-Based Compensation continued

As of June 30, 2006, unrecognized compensation expense related to stock options and RSAs totaling $332,000 and $1,113,000, respectively, is expected to be recognized over weighted-average periods of 1.58 and 2.58 years, respectively.

Stock option activity under the Corporation's stock option plans as of June 30, 2006 and changes during the six months ended June 30, 2006 were as follows:

	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in Years)
Outstanding at January 1, 2006	1,104,787	$ 23.28	
Granted	63,000	25.14	

Exercised	(40,227)	17.79	
Cancelled	(9,923)	25.90	
Outstanding at June 30, 2006	1,117,637	$ 23.56	6.14
Vested and Expected to Vest at June 30, 2006	1,113,076	$ 23.56	.10
Exercisable at June 30, 2006	1,043,135	$ 23.44	5.90

The weighted-average grant date fair value was $6.15 for stock options granted during the six months ended June 30, 2006.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Corporation's closing stock price on the last trading day of the first six months of 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their stock options on June 30, 2006. The amount of aggregate intrinsic value will change based on the fair market value of the Corporation's common stock.

The aggregate intrinsic value of stock options exercised during the first six months of 2006 was $310,000. Exercise of options during this same period resulted in cash receipts of $620,000. The Corporation recognized a tax benefit of approximately $78,000 in the first six months of 2006, related to the exercise of employee stock options and has been recorded as an increase to additional paid-in capital.

The following table summarizes information on unvested restricted stock awards outstanding as of June 30, 2006:

	Number of Shares	Weighted-Average Grant-Date Fair Value
Unvested RSAs at January 1, 2006	0	0
Granted	58,167	$ 25.10
Forfeited	(1,500)	25.14
Vested		
Unvested RSAs at June 30, 2006	56,667	$ 25.10

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(Table dollars in thousands)
(Unaudited)

NOTE 2. Share-Based Compensation continued

The grant date fair value of ESPP options was estimated at the beginning of the July 1, 2005 offering period and approximates $212,000. The ESPP options vested during the twelve month period ending June 30, 2006. At June 30, 2006, the entire amount had been recognized. On July 1, 2006, the Corporation granted additional options under the ESPP. The grant date fair value was estimated at $198,000 and will be recognized over the twelve month period ending June 30, 2007.

NOTE 3. Investment Securities

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at June 30, 2006				
U.S. Treasury	$ 1,487		$ (2)	$ 1,485
U.S. Government-sponsored agency securities..................	93,593		(2,747)	90,846
State and municipal	161,386	$ 1,355	(1,780)	160,961
Mortgage-backed securities	197,522	48	(7,985)	189,585
Marketable equity securities..........	13,968		(346)	13,622
Total available for sale	467,956	1,403	(12,860)	456,499
Held to maturity at June 30, 2006				
State and municipal..................	10,363	224	(396)	10,191
Mortgage-backed securities............	20			20
Total held to maturity	10,383	224	(396)	10,211
Total investment securities	$478,339	$ 1,627	$(13,256)	$466,710

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2005				
U.S. Treasury	$ 1,586		$ (1)	$ 1,585
U.S. Government-sponsored agency securities	83,026	$ 1	(1,836)	81,191
State and municipal	167,095	2,159	(1,131)	168,123
Mortgage-backed securities	168,019	139	(5,656)	162,502
Other asset-backed securities.........	1			1
Marketable equity securities	9,660		(435)	9,225
Total available for sale	429,387	2,299	(9,059)	422,627
Held to maturity at December 31, 2005				
State and municipal	11,609	283	(412)	11,480
Mortgage-backed securities	30			30
Total held to maturity	11,639	283	(412)	11,510
Total investment securities	$441,026	$ 2,582	$ (9,471)	$434,137

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 4. Loans and Allowance

	June 30, 2006
Loans:	
Commercial and industrial loans	$ 501,238
Agricultural production financing and other loans to farmers	95,352
Real estate loans:	
Construction	178,254
Commercial and farmland	813,171
Residential	744,552
Individuals' loans for household and other personal expenditures	208,768
Tax-exempt loans	13,656
Lease financing receivables, net of unearned income	8,589
Other loans	27,860
	2,591,440
Allowance for loan losses	(25,884)
Total Loans	$ 2,565,556

	Six Months June 2006
Allowance for loan losses:	
Balances, January 1	$ 25,188
Provision for losses	3,455
Recoveries on loans	620
Loans charged off	(3,379)
Balances, June 30	$ 25,884

Information on nonaccruing, contractually past due 90 days or more other than nonaccruing and restructured loans is summarized below:	June 30, 2006	December 31, 2005

Non-accrual loans	$ 12,611	$ 10,030
Loans contractually past due 90 days or more other than nonaccruing	8,818	3,965
Restructured loans	111	310
Total	$ 21,540	$ 14,305

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 5. Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted-average shares outstanding during the reporting period. Diluted net income per share is computed by dividing net income by the combination of all dilutive common share equivalents, comprised of shares issuable under the Corporation's share-based compensation plans, and the weighted-average shares outstanding during the reporting period.

