

MIDDLEFIELD BANC CORP

Form 10-Q

November 09, 2010

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20552
FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2010
Commission File Number 000-32561

Middlefield Banc Corp.
(Exact name of registrant as specified in its charter)

Ohio **34-1585111**
(State or other jurisdiction of incorporation (IRS Employer Identification No.)
or organization)

15985 East High Street, Middlefield, Ohio 44062-9263
(Address of principal executive offices)
(440) 632-1666

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

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 definition of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Small reporting company

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

State the number of shares outstanding of each of the issuer's classes of common equity as of the latest practicable date:

Class: Common Stock, without par value
Outstanding at November 9, 2010: 1,584,281

**MIDDLEFIELD BANC CORP.
INDEX**

| | Page Number |
|--|------------------------|
| <u>PART I FINANCIAL INFORMATION</u> | |
| <u>Item 1. Financial Statements</u> | |
| <u>Consolidated Balance Sheet (Unaudited) as of September 30, 2010 and December 31, 2009</u> | 3 |
| <u>Consolidated Statement of Income (Unaudited) for the Three and Nine Months ended September 30, 2010 and 2009</u> | 4 |
| <u>Consolidated Statement of Changes in Stockholders' Equity (Unaudited) for the Nine Months ended September 30, 2010</u> | 5 |
| <u>Consolidated Statement of Cash Flows (Unaudited) for the Nine Months ended September 30, 2010 and 2009</u> | 6 |
| <u>Notes to Unaudited Consolidated Financial Statements</u> | 7 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 16 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 26 |
| <u>Item 4. Controls and Procedures</u> | 26 |
| <u>PART II OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 27 |
| <u>Item 1A. Risk Factors</u> | 27 |
| <u>Item 2. Unregistered sales of equity securities and use of proceeds</u> | 27 |
| <u>Item 3. Default Upon Senior Securities</u> | 27 |
| <u>Item 4. Reserved</u> | 27 |
| <u>Item 5. Other Information</u> | 27 |
| <u>Item 6. Exhibits and Reports on Form 8-K</u> | 28 |
| <u>SIGNATURES</u> | 31 |

Exhibit 31.1

Exhibit 31.2

Exhibit 32

Exhibit 99

Table of Contents

MIDDLEFIELD BANC CORP.
CONSOLIDATED BALANCE SHEET
(Dollar amounts in thousands)
(Unaudited)

| | September 30, 2010 | December 31, 2009 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 13,645 | \$ 12,909 |
| Federal funds sold | 37,701 | 28,123 |
| Interest-bearing deposits in other institutions | 124 | 121 |
| Cash and cash equivalents | 51,470 | 41,153 |
| Investment securities available for sale | 195,101 | 136,711 |
| Loans | 365,219 | 353,597 |
| Less allowance for loan losses | 5,971 | 4,937 |
| Net loans | 359,248 | 348,660 |
| Premises and equipment | 8,222 | 8,394 |
| Goodwill | 4,559 | 4,559 |
| Bank-owned life insurance | 7,911 | 7,706 |
| Accrued interest and other assets | 10,578 | 11,475 |
| TOTAL ASSETS | \$ 637,089 | \$ 558,658 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing demand | \$ 55,448 | \$ 44,387 |
| Interest-bearing demand | 44,232 | 38,111 |
| Money market | 71,097 | 56,451 |
| Savings | 141,693 | 107,358 |
| Time | 251,021 | 240,799 |
| Total deposits | 563,491 | 487,106 |
| Short-term borrowings | 7,762 | 6,800 |
| Other borrowings | 22,035 | 25,865 |
| Accrued interest and other liabilities | 2,111 | 2,180 |
| TOTAL LIABILITIES | 595,399 | 521,951 |
| STOCKHOLDERS EQUITY | | |
| Common stock, no par value; 10,000,000 shares authorized, 1,773,811 and 1,754,112 shares issued | 28,315 | 27,919 |
| Retained earnings | 15,558 | 14,960 |
| Accumulated other comprehensive income | 4,551 | 562 |

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

| | | |
|--|------------|------------|
| Treasury stock, at cost; 189,530 shares in 2010 and 2009 | (6,734) | (6,734) |
| TOTAL STOCKHOLDERS EQUITY | 41,690 | 36,707 |
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 637,089 | \$ 558,658 |

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

MIDDLEFIELD BANC CORP.
CONSOLIDATED STATEMENT OF INCOME
(Dollar amounts in thousands, except per share data)
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|--------------|------------------------------------|---------------|
| | 2010 | 2009 | 2010 | 2009 |
| INTEREST INCOME | | | | |
| Interest and fees on loans | \$ 5,325 | \$ 5,176 | \$ 15,721 | \$ 15,080 |
| Interest-bearing deposits in other institutions | 3 | 2 | 10 | 12 |
| Federal funds sold | 15 | 4 | 38 | 11 |
| Investment securities: | | | | |
| Taxable interest | 1,290 | 976 | 3,832 | 2,753 |
| Tax-exempt interest | 702 | 475 | 1,941 | 1,375 |
| Dividends on stock | 33 | 15 | 82 | 46 |
| Total interest income | 7,368 | 6,648 | 21,624 | 19,277 |
| INTEREST EXPENSE | | | | |
| Deposits | 2,391 | 2,501 | 7,249 | 7,776 |
| Short term borrowings | 66 | 5 | 186 | 15 |
| Other borrowings | 147 | 222 | 520 | 717 |
| Trust preferred securities | 148 | 134 | 412 | 399 |
| Total interest expense | 2,752 | 2,862 | 8,367 | 8,907 |
| NET INTEREST INCOME | 4,616 | 3,786 | 13,257 | 10,370 |
| Provision for loan losses | 1,226 | 1,346 | 2,355 | 1,760 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 3,390 | 2,440 | 10,902 | 8,610 |
| NONINTEREST INCOME | | | | |
| Service charges on deposit accounts | 473 | 488 | 1,321 | 1,394 |
| Investment securities gains, net | 18 | | 45 | |
| Earnings on bank-owned life insurance | 72 | 68 | 204 | 197 |
| Other income | 132 | 134 | 419 | 359 |
| Total noninterest income | 695 | 690 | 1,989 | 1,950 |
| NONINTEREST EXPENSE | | | | |
| Salaries and employee benefits | 1,543 | 1,396 | 4,767 | 4,304 |

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

| | | | | |
|---|---------|---------|----------|----------|
| Occupancy expense | 224 | 215 | 717 | 691 |
| Equipment expense | 156 | 152 | 558 | 425 |
| Data processing costs | 160 | 224 | 575 | 692 |
| Ohio state franchise tax | 134 | 123 | 404 | 370 |
| Federal deposit insurance expense | 197 | 86 | 589 | 529 |
| Professional fees | 110 | 159 | 490 | 444 |
| Loss on sale of other real estate owned | 536 | 128 | 750 | 183 |
| Other expense | 682 | 556 | 2,278 | 1,700 |
| | | | | |
| Total noninterest expense | 3,742 | 3,039 | 11,128 | 9,338 |
| | | | | |
| Income before income taxes | 343 | 91 | 1,763 | 1,222 |
| Income taxes (benefit) | (120) | (122) | (60) | (55) |
| | | | | |
| NET INCOME | \$ 463 | \$ 213 | \$ 1,823 | \$ 1,277 |
| | | | | |
| EARNINGS PER SHARE | | | | |
| Basic | \$ 0.29 | \$ 0.14 | \$ 1.16 | \$ 0.83 |
| Diluted | 0.29 | 0.14 | 1.16 | 0.83 |
| | | | | |
| DIVIDENDS DECLARED PER SHARE | \$ 0.26 | \$ 0.26 | \$ 0.78 | \$ 0.78 |

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

MIDDLEFIELD BANC CORP.
 CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
 (Dollar amounts in thousands, except dividend per share amount)
 (Unaudited)

| | Common Stock | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total Stockholders Equity | Comprehensive Income |
|---|-----------------|----------------------|---|-------------------|---------------------------------|-------------------------|
| Balance, December 31, 2009 | \$ 27,919 | \$ 14,960 | \$ 562 | \$ (6,734) | \$ 36,707 | |
| Net income | | 1,823 | | | 1,823 | \$ 1,823 |
| Other comprehensive income: | | | | | | |
| Unrealized gains on available for sale securities net of taxes of \$2,055 | | | 3,989 | | 3,989 | 3,989 |
| Comprehensive income | | | | | | \$ 5,812 |
| Dividend reinvestment and purchase plan | 396 | | | | 396 | |
| Cash dividends (\$0.78 per share) | | (1,225) | | | (1,225) | |
| Balance, September 30, 2010 | \$ 28,315 | \$ 15,558 | \$ 4,551 | \$ (6,734) | \$ 41,690 | |

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

MIDDLEFIELD BANC CORP.
CONSOLIDATED STATEMENT OF CASH FLOWS
(Dollar amounts in thousands)
(Unaudited)

| | Nine Months Ended September 30, | |
|---|------------------------------------|----------|
| | 2010 | 2009 |
| OPERATING ACTIVITIES | | |
| Net income | \$ 1,823 | \$ 1,277 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 2,355 | 1,760 |
| Investment securities gains, net | (45) | |
| Depreciation and amortization | 581 | 437 |
| Amortization of premium and discount on investment securities | (93) | (385) |
| Amortization of deferred loan fees, net | (37) | (43) |
| Earnings on bank-owned life insurance | (204) | (197) |
| Deferred income taxes | (384) | 221 |
| Expense related to stock option | | 45 |
| Loss on sale of other real estate owned | 750 | 183 |
| Increase in accrued interest receivable | (447) | (409) |
| Increase (decrease) in accrued interest payable | 33 | (233) |
| Decrease (increase) in prepaid federal deposit insurance | 545 | (92) |
| Other, net | (1,240) | (520) |
| Net cash provided by operating activities | 3,637 | 2,044 |
| INVESTING ACTIVITIES | | |
| Investment securities available for sale: | | |
| Proceeds from repayments and maturities | 31,882 | 14,903 |
| Proceeds from sale of securities | 5,829 | |
| Purchases | (89,919) | (24,268) |
| Increase in loans, net | (14,431) | (26,146) |
| Purchase of Federal Home Loan Bank stock | | (14) |
| Proceeds from the sale of other real estate owned | 923 | 100 |
| Purchase of premises and equipment | (292) | (246) |
| Net cash used for investing activities | (66,008) | (35,671) |
| FINANCING ACTIVITIES | | |
| Net increase in deposits | 76,385 | 53,109 |
| Increase (decrease) in short-term borrowings, net | 962 | (218) |
| Repayment of other borrowings | (3,830) | (5,131) |
| Proceeds from dividend reinvestment & purchase plan | 396 | 413 |
| Cash dividends | (1,225) | (1,203) |
| Net cash provided by financing activities | 72,688 | 46,970 |

| | | |
|--|-----------|-----------|
| Increase in cash and cash equivalents | 10,317 | 13,343 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 41,153 | 17,455 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 51,470 | \$ 30,798 |

SUPPLEMENTAL INFORMATION

Cash paid during the year for:

| | | |
|-------------------------------------|----------|----------|
| Interest on deposits and borrowings | \$ 8,334 | \$ 9,148 |
| Income taxes | 850 | 275 |

Non-cash investing transactions:

| | | |
|---|----------|----------|
| Transfers from loans to other real estate owned | \$ 1,525 | \$ 1,475 |
| Loans to facilitate the sale of other real estate owned | | 531 |

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

MIDDLEFIELD BANC CORP.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

The consolidated financial statements of Middlefield Banc Corp. (Company) includes its two bank subsidiaries (The Middlefield Banking Company (MB) and Emerald Bank (EB)) and a non-bank asset resolution subsidiary EMORECO. All significant inter-company items have been eliminated in consolidation.

