

MIDDLEFIELD BANC CORP

Form 10-Q

August 14, 2009

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

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

For the quarterly period ended June 30, 2009

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 or organization)

(IRS Employer Identification No.)

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 August 13, 2009: 1,549,852

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MIDDLEFIELD BANC CORP.
CONSOLIDATED BALANCE SHEET
(Unaudited)

| | June 30, 2009 | December 31, 2008 |
|---|-----------------------|-----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 9,169,682 | \$ 9,795,248 |
| Federal funds sold | 7,530,082 | 7,548,000 |
| Interest-bearing deposits in other institutions | 120,056 | 112,215 |
| | | |
| Cash and cash equivalents | 16,819,820 | 17,455,463 |
| Investment securities available for sale | 101,635,476 | 104,270,366 |
| Loans | 335,513,351 | 321,575,293 |
| Less allowance for loan losses | 3,668,122 | 3,556,763 |
| | | |
| Net loans | 331,845,229 | 318,018,530 |
| Premises and equipment | 8,300,496 | 8,448,915 |
| Goodwill | 4,558,687 | 4,558,687 |
| Bank-owned life insurance | 7,569,318 | 7,440,687 |
| Accrued interest and other assets | 8,990,338 | 7,654,287 |
| | | |
| TOTAL ASSETS | \$ 479,719,364 | \$ 467,846,935 |
| | | |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing demand | \$ 41,512,139 | \$ 42,357,154 |
| Interest-bearing demand | 30,732,983 | 26,404,660 |
| Money market | 34,704,138 | 27,845,438 |
| Savings | 87,205,502 | 68,968,844 |
| Time | 216,345,304 | 229,243,506 |
| | | |
| Total deposits | 410,500,065 | 394,819,602 |
| Short-term borrowings | 1,237,795 | 1,886,253 |
| Other borrowings | 30,104,627 | 33,903,019 |
| Accrued interest and other liabilities | 2,198,215 | 2,178,813 |
| | | |
| TOTAL LIABILITIES | 444,040,702 | 432,787,687 |
| | | |
| STOCKHOLDERS EQUITY | | |
| Common stock, no par value; 10,000,000 shares authorized, 1,739,382 and 1,725,381 shares issued | 27,617,948 | 27,301,403 |
| Retained earnings | 15,050,193 | 14,786,353 |
| Accumulated other comprehensive loss | (255,872) | (294,901) |
| Treasury stock, at cost; 189,530 shares in 2009 and 2008 | (6,733,607) | (6,733,607) |

| | | |
|---|----------------|----------------|
| TOTAL STOCKHOLDERS EQUITY | 35,678,662 | 35,059,248 |
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 479,719,364 | \$ 467,846,935 |

See accompanying notes to the unaudited consolidated financial statements.

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MIDDLEFIELD BANC CORP.
CONSOLIDATED STATEMENT OF INCOME
(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|------------------|------------------------------|-------------------|
| | 2009 | 2008 | 2009 | 2008 |
| INTEREST INCOME | | | | |
| Interest and fees on loans | \$ 4,906,206 | \$ 5,393,090 | \$ 9,904,308 | \$ 10,848,364 |
| Interest-bearing deposits in other institutions | 2,272 | 3,638 | 9,507 | 8,841 |
| Federal funds sold | 3,285 | 22,982 | 7,041 | 102,286 |
| Investment securities: | | | | |
| Taxable interest | 924,120 | 606,382 | 1,777,317 | 1,171,461 |
| Tax-exempt interest | 453,894 | 456,932 | 900,218 | 910,875 |
| Dividends on FHLB stock | 15,395 | 29,612 | 30,764 | 59,012 |
| Total interest income | 6,305,172 | 6,512,636 | 12,629,155 | 13,100,839 |
| INTEREST EXPENSE | | | | |
| Deposits | 2,558,647 | 3,098,688 | 5,274,867 | 6,432,668 |
| Short-term borrowings | 4,511 | 7,288 | 10,174 | 17,183 |
| Other borrowings | 371,475 | 407,874 | 760,130 | 821,985 |
| Total interest expense | 2,934,633 | 3,513,850 | 6,045,171 | 7,271,836 |
| NET INTEREST INCOME | 3,370,539 | 2,998,786 | 6,583,984 | 5,829,003 |
| Provision for loan losses | 260,000 | 95,000 | 414,000 | 170,000 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 3,110,539 | 2,903,786 | 6,169,984 | 5,659,003 |
| NONINTEREST INCOME | | | | |
| Service charges on deposit accounts | 466,652 | 459,033 | 905,565 | 924,561 |
| Investment securities gains, net | | 8,750 | | 8,750 |
| Earnings on bank-owned life insurance | 60,054 | 72,374 | 128,631 | 142,462 |
| Other income | 109,514 | 97,060 | 225,475 | 198,895 |
| Total noninterest income | 636,220 | 637,217 | 1,259,671 | 1,274,668 |
| NONINTEREST EXPENSE | | | | |
| Salaries and employee benefits | 1,538,004 | 1,126,754 | 2,908,584 | 2,321,173 |
| Occupancy expense | 220,854 | 209,403 | 475,770 | 440,586 |
| Equipment expense | 150,738 | 139,326 | 273,433 | 285,436 |