Dilutive common share equivalents include the dilutive effect of in-the-money share-based awards, which are calculated based on the average share price for each period using the treasury stock method. Under the treasury stock method, the exercise price of share-based awards, the amount of compensation expense, if any, for future service that the Corporation has not yet recognized, and the amount of estimated tax benefits that would be recorded in additional paid-in-captial when share-based awards are exercised, are assumed to be used to repurchase common stock in the current period.

	Three Months Ended June 30,			
	2006			
	Income	Weighted-Average Shares	Per Share Amount	Income
Basic net income per share:				
Net income available to common stockholders	$ 7,291	18,385,298	$ .39	$ 7,92
Effect of dilutive stock options		77,980		
Diluted net income per share:				
Net income available to common stockholders and assumed conversions	$ 7,291	18,463,278	$ .39	$ 7,92

Options to purchase 659,659 and 329,286 shares for the three months ended June 30, 2006 and 2005 were not included in the earnings per share calculation because the exercise price exceeded the average market price.

(Table dollars in thousands)

	Six Months Ended June 30, 2006			
	Income	Weighted-Average Shares	Per Share Amount	Income
Basic net income per share:				
Net income available to common stockholders................	$ 14,800	18,405,063	$ .80	$ 14,48
Effect of dilutive stock options........		89,818		
Diluted net income per share:				
Net income available to common stockholders and assumed conversions............	$ 14,800	18,494,881	$ .80	$ 14,48

Options to purchase 572,616 and 319,256 shares for the six months ended June 30, 2006 and 2005 were not included in the earnings per share calculation because the exercise price exceeded the average market price.

Note 6. Defined Benefit Pension Costs

The Corporation has defined benefit pension plans covering substantially all employees. The plans provide benefits that are based on the employees' compensation and years of service. The Corporation uses an actuarial calculation to determine pension plan costs.

In January 2005, the Board of Directors of the Corporation approved the curtailment of the accumulation of defined benefits for future services provided by certain participants in the First Merchants Corporation Retirement Pension Plan (the "Plan"). Employees of the Corporation and certain of its subsidiaries who are participants in the Plan were notified that, on and after March 1, 2005, no additional pension benefits will be earned by employees who have not both attained the age of fifty-five (55) and accrued at least ten (10) years of "Vesting Service". As a result of this action, the Corporation recorded a $1,630,000 pension curtailment loss to record previously unrecognized prior service costs in accordance with SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Plans and for Termination Benefits." This loss was recognized and recorded by the Corporation in the first quarter of 2005.

The following represents the pension cost for the three and six months ended

(Table dollars in thousands)

June 30, 2006.

	Three Months Ended June 30, 2006	2005	Si... 20...
Pension Cost			
Service cost...	$ 131	$ 145	$
Interest cost	683	658	1,
Expected return on plan assets	(728)	(768)	(1,
Amortization of the transition asset...................		(7)	
Amortization of prior service cost.....................	1	1	
Amortization of the net loss...........................	87	24	
Curtailment loss.......................................			
Total Pension Cost..............................	$ 174	$ 53	$

Note 7. Impact of Accounting Changes

In March 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 156 ("SFAS No. 156"). This Statement amends SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing liabilities.

SFAS No. 156 requires an entity to initially recognize a servicing asset or servicing liability at fair value each time it undertakes an obligation to service a financial asset by entering into a servicing contract in other specific situations.

In addition, SFAS No. 156 permits an entity to choose either of the following subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities:

o Amortization method- Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income or net servicing loss and assess servicing assets or servicing liabilities for impairment or increased obligation, based on fair value at each reporting date.

o Fair value measurement method- Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur.

SFAS No. 156 is effective for the Corporation at the beginning of its first fiscal year that begins after September 15, 2006, and should be applied prospectively for recognition and initial measurement of servicing assets and servicing liabilities. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year.

The Corporation did not early adopt SFAS No. 156 on January 1, 2006. The Corporation is currently evaluating the effect of adoption of this Statement on its financial condition and results of operations.

Note 8. Subsequent Event

On August 1, 2006, the Corporation purchased three prime-based interest rate floor agreements with an aggregate notional amount of $250 million and strike rates ranging from 6% to 7%. The combined purchase price of approximately $550,000 will be amortized on an allocated fair value basis over the three-year term of the agreements. The Corporation's objective in using interest rate floors is to add stability to interest income by reducing its exposure to decreases in cash flows on its prime-based loans. An interest rate floor agreement involves the receipt of cash payments when the underlying interest rate falls below the floor strike rate over the life of the agreement without exchange of the underlying principal (notional) amount. The interest rate floors are designated as cash flow hedges and will be accounted for in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended.