The accompanying financial statements have been prepared in accordance with U.S. generally accepted accounting principles and the instructions for Form 10-Q and Article 10 of Regulation S-X. In management's opinion, the financial statements include all adjustments, consisting of normal recurring adjustments, that the Company considers necessary to fairly state the Company's financial position and the results of operations and cash flows. The balance sheet at December 31, 2009, has been derived from the audited financial statements at that date but does not include all of the necessary informational disclosures and footnotes as required by U. S. generally accepted accounting principles. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included with the Company's Form 10-K. The results of the Company's operations for any interim period are not necessarily indicative of the results of the Company's operations for any other interim period or for a full fiscal year.

Recent Accounting Pronouncements:

In December 2009, the FASB issued ASU 2009-16, *Accounting for Transfer of Financial Assets*. ASU 2009-16 provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. ASU 2009-16 is effective for annual periods beginning after November 15, 2009 and for interim periods within those fiscal years. The adoption of this guidance did not have a material impact on the Company's financial position or results of operation.

In January 2010, the FASB issued ASU 2010-01, *Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash – a consensus of the FASB Emerging Issues Task Force*. ASU 2010-01 clarifies that the stock portion of a distribution to shareholders that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in EPS prospectively and is not a stock dividend. ASU 2010-01 is effective for interim and annual periods ending on or after December 15, 2009 and should be applied on a retrospective basis. The adoption of this guidance did not have a material impact on the Company's financial position or results of operation.

In January 2010, the FASB issued ASU 2010-05, *Compensation – Stock Compensation (Topic 718): Escrowed Share Arrangements and the Presumption of Compensation*. ASU 2010-05 updates existing guidance to address the SEC staff's views on overcoming the presumption that for certain shareholders escrowed share arrangements represent compensation. ASU 2010-05 is effective January 15, 2010. The adoption of this guidance did not have a material impact on the Company's financial position or results of operation.

In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of this guidance is not expected to have a significant impact on the Company's financial statements.

In February 2010, the FASB issued ASU 2010-08, *Technical Corrections to Various Topics*. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. The adoption of this guidance did not have a material impact on the Company's financial position or results of operation.

In March 2010, the FASB issued ASU 2010-11, *Derivatives and Hedging*. ASU 2010-11 provides clarification and related additional examples to improve financial reporting by resolving potential ambiguity about the breadth of the embedded credit derivative scope exception in ASC 815-15-15-8. ASU 2010-11 is effective at the beginning of the first fiscal quarter beginning after June 15, 2010. The adoption of this guidance is not expected to have a significant impact on the Company's financial statements.

In April 2010, the FASB issued ASU 2010-18, *Receivables (Topic 310): Effect of a Loan Modification When the Loan is a Part of a Pool That is Accounted for as a Single Asset* a consensus of the FASB Emerging Issues Task Force. ASU 2010-18 clarifies the treatment for a modified loan that was acquired as part of a pool of assets. Refinancing or restructuring the loan does not make it eligible for removal from the pool, the FASB said. The amendment will be effective for loans that are part of an asset pool and are modified during financial reporting periods that end July 15, 2010 or later and is not expected to have a significant impact on the Company's financial statements.

Table of Contents

In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The Company is currently evaluating the impact the adoption of this guidance will have on the Company's financial position or results of operations.

In August, 2010, the FASB issued ASU 2010-21, *Accounting for Technical Amendments to Various SEC Rules and Schedules*. This ASU amends various SEC paragraphs pursuant to the issuance of Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules, and Codification of Financial Reporting Policies and is not expected to have a significant impact on the Company's financial statements.

In August, 2010, the FASB issued ASU 2010-22, *Technical Corrections to SEC Paragraphs* An announcement made by the staff of the U.S. Securities and Exchange Commission. This ASU amends various SEC paragraphs based on external comments received and the issuance of SAB 112, which amends or rescinds portions of certain SAB topics and is not expected to have a significant impact on the Company's financial statements.

NOTE 2 STOCK-BASED COMPENSATION

The Company has no unrecognized stock-based compensation costs or unvested stock options outstanding as of September 30, 2010.

Stock option activity during the nine months ended September 30, 2010 and 2009 is as follows:

| | 2010 | Weighted- average Exercise Price | 2009 | Weighted- average Exercise Price |
|---------------------------|--------|---|---------|---|
| Outstanding, January 1 | 99,219 | \$ 26.85 | 110,465 | \$ 27.21 |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | | | (7,575) | |
| Outstanding, September 30 | 99,219 | \$ 26.85 | 102,890 | \$ 26.74 |

NOTE 3 EARNINGS PER SHARE

The Company provides dual presentation of Basic and Diluted earnings per share. Basic earnings per share utilizes net income as reported as the numerator and the actual average shares outstanding as the denominator. Diluted earnings per share includes any dilutive effects of options, warrants, and convertible securities.

Table of Contents

There are no convertible securities that would affect the numerator in calculating basic and diluted earnings per share; therefore, net income as presented on the Consolidated Statement of Income (Unaudited) will be used as the numerator. The following tables set forth the composition of the weighted-average common shares (denominator) used in the basic and diluted earnings per share computation.

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|--|--|-----------|---|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| Weighted average common shares outstanding | 1,768,362 | 1,740,586 | 1,761,292 | 1,733,107 |
| Average treasury stock shares | (189,530) | (189,530) | (189,530) | (189,530) |
| Weighted average common shares and common stock equivalents used to calculate basic earnings per share | 1,578,832 | 1,551,056 | 1,571,762 | 1,543,577 |
| Additional common stock equivalents (stock options) used to calculate diluted earnings per share | | 13 | 964 | 1,100 |
| Weighted average common shares and common stock equivalents used to calculate diluted earnings per share | 1,578,832 | 1,551,069 | 1,572,726 | 1,544,677 |

Options to purchase 99,219 shares of common stock at prices ranging from \$17.90 to \$40.24 were outstanding during the three months ended September 30, 2010 and options to purchase 89,077 shares of common stock at prices ranging from \$22.33 to \$40.24 were outstanding during the nine months ended September 30, 2010 but were not included in the computation of diluted earnings per share as they were anti-dilutive due to the strike price being greater than the market price as of September 30, 2010. Options to purchase 92,618 shares of common stock at prices ranging from \$22.33 to \$40.24 were outstanding during the three and nine months ended September 30, 2009 but were not included in the computation of diluted earnings per share.

NOTE 4 COMPREHENSIVE INCOME

The components of comprehensive income consist exclusively of unrealized gains and losses on available for sale securities. For the nine months ended September 30, 2010, this activity is shown under the heading Comprehensive Income as presented in the Consolidated Statement of Changes in Stockholders' Equity (Unaudited).

Table of Contents

The following shows the components and activity of comprehensive income during the periods ended September 30, 2010 and 2009 (net of the income tax effect):

| (Dollar amounts in thousands) | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|----------|--|----------|
| | 2010 | 2009 | 2010 | 2009 |
| Unrealized holding gains arising during the period on securities held | \$ 1,926 | \$ 1,848 | \$ 4,019 | \$ 1,887 |
| Reclassification adjustment for gains included in net income | (12) | | (30) | |
| Net change in unrealized gains during the period | 1,914 | 1,848 | 3,989 | 1,887 |
| Unrealized holding gains (losses), beginning of period | 2,637 | (256) | 562 | (295) |
| Unrealized holding gains, end of period | 4,551 | 1,592 | 4,551 | 1,592 |
| Net income | 463 | 213 | 1,823 | 1,277 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized holding gains arising during the period | 1,914 | 1,848 | 3,989 | 1,887 |
| Comprehensive income | \$ 2,377 | \$ 2,061 | \$ 5,812 | \$ 3,164 |

NOTE 5 FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants at the measurement date. GAAP established a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into the following three levels:

Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level II: Pricing inputs are other than the quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities includes items for which quoted prices are available but traded less frequently and items that are fair-valued using other financial instruments, the parameters of which can be directly observed.

Level III: Assets and liabilities that have little to no pricing observe ability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

The following tables present the assets and liabilities measured on a recurring basis on the consolidated balance sheet at their fair value as of September 30, 2010 and December 31, 2009 by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| (Dollar amounts in thousands) | September 30, 2010 | | | Total |
|--|--------------------|------------|-----------|------------|
| | Level I | Level II | Level III | |
| Assets Measured on a Recurring Basis: | | | | |
| U.S. government agency securities | \$ | \$ 22,505 | \$ | \$ 22,505 |
| Obligations of states and political subdivisions | | 81,791 | | 81,791 |
| Mortgage-backed securities | | 89,885 | | 89,885 |
| Total debt securities | | 194,181 | | 194,181 |
| Equity securities | 920 | | | 920 |
| Total | \$ 920 | \$ 194,181 | \$ | \$ 195,101 |

Table of Contents

| | December 31, 2009 | | | Total |
|--|-------------------|------------|-----------|------------|
| | Level I | Level II | Level III | |
| Assets Measured on a Recurring Basis: | | | | |
| U.S. government agency securities | \$ | \$ 18,330 | \$ | \$ 18,330 |
| Obligations of states and political subdivisions | | 56,720 | | 56,720 |
| Mortgage-backed securities | | 60,742 | | 60,742 |
| Total debt securities | | 135,792 | | 135,792 |
| Equity securities | 919 | | | 919 |
| Total | \$ 919 | \$ 135,792 | \$ | \$ 136,711 |

Financial instruments are considered Level III when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. In addition to these unobservable inputs, the valuation models for Level III financial instruments typically also rely on a number of inputs that are readily observable either directly or indirectly. Level III financial instruments also include those for which the determination of fair value requires significant management judgment or estimation. The Company has no securities considered to be Level III as of September 30, 2010.