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| | | | | |
|------------------------------|------------|------------|--------------|--------------|
| Data processing costs | 218,865 | 188,785 | 467,747 | 398,065 |
| Ohio state franchise tax | 123,300 | 117,000 | 246,600 | 234,000 |
| FDIC assessment | 271,119 | 28,790 | 443,160 | 45,692 |
| Other expense | 780,117 | 768,916 | 1,483,491 | 1,369,694 |
| Total noninterest expense | 3,302,997 | 2,578,974 | 6,298,785 | 5,094,646 |
| Income before income taxes | 443,762 | 962,029 | 1,130,870 | 1,839,025 |
| Income taxes | (17,000) | 179,000 | 67,000 | 319,000 |
| NET INCOME | \$ 460,762 | \$ 783,029 | \$ 1,063,870 | \$ 1,520,025 |
| EARNINGS PER SHARE | | | | |
| Basic | \$ 0.30 | \$ 0.51 | \$ 0.69 | \$ 0.99 |
| Diluted | 0.30 | 0.51 | 0.69 | 0.98 |
| DIVIDENDS DECLARED PER SHARE | \$ 0.26 | \$ 0.26 | \$ 0.52 | \$ 0.51 |

See accompanying notes to the unaudited consolidated financial statements.

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MIDDLEFIELD BANC CORP.
 CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
 (Unaudited)

| | Common Stock | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total Stockholders' Equity | Comprehensive Income |
|---|-----------------|----------------------|---|-------------------|----------------------------------|-------------------------|
| Balance, December 31, 2008 | \$ 27,301,403 | \$ 14,786,353 | \$ (294,901) | \$ (6,733,607) | \$ 35,059,248 | |
| Net income | | 1,063,870 | | | 1,063,870 | \$ 1,063,870 |
| Other comprehensive income: | | | | | | |
| Unrealized gains on available for sale securities net of taxes of \$20,105 | | | 39,029 | | 39,029 | 39,029 |
| Comprehensive income | | | | | | \$ 1,102,899 |
| Stock based compensation expense recognized in earnings | 30,294 | | | | 30,294 | |
| Dividend reinvestment and purchase plan | 286,251 | | | | 286,251 | |
| Cash dividends (\$0.52 per share) | | (800,030) | | | (800,030) | |
| Balance, June 30, 2009 | \$ 27,617,948 | \$ 15,050,193 | \$ (255,872) | \$ (6,733,607) | \$ 35,678,662 | |

See accompanying notes to the unaudited consolidated financial statements.

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MIDDLEFIELD BANC CORP.
CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

| | Six Months Ended June 30, | |
|--|------------------------------|------------------|
| | 2009 | 2008 |
| OPERATING ACTIVITIES | | |
| Net income | \$ 1,063,870 | \$ 1,520,025 |
| Adjustments to reconcile net income to net cash used for operating activities: | | |
| Provision for loan losses | 414,000 | 170,000 |
| Depreciation | 293,687 | 253,770 |
| Amortization of premium and discount on investment securities | (190,860) | 108,373 |
| Amortization of deferred loan fees, net | (35,342) | (80,287) |
| Earnings on bank-owned life insurance | (128,631) | (142,463) |
| Compensation for stock option expense | 30,294 | 7,524 |
| Increase in accrued interest receivable | 104,605 | 42,045 |
| Decrease in accrued interest payable | (222,688) | (205,513) |
| Other, net | (343,635) | (358,975) |
| Net cash provided by operating activities | 985,301 | 1,314,499 |
| INVESTING ACTIVITIES | | |
| Investment securities available for sale: | | |
| Proceeds from repayments and maturities | 10,571,248 | 8,578,818 |
| Purchases | (7,686,364) | (18,144,564) |
| Increase in loans, net | (15,066,292) | (10,769,677) |
| Purchase of Federal Home Loan Bank stock | (14,100) | (61,500) |
| Purchase of premises and equipment | (145,269) | (1,183,218) |
| Net cash used for investing activities | (12,340,777) | (21,580,141) |
| FINANCING ACTIVITIES | | |
| Net increase in deposits | 15,680,463 | 11,170,442 |
| Increase (decrease) in short-term borrowings, net | (648,458) | 4,201,713 |
| Repayment of other borrowings | (3,798,390) | (1,739,002) |
| Proceeds from other borrowings | | 1,000,000 |
| Purchase of treasury stock | | (1,350,881) |
| Proceeds from dividend reinvestment & purchase plan | 286,251 | 352,860 |
| Cash dividends | (800,030) | (781,981) |
| Net cash provided by financing activities | 10,719,836 | 12,853,151 |
| Decrease in cash and cash equivalents | (635,643) | (7,412,491) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 17,455,463 | 17,815,322 |

| | | |
|--|---------------|---------------|
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 16,819,820 | \$ 10,402,831 |
|--|---------------|---------------|

SUPPLEMENTAL INFORMATION

Cash paid during the year for:

| | | |
|-------------------------------------|--------------|--------------|
| Interest on deposits and borrowings | \$ 6,267,859 | \$ 7,516,559 |
| Income taxes | 275,000 | 350,000 |

See accompanying notes to the unaudited consolidated financial statements.