FIRST MERCHANTS CORPORATION

FORM 10-Q

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

FORWARD-LOOKING STATEMENTS

We from time to time include forward-looking statements in our oral and written communication. We may include forward-looking statements in filings with the Securities and Exchange Commission, such as this Form 10-Q, in other written materials and in oral statements made by senior management to analysts, investors, representatives of the media and others. We intend these forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of these safe harbor provisions. Forward-looking statements can often be identified by the use of words like "believe", "continue", "pattern", "estimate", "project", "intend", "anticipate", "expect" and similar expressions or future or conditional verbs such as "will", "would", "should", "could", "might", "can", "may", or similar expressions. These forward-looking statements include:

* statements of our goals, intentions and expectations;

* statements regarding our business plan and growth strategies;

* statements regarding the asset quality of our loan and investment portfolios; and

* estimates of our risks and future costs and benefits.

These forward-looking statements are subject to significant risks, assumptions and uncertainties, including, among other things, the following important factors which could affect the actual outcome of future events:

* fluctuations in market rates of interest and loan and deposit pricing, which could negatively affect our net interest margin, asset valuations and expense expectations;

* adverse changes in the economy, which might affect our business prospects and could cause credit-related losses and expenses;

* adverse developments in our loan and investment portfolios;

* competitive factors in the banking industry, such as the trend towards consolidation in our market;

* changes in the banking legislation or the regulatory requirements of federal and state agencies applicable to bank holding companies and banks like our affiliate banks;

* acquisitions of other businesses by us and integration of such acquired businesses;

* changes in market, economic, operational, liquidity, credit and interest rate risks associated with our business; and

* the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends.

Because of these and other uncertainties, our actual future results may be materially different from the results indicated by these forward- looking statements. In addition, our past results of operations do not necessarily indicate our anticipated future results.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations continued

CRITICAL ACCOUNTING POLICIES

Generally accepted accounting principles are complex and require us to apply significant judgments to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply these principles where actual measurement is not possible or practical. For a complete discussion of our significant accounting policies, see "Notes to the Consolidated Financial Statements" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2005. Certain policies are considered critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

We believe there have been no significant changes during the quarter ended June 30, 2006 to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2005.

BUSINESS SUMMARY

We are a financial holding company headquartered in Muncie, Indiana. Since our organization in 1982, we have grown to include 8 affiliate banks with 64 locations in 17 Indiana and 3 Ohio counties. In addition to our branch network, our delivery channels include ATMs, check cards, interactive voice response systems and internet technology.

Our business activities are currently limited to one significant business segment, which is community banking. Our financial service affiliates include eight nationally chartered banks: First Merchants Bank, N.A., The Madison Community Bank, N.A., United Communities National Bank, First National Bank, Decatur Bank and Trust Company, N.A., Frances Slocum Bank & Trust Company, N.A., Lafayette Bank and Trust Company, N.A. and Commerce National Bank. The banks provide commercial and retail banking services. In addition, our trust company, multi-line insurance company and title company provide trust asset management services, retail and commercial insurance agency services and title services, respectively.

We believe that our mission, guiding principles and strategic initiatives produce profitable growth for stockholders. Our vision is to satisfy all the financial needs of our customers, help them succeed financially and be recognized as the premier financial services company in our markets. Our primary strategy to achieve this vision is to increase product usage and focus on providing each customer with all of the financial products that fulfill their needs. Our cross-sell strategy and diversified business model facilitate growth in strong and weak economic cycles.

We believe it is important to maintain a well controlled environment as we continue to grow our businesses. Sound credit policies are maintained and interest rate and market risks inherent in our asset and liability balances are managed within prudent ranges, while ensuring adequate liquidity and funding. Our stockholder value has continued to increase due to customer satisfaction and the balanced way we manage our business risk.

RESULTS OF OPERATIONS

Net income for the three months ended June 30, 2006, equaled $7,291,000, compared to $7,921,000 in the same period of 2005. Diluted earnings per share were $.39, a decrease of 9.3 percent from the $.43 reported for the second quarter 2005. The decrease in earnings per share is primarily a result of the decrease in the net interest margin of 19 basis points from the same period of 2005.

Net income for the six months ended June 30, 2006, equaled $14,800,000, compared to $14,488,000 during the same period in 2005. Diluted earnings per share were $.80 a 2.6 percent increase from the $.78 reported in 2005.