The following tables present the assets measured on a nonrecurring basis on the consolidated balance sheet at their fair value as of September 30, 2010 and December 31, 2009, by level within the fair value hierarchy. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secure the impaired loan include: quoted market prices for identical assets classified as Level I inputs; observable inputs, employed by certified appraisers, for similar assets classified as Level II inputs. In cases where valuation techniques included inputs that are unobservable and are based on estimates and assumptions developed by management based on the best information available under each circumstance, the asset valuation is classified as Level III inputs.

| (Dollar amounts in thousands) | September 30, 2010 | | | Total |
|---|--------------------|----------|-----------|----------|
| | Level I | Level II | Level III | |
| Assets Measured on a non-recurring Basis: | | | | |
| Impaired loans | \$ | \$ 5,445 | \$ 2,593 | \$ 8,038 |
| Other real estate owned | | 2,016 | | 2,016 |

| | December 31, 2009 | | | Total |
|---|-------------------|----------|-----------|----------|
| | Level I | Level II | Level III | |
| Assets Measured on a non-recurring Basis: | | | | |
| Impaired loans | \$ | \$ 5,644 | \$ 149 | \$ 5,793 |
| Other real estate owned | | 2,164 | | 2,164 |

Table of Contents

The estimated fair value of the Company's financial instruments is as follows:

| (Dollar amounts in thousands) | September 30, 2010 | | December 31, 2009 | |
|-------------------------------|--------------------|------------|-------------------|------------|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 51,470 | \$ 51,470 | \$ 41,153 | \$ 41,153 |
| Investment securities | | | | |
| Available for sale | 195,101 | 195,101 | 136,711 | 136,711 |
| Net loans | 359,248 | 341,906 | 348,660 | 332,401 |
| Bank-owned life insurance | 7,911 | 7,911 | 7,706 | 7,706 |
| Federal Home Loan Bank stock | 1,887 | 1,887 | 1,887 | 1,887 |
| Accrued interest receivable | 1,858 | 1,858 | 1,411 | 1,411 |
| Financial liabilities: | | | | |
| Deposits | \$ 563,491 | \$ 570,677 | \$ 487,106 | \$ 491,436 |
| Short-term borrowings | 7,762 | 7,762 | 6,800 | 6,800 |
| Other borrowings | 22,035 | 25,325 | 25,865 | 27,356 |
| Accrued interest payable | 966 | 966 | 933 | 933 |

Financial instruments are defined as cash, evidence of ownership interest in an entity, or a contract which creates an obligation or right to receive or deliver cash or another financial instrument from/to a second entity on potentially favorable or unfavorable terms.

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing parties other than in a forced liquidation sale. If a quoted market price is available for a financial instrument, the estimated fair value would be calculated based upon the market price per trading unit of the instrument.

If no readily available market exists, the fair value estimates for financial instruments should be based upon management's judgment regarding current economic conditions, interest rate risk, expected cash flows, future estimated losses, and other factors as determined through various option pricing formulas or simulation modeling. Since many of these assumptions result from judgments made by management based upon estimates which are inherently uncertain, the resulting estimated fair values may not be indicative of the amount realizable in the sale of a particular financial instrument. In addition, changes in assumptions on which the estimated fair values are based may have a significant impact on the resulting estimated fair values.

As certain assets such as deferred tax assets and premises and equipment are not considered financial instruments, the estimated fair value of financial instruments would not represent the full value of the Company.

The Company employed simulation modeling in determining the estimated fair value of financial instruments for which quoted market prices were not available based upon the following assumptions:

Cash and Cash Equivalents, Federal Home Loan Bank Stock, Accrued Interest Receivable, Accrued Interest Payable, and Short-Term Borrowings

The fair value is equal to the current carrying value.

Bank-Owned Life Insurance

The fair value is equal to the cash surrender value of the life insurance policies.

Investment Securities Available for Sale

The fair value of investment securities is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities. Fair value for certain private-label collateralized mortgage obligations was determined utilizing discounted cash flow models, due to the absence of a current market to provide reliable market quotes for the instruments.

Table of Contents**Loans**

The fair value is estimated by discounting future cash flows using current market inputs at which loans with similar terms and qualities would be made to borrowers of similar credit quality. Where quoted market prices were available, primarily for certain residential mortgage loans, such market rates were utilized as estimates for fair value.

Deposits and Other Borrowed Funds

The fair values of certificates of deposit and other borrowed funds are based on the discounted value of contractual cash flows. The discount rates are estimated using rates currently offered for similar instruments with similar remaining maturities. Demand, savings, and money market deposits are valued at the amount payable on demand as of year-end.

Commitments to Extend Credit

These financial instruments are generally not subject to sale, and estimated fair values are not readily available. The carrying value represented by the net deferred fee arising from the unrecognized commitment or letter of credit, and the fair value, determined by discounting the remaining contractual fee over the term of the commitment using fees currently charged to enter into similar agreements with similar credit risk, are not considered material for disclosure.

NOTE 6 INVESTMENT SECURITIES AVAILABLE FOR SALE

The amortized cost and fair values of securities available for sale are as follows:

| (Dollar amounts in thousands) | Amortized Cost | September 30, 2010 | | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| U.S. government agency securities | \$ 22,171 | \$ 334 | \$ | \$ 22,505 |
| Obligations of states and political subdivisions: | | | | |
| Taxable | 7,872 | 462 | | 8,334 |
| Tax-exempt | 70,149 | 3,334 | (26) | 73,457 |
| Mortgage-backed securities | 87,069 | 3,295 | (479) | 89,885 |
| Total debt securities | 187,261 | 7,425 | (505) | 194,181 |
| Equity Securities | 944 | 80 | (104) | 920 |
| Total | \$ 188,205 | \$ 7,505 | \$ (609) | \$ 195,101 |

| | Amortized Cost | December 31, 2009 | | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| U.S. government agency securities | \$ 18,657 | \$ 38 | \$ (365) | \$ 18,330 |
| Obligations of states and political subdivisions: | | | | |
| Taxable | 3,451 | 10 | (86) | 3,375 |
| Tax-exempt | 52,752 | 942 | (349) | 53,345 |
| Mortgage-backed securities | 60,055 | 1,817 | (1,130) | 60,742 |
| Total debt securities | 134,915 | 2,807 | (1,930) | 135,792 |
| Equity Securities | 944 | 80 | (105) | 919 |

| | | | | |
|-------|------------|----------|------------|------------|
| Total | \$ 135,859 | \$ 2,887 | \$ (2,035) | \$ 136,711 |
|-------|------------|----------|------------|------------|

Table of Contents

The amortized cost and fair value of debt securities at September 30, 2010, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollar amounts in thousands) | Amortized Cost | Fair Value |
|--|-------------------|----------------|
| Due in one year or less | \$ 1,664 | \$ 1,677 |
| Due after one year through five years | 6,041 | 6,409 |
| Due after five years through ten years | 20,579 | 21,934 |
| Due after ten years | 158,977 | 164,161 |
| Total | \$ 187,261 | \$ 194,181 |

Proceeds from sales of investment securities available for sale were \$5.8 million and \$0 during the nine-months ended September 30, 2010 and September 30, 2009, respectively. Gross gains realized were \$45,000 and \$0, respectively, during the nine-months ended September 30, 2010 and September 30, 2009.

Proceeds from sales of investment securities available for sale were \$715,000 and \$0 during the three-months ended September 30, 2010 and September 30, 2009, respectively. Gross gains realized were \$18,000 and \$0 during the three-months ended September 30, 2010 and September 30, 2009, respectively.

The following table shows the Company's gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

| (Dollar amounts in thousands) | Less than Twelve Months | | September 30, 2010 Twelve Months or Greater | | Total | |
|-------------------------------|--|-------------------------------|---|-------------------------------|---------------|-------------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| | Obligations of states and political subdivisions | \$ 253 | \$ (5) | \$ 471 | \$ (21) | \$ 724 |
| Mortgage-backed securities | 8,240 | (38) | 2,576 | (441) | 10,816 | (479) |
| Equity securities | 372 | (26) | 218 | (78) | 590 | (104) |
| Total | \$ 8,865 | \$ (69) | \$ 3,265 | \$ (540) | \$ 12,130 | \$ (609) |

| (Dollar amounts in thousands) | Less than Twelve Months | | December 31, 2009 Twelve Months or Greater | | Total | |
|-------------------------------|-----------------------------------|-------------------------------|--|-------------------------------|---------------|-------------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| | U.S. government agency securities | \$ 17,134 | \$ (365) | \$ 1,417 | \$ (121) | \$ 17,134 |
| | 21,594 | (314) | 1,417 | (121) | 23,011 | (435) |

Obligations of states and
political subdivisions

| | | | | | | |
|----------------------------|-----------|------------|----------|----------|-----------|------------|
| Mortgage-backed securities | 18,509 | (334) | 4,064 | (796) | 22,573 | (1,130) |
| Equity securities | 580 | (68) | 8 | (37) | 588 | (105) |
| Total | \$ 57,817 | \$ (1,082) | \$ 5,489 | \$ (953) | \$ 63,306 | \$ (2,035) |

There were 16 and 103 securities that were considered temporarily impaired at September 30, 2010 and December 31, 2009.

Table of Contents

On a quarterly basis, the Company performs an assessment to determine whether there have been any events or economic circumstances indicating that a security with an unrealized loss has suffered other-than-temporary impairment (OTTI) pursuant to FASB ASC Topic 320 Investments Debt and Equity Securities. A debt security is considered impaired if the fair value is less than its amortized cost basis at the reporting date. The accounting literature requires the Company to assess whether the unrealized loss is other-than-temporary. Prior to the adoption of FSP FAS 115-2 which was subsequently incorporated into FASB ASC Topic 320 Investments Debt and Equity Securities, unrealized losses that were determined to be temporary were recorded, net of tax, in other comprehensive income for available for sale securities, whereas unrealized losses related to held-to-maturity securities determined to be temporary were not recognized. Regardless of whether the security was classified as available for sale or held to maturity, unrealized losses that were determined to be other-than-temporary were recorded to earnings. An unrealized loss was considered other-than-temporary if (i) it was probable that the holder would not collect all amounts due according to the contractual terms of the debt security, or (ii) the fair value was below the amortized cost of the debt security for a prolonged period of time and the Company did not have the positive intent and ability to hold the security until recovery or maturity.