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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 subsidiaries The Middlefield Banking Company and Emerald Bank. 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, 2008, 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.

Certain items contained in the 2008 financial statements have been reclassified to conform to the presentation for 2009. Such reclassifications had no effect on the net results of operations.

Recent Accounting Pronouncements

In December 2007, the FASB issued FAS No. 141 (revised 2007), *Business Combinations* (FAS 141(R)), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. FAS No. 141(R) is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

In February 2008, the FASB issued Staff Position No.157-2, *Partial Deferral of the Effective Date of Statement 157*, which deferred the effective date of FAS No. 157, *Fair Value Measurements*, for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In December 2007, the FASB issued FAS No. 160, *Non-controlling Interests in Consolidated Financial Statements an amendment of ARB No. 51*. FAS No. 160 amends ARB No. 51 to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a non-controlling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Among other requirements, this statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. FAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

In March 2008, the FASB issued FAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, to require enhanced disclosures about derivative instruments and hedging activities. The new standard has revised financial reporting for derivative instruments and hedging activities by requiring more transparency about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under FAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. FAS No. 161 requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also requires entities to provide more information about their liquidity by requiring disclosure of derivative features that are credit risk-related. Further, it requires cross-referencing within footnotes to enable financial statement users to

locate important information about derivative instruments. FAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encourage. The adoption of this standard will not have a material effect on the Company s results of operations or financial position.

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In May 2009, the FASB issued FAS No. 165, *Subsequent Events*, which requires companies to evaluate events and transactions that occur after the balance sheet date but before the date the financial statements are issued, or available to be issued in the case of non-public entities. FAS No. 165 requires entities to recognize in the financial statements the effect of all events or transactions that provide additional evidence of conditions that existed at the balance sheet date, including the estimates inherent in the financial preparation process. Entities shall not recognize the impact of events or transactions that provide evidence about conditions that did not exist at the balance sheet date but arose after that date. FAS No. 165 also requires entities to disclose the date through which subsequent events have been evaluated. FAS No. 165 was effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted the provisions of FAS No. 165 for the quarter ended June 30, 2009, as required, and adoption did not have a material impact on Company's results of operations or financial position.

In June 2009, the FASB issued FAS No. 167, *Amendments to FASB Interpretation No. 46(R)*. FAS 167, which amends FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, (FIN 46(R)), prescribes a qualitative model for identifying whether a company has a controlling financial interest in a variable interest entity (VIE) and eliminates the quantitative model prescribed by FIN 46(R). The new model identifies two primary characteristics of a controlling financial interest: (1) provides a company with the power to direct significant activities of the VIE, and (2) obligates a company to absorb losses of and/or provides rights to receive benefits from the VIE. FAS No. 167 requires a company to reassess on an ongoing basis whether it holds a controlling financial interest in a VIE. A company that holds a controlling financial interest is deemed to be the primary beneficiary of the VIE and is required to consolidate the VIE. This statement is effective for fiscal years beginning after November 15, 2009. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In June 2009, the FASB issued FAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*. FAS No. 168 establishes the *FASB Accounting Standards Codification* (Codification), which was officially launched on July 1, 2009, and became the primary source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under the authority of Federal securities laws are also sources of authoritative GAAP for SEC registrants. The subsequent issuances of new standards will be in the form of Accounting Standards Updates that will be included in the Codification. FAS No. 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. As such, the Company plans to adopt FAS No.168 in connection with its third quarter 2009 reporting. As the Codification is neither expected nor intended to change GAAP, the adoption of FAS No.168 will not have a material impact on its results of operations or financial position.

In June 2008, the FASB ratified EITF Issue No. 08-4, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjusted Conversion Ratios*. This Issue provides transition guidance for conforming changes made to EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjusted Conversion Ratios*, that resulted from EITF Issue No. 00-27, *Application of Issue No. 98-5 to Certain Convertible Instruments*, and FAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liability and Equity*. The conforming changes are effective for financial statements issued for fiscal years ending after December 15, 2008, with earlier application permitted. The adoption of this FSP will not have a material effect on the Company's results of operations or financial position.

In May 2008, the FASB issued FASB Staff Position (FSP) No. APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*. This FSP provides guidance on the accounting for certain types of convertible debt instruments that may be settled in cash upon conversion. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. The FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The adoption of this FSP will not have a material effect on the Company's results of operations or financial position.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing assumptions about renewal or extension used in

estimating the useful life of a recognized intangible asset under FAS No. 142, *Goodwill and Other Intangible Assets*. This standard is intended to improve the consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141R and other GAAP. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The measurement provisions of this standard will apply only to intangible assets of the Company acquired after the effective date. The adoption of this FSP will not have a material effect on the Company's results of operations or financial position.