Annualized returns on average assets and average stockholders' equity for the three months ended June 30, 2006, were .88 percent and 9.20 percent, respectively, compared with .99 percent and 10.13 percent for the same period of

2005.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations continued

RESULTS OF OPERATIONS (continued)

Annualized returns on average assets and average stockholders' equity for the six months ended June 30, 2006 were .90 percent and 9.35 percent, respectively, compared with .91 percent and 9.23 percent for the same period of 2005. For further analysis, see the respective sections of Management's Discussion and Analysis of Financial Condition and Results of Operations.

CAPITAL

Our regulatory capital continues to exceed regulatory "well capitalized" standards. Tier I regulatory capital consists primarily of total stockholders' equity and subordinated debentures issued to business trusts categorized as qualifying borrowings, less non-qualifying intangible assets and unrealized net securities gains. Our Tier I capital to average assets ratio was 7.5 percent at June 30, 2006 and 7.7 percent at year end 2005. In addition, at June 30, 2006, we had a Tier I risk-based capital ratio of 9.3 percent and total risk-based capital ratio of 11.3 percent. Regulatory capital guidelines require a Tier I risk-based capital ratio of 4.0 percent and a total risk-based capital ratio of 8.0 percent.

Our GAAP capital ratio, defined as total stockholders' equity to total assets, equaled 9.2 percent at June 30, 2006 and 9.7 percent at December 31, 2005. When we acquire other companies for stock, GAAP capital increases by the entire amount of the purchase price.

Our tangible capital ratio, defined as total stockholders' equity less intangibles net of tax to total assets less intangibles net of tax, equaled 5.6 percent as of June 30, 2006, and 5.8 percent at December 31, 2005.

We believe that all of the above capital ratios are meaningful measurements for evaluating our safety and soundness. Additionally, we believe the following table is also meaningful when considering our performance measures. The table details and reconciles tangible earnings per share, return on tangible capital and tangible assets to traditional GAAP measures.

(Dollars in thousands)	June 30, 2006	December 31, 2005
Average Goodwill	$ 121,378	$ 120,867
Average Core Deposit Intangible (CDI)	16,790	19,087
Average Deferred Tax on CDI	(5,667)	(7,141)
Intangible Adjustment	$ 132,501	$ 132,813
Average Stockholders' Equity (GAAP Capital)	$ 316,750	$ 315,907
Intangible Adjustment	(132,501)	(132,813)
Average Tangible Capital	$ 184,249	$ 183,094

Average Assets	$ 3,279,130	$ 3,195,784
Intangible Adjustment	(132,501)	(132,813)
Average Tangible Assets	$ 3,146,629	$ 3,062,971
Net Income	$ 14,800	$ 30,239
CDI Amortization, net of tax	960	1,952
Tangible Net Income	$ 15,760	$ 32,191
Diluted Earnings per Share	$ 0.80	$ 1.63
Diluted Tangible Earnings per Share	$ 0.85	$ 1.73
Return on Average GAAP Capital	9.42%	9.58%
Return on Average Tangible Capital	17.25%	17.58%
Return on Average Assets	0.91%	0.95%
Return on Average Tangible Assets	1.01%	1.05%

ASSET QUALITY/PROVISION FOR LOAN LOSSES

Our primary business focus is middle market commercial and residential real estate, auto and small consumer lending, which results in portfolio diversification. We ensure that appropriate methods to understand and underwrite risk are utilized. Commercial loans are individually underwritten and judgmentally risk rated. They are periodically monitored and prompt corrective actions are taken on deteriorating loans. Retail loans are typically underwritten with statistical decision-making tools and are managed throughout their life cycle on a portfolio basis.

The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The amount provided for loan losses and the determination of the adequacy of the allowance are based on a continuous review of the loan portfolio, including an internally administered loan "watch" list and an ongoing loan review. The evaluation takes into consideration identified credit problems, as well as the possibility of losses inherent in the loan portfolio that are not specifically identified.

At June 30, 2006, non-performing loans totaled $21,540,000, an increase of $7,235,000 from December 31, 2005, as noted in Note 4. Our top ten largest non-performers total $8.8 million, up from 7.3 million at March 31, 2006. Of those top ten, only three have balances in excess of $1 million. Loans and Allowance, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

At June 30, 2006, impaired loans totaled $54,453,000, an increase of $2,073,000 from December 31, 2005. At June 30, 2006, an allowance for losses was not deemed necessary for impaired loans totaling $38,788,000, but an allowance of $3,608,000 was recorded for the remaining balance of impaired loans of $15,665,000 and is included in our allowance for loan losses.

At December 31, 2005, impaired loans totaled $52,380,000, an increase of $2,969,000 from year end 2004. At December 31, 2005, a specific allowance for losses was not deemed necessary for impaired loans totaling $44,840,000, but a specific allowance of $2,824,000 was recorded for the remaining balance of impaired loans of $7,540,000 and is included in our allowance for loan losses. The average balance of impaired loans for 2005 was $44,790,000. The increase of total impaired loans is primarily due to the increase of performing, substandard classified loans, which comprise a portion of the total impaired loans. A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected. For the Corporation, all performing, substandard classified loans are included in the impaired loan total.