The Company adopted this ASC during the second quarter of 2009 which amended the OTTI model for debt securities. Under the new guidance, OTTI losses must be recognized in earnings if an investor has the intent to sell the debt security or it is more likely than not that it will be required to sell the debt security before recovery of its amortized cost basis. However, even if a Company does not expect to sell a debt security, it must evaluate expected cash flows to be received and determine if a credit loss has occurred.

Under this ASC, an unrealized loss is generally deemed to be other-than-temporary and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. As a result the credit loss component of an OTTI is recorded as a component of investment securities gains (losses) in the accompanying consolidated statement of income, while the remaining portion of the impairment loss is recognized in other comprehensive income, provided the Company does not intend to sell the underlying debt security and it is more likely than not that the company will not have to sell the debt security prior to recovery.

Debt securities issued by U.S. government agencies, U.S. government-sponsored enterprises, and state and political subdivisions accounted for more than 90% of the total available-for-sale portfolio as of September 30, 2010 and no credit losses are expected, given the explicit and implicit guarantees provided by the U.S. federal government and the lack of significant unrealized loss positions within the obligations of state and political subdivisions security portfolio. The Company's assessment was concentrated mainly on private-label collateralized mortgage obligations of approximately \$17.8 million for which the Company evaluates credit losses on a quarterly basis. Gross unrealized gain and loss positions related to these private-label collateralized mortgage obligations amounted to \$1.3 million and 441,000 respectively. The Company considered the following factors in determining whether a credit loss exists and the period over which the debt security is expected to recover:

The length of time and the extent to which the fair value has been less than the amortized cost basis.

Changes in the near term prospects of the underlying collateral of a security such as changes in default rates, loss severity given default and significant changes in prepayment assumptions;

The level of cash flows generated from the underlying collateral supporting the principal and interest payments of the debt securities; and

Any adverse change to the credit conditions and liquidity of the issuer, taking into consideration the latest information available about the overall financial condition of the issuer, credit ratings, recent legislation and government actions affecting the issuer's industry and actions taken by the issuer to deal with the present economic climate.

For the nine months ended September 30, 2010, there were no available-for-sale debt securities with an unrealized loss that has suffered OTTI.

NOTE 7 SUBSEQUENT EVENTS

None

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

The following discussion and analysis provides further detail to the financial condition and results of operations of the Company. The MD&A should be read in conjunction with the notes and financial statements presented in this report.

FORWARD-LOOKING STATEMENT

This release contains forward-looking statements relating to present or future trends or factors affecting the banking industry, and specifically the financial condition and results of operations, including without limitation, statements relating to the earnings outlook of the Company, as well as its operations, markets and products. Actual results could differ materially from those indicated. Among the factors that could cause results to differ materially are changes in interest rates, continued weakening of the economy, which could materially impact credit quality and the opportunity to generate loans, competitive pressures, changes in accounting, tax or regulatory requirements and those risk factors detailed in the Company's periodic reports and registration statements filed with the Securities and Exchange Commission. The Company undertakes no obligation to release revisions to these forward-looking statements or reflect events or circumstances after the date of this release.

CRITICAL ACCOUNTING ESTIMATES

The Company's critical accounting estimates involving the more significant judgments and assumptions used in the preparation of the consolidated financial statements as of September 30, 2010, have remained unchanged from December 31, 2009.

CHANGES IN FINANCIAL CONDITION

General. The Company's total assets increased \$78.4 million or 14.0% from December 31, 2009 to September 30, 2010 to a balance of \$637.1 million. Loans receivable, cash and cash equivalents and investment securities increased \$11.6 million, \$10.3 million and \$58.4 million, respectively. The increase in total assets reflects a corresponding increase in total liabilities of \$73.4 million or 14.1% and an increase in stockholders' equity of \$5.0 million or 13.6%. The increase in total liabilities was the result of deposit growth of \$76.4 million. The increase in stockholders' equity was the result of increases in common stock, retained earnings and accumulated other comprehensive income of \$396,000, \$598,000 and \$4.0 million, respectively.

Cash on hand and due from banks. Cash and due from banks, Federal funds sold and interest-bearing deposits in other institutions represent cash and cash equivalents. Cash and cash equivalents increased \$10.3 million or 25.1% to \$51.5 million at September 30, 2010 from \$41.2 million at December 31, 2009. Deposits from customers into savings and checking accounts, loan and security repayments and proceeds from borrowed funds typically increase these accounts. Decreases result from customer withdrawals, new loan originations, security purchases and repayments of borrowed funds.

Investment securities. Investment securities available for sale ended the September 30, 2010 nine month period at \$195.1 million an increase of \$58.4 million or 42.7% from \$136.7 million at December 31, 2009. During this period the Company recorded purchases of available for sale securities of \$89.9 million, consisting of purchases of mortgage-backed securities, U.S. government agencies and municipal securities. Offsetting the purchases of securities were repayments and maturities of securities of \$31.9 million and sales of securities totaling \$5.8 million during the nine months ended September 30, 2010. In addition, the securities portfolio increased approximately \$6.9 million due to an increase in the market value. These fair value adjustments represent temporary fluctuations resulting from changes in market rates in relation to average yields in the available for sale portfolio. If securities are held to their respective maturity dates, no fair value gain or loss will be realized.

Loans receivable. The loans receivable category consists primarily of single family mortgage loans used to purchase or refinance personal residences located within the Company's market area and commercial real estate loans used to finance properties that are used in the borrowers' businesses or to finance investor-owned rental properties, and to a lesser extent commercial and consumer loans. Net loans receivable increased \$10.5 million or 3.0% to \$359.2 million as of September 30, 2010 from \$348.7 million at December 31, 2009. Included in this amount was an increase in the commercial real estate loan portfolio of \$3.0 million or 3.8% and real estate construction loans of \$6.0 million or 77.1% during the nine months ended September 30, 2010. The Company's lending philosophy is to focus on the commercial loans and to attempt to grow the portfolio. To attract and build the commercial loan portfolio, the Company has taken a proactive approach in contacting new and current clients to ensure that the Company is

servicing its client's needs. These lending relationships generally offer more attractive returns than residential loans and also offer opportunities for attracting larger balance deposit relationships. However, the shift in loan portfolio mix from residential real estate to commercial oriented loans may increase credit risk.

Allowance for Loan Losses and Asset Quality. For the first nine months of 2010, because of continued high unemployment, depressed real estate values for both residential and commercial properties and sustained economic weakness in the Company's market area, management believes that non-performing assets may increase further and therefore believes it is prudent to continue funding the allowance for loan losses at higher than historical levels. The Company increased the allowance for loan losses to \$6.0 million, or 1.63% of total loans, at September 30, 2010, from \$4.9 million, or 1.40%, at December 31, 2009. The increase in the allowance for loan losses was necessitated by loan downgrades and an increase to specific reserves for impaired commercial real estate loans, coupled with the impact of charge-offs remaining at an elevated level. Third quarter 2010 net loan charge-offs totaled \$1.1 million, or 0.30% of average loans, compared to \$135,000, or 0.04%, and \$592,000, or 0.17%, for the second quarter of 2010 and third quarter of 2009, respectively. Year to date net loan charge-offs totaled \$1.3 million compared to \$895,000 for the same period in 2009. To maintain the adequacy of the allowance for loan losses, the Company recorded a third quarter provision for loan losses of \$1.2 million, versus \$1.3 million for third quarter of 2009. For the nine month period ended September 30, 2010, the Company recorded a provision for loan losses of \$2.4 million compared to \$1.8 million for the comparable period in 2009.

Table of Contents

Management analyzes the adequacy of the allowance for loan losses regularly through reviews of the performance of the loan portfolio considering economic conditions, changes in interest rates and the effect of such changes on real estate values and changes in the amount and composition of the loan portfolio. The allowance for loan losses is a material estimate that is particularly susceptible to significant changes in the near term. Such evaluation, which includes a review of all loans for which full collectability may not be reasonably assured, considers among other matters, historical loan loss experience, the estimated fair value of the underlying collateral, economic conditions, current interest rates, trends in the borrower's industry and other factors that management believes warrant recognition in providing for an appropriate allowance for loan losses. Future additions to the allowance for loan losses will be dependent on these factors. Additionally, the Company utilizes an outside party to conduct an independent review of commercial and commercial real estate loans. The Company uses the results of this review to help determine the effectiveness of the existing policies and procedures, and to provide an independent assessment of the allowance for loan losses allocated to these types of loans. Management believes that the allowance for loan losses was appropriately stated at September 30, 2010. Based on the variables involved and the fact that management must make judgments about outcomes that are uncertain, the determination of the allowance for loan losses is considered a critical accounting policy.

Non-performing assets. Non-performing assets includes non-accrual loans, troubled debt restructurings (TDR), loans 90 days or more past due, assets purchased by EMORECO from EB in November 2009, other real estate, and repossessed assets. A loan is classified as non-accrual when, a loan becomes 90 days past due in principal and interest or in the opinion of management, there are serious doubts about the collectability of interest and principal. At that time the accrual of interest is discontinued, future income is recognized only when cash is received and is not applied to the principal. TDRs are those loans which the Company, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that the Company would not otherwise consider. The Company had six TDRs with a combined principal balance of \$603,000 as of September 30, 2010. Non-performing loans amounted to \$21.0 million or 5.8% and \$16.3 million or 4.6% of total loans at September 30, 2010 and December 31, 2009, respectively. The increase in nonperforming loans has occurred primarily in the commercial loan portfolio and in one-to-four family real estate loans. Non-performing loans secured by real estate totaled \$16.6 million as of September 30, 2010, up \$3.7 million from \$12.9 million at December 31, 2009. The depressed state of the economy and continued levels of high unemployment have contributed to this trend, as well as the decline in the housing market across our geographic footprint that reflected declining home prices and increasing inventories of houses for sale. Real estate owned is written down to fair value at its initial recording and continually monitored.

Nonperforming Assets and Allowance for Loan Losses. The following table indicates asset quality data over the past five quarters.