In June 2008, the FASB issued FSP No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*, to clarify that instruments granted in share-based payment transactions can be participating securities prior to the requisite service having been rendered. A basic principle of the FSP is that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of EPS pursuant to the two-class method. The provisions of this FSP are effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented (including interim financial statements, summaries of earnings, and selected financial data) are required to be adjusted retrospectively to conform with the provisions of the FSP. The adoption of this FSP will not have a material effect on the Company's results of operations or financial position.

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In April 2009, the FASB issued FSP No. FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*. This FSP requires companies acquiring contingent assets or assuming contingent liabilities in business combination to either (a) if the assets or liabilities fair value can be determined, recognize them at fair value, at the acquisition date, or (b) if the assets or liabilities fair value cannot be determined, but (i) it is probable that an asset existed or that a liability had been incurred at the acquisition date and (ii) the amount of the asset or liability can be reasonably estimated, recognize them at their estimated amount, at the acquisition date. If the fair value of these contingencies cannot be determined and they are not probable or cannot be reasonably estimated, then companies should not recognize these contingencies as of the acquisition date and instead should account for them in subsequent periods by following other applicable GAAP. This FSP also eliminates the FAS 141R requirement of disclosing in the footnotes to the financial statements the range of expected outcomes for a recognized contingency. This FSP shall be effective for assets or liabilities arising from contingencies in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company is currently evaluating the impact the adoption of the FSP will have on the Company's results of operations.

In April 2009, the FASB issued FSP No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. This FSP relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. FSP No. FAS 157-4 is effective for interim and annual periods ending after June 15, 2009. The adoption of this FSP did not have a material effect on the Company's results of operations or financial position.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, which relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet of companies at fair value. Prior to issuing this FSP, fair values for these assets and liabilities were only disclosed once a year. The FSP now requires these disclosures on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value. FSP No. FAS 107-1 and APB 28-1 is effective for interim and annual periods ending after June 15, 2009. The Company has presented the necessary disclosures in Note 5 herein.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, which provides additional guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on securities. FSP No. FAS 115-2 and FAS 124-2 is effective for interim and annual periods ending after June 15, 2009. The adoption of FSP No. FAS 115-2 and FAS 124-2 did not have a material impact on the Company's financial position or results of operations.

NOTE 2 STOCK-BASED COMPENSATION

During the six months ended June 30, 2009, the Company recorded \$30,294 in compensation cost. As of June 30, 2009 there was approximately \$36,676 of unrecognized compensation cost related to the unvested share-based compensation awards granted. The cost is expected to be recognized in 2009. The Company had 23,500 unvested stock options outstanding as of June 30, 2009.

Stock option activity during the six months ended June 30, 2009 and 2008 is as follows:

| | 2009 | Weighted- average Exercise Price | 2008 | Weighted- average Exercise Price |
|------------------------|---------|---|--------|---|
| Outstanding, January 1 | 110,465 | \$ 27.21 | 88,211 | \$ 28.34 |
| Granted | | | 1,337 | 36.25 |
| Exercised | | | (842) | 19.11 |
| Forfeited | (7,575) | 33.60 | | |

| | | | | | | |
|----------------------|---------|----|-------|--------|----|-------|
| Outstanding, June 30 | 102,890 | \$ | 26.74 | 88,706 | \$ | 28.55 |
|----------------------|---------|----|-------|--------|----|-------|

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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.

There are no convertible securities that would affect the denominator 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 June 30, | | For the Six Months Ended June 30, | |
|--|---|-----------|---|-----------|
| | 2009 | 2008 | 2009 | 2008 |
| Weighted average common shares outstanding | 1,731,490 | 1,707,946 | 1,729,344 | 1,705,266 |
| Average treasury stock shares | (189,530) | (177,691) | (189,530) | (166,117) |
| Weighted average common shares and common stock equivalents used to calculate basic earnings per share | 1,541,960 | 1,530,255 | 1,539,814 | 1,539,149 |
| Additional common stock equivalents (stock options) used to calculate diluted earnings per share | 1,578 | 18,352 | 1,591 | 19,345 |
| Weighted average common shares and common stock equivalents used to calculate diluted earnings per share | 1,543,538 | 1,548,607 | 1,541,405 | 1,558,494 |

Options to purchase 92,616 shares of common stock at prices ranging from \$22.33 to \$40.24 were outstanding during the six months ended June 30, 2009 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 June 30, 2009. Options to purchase 25,897 shares of common stock at prices ranging from \$36.25 to \$40.24 were outstanding during six months ended June 30, 2008 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 June 30, 2008.

NOTE 4 COMPREHENSIVE INCOME

The components of comprehensive income consist exclusively of unrealized gains and losses on available for sale securities. For the six months ended June 30, 2009, this activity is shown under the heading Comprehensive Income as presented in the Consolidated Statement of Changes in Stockholders' Equity (Unaudited).