At June 30, 2006, the allowance for loan losses was $25,884,000, an increase of $696,000 from year end 2005. As a percent of loans, the allowance was 1.00 percent at June 30, 2006 and 1.02 percent at December 31, 2005.

The provision for loan losses for the first six months of 2006 was $3,455,000, a decrease of $1,160,000 from $4,615,000 for the same period in 2005.

LIQUIDITY

Liquidity management is the process by which we ensure that adequate liquid funds are available for us and our subsidiaries. These funds are necessary in order for us and our subsidiaries to meet financial commitments on a timely basis. These commitments include withdrawals by depositors, funding credit obligations to borrowers, paying dividends to shareholders, paying operating expenses, funding capital expenditures, and maintaining deposit reserve requirements. Liquidity is monitored and closely managed by the asset/liability committees at each subsidiary and by our asset/liability committee.

Our liquidity is dependent upon our receipt of dividends from our bank subsidiaries, which are subject to certain regulatory limitations and access to other funding sources. Liquidity of our bank subsidiaries is derived primarily from core deposit growth, principal payments received on loans, the sale and maturity of investment securities, net cash provided by operating activities, and access to other funding sources.

The most stable source of liability-funded liquidity for both the long- term and short-term is deposit growth and retention in the core deposit base. In addition, we utilize advances from the Federal Home Loan Bank. ("FHLB") and a revolving line of credit with LaSalle Bank, N.A. as funding sources. At June 30, 2006, total borrowings from the FHLB were $225,329,000. Our bank subsidiaries have pledged certain mortgage loans and certain investments to the FHLB. The total available remaining borrowing capacity from the FHLB at June 30, 2006, was $45,505,000. At June 30, 2006, our revolving line of credit had a balance of $11,250,000 and a remaining borrowing capacity of $8,750,000.

The principal source of asset-funded liquidity is investment securities classified as available-for-sale, the market values of which totaled $456,499,000 at June 30, 2006, an increase of $33,872,000 or 8.0 percent over December 31, 2005. Securities classified as held-to-maturity that are maturing within a short period of time can also be a source of liquidity. Securities classified as held-to-maturity and that are maturing in one year or less totaled $599,000 at June 30, 2006. In addition, other types of assets such as cash and due from banks, federal funds sold and securities purchased under agreements to resell, and loans and interest-bearing deposits with other banks maturing within one year are sources of liquidity.

In the normal course of business, we are a party to a number of other off-balance sheet activities that contain credit, market and operational risk that are not reflected in whole or in part in our consolidated financial statements. Such activities include: traditional off-balance sheet credit-related financial instruments, commitments under operating leases and long-term debt.

We provide customers with off-balance sheet credit support through loan commitments and standby letters of credit. Summarized credit-related financial instruments at June 30, 2006 are as follows:

(Dollars in thousands)	At June 30, 2006
Amounts of commitments:	
Loan commitments to extend credit	$ 668,651
Standby letters of credit	24,351
	$ 693,002

Since many of the commitments are expected to expire unused or be only partially used, the total amount of unused commitments in the preceding table does not necessarily represent future cash requirements.

In addition to owned banking facilities, we have entered into a number of long-term leasing arrangements to support our ongoing activities. The required payments under such commitments and long-term debt at June 30, 2006 are as follows:

(Dollars in thousands)	2006 remaining	2007	2008	2009	2010	2011 and after	
Operating leases	$ 1,042	$ 1,787	$ 1,305	$ 1,142	$ 1,087	$ 1,680	$
Long-term debt	214,647	54,745	32,706	20,372	35,161	169,716	5
Total	$215,689	$ 56,532	$ 34,011	$ 21,514	$ 36,248	$171,396	$5

INTEREST SENSITIVITY AND DISCLOSURES ABOUT MARKET RISK

Asset/Liability Management has been an important factor in our ability to record consistent earnings growth through periods of interest rate volatility and product deregulation. Management and the Board of Directors monitor our liquidity and interest sensitivity positions at regular meetings to review how changes in interest rates may affect earnings. Decisions regarding investments and the pricing of loan and deposit products are made after analysis of reports designed to measure liquidity, rate sensitivity, our exposure to changes in net interest income given various rate scenarios and the economic and competitive environments.

It is our objective to monitor and manage risk exposure to net interest income caused by changes in interest rates. It is the goal of our Asset Liability function to provide optimum and stable net interest income. To accomplish this, we use two asset liability tools. GAP/Interest Rate Sensitivity Reports and Net Interest Income Simulation Modeling are both constructed, presented, and monitored quarterly.