Asset Quality History

| (Dollar amounts in thousands) | 9/30/2010 | 6/30/2010 | 3/31/2010 | 12/31/2009 | 9/30/2009 |
|--------------------------------------|-----------|-----------|-----------|------------|-----------|
| Nonperforming loans | \$ 20,983 | \$ 20,053 | \$ 18,143 | \$ 16,285 | \$ 14,368 |
| Real estate owned | \$ 2,016 | \$ 1,886 | \$ 2,175 | \$ 2,164 | \$ 1,775 |
| Nonperforming assets | \$ 22,999 | \$ 21,939 | \$ 20,318 | \$ 18,449 | \$ 16,143 |
| Allowance for loan losses | \$ 5,971 | \$ 5,834 | \$ 5,279 | \$ 4,937 | \$ 4,422 |
| Ratios | | | | | |
| Nonperforming loans to total loans | 5.75% | 5.50% | 5.04% | 4.61% | 4.15% |
| Nonperforming assets to total assets | 3.61% | 3.61% | 3.42% | 3.30% | 3.12% |

| | | | | | |
|--|--------|--------|--------|--------|--------|
| Allowance for loan losses to total loans | 1.63% | 1.60% | 1.47% | 1.40% | 1.28% |
| Allowance for loan losses to nonperforming loans | 28.46% | 29.09% | 29.10% | 30.32% | 30.78% |

A major factor in determining the appropriateness of the allowance for loan losses is the type of collateral which secures the loans. Of the total nonperforming loans at September 30, 2010, 79.3% were secured by real estate. Although this does not insure against all losses, the real estate provides substantial recovery, even in a distressed-sale and declining-value environment. In response to the poor economic conditions which have eroded the performance of the Company's loan portfolio, additional resources have been allocated to the loan workout process. The Company's objective is to work with the borrower to minimize the burden of the debt service and to minimize the future loss exposure to the Company.

Table of Contents

Deposits. The Company considers various sources when evaluating funding needs, including but not limited to deposits, which are a significant source of funds totaling \$563.5 million or 95.0% of the Company's total funding sources at September 30, 2010. Total deposits increased \$76.4 million or 15.7% to \$563.5 million at September 30, 2010 from \$487.1 million at December 31, 2009. The increase in deposits is primarily related to the growth of savings deposits, money market and noninterest-bearing accounts of \$34.3 million or 32.0%, \$14.6 million or 25.9% and \$11.1 million or 24.9%, respectively.

Borrowed funds. The Company utilizes short and long-term borrowings as another source of funding for asset growth and liquidity needs. These borrowings primarily include FHLB advances, junior subordinated debt, short-term borrowings from other banks and repurchase agreements. Short-term borrowings increased \$1.0 million or 14.2% to \$7.8 million at September 30, 2010 from \$6.8 million at December 31, 2009. For the nine months ended September 30, 2010, other borrowings declined \$3.8 million which represents advances from the Federal Home Loan Bank of Cincinnati. The decline in FHLB advances was the result of scheduled principal payments.

Stockholders equity. Stockholders' equity increased \$5.0 million or 13.6% to \$41.7 million at September 30, 2010 from \$36.7 million at December 31, 2009. This increase was the result of increases in common stock, retained earnings and accumulated other comprehensive income of \$396,000, \$598,000 and \$4.0 million, respectively. The increase of accumulated other comprehensive income was the result of an increase in the fair value of the Company's securities available for sale portfolio. The increase in common stock was the result of issuing 19,699 shares through the Company's dividend reinvestment and purchase plan at an average price of \$20.05 since December 31, 2009.

RESULTS OF OPERATIONS

General. Net income for the third quarter of 2010 of \$463,000 represented a \$250,000, or 117.4% increase from the \$213,000 earned during the third quarter of 2009. Net income for the nine months ended September 30, 2009, totaled \$1.8 million a \$546,000, or 42.8% increase from the \$1.3 million earned during the same period in 2009. Diluted earnings per share for the third quarter of 2010 were \$0.29 compared to \$0.14 for the same period in 2009.

Year-to-date diluted earnings per share were \$1.16 in 2010 compared to \$0.83 in 2009.

The company's annualized return on average assets (ROA) and return on average equity (ROE) for the third quarter of 2010 were 0.29% and 4.54%, respectively, compared with 0.17% and 2.34% for the third quarter of 2009. For the first nine months of 2010, the company's annualized ROA was 0.41% compared to 0.35% in 2009, while the ROE was 6.31% compared to 4.72% for the same period of 2009.

The Company's earnings for the quarter and the year were positively impacted by an increase in loan and investment interest income combined with a decrease in interest expense. This was partially offset by increases in the provision for loan losses and non-interest expense.

Net interest income. Net interest income, the primary source of revenue for the Company, is determined by the Company's interest rate spread, which is defined as the difference between income on earning assets and the cost of funds supporting those assets, and the relative amounts of interest-earning assets and interest-bearing liabilities. Management periodically adjusts the mix of assets and liabilities, as well as the rates earned or paid on those assets and liabilities in order to manage and improve net interest income. The level of interest rates and changes in the amount and composition of interest-earning assets and liabilities affect the Company's net interest income. Historically from an interest rate risk perspective, it has been management's goal to maintain steady net interest income growth while managing the risks associated with interest rate fluctuations by pricing and growth strategies.

Net interest income totaled \$4.6 million for the third quarter of 2010, an increase of 21.9% from the \$3.8 million reported for the comparable period of 2009. The net interest margin of 3.39% for the third quarter of 2010 declined slightly from the 3.46% reported for the same quarter of 2009. The decrease in the net interest margin is primarily attributable to the lack of quality lending opportunities which forces excess funds into lower yielding short-term investments.

Net interest income increased \$2.9 million, or 27.8%, to \$13.3 million for the nine months ended September 30, 2010 compared to the same period in the prior year. The year to date net interest margin was positively impacted by increases in investment securities interest of \$1.6 million and loan interest of \$641,000 coupled with the reduced cost of interest-bearing liabilities by \$540,000 when compared to the same period in 2009. The net interest margin of 3.39% for the first three quarters of 2010 was up from the 3.31% reported for the same period of 2009. The increasing

margin for the first nine months of the year is primarily attributable to deposit growth in products which generally carry lower interest costs than other deposit alternatives allowing for increased loan underwriting and the purchase of investment securities that maximize the Company's interest income.

Interest income. Interest income increased \$720,000, or 10.8%, for the three months ended September 30, 2010, compared to the same period in the prior year. This increase was partly offset by a 66 basis point decline on the yield of average interest-earning assets. Interest income increased \$2.3 million, or 12.2%, for the nine months ended September 30, 2010, compared to the same period in the prior year. The year-to-date increase can be attributed to the growth of average interest-earning assets of \$114.6 million. A decrease of 59 basis points offset some of the gains from the increased levels of interest-earning assets.

Table of Contents

Interest earned on loans receivable increased \$149,000, or 2.9%, for the three months ended September 30, 2010, compared to the same period in the prior year. This increase was attributable to a \$24.2 million or a 7.1% increase in the average balance of loans receivable from September 30, 2009. This increase was partially offset by a decline in the yield on the total loan portfolio of 24 basis points to 5.80% for the three months ended September 30, 2010 from 6.04% for the same period in the prior year.

For the nine months ended September 30, 2010, interest earned on loans receivable increased \$641,000, or 4.3%, compared to the same period in the prior year. This increase was attributable to an increase in the average balance of loans outstanding of \$29.9 million, or 9.1%, to \$360.8 million for the nine months ended September 30, 2010 compared to \$330.8 million for the same period in the prior year. This increase was partially offset by a decline in the yield on the total loan portfolio of 26 basis points to 5.83% for the nine months ended September 30, 2010 from 6.09% for the same period in the prior year.

Interest earned on securities increased \$541,000, or 37.3%, for the three months ended September 30, 2010, compared to the same period in the prior year. This increase was primarily the result of an increase in the average balance of the securities portfolio of \$76.6 million, or 71.9%, to \$183.2 million at September 30, 2010 from \$106.6 million for the same period in the prior year. The increase of interest earned on investment securities was partially offset by a decrease in the yield on the average investments to 5.10% for the three months ended September 30, 2010 from 6.31% for the same period in the prior year.

Interest earned on securities increased \$1.6 million, or 39.8%, for the nine months ended September 30, 2010, compared to the same period in the prior year. This increase was primarily the result of an increase in the average balance of the securities portfolio of \$64.4 million, or 61.3%, to \$169.5 million at September 30, 2010 from \$105.1 million for the same period in the prior year. The increase of interest earned on investment securities was partially offset by a decrease of 81 basis points to 5.34% for the nine months ended September 30, 2010 from 6.15% for the same period in the prior year.

Interest expense. Interest expense decreased \$110,000, or 3.8%, for the three months ended September 30, 2010, compared to the same period in the prior year. The decline in interest expense can be attributed to decreases in interest incurred on deposits of \$110,000. This reduction in interest cost was mainly due to the rate paid on interest-bearing liabilities which declined by 66 basis points when comparing the two quarters.

Interest expense decreased \$540,000, or 6.1%, for the nine months ended September 30, 2010, compared to the same period in the prior year. The year-to-date decline is the result of lower rates paid on interest-bearing liabilities. Interest incurred on deposit decreased \$527,000 and borrowings declined \$13,000 when compared to the first three quarters of 2009. These decreases were partially offset by increased deposits.

Interest incurred on deposits, the largest component of the Company's interest-bearing liabilities, decreased \$110,000, or 4.4%, for the three months ended September 30, 2010, compared to the same period in the prior year. Interest expense was positively affected by a reduction in the cost of interest-bearing deposits to 1.91% from 2.57% for the quarters ended September 30, 2010 and 2009, respectively. The reduced cost was partially offset by the average balance of interest-bearing deposits which increased by \$108.5 million, or 28.0%, to \$495.5 million for the three months ended September 30, 2010, compared to \$387.0 million for the same period in the prior year. The Company diligently monitors the interest rates on its products as well as the rates being offered by its competition and utilizing rate surveys to keep its total interest expense costs down.

For the nine months ended September 30, 2010 interest incurred on deposits declined \$527,000, or 6.8%, compared to the same period in the prior year. This was primarily attributable to a decrease in interest expense which was positively affected by a reduction in the cost of interest-bearing deposits to 2.02% from 2.82% for the nine months September 30, 2010 and 2009, respectively. The reduction in interest costs was partially offset by an increase in the average balance of interest-bearing deposits of \$110.7 million, or 30.0%, to \$479.1 million for the nine months ended September 30, 2010, compared to \$368.4 million for the same period in the prior year.

Interest incurred on borrowed funds totaled \$361,000 for the three months ended September 30, 2010, unchanged when compared to the same period in the prior year. The interest rate paid on borrowings declined to 4.65% from 4.67% for the quarters ended September 30, 2010 and 2009, respectively. Offsetting the reduction in the cost of these funds was an increase in the average balance of borrowed funds of \$156,000, or 0.5%, to \$30.8 million for the three

months ended September 30, 2010, compared to \$30.6 million for the same period in the prior year. For the nine months ended September 30, 2010, interest incurred on borrowed funds decreased by \$13,000, or 1.1%, compared to the same period in the prior year. This decline was due to a decrease in the average balance of borrowing. The average balance of borrowed funds declined by \$499,000, or 1.6%, to \$31.8 million for the nine months ended September 30, 2010, compared to \$32.3 million for the nine months ended September 30, 2009.