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The following shows the components and activity of comprehensive income during the periods ended June 30, 2009 and 2008 (net of the income tax effect):

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|--|---|----------------|---|----------------|
| | 2009 | 2008 | 2009 | 2008 |
| Unrealized holding gains (losses) arising during the period on securities held | \$ 570,161 | \$ (1,312,215) | \$ 39,029 | \$ (1,080,231) |
| Reclassification adjustment for gains included in net income | | 5,775 | | 5,775 |
| Net change in unrealized gains (losses) during the period | 570,161 | (1,306,440) | 39,029 | (1,074,456) |
| Unrealized holding gains and (losses), beginning of period | (826,033) | 179,015 | (294,901) | (52,969) |
| Unrealized holding losses, end of period | (255,872) | (1,127,425) | (255,872) | (1,127,425) |
| Net income | 460,762 | 783,029 | 1,063,870 | 1,520,025 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized holding gains (losses) arising during the period | 570,161 | (1,306,440) | 39,029 | (1,074,456) |
| Comprehensive income (loss) | \$ 1,030,923 | \$ (523,411) | \$ 1,102,899 | \$ 445,569 |

NOTE 5 FAIR VALUE MEASUREMENTS

Effective January 1, 2008, the Association adopted FAS No. 157, which, among other things, requires enhanced disclosures about assets and liabilities carried at fair value. FAS No. 157 establishes a hierarchal disclosure framework associated with the level of pricing observe ability utilized in measuring assets and liabilities at fair value. The three broad levels defined by FAS No. 157 hierarchy are as follows:

- 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 measured on a recurring basis on the consolidated balance sheet at their fair value as of June 30, 2009 and December 31, 2008 by level within the fair value hierarchy. As required by FAS No. 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| | June 30, 2009 | | | Total |
|--|---------------|---------------|--------------|----------------|
| | Level I | Level II | Level III | |
| Assets Measured on a Recurring Basis: | | | | |
| Investment securities available for sale | \$ 955,508 | \$ 95,366,104 | \$ 5,313,864 | \$ 101,635,476 |

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| | December 31, 2008 | | | Total |
|---|-------------------|---------------|--------------|-------------------------------|
| | Level I | Level II | Level III | |
| Assets Measured on a Recurring Basis: | | | | |
| Investment securities available for sale | \$ 1,022,162 | \$ 96,568,054 | \$ 6,680,150 | \$ 104,270,366 |
| 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 following table presents the changes in the Level III fair-value category for the quarter ended June 30, 2009. The following represent fair value measurements using significant unobservable inputs (Level III): | | | | |
| | | | | Available-for-Sale Securities |
| Balance, December 31, 2008 | | | | \$ 6,680,150 |
| Total gains or losses (realized/unrealized) | | | | |
| Included in earnings | | | | |
| Included in other comprehensive loss | | | | (1,366,286) |
| Purchases, issuances and settlements | | | | |
| Transfers in and/or out of Level III | | | | |
| Balance, June 30, 2009 | | | | \$ 5,313,864 |

The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at the reporting date \$ Gains and losses (realized and unrealized) included in earnings (or changes in net assets) for the quarter ended June 30, 2009 are reported as investment securities gains (losses), net on the Consolidated Statement of Income. At December 31, 2008, the Company changed its valuation technique for certain private-label collateralized mortgage obligations (CMOs). Previously, the Company relied on prices compiled by third party vendors using observable market data (Level II) to determine the values of these securities. However, FAS 157 assumes that fair values of financial assets are determined in an orderly transaction and not a forced liquidation or distressed sale at the measurement date. Based on financial market conditions at December 31, 2008, the Company concluded the fair values obtained from third-party vendors reflected forced liquidation or distressed sales for these CMOs. Therefore, the Company estimated fair value based on a discounted cash flow methodology using appropriately adjusted discount rates reflecting nonperformance and liquidity risks. The change in the valuation technique for these CMOs resulted in a transfer of \$6,680,150 into Level III financial assets.

The following tables present the assets measured on a nonrecurring basis on the consolidated balance sheet at their fair value as of June 30, 2009 and December 31, 2008, 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.

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| | June 30, 2009 | | | Total |
|---|---------------|--------------|--------------|--------------|
| | Level I | Level II | Level III | |
| Assets Measured on a non-recurring Basis: | | | | |
| Impaired loans | \$ | \$ 1,342,736 | \$ 2,366,592 | \$ 3,709,328 |

| | December 31, 2008 | | | Total |
|---|-------------------|--------------|--------------|--------------|
| | Level I | Level II | Level III | |
| Assets Measured on a non-recurring Basis: | | | | |
| Impaired loans | \$ | \$ 1,194,594 | \$ 1,027,366 | \$ 2,221,960 |