We believe that our liquidity and interest sensitivity position at June 30, 2006, remained adequate to meet our primary goal of achieving optimum interest margins while avoiding undue interest rate risk.

We place our greatest credence in net interest income simulation modeling. The GAP/Interest Rate Sensitivity Report is believed by our management to have two major shortfalls. The GAP/Interest Rate Sensitivity Report fails to precisely gauge how often an interest rate sensitive product reprices, nor is it able to measure the magnitude of potential future rate movements.

Net interest income simulation modeling, or earnings-at-risk, measures the sensitivity of net interest income to various interest rate movements. Our asset liability process monitors simulated net interest income under three separate interest rate scenarios; base, rising and falling. Estimated net interest income for each scenario is calculated over a 12-month horizon. The immediate and parallel changes to the base case scenario used in the model are presented below. The interest rate scenarios are used for analytical purposes and do not necessarily represent our view of future market movements. Rather, these are intended to provide a measure of the degree of volatility interest rate movements may introduce into our earnings.

The base scenario is highly dependent on numerous assumptions embedded in the model, including assumptions related to future interest rates. While the base sensitivity analysis incorporates our best estimate of interest rate and balance sheet dynamics under various market rate movements, the actual behavior and resulting earnings impact will likely differ from that projected. For mortgage-related assets, the base simulation model captures the expected prepayment behavior under changing interest rate environments. Assumptions and methodologies regarding the interest rate or balance behavior of indeterminate maturity products, e.g., savings, money market, NOW and demand deposits, reflect our best estimate of expected future behavior.

The comparative rising and falling scenarios for the period ended May 31, 2007 assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In addition, total rate movements (beginning point minus ending point) to each of the various driver rates utilized by us in the base simulation for the period ended May 31, 2007 are as follows:

Driver Rates	RISING	FALLING
Prime	200 Basis Points	(200) Basis Points
Federal Funds	200	(200)
One-Year CMT	200	(200)
Three-Year CMT	200	(200)
Five-Year CMT	200	(200)
CD's	200	(183)

FHLB Advances	200	(200)

Results for the base, rising and falling interest rate scenarios are listed below, based upon our rate sensitive assets and liabilities at May 31, 2006. The net interest income shown represents cumulative net interest income over a 12-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

	BASE	RISING	FALLING
	(Dollars in thousands)		
Net Interest Income	$107,785	$109,264	$106,220
Variance from base		$ 1,480	$ (1,565)
Percent of change from base		1.40%	(1.50)%

The comparative rising and falling scenarios for the period ended December 31, 2006 assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In addition, total rate movements (beginning point minus ending point) to each of the various driver rates utilized by us in the base simulation for the period ended December 31, 2006 are as follows:

Driver Rates	RISING	FALLING
Prime	200 Basis Points	(200) Basis Points
Federal Funds	200	(200)
One-Year CMT	200	(200)
Two-Year CMT	200	(200)
Three-Year CMT	200	(200)
Five-Year CMT	200	(200)
CD's	200	(89)
FHLB Advances	200	(200)

Results for the base, rising and falling interest rate scenarios are listed below, based upon our rate sensitive assets and liabilities at November 30, 2005. The net interest income shown represents cumulative net interest income over a 12-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

	BASE	RISING	FALLING
	(Dollars in thousands)		
Net Interest Income	$111,989	$114,930	$109,220
Variance from base		$ 2,941	$ (2,769)
Percent of change from base		2.63%	(2.47)%

EARNING ASSETS

The following table presents the earning asset mix as of June 30, 2006, and December 31, 2005.

Loans increased approximately $134,441,000 from December 31, 2005 to June 30, 2006, and investment securities increased by approximately $32,616,000 during the same period. Real estate construction, real estate commercial and farmland, commercial and industrial loans, tax exempt loans, loans to individuals and other loans increased approximately $140,581,000 during the first six months of 2006 as compared to the balances outstanding at December 31, 2005. These increases were offset by a decline in residential real estate loans.

EARNING ASSETS (Dollars in thousands)	June 30, 2006	December 2005
Interest-bearing time deposits	$ 8,529	$ 8,74
Investment securities available for sale	456,499	422,62
Investment securities held to maturity	10,383	11,63
Mortgage loans held for sale	5,338	4,91
Loans	2,591,440	2,457,42
Federal Reserve and Federal Home Loan Bank stock	23,889	23,20
Total	$3,096,078	$2,928,55

DEPOSITS AND BORROWINGS

The table below reflects the level of deposits and borrowed funds (federal funds purchased; repurchase agreements; Federal Home Loan Bank advances; and subordinated debentures, revolving credit lines and term loans) based on period ending amounts as of June 30, 2006 and December 31, 2005.