Table of Contents

Provision for loan losses. The provision for loan losses represents the charge to income necessary to adjust the allowance for loan losses to an amount that represents management's assessment of the estimated probable incurred credit losses inherent in the loan portfolio. Each quarter management performs a review of estimated probable credit losses in the loan portfolio. Based on this review, a provision for loan losses of \$1.2 million was recorded for the quarter ended September 30, 2010 compared to \$1.3 million for the quarter ended September 30, 2009. The year-to-date provision for loan losses increased \$595,000 or 33.8% compared to the first three quarters of 2009. The provision for loan losses was higher year-to-date due to increases in net charge-offs, increases in nonperforming and delinquent loans and the continued distressed state of the economy. Nonperforming loans were \$21.0 million, or 5.8% of total loans at September 30, 2010 compared with \$14.4 million, or 4.2% at September 30, 2009. Net charge-offs were \$1.1 million for the quarter ended September 30, 2010 and \$1.3 million year-to-date compared with \$592,000 and \$895,000 for the same periods ended September 30, 2009. Total loans were \$365.2 million at September 30, 2010 compared with \$345.9 million at September 30, 2009.

Non-interest income. Non-interest income increased \$5,000, or 0.7%, and \$39,000, or 2.0%, for the three and nine months ended September 30, 2010, respectively, compared to the same periods of 2009. This increase is primarily a result of rental income on other real estate owned of \$14,000 and \$42,000 for the three and nine month periods ended September 30, 2010, respectively. Additionally the Company recognized a net gain on the sale of investment securities of \$18,000 for the quarter and \$45,000 year-to-date.

Non-interest expense. Non-interest expense of \$3.7 million for the third quarter of 2010 was 23.1%, or \$703,000, higher than the third quarter of 2009. The increase in salaries and employee benefits of \$147,000 is primarily attributable to the growth of the Company and a 10% increase in employee health insurance premiums. Losses on the sale of other real estate owned totaled \$536,000, an increase of 318.8% when compared to the third quarter of 2009. The entire amount was recognized by the Company's non-bank asset resolution subsidiary EMORECO. Other expenses grew \$126,000 over the 2009 quarter to \$682,000. Expenses related to delinquent loans, foreclosures and other real estate owned totaled \$213,000 or 169.1% of the increase. EMORECO had \$34,000 in loan and other real estate owned expenses as of the quarter ended September 30, 2010.

The year-to-date non-interest expense total of \$11.1 million was 19.2%, or \$1.8 million, higher than the same period of 2009. The increase in salaries and employee benefits of \$463,000 is attributable to the growth of the Company and a 10% increase in employee health insurance premiums. The Company upgraded its computer network in conjunction with changing data processors in April 2010. These improvements have resulted in an increase of \$133,000 in equipment expense when compared to September 30, 2009. The FDIC fees increased \$60,000 for the nine months ended September 30, 2010 when compared to the same period in the prior year. Losses on the sale of other real estate owned totaled \$750,000, an increase of \$567,000 or 309.8% over the comparable period in 2009. This increase reflects the Company's active pursuit of sales opportunities of other real estate owned properties and conservative approach in valuing these properties. Included in this total is the Company's non-bank asset resolution subsidiary EMORECO which had \$693,000 in losses on the sale of other real estate owned for the nine months ended September 30, 2010. Based on the number of non-performing loans management believes that the higher than historic losses on other real estate owned will continue in the fourth quarter of 2010 and into 2011. Other expenses grew \$578,000 or 34.0%, over the first three quarters of 2009. Included in this amount are expenses related to delinquent loans, foreclosures and other real estate owned which totaled \$443,000 or 76.6% of the increase. EMORECO had \$319,000 in loan and other real estate owned expenses for the nine months ended September 30, 2010.

Provision for income taxes. The Company recognized \$60,000 in income tax benefit, which reflected an effective tax rate of (3.4%) for the nine months, ended September 30, 2010, as compared to an income tax benefit of \$55,000 with an effective tax rate of (4.5%) for the respective 2009 period. The increase in income tax benefit for the nine month period was due to an increase in the percentage of tax-exempt income to total income before taxes. For the nine months ending September 30, 2010 non-taxable income from obligations of states and political subdivisions totaled \$1.9 million or a 41.2% increase over the comparable prior year period. This benefit was offset by a 44.3% increase in pre-tax income.

Table of Contents

Average Balance Sheet and Yield/Rate Analysis. The following tables sets forth, for the periods indicated, information concerning the total dollar amounts of interest income from interest-earning assets and the resultant average yields, the total dollar amounts of interest expense on interest-bearing liabilities and the resultant average costs, net interest income, interest rate spread and the net interest margin earned on average interest-earning assets. For purposes of this table, average balances are calculated using monthly averages and the average loan balances include non-accrual loans and exclude the allowance for loan losses, and interest income includes accretion of net deferred loan fees. Interest and yields on tax-exempt securities (tax-exempt for federal income tax purposes) are shown on a fully tax equivalent basis utilizing a federal tax rate of 34%. Yields and rates have been calculated on an annualized basis utilizing monthly interest amounts.

| (Dollars in thousands) | For the Three Months Ended September 30, | | | | | |
|--|--|-----------------|--------------------|-------------------|-----------------|--------------------|
| | Average Balance | Interest | Average Yield/Cost | Average Balance | Interest | Average Yield/Cost |
| Interest-earning assets: | | | | | | |
| Loans receivable | \$ 364,216 | \$ 5,325 | 5.80% | \$ 339,979 | \$ 5,175 | 6.04% |
| Investment securities (3) | 183,191 | 1,992 | 5.10% | 106,556 | 1,450 | 6.31% |
| Interest-bearing deposits with other banks | 35,461 | 51 | 0.57% | 15,124 | 22 | 0.58% |
| Total interest-earning assets | 582,868 | 7,368 | 5.26% | 461,659 | 6,647 | 5.92% |
| Noninterest-earning assets | 40,421 | | | 36,226 | | |
| Total assets | \$ 623,289 | | | \$ 497,885 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | \$ 43,613 | 108 | 0.98% | \$ 34,189 | 87 | 1.01% |
| Money market deposits | 68,688 | 236 | 1.36% | 37,286 | 191 | 2.03% |
| Savings deposits | 136,499 | 426 | 1.24% | 92,101 | 372 | 1.60% |
| Certificates of deposit | 246,659 | 1,621 | 2.61% | 223,373 | 1,852 | 3.29% |
| Borrowings | 30,776 | 361 | 4.65% | 30,620 | 360 | 4.67% |
| Total interest-bearing liabilities | 526,235 | 2,752 | 2.08% | 417,569 | 2,862 | 2.72% |
| Noninterest-bearing liabilities | | | | | | |
| Other liabilities | 56,597 | | | 43,787 | | |
| Stockholders equity | 40,457 | | | 36,529 | | |
| Total liabilities and stockholders equity | \$ 623,289 | | | \$ 497,885 | | |
| Net interest income | | \$ 4,616 | | | \$ 3,785 | |
| Interest rate spread (1) | | | 3.19% | | | 3.20% |
| Net yield on interest-earning assets (2) | | | 3.39% | | | 3.46% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 110.76% | | | 110.56% |

(1)

Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.

(2) Net interest margin represents net interest income as a percentage of average interest-earning assets.

(3) Tax equivalent adjustments to interest income for tax-exempt securities was \$361 and \$245 for 2010 and 2009, respectively.

Table of Contents

| (Dollars in thousands) | For the Nine Months Ended September 30, | | | | | |
|--|---|------------------|-----------------------|--------------------|------------------|-----------------------|
| | Average Balance | Interest | Average Yield/Cost | Average Balance | Interest | Average Yield/Cost |
| Interest-earning assets: | | | | | | |
| Loans receivable | \$ 360,751 | \$ 15,721 | 5.83% | \$ 330,809 | \$ 15,080 | 6.09% |
| Investment securities (3) | 169,536 | 5,773 | 5.34% | 105,094 | 4,128 | 6.15% |
| Interest-bearing deposits with other banks | 31,906 | 130 | 0.54% | 11,690 | 69 | 0.79% |
| Total interest-earning assets | 562,193 | 21,624 | 5.38% | 447,593 | 19,277 | 5.97% |
| Noninterest-earning assets | 39,112 | | | 32,339 | | |
| Total assets | \$ 601,305 | | | \$ 479,932 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | \$ 41,202 | 303 | 0.98% | \$ 31,076 | 224 | 0.96% |
| Money market deposits | 64,762 | 744 | 1.54% | 33,060 | 512 | 2.07% |
| Savings deposits | 125,524 | 1,248 | 1.33% | 82,272 | 954 | 1.55% |
| Certificates of deposit | 247,637 | 4,954 | 2.67% | 222,040 | 6,087 | 3.67% |
| Borrowings | 31,750 | 1,118 | 4.71% | 32,249 | 1,130 | 4.69% |
| Total interest-bearing liabilities | 510,875 | 8,367 | 2.19% | 400,697 | 8,907 | 2.97% |
| Noninterest-bearing liabilities | | | | | | |
| Other liabilities | 51,801 | | | 43,154 | | |
| Stockholders equity | 38,629 | | | 36,081 | | |
| Total liabilities and stockholders equity | \$ 601,305 | | | \$ 479,932 | | |
| Net interest income | | \$ 13,257 | | | \$ 10,370 | |
| Interest rate spread (1) | | | 3.19% | | | 3.00% |
| Net yield on interest-earning assets (2) | | | 3.39% | | | 3.31% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 110.05% | | | 111.70% |

(1) Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.

(2) Net interest margin represents net interest income as a percentage of average interest-earning assets.

(3) Tax equivalent adjustments to interest income for tax-exempt securities was \$1,000 and \$708 for 2010 and 2009, respectively.

Analysis of Changes in Net Interest Income. The following tables analyze the changes in interest income and interest expense, between the three and nine month periods ended September 30, 2010 and 2009, in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Company's interest income and interest expense are attributable to changes in rate (change in rate multiplied by prior period volume), changes in volume (changes in volume multiplied by prior period rate) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances. Changes in interest income on securities reflects the changes in interest income on a fully tax equivalent basis.