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

| | June 30, 2009 | | December 30, 2008 | |
|--|----------------|----------------|-------------------|----------------|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 16,819,820 | \$ 16,819,820 | \$ 17,455,464 | \$ 17,455,464 |
| Investment securities Available for sale | 101,635,476 | 101,635,476 | 104,270,366 | 104,270,366 |
| Net loans | 331,845,229 | 329,576,631 | 318,018,530 | 317,010,526 |
| Bank-owned life insurance | 7,569,318 | 7,569,318 | 7,440,687 | 7,440,687 |
| Federal Home Loan Bank stock | 1,887,200 | 1,887,200 | 1,873,100 | 1,873,100 |
| Accrued interest receivable | 1,341,769 | 1,341,769 | 1,446,373 | 1,446,373 |
| Financial liabilities: | | | | |
| Deposits | \$ 410,500,065 | \$ 413,061,178 | \$ 394,819,601 | \$ 399,946,594 |
| Short-term borrowings | 1,237,795 | 1,237,795 | 1,886,253 | 1,886,253 |
| Other borrowings | 30,104,627 | 32,102,463 | 33,903,019 | 35,771,019 |
| Accrued interest payable | 1,076,426 | 1,076,426 | 1,299,114 | 1,299,114 |

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.

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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 were determined utilizing discounted cash flow models, due to the absence of a current market to provide reliable market quotes for the instruments.

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:

| | | June 30, 2009 | | |
|---|----------------|---------------|----------------|----------------|
| | Amortized | Gross | Gross | Fair |
| | Cost | Unrealized | Unrealized | Value |
| | | Gains | Losses | |
| U.S. government agency securities | \$ 3,338,056 | \$ 59,826 | \$ (46,326) | \$ 3,351,556 |
| Obligations of states and political subdivisions: | | | | |
| Taxable | 499,644 | 8,381 | | 508,025 |
| Tax-exempt | 44,812,145 | 524,658 | (840,471) | 44,496,332 |
| Mortgage-backed securities | 52,429,033 | 1,368,013 | (1,472,989) | 52,324,057 |
| Total debt securities | 101,078,878 | 1,960,878 | (2,359,786) | 100,679,970 |
| Equity Securities | 944,283 | 71,425 | (60,202) | 955,506 |
| Total | \$ 102,023,161 | \$ 2,032,303 | \$ (2,419,988) | \$ 101,635,476 |

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| | Amortized Cost | December 31, 2008 | | Fair Value |
|---|-------------------|------------------------------|-------------------------------|----------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| U.S. government agency securities | \$ 4,376,650 | \$ 126,912 | \$ | \$ 4,503,562 |
| Obligations of states and political subdivisions: | | | | |
| Taxable | 499,528 | | (3,278) | 496,250 |
| Tax-exempt | 44,328,318 | 405,958 | (1,050,244) | 43,684,032 |
| Mortgage-backed securities | 54,568,407 | 1,042,038 | (1,046,085) | 54,564,360 |
| Total debt securities | 103,772,903 | 1,574,908 | (2,099,607) | 103,248,204 |
| Equity Securities | 944,283 | 141,079 | (63,200) | 1,022,162 |
| Total | \$ 104,717,186 | \$ 1,715,987 | \$ (2,162,807) | \$ 104,270,366 |

The amortized cost and fair value of debt securities at June 30, 2009, 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.

| | Amortized Cost | Fair Value |
|--|-------------------|----------------|
| Due in one year or less | \$ 1,219,224 | \$ 1,236,760 |
| Due after one year through five years | 7,061,546 | 7,360,949 |
| Due after five years through ten years | 12,713,108 | 12,872,703 |
| Due after ten years | 80,085,000 | 79,209,558 |
| Total | \$ 101,078,878 | \$ 100,679,970 |

Proceeds from sales of investment securities available for sale were \$0 during the six-months ended June 30, 2009. Gross gains and gross losses realized were \$0 and \$8,750, respectively, during the six-months ended June 30, 2009. There were no sales of investment securities available for sale during the six-months ended June 30, 2009 and 2008. 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.

| | June 30, 2009 | | | | Total Fair Value | Total Gross Unrealized Losses |
|--|--|-------------------------------|---|-------------------------------|------------------------|--|
| | Less than Twelve Months Fair Value | Gross Unrealized Losses | Twelve Months or Greater Fair Value | Gross Unrealized Losses | | |
| U.S. government agency securities | \$ 744,797 | \$ (18,259) | \$ 971,932 | \$ (28,068) | \$ 1,716,729 | \$ (46,326) |
| Obligations of states and political subdivisions | 3,643,236 | (119,537) | 19,673,799 | (720,934) | 23,317,035 | (840,471) |
| | 7,293,546 | (310,390) | 6,675,971 | (1,162,599) | 13,969,517 | (1,472,989) |

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| | | | | | | |
|----------------------------|---------------|--------------|---------------|----------------|---------------|----------------|
| Mortgage-backed securities | | | | | | |
| Equity securities | 220,250 | (29,750) | 15,500 | (30,452) | 235,750 | (60,202) |
| Total | \$ 11,901,829 | \$ (477,935) | \$ 27,337,202 | \$ (1,942,053) | \$ 39,239,031 | \$ (2,419,988) |