(Dollars in thousands)	June 30, 2006	December 31, 2005
Deposits	$2,535,400	$2,382,576
Federal funds purchased........................	94,200	50,000
Securities sold under repurchase agreements......	77,612	106,415
Federal Home Loan Bank advances	255,329	247,865
Subordinated debentures, revolving credit lines and term loans..............................	100,206	103,956
	$3,062,747	$2,890,812

We have continued to leverage our capital position with Federal Home Loan Bank advances, as well as repurchase agreements which are pledged against acquired investment securities as collateral for the borrowings. The interest rate risk is included as part of our interest simulation discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations under the headings "LIQUIDITY" and "INTEREST SENSITIVITY AND DISCLOSURES ABOUT MARKET RISK".

NET INTEREST INCOME

Net Interest Income is the primary source of our earnings. It is a function of net interest margin and the level of average earning assets. The table below presents our asset yields, interest expense, and net interest income as a percent of average earning assets for the three and six months ended June 30, 2006 and 2005.

During the six months ended June 30, 2006, asset yields increased 75 basis points (FTE) and interest costs increased 85 basis points, resulting in a ten basis point (FTE) decrease in net interest income as compared to the same period in 2005. The increases in interest income and interest expense were primarily a result of eight 25 basis point overnight federal funds rate increases by the Federal Open Market Committee during this period.

	Three Months Ended June 30,		Six Month June
(Dollars in Thousands)	2006	2005	2006
Annualized Net Interest Income.......................	$ 111,062	$ 111,683	$ 110,709
Annualized FTE Adjustment............................	$ 3,969	$ 3,753	$ 3,940
Annualized Net Interest Income On a Fully Taxable Equivalent Basis.................	$ 115,031	$ 115,435	$ 114,649
Average Earning Assets...............................	$3,029,988	$2,897,984	$2,991,851
Interest Income (FTE) as a Percent of Average Earning Assets...........................	6.87%	6.14%	6.76%
Interest Expense as a Percent of Average Earning Assets...........................	3.07%	2.15%	2.93%
Net Interest Income (FTE) as a Percent of Average Earning Assets...........................	3.80%	3.99%	3.83%

Average earning assets include the average balance of securities classified as available for sale, computed based on the average of the historical amortized cost balances without the effects of the fair value adjustment. In addition, annualized amounts are computed utilizing a 30/360 day basis.

OTHER INCOME

Other income in the second quarter of 2006 was $351,000 or 4.0 percent lower than the same quarter of 2005. Gains on loan sales decreased by $268,000 from the same period in 2005 due to a reduction in mortgage loan originations.

Other income in the first six months of 2006 was $800,000 or 4.5 percent lower than the same period of 2005.

Two items primarily account for the change:

1. Gains on loan sales decreased by $391,000 or 26.9 percent from the same period in 2005 due to a reduction in mortgage loan originations.

2. A cash payment was received in the first quarter of 2005 of approximately $200,000, related to the Corporation's membership in a credit card network that was merged with another card network. No such payment was received during the same period in 2006.

OTHER EXPENSES

Total other expenses represent non-interest expenses of the Corporation. Total other expenses during the second quarter of 2006 increased from the second quarter of 2005 by $695,000 or 3.0 percent. A fixed asset write off $300,000 was recognized in the second quarter of 2006 as a result of closed branches.

Total other expenses in the first six months of 2006 were $252,000 or .5 percent higher than the same period of 2005.

Three areas account for most of the change:

1. A pension accounting loss, totaling approximately $1,630,000, was recorded during the first quarter of 2005. The loss resulted from the curtailment of the accumulation of defined benefits in our defined benefit pension plan.

2. Salary expenses were $1,718,000 higher than the same period in 2005, primarily due to staff additions and normal annual increases. In addition, salary expenses of $352,000 were recorded in the first six months of 2006, due to share-based compensation expense recorded.

3. A fixed asset write off $300,000 was recognized in the second quarter of 2006 as a result of closed branches.

INCOME TAXES

Income tax expense, for the six months ended June 30, 2006, increased by $288,000 from the same period in 2005. The effective tax rate was 30.3 and 29.8 percent for the 2006 and 2005 periods.

OTHER

The Securities and Exchange Commission maintains a Web site that contains reports, proxy and information statements and other information regarding registrants that file electronically with the Commission, including us, and that address is (http://www.sec.gov).

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The information required under this item is included as part of Management's Discussion and Analysis of Financial Condition and Results of Operations, under the headings "LIQUIDITY" and "INTEREST SENSITIVITY AND DISCLOSURES ABOUT MARKET RISK".