Table of Contents

| (Dollars in thousands) | For the Three Months ended September 30, 2010 versus 2009 | | |
|--|--|----------|--------|
| | Increase (decrease) due to | | |
| | Volume | Rate | Total |
| Interest-earning assets: | | | |
| Loans receivable | \$ 368 | \$ (219) | \$ 149 |
| Investment securities | 1,218 | (677) | 541 |
| Interest-bearing deposits with other banks | 31 | (1) | 30 |
| Total interest-earning assets | 1,617 | (897) | 720 |
| Interest-bearing liabilities: | | | |
| Interest-bearing demand deposits | 24 | (3) | 21 |
| Money market deposits | 161 | (116) | 45 |
| Savings deposits | 179 | (125) | 54 |
| Certificates of deposit | 193 | (424) | (231) |
| Borrowings | 2 | (1) | 1 |
| Total interest-bearing liabilities | 559 | (669) | (110) |
| Net interest income | \$ 1,058 | \$ (228) | \$ 830 |

| (Dollars in thousands) | For the Nine Months ended September 30, 2010 versus 2009 | | |
|--|---|----------|----------|
| | Increase (decrease) due to | | |
| | Volume | Rate | Total |
| Interest-earning assets: | | | |
| Loans receivable | \$ 1,369 | \$ (728) | \$ 641 |
| Investment securities | 2,975 | (1,330) | 1,645 |
| Interest-bearing deposits with other banks | 120 | (59) | 61 |
| Total interest-earning assets | 4,464 | (2,117) | 2,347 |
| Interest-bearing liabilities: | | | |
| Interest-bearing demand deposits | 73 | 6 | 79 |
| Money market deposits | 493 | (261) | 232 |
| Savings deposits | 503 | (209) | 294 |
| Certificates of deposit | 706 | (1,839) | (1,133) |
| Borrowings | (18) | 6 | (12) |
| Total interest-bearing liabilities | 1,757 | (2,297) | (540) |
| Net interest income | \$ 2,707 | \$ 180 | \$ 2,887 |

LIQUIDITY

Management's objective in managing liquidity is maintaining the ability to continue meeting the cash flow needs of bank customers, such as borrowings or deposit withdrawals, as well as the Company's own financial commitments. The principal sources of liquidity are net income, loan payments, maturing and principal reductions on securities and sales of securities available for sale, federal funds sold and cash and deposits with banks. Along with its liquid assets, the Company has additional sources of liquidity available to ensure that adequate funds are available as needed. These include, but are not limited to, the purchase of federal funds, the ability to borrow funds under line of credit agreements with correspondent banks, a borrowing agreement with the Federal Home Loan Bank of Cincinnati, Ohio and the adjustment of interest rates to obtain deposits. Management believes that the Company has the capital adequacy, profitability and reputation to meet the current and projected needs of its customers.

Table of Contents

We manage liquidity based upon factors that include the amount of core deposits as a percentage of total deposits, the level of diversification of our funding sources, the allocation and amount of our deposits among deposit types, the short-term funding sources used to fund assets, the amount of non-deposit funding used to fund assets, the availability of unused funding sources, off-balance sheet obligations, the availability of assets to be readily converted into cash without undue loss, the amount of cash and liquid securities we hold, and the re-pricing characteristics and maturities of our assets when compared to the re-pricing characteristics of our liabilities and other factors.

For the nine months ended September 30, 2010, the adjustments to reconcile net income to net cash from operating activities consisted mainly of depreciation and amortization of premises and equipment, the provision for loan losses, net amortization of premiums and discounts on investment securities and net changes in other assets and liabilities. Cash and cash equivalents increased as a result of an increase in total deposits and proceeds from maturities and principal repayments of investment securities. This increase was offset by the purchase of investment securities and funding new loans. For a more detailed illustration of sources and uses of cash, refer to the consolidated statements of cash flows.

INFLATION

Substantially all of the Company's assets and liabilities relate to banking activities and are monetary in nature. The consolidated financial statements and related financial data are presented in accordance with U.S. Generally Accepted Accounting Principles or GAAP. GAAP currently requires the Company to measure the financial position and results of operations in terms of historical dollars, with the exception of securities available for sale, impaired loans and other real estate loans that are measured at fair value. Changes in the value of money due to rising inflation can cause purchasing power loss.

Management's opinion is that movements in interest rates affect the financial condition and results of operations to a greater degree than changes in the rate of inflation. It should be noted that interest rates and inflation do affect each other, but do not always move in correlation with each other. The Company's ability to match the interest sensitivity of its financial assets to the interest sensitivity of its liabilities in its asset/liability management may tend to minimize the effect of changes in interest rates on the Company's performance.

REGULATORY MATTERS

The Company is subject to the regulatory requirements of The Federal Reserve System as a multi-bank holding company. The affiliate banks are subject to regulations of the Federal Deposit Insurance Corporation (FDIC) and the State of Ohio, Division of Financial Institutions.

Effective February 11, 2010, the Board of Directors of the Company's subsidiary, EB, entered into a Memorandum of Understanding (MOU) with the FDIC and the Ohio Division of Financial Institutions as a result of the joint examination by the FDIC and the Ohio Division of Financial Institutions completed in the fourth quarter of 2009. The MOU sets forth certain actions required to be taken by management of EB to rectify unsatisfactory conditions identified by the federal and state banking regulators that relate to EB's concentration of credit for non-owner occupied 1 - 4 family residential mortgage loans. The MOU requires EB to reduce delinquent and classified loans and enhance credit administration for non-owner occupied residential real estate; to develop specific plans for the reduction of borrower indebtedness on classified and delinquent credits; to correct violations of laws and regulations listed in the joint examination report; to implement an earnings improvement plan; to maintain specified capital discussed below; to submit to the FDIC and the Ohio Division of Financial Institutions for review and comment a revised methodology for calculating and determining the adequacy of the allowance for loan losses; and to provide 30 days' advance notification of proposed dividend payments.

Compliance with the terms of the MOU is a high priority for the Company. In anticipation of the requirements that would be imposed by the MOU executed February 11, 2010, management devoted significant resources to the preceding matters during the fiscal year ended December 31, 2009, and continues to do so during 2010. Specific actions taken included the evaluation and reorganization of lending and credit administration personnel, retention of collection and workout personnel, and the sale of \$4.6 million of nonperforming assets to a sister, nonbank-asset resolution subsidiary established late in the fourth quarter of 2009. In 2009, the Company invested \$1.25 million in EB in the form of capital infusions to maintain Tier I capital at the level expected by the FDIC and the Ohio Division of Financial Institutions.

The MOU requires that EB submit plans and report to the Ohio Division of Financial Institutions and the FDIC regarding EB's loan portfolio and profit plan, among other matters. The MOU also requires that the Bank maintain its Tier I Leverage Capital ratio at not less than 9 percent.

Table of Contents

The following table sets forth the capital requirements for EB under the FDIC regulations and EB's capital ratios at September 30, 2010 and December 31, 2009:

| Capital Ratio | FDIC Regulations | | September 30, 2010 | December 31, 2009 |
|---|------------------------|------------------|--------------------|-------------------|
| | Adequately Capitalized | Well Capitalized | | |
| Tier I Leverage Capital Risk-Based Capital: | 4.00% | 5.00%(1) | 9.64% | 10.29% |
| Tier I | 4.00 | 6.00 | 13.75 | 13.63 |
| Total | 8.00 | 10.00 | 15.04 | 14.91 |

(1) 9 percent required by the MOU.

REGULATORY CAPITAL REQUIREMENTS

The Company is subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings and other factors and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can trigger regulatory action that could have a direct material effect on the Company's operations.

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion and plans for capital restoration are required.

The following table illustrates the Company's risk-weighted capital ratios at September 30, 2010:

| | Middlefield Banc Corp. September 30, 2010 | | The Middlefield Banking Co. September 30, 2010 | | Emerald Bank September 30, 2010 | |
|---|--|--------|---|--------|------------------------------------|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital (to Risk-weighted Assets) | | | | | | |
| Actual | \$ 44,952 | 11.72% | \$ 37,304 | 11.26% | \$ 7,318 | 15.04% |
| For Capital Adequacy Purposes | 30,679 | 8.00 | 26,493 | 8.00 | 3,893 | 8.00 |
| To Be Well Capitalized | 38,349 | 10.00 | 33,117 | 10.00 | 4,867 | 10.00 |
| Tier I Capital (to Risk-weighted Assets) | | | | | | |
| Actual | \$ 40,144 | 10.47% | \$ 33,467 | 10.11% | \$ 6,691 | 13.75% |
| For Capital Adequacy Purposes | 15,340 | 4.00 | 13,247 | 4.00 | 1,947 | 4.00 |

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

| | | | | | | |
|---------------------------------------|-----------|-------|-----------|-------|----------|-------|
| To Be Well Capitalized | 23,010 | 6.00 | 19,870 | 5.00 | 2,920 | 6.00 |
| Tier I Capital (to Average Assets) | | | | | | |
| Actual | \$ 40,144 | 6.81% | \$ 33,467 | 6.52% | \$ 6,691 | 9.64% |
| For Capital Adequacy Purposes | 23,567 | 4.00 | 20,543 | 4.00 | 2,777 | 4.00 |
| To Be Well Capitalized | 29,458 | 5.00 | 25,678 | 5.00 | 3,471 | 5.00 |

Table of Contents**Item 3. Quantitative and Qualitative Disclosures about Market Risk****ASSET AND LIABILITY MANAGEMENT**

The primary objective of the Company's asset and liability management function is to maximize the Company's net interest income while simultaneously maintaining an acceptable level of interest rate risk given the Company's operating environment, capital and liquidity requirements, performance objectives and overall business focus. The principal determinant of the exposure of the Company's earnings to interest rate risk is the timing difference between the re-pricing and maturity of interest-earning assets and the re-pricing or maturity of its interest-bearing liabilities. The Company's asset and liability management policies are designed to decrease interest rate sensitivity primarily by shortening the maturities of interest-earning assets while at the same time extending the maturities of interest-bearing liabilities. The Board of Directors of the Company continues to believe in strong asset/liability management in order to insulate the Company from material and prolonged increases in interest rates. As a result of this policy, the Company emphasizes a larger, more diversified portfolio of residential mortgage loans in the form of mortgage-backed securities. Mortgage-backed securities generally increase the quality of the Company's assets by virtue of the insurance or guarantees that back them, are more liquid than individual mortgage loans and may be used to collateralize borrowings or other obligations of the Company.

The Company's Board of Directors has established an Asset and Liability Management Committee consisting of four outside directors, the President and Chief Executive Officer, Executive Vice President/ Chief Operating Officer, Senior Vice President /Chief Financial Officer and Senior Vice President/Commercial Lending. This committee, which meets quarterly, generally monitors various asset and liability management policies and strategies, which were implemented by the Company over the past few years. These strategies have included: (i) an emphasis on the investment in adjustable-rate and shorter duration mortgage-backed securities; (ii) an emphasis on the origination of commercial loans, residential construction loans and commercial real estate loans, which generally have adjustable or floating interest rates and/or shorter maturities than traditional single-family residential loans, and consumer loans, which generally have shorter terms and higher interest rates than mortgage loans; (iii) increase in the duration of the liability base of the Company by extending the maturities of savings deposits, borrowed funds and repurchase agreements.