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| | Less than Twelve Months | | December 31, 2008 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 | 17,777,295 | (561,005) | 7,820,417 | (492,517) | 25,597,712 |
| Mortgage-backed securities | 16,107,618 | (966,793) | 5,062,619 | (79,292) | 21,170,237 | (1,046,085) |
| Equity securities | 221,500 | (28,500) | 11,250 | (34,700) | 232,750 | (63,200) |
| Total | \$ 34,106,413 | \$ (1,556,298) | \$ 12,894,286 | \$ (606,509) | \$ 47,000,699 | \$ (2,162,807) |

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 FSP SFAS 115-1 and SFAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (FSP SFAS 115-1 and 124-1). 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, 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 FSP FAS 115-2 during the second quarter of 2009. FSP FAS 115-2 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 FSP FAS 115-2, 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 of the Company's adoption of FSP FAS 115-2, 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 95% of the total available-for-sale portfolio as of June 30, 2009 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 \$5.3 million for which the Company evaluates credit losses on a quarterly basis. 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

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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 six months ended June 30, 2009, there were no available-for-sale debt securities with an unrealized loss that has suffered OTTI.

NOTE 7 SUBSEQUENT EVENTS

The Company assessed events occurring subsequent to June 30, 2009 through August 12, 2009 for potential recognition and disclosure in the consolidated financial statements. No events have occurred that would require adjustment to or disclosure in the consolidated financial statements which were issued on August 12, 2009.

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.

CHANGES IN FINANCIAL CONDITION

General. The Company's total assets increased by \$12.0 million or 2.5% from December 31, 2008 to June 30, 2009 to a balance of \$479.7 million. Loans receivable and accrued interest and other assets increased \$13.9 million and \$1.3 million respectively. The increase in total assets reflects a corresponding increase in total liabilities of \$11.3 million or 2.6% and an increase in stockholders' equity of \$619,000 or 1.8%. The increase in total liabilities was primarily the result of deposit growth of \$15.7 million. The increase in stockholders' equity was the result of increases in common stock, retained earnings and accumulated other comprehensive loss of \$317,000, \$264,000 and \$39,000 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 declined \$636,000 or 3.6% to \$16.8 million at June 30, 2009 from \$17.5 million at December 31, 2008. 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 June 30, 2009 quarter at \$101.6 million a decrease of \$2.6 million or 2.5% from \$104.3 million at December 31, 2008. During this period the Company recorded purchases of available for sale securities of \$7.7 million, consisting of purchases of mortgage-backed securities. Offsetting the purchases of securities were repayments and maturities of securities of \$10.6 million during the six months ended June 30, 2009. In addition, the securities portfolio increased approximately \$59,000 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 \$13.8 million or 4.3% to \$331.9 million as of June 30, 2009 from \$318.0 million at December 31, 2008. Included in this increase was an increase in the commercial real estate loan portfolio of \$11.4 million or 26.8% during the six months ended June 30, 2009. 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 clients' 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.

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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 collectibility 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 June 30, 2009. 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 included non-accrual loans, renegotiated loans, loans 90 days or more past due, other real estate, and repossessed assets. A loan is classified as non-accrual when, in the opinion of management, there are serious doubts about collectibility of interest and principal. At the time the accrual of interest is discontinued, future income is recognized only when cash is received. Non-performing loans amounted to \$14.0 million or 4.2% and \$8.5 million or 2.6% of total loans at June 30, 2009 and December 31, 2008, respectively. The increase in nonperforming assets has occurred primarily in real estate mortgage loans and other real estate owned. Non-performing loans secured by real estate totaled \$11.7 million as of June 30, 2009, up \$7.2 million from \$4.5 million at December 31, 2008. The depressed state of the economy and rising levels of 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.

| | 6/30/2009 | 3/31/2009 | 12/31/2008 | 9/30/2008 | 6/30/2008 |
|---------------------------|-----------|-----------|------------|-----------|-----------|
| Nonperforming loans | \$ 14,023 | \$ 13,370 | \$ 8,481 | \$ 6,749 | \$ 6,530 |
| Real estate owned | 1,967 | 1,331 | 1,106 | 1,108 | 911 |
| Nonperforming assets | \$ 15,991 | \$ 14,701 | \$ 9,587 | \$ 7,857 | \$ 7,441 |
| Allowance for loan losses | \$ 3,668 | \$ 3,621 | \$ 3,557 | \$ 3,614 | \$ 3,435 |

Ratios

| | | | | | |
|--|--------|--------|--------|--------|--------|
| Nonperforming loans to total loans | 4.18% | 4.16% | 2.64% | 2.11% | 2.04% |
| Nonperforming assets to total assets | 3.33% | 3.14% | 2.11% | 1.76% | 1.66% |
| Allowance for loan losses to total loans | 1.09% | 1.13% | 1.11% | 1.13% | 1.08% |
| Allowance for loan losses to nonperforming loans | 26.16% | 27.08% | 41.94% | 53.55% | 52.60% |

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 June 30, 2009, 83.6% 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.