Item 4. Controls and Procedures

At the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There have been no changes in our internal controls over financial reporting identified in connection with the evaluation referenced above that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

FIRST MERCHANTS CORPORATION
FORM 10-Q
PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 1.A. Risk Factors

There have been no material changes from the risk factors previously disclosed in the Corporation's December 31, 2005 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

a. None

b. None

c. Issuer Purchases of Equity Securities

The following table presents information relating to our purchases of equity securities during the quarter ended June 30, 2006, as follows(1):

PERIOD	TOTAL NUMBER OF SHARES PURCHASED	AVERAGE PRICE PAID PER SHARE	TOTAL NUMBER OF SHARES PURCHASED AS PART OF BOARD AUTHORIZATION(1)	MAX SHAR BE BOARD
04/01/06 - 04/30/06	1,594(2)	$25.99	0	
05/01/06 - 05/31/06	50,000(1)	$24.64	50,000	
06/01/06 - 06/30/06	170,000(1)	$24.05	170,000	

(1) On February 14, 2006, the Corporation's Board authorized management to repurchase up to 250,000 shares of the Corporation's Common Stock. This authorization was not publicly announced and expires February 13, 2007. There were 30,000 remaining shares that may yet be purchased pursuant to such authorizations as of June 30, 2006.

(2) These shares were purchased in connection with the exercise of certain outstanding stock options.

Item 3. Defaults Upon Senior Securities

None

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

a. The Annual Meeting of Shareholders of the Corporation was held on April 13, 2006.

b. No response is required.

c. The following matters were voted on by shareholders:

i) Election of Directors - The following directors were elected for a term of three years.

	Vote Count		
	Vote For	Vote Against	Vote Abstained
Richard A. Boehning	14,357,854	0	1,064,113
Barry J. Hudson	15,000,475	0	421,492
Michael C. Rechin	15,101,266	0	320,701

ii) Ratification of the appointment of Independent Public Accounting Firm - BKD, LLP, Indianapolis, Indiana: Votes For - 15,253,391, Votes Against - 49,734, Votes Abstained - 118,842.

d. Not applicable.

Item 5. Other Information

a. None

b. None

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PART II. OTHER INFORMATION

Item 6. Exhibits

Exhibit No.:	Description of Exhibit:	Form 10-Q Page No.:
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002	32
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002	33
32	Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	34

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SIGNATURES

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

First Merchants Corporation
(Registrant)

Date: August 9, 2006 by /s/ Michael L. Cox

Michael L. Cox
President and
Chief Executive Officer
(Principal Executive Officer)

Date: August 9, 2006 by /s/ Mark K. Hardwick

Mark K. Hardwick

Executive Vice President and
Chief Financial Officer
(Principal Financial and
Chief Accounting Officer)

FIRST MERCHANTS CORPORATION

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INDEX TO EXHIBITS

INDEX TO EXHIBITS

(a)3. Exhibits:

EXHIBIT-31.1

FIRST MERCHANTS CORPORATION

FORM 10-Q
CERTIFICATIONS PURSUANT TO
SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002

CERTIFICATION

I, Michael L. Cox, President and Chief Executive Officer of First Merchants Corporation, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Merchants Corporation;

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

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

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

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

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

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

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

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

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

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

Date: August 9, 2006

by /s/ Michael L. Cox

Michael L. Cox

President and
Chief Executive Officer
(Principal Executive Officer)

EXHIBIT-31.2

FIRST MERCHANTS CORPORATION

FORM 10-Q
CERTIFICATIONS PURSUANT TO
SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002

CERTIFICATION

I, Mark K. Hardwick, Executive Vice President and Chief Financial Officer of First Merchants Corporation, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Merchants Corporation;

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

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

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

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

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

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

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

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

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

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

Date: August 9, 2006

/s/Mark K. Hardwick

Mark K. Hardwick
Executive Vice President and
Chief Financial Officer
(Principal Financial and
Chief Accounting Officer)

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EXHIBIT-32

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

In connection with the quarterly report of First Merchants Corporation (the "Corporation") on Form 10-Q for the period ending June 30, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael L. Cox, President and Chief Executive Officer of the Corporation, do hereby certify, in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o (d)); and

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

Date: August 9, 2006

by /s/ Michael L. Cox

Michael L. Cox
President and
Chief Executive Officer
(Principal Executive Officer)

A signed copy of this written statement required by Section 906 has been provided to First Merchants Corporation and will be retained by First Merchants Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

In connection with the quarterly report of First Merchants Corporation (the "Corporation") on Form 10-Q for the period ending June 30, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Mark K. Hardwick, Executive Vice President and Chief Financial Officer of the Corporation, do hereby certify, in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o (d)); and

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

Date: August 9, 2006

by /s/ Mark K. Hardwick

Mark K. Hardwick
Executive Vice President and
Chief Financial Officer
(Principal Financial and
Chief Accounting Officer)

A signed copy of this written statement required by Section 906 has been provided to First Merchants Corporation and will be retained by First Merchants Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

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