The Company has established the following guidelines for assessing interest rate risk:

Net interest income simulation. Given a 200 basis point parallel and gradual increase or decrease in market interest rates, net interest income may not change by more than 10% for a one-year period.

Portfolio equity simulation. Portfolio equity is the net present value of the Company's existing assets and liabilities. Given a 200 basis point immediate and permanent increase or decrease in market interest rates, portfolio equity may not correspondingly decrease or increase by more than 20% of stockholders' equity.

The following table presents the simulated impact of a 200 basis point upward and a 200 basis point downward shift of market interest rates on net interest income and the change in portfolio equity. This analysis was done assuming that the interest-earning asset and interest-bearing liability levels at September 30, 2010 remained constant. The impact of the market rate movements was developed by simulating the effects of rates changing gradually over a one-year period from the September 30, 2010 levels for net interest income. The impact of market rate movements was developed by simulating the effects of an immediate and permanent change in rates at September 30, 2010 for portfolio equity:

| | Increase 200 Basis Points | Decrease 200 Basis Points |
|--|---------------------------------|---------------------------------|
| Net interest income increase (decrease) | 1.43% | 2.71% |
| Portfolio equity increase (decrease) | (12.34)% | (20.82)% |

Item 4. Controls and Procedures Disclosure

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Table of Contents

As of the end of the period covered by this quarterly report, an evaluation was carried out 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 defined in Exchange Act Rules 13a-14(e) and 15d-14(e) under the Securities Exchange Act of 1934). Based on their evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are, to the best of their knowledge, effective to ensure that information required to be disclosed by the Corporation in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. Subsequent to the date of their evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that there were no significant changes in internal control or in other factors that could significantly affect its internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

A material weakness is a significant deficiency (as defined in Public Company Accounting Oversight Board Auditing Standard No. 2), or a combination of significant deficiencies, that results in there being more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by management or employees in the normal course of performing their assigned functions.

Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 1a. There are no material changes to the risk factors set forth in Part I, Item 1A, Risk Factors, of the Company's Annual Report on Form 10-K for the year ended December 31, 2009. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company's business.

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

None

Item 3. Defaults by the Company on its senior securities

None

Item 4. Reserved

Item 5. Other information

At a meeting on November 8, 2010 the board of directors of Middlefield Banc Corp. agreed to terminate the offering of up to 1.7 million shares at \$18.00 per share, which offering had begun on or about August 16, 2010. Middlefield Banc Corp. filed a Form 8-K Current Report with the SEC on August 20, 2010 to report commencement of the offering, which was conducted as a private offering in reliance upon Rule 506 of Regulation D. No shares were sold in the offering. Despite termination of the private offering, Middlefield Banc Corp. is pursuing alternative capital-raising opportunities and has authorized the sales agent involved with the terminated private offering to continue discussions with selected investors that have expressed interest in a potential investment in Middlefield Banc Corp. stock. Any capital raised in this process would be used for general corporate purposes and to support subsidiary bank capital, but Middlefield Banc Corp. can give no assurance about whether any capital will be raised. Further, Middlefield Banc Corp. is unable to determine at this time the amount of capital that may be raised over the next few months.

Table of Contents

Item 6. Exhibits

Exhibit list for Middlefield Banc Corp. s Form 10-Q Quarterly Report for the Period Ended September 30, 2010

| exhibit number | description | location |
|-----------------------|--|--|
| 3.1 | Second Amended and Restated Articles of Incorporation of Middlefield Banc Corp., as amended | Incorporated by reference to Exhibit 3.1 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2005, filed on March 29, 2006 |
| 3.2 | Regulations of Middlefield Banc Corp. | Incorporated by reference to Exhibit 3.2 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001 |
| 4.0 | Specimen stock certificate | Incorporated by reference to Exhibit 4 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001 |
| 4.1 | Amended and Restated Trust Agreement, dated as of December 21, 2006, between Middlefield Banc Corp., as Depositor, Wilmington Trust Company, as Property trustee, Wilmington Trust Company, as Delaware Trustee, and Administrative Trustees | Incorporated by reference to Exhibit 4.1 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 27, 2006 |
| 4.2 | Junior Subordinated Indenture, dated as of December 21, 2006, between Middlefield Banc Corp. and Wilmington Trust Company | Incorporated by reference to Exhibit 4.2 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 27, 2006 |
| 4.3 | Guarantee Agreement, dated as of December 21, 2006, between Middlefield Banc Corp. and Wilmington Trust Company | Incorporated by reference to Exhibit 4.3 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 27, 2006 |
| 10.1.0* | 1999 Stock Option Plan of Middlefield Banc Corp. | Incorporated by reference to Exhibit 10.1 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001 |
| 10.1.1* | 2007 Omnibus Equity Plan | Incorporated by reference to Middlefield Banc Corp. s definitive proxy statement for the 2008 Annual Meeting of Shareholders, Appendix A, filed on April 7, 2008 |
| 10.2* | Severance Agreement between Middlefield Banc Corp. and Thomas G. Caldwell, dated January 7, 2008 | Incorporated by reference to Exhibit 10.2 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.3* | | |

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-Q

| | | |
|---------|---|--|
| | Severance Agreement between Middlefield Banc Corp. and James R. Heslop, II, dated January 7, 2008 | Incorporated by reference to Exhibit 10.3 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.4.0* | Severance Agreement between Middlefield Banc Corp. and Jay P. Giles, dated January 7, 2008 | Incorporated by reference to Exhibit 10.4 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.4.1* | Severance Agreement between Middlefield Banc Corp. and Teresa M. Hetrick, dated January 7, 2008 | Incorporated by reference to Exhibit 10.4.1 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.4.2* | Severance Agreement between Middlefield Banc Corp. and Jack L. Lester, dated January 7, 2008 | Incorporated by reference to Exhibit 10.4.2 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |

Table of Contents

| exhibit number | description | location |
|-----------------------|---|---|
| 10.4.3* | Severance Agreement between Middlefield Banc Corp. and Donald L. Stacy, dated January 7, 2008 | Incorporated by reference to Exhibit 10.4.3 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.4.4* | Severance Agreement between Middlefield Banc Corp. and Alfred F. Thompson Jr., dated January 7, 2008 | Incorporated by reference to Exhibit 10.4.4 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.5 | Federal Home Loan Bank of Cincinnati Agreement for Advances and Security Agreement dated September 14, 2000 | Incorporated by reference to Exhibit 10.4 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001 |
| 10.6* | Amended Director Retirement Agreement with Richard T. Coyne | Incorporated by reference to Exhibit 10.6 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.7* | Amended Director Retirement Agreement with Frances H. Frank | Incorporated by reference to Exhibit 10.7 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.8* | Amended Director Retirement Agreement with Thomas C. Halstead | Incorporated by reference to Exhibit 10.8 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.9* | Director Retirement Agreement with George F. Hasman | Incorporated by reference to Exhibit 10.9 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002 |
| 10.10* | Director Retirement Agreement with Donald D. Hunter | Incorporated by reference to Exhibit 10.10 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002 |
| 10.11* | Director Retirement Agreement with Martin S. Paul | Incorporated by reference to Exhibit 10.11 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002 |
| 10.12* | Amended Director Retirement Agreement with Donald E. Villers | Incorporated by reference to Exhibit 10.12 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008 |
| 10.13* | Executive Survivor Income Agreement (aka DBO agreement [death benefit only]) with Donald L. Stacy | Incorporated by reference to Exhibit 10.14 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, |

2003, filed on March 30, 2004

| | | |
|--------|--|---|
| 10.14* | DBO Agreement with Jay P. Giles | Incorporated by reference to Exhibit 10.15 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004 |
| 10.15* | DBO Agreement with Alfred F. Thompson, Jr. | Incorporated by reference to Exhibit 10.16 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004 |
| 10.16* | Reserved | |

Table of Contents

| exhibit number | description | location |
|-----------------------|--|--|
| 10.17* | DBO Agreement with Theresa M. Hetrick | Incorporated by reference to Exhibit 10.18 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004 |
| 10.18* | DBO Agreement with Jack L. Lester | Incorporated by reference to Exhibit 10.19 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004 |
| 10.19* | DBO Agreement with James R. Heslop, II | Incorporated by reference to Exhibit 10.20 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004 |
| 10.20* | DBO Agreement with Thomas G. Caldwell | Incorporated by reference to Exhibit 10.21 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004 |
| 10.21* | Form of Indemnification Agreement with directors of Middlefield Banc Corp. and with executive officers of Middlefield Banc Corp. and The Middlefield Banking Company | Incorporated by reference to Exhibit 99.1 of Middlefield Banc Corp. s registration statement on Form 10, Amendment No. 1, filed on September 14, 2001 |
| 10.22* | Annual Incentive Plan Summary | Incorporated by reference to the summary description of the annual incentive plan included as Exhibit 10.22 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 16, 2005 |
| 10.23* | Amended Executive Deferred Compensation Agreement with Thomas G. Caldwell | Incorporated by reference to Exhibit 10.23 of Middlefield Banc Corp. s Form 8-K Current Report filed on May 9, 2008 |
| 10.24* | Amended Executive Deferred Compensation Agreement with James R. Heslop, II | Incorporated by reference to Exhibit 10.24 of Middlefield Banc Corp. s Form 8-K Current Report filed on May 9, 2008 |
| 10.25* | Amended Executive Deferred Compensation Agreement with Donald L. Stacy | Incorporated by reference to Exhibit 10.25 of Middlefield Banc Corp. s Form 8-K Current Report filed on May 9, 2008 |
| 31.1 | Rule 13a-14(a) certification of Chief Executive Officer | filed herewith |

| | | |
|------|---|----------------|
| 31.2 | Rule 13a-14(a) certification of Chief Financial Officer | filed herewith |
| 32 | Rule 13a-14(b) certification | filed herewith |
| 99 | Report of independent registered public accounting firm | filed herewith |

* management contract or compensatory plan or arrangement

Table of Contents

SIGNATURES

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

MIDDLEFIELD BANC CORP.

Date: November 9, 2010

By: /s/ Thomas G. Caldwell
Thomas G. Caldwell
President and Chief Executive Officer

Date: November 9, 2010

By: /s/ Donald L. Stacy
Donald L. Stacy
Principal Financial and Accounting
Officer