Deposits. The Company considers various sources when evaluating funding needs, including but not limited to deposits, which are a significant source of funds totaling \$410.5 million or 92.9% of the Company's total funding sources at June 30, 2009. Total deposits increased \$15.7 million or 4.0% to \$410.5 million at June 30, 2009 from \$394.8 million at December 31, 2008. The increase in deposits is primarily related to the growth of savings deposits that totaled \$87.2 million at June 30, 2009 an increase of \$18.2 million or 26.4% for the year. Interest-bearing demand and money market accounts increased \$4.3 and \$6.9 while time deposits declined by \$12.9 million during the six months ended June 30, 2009.

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 and repurchase agreements. Borrowed funds declined \$4.5 million or 12.4% to \$31.3 million at June 30, 2009 from \$35.8 million at December 31, 2008. The majority of the decrease came from FHLB borrowings which declined \$3.8 million or 11.2%. The decline in FHLB advances was the result of matured borrowings which were replaced with deposit growth.

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Stockholders equity. Stockholders equity increased \$619,000 or 1.8% to \$35.7 million at June 30, 2009 from \$35.0 million at December 31, 2008. The increase in stockholders equity was the result of increases in common stock and retained earnings of \$317,000 and \$264,000, respectively. Stockholders equity was also increased by a decline in other comprehensive loss of \$39,000.

The decrease of accumulated other comprehensive loss was the result of an increase in the mark to market value of the Company's securities available for sale portfolio. The increase in common stock was due to stock purchased through the dividend reinvestment plan and stock based compensation expense recognized in earnings of \$286,251 and \$30,294, respectively. The increase in retained earnings was the result of \$1.1 million in net income for the six months which was partially offset by \$800,000 in cash dividends.

RESULTS OF OPERATIONS

General. Net income for the second quarter of 2009 of \$461,000, a \$322,000, or 41.2% decrease from the \$783,000 earned during the second quarter of 2008. Net income for the six months ended June 30, 2009, was \$1,064,000, a \$456,000, or 30.0% decrease from the \$1,520,000 earned during the same period in 2008. Diluted earnings per share for the second quarter of 2009 were \$0.30 compared to \$0.51 for the same period in 2008. Year-to-date diluted earnings per share were \$0.69 in 2009 compared to \$0.98 in 2008.

The company's annualized return on average assets (ROA) and return on average equity (ROE) for the second quarter were 0.39% and 5.22%, respectively, compared with 0.70% and 9.11% for the second quarter of 2008. For the first six months of 2009, the company's annualized ROA was 0.45% compared to 0.68% in 2008, while the ROE was 6.04% compared to 8.86% for the same period of 2008.

The single most significant impact to the company's year-to-date earnings was an increase in the amount of premiums paid for FDIC insurance coverage. This expense totaled \$443,000 for the six months ended June 30, 2009, a \$397,000 increase from the \$46,000 recorded for the same period in 2008. In addition to its regular assessment increase, the FDIC issued a special one-time assessment to replenish reserves depleted by bank failures in the last two years. The special assessment totaled \$220,000 and was expensed entirely in the first six months of 2009.

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 perception that differing interest rate environments can cause sensitivity to the Company's net interest income, these being extended low long-term interest rates or rapidly rising short-term interest rates.

Net interest income totaled \$3.4 million for the second quarter of 2009, an increase of 12.4% from the \$3.0 million reported for the comparable period of 2008. The net interest margin of 3.28% for the second quarter of 2009 showed improvement over the 3.09% reported for the same quarter of 2008. The increase in the net interest margin is primarily attributable to the reduced cost of interest-bearing liabilities by \$579,000 compared to the same period in 2008.

Net interest income increased \$755,000, or 13.0%, for the six months ended June 30, 2009 compared to the same period in the prior year. For the same reason as the second quarter the net interest margin was primarily attributable to the reduced cost of interest-bearing liabilities by \$1.2 million compared to the same period in 2008. The net interest margin of 3.23% for the first two quarters of 2009 was up from the 3.03% reported for the same period of 2008. The increasing margin for the first six months of the year is primarily attributable to the change in the mix of our deposit base along with the declining rate environment in which helped us reduce our interest cost.

Interest income. Interest income declined \$207,000, or 3.2%, for the three months ended June 30, 2009, compared to the same period in the prior year. This decrease can be attributed to a 49 basis point drop in the yield on interest-earning assets for the quarter. The largest factor in this decline was the 82 basis point loan yield reduction due to the falling prime rate for the period. This decline was partly offset by an 84 basis point increase in the investment portfolio. Interest income decreased \$472,000, or 3.6%, for the six months ended June 30, 2009, compared to the same

period in the prior year. This decline can be attributed to a decrease in interest earned on loans receivable of \$944,000 which was partially offset with a \$578,000 increase in earnings from the investment portfolio.

Interest earned on loans declined 487,000, or 9.0%, for the three months ended June 30, 2009, compared to the same period in the prior year. This decline was the result of an increase in the average balance in the loan portfolio which was more than offset by a reduction of interest income due to the lower rate environment.

For the six months ended June 30, 2009, interest earned on loans receivable decreased \$944,000, or 8.7%, compared to the same period in the prior year. This decrease was attributable to an increase in the average balance of loans outstanding of \$11.5 million, or 3.7%, to \$326.2 million for the six months ended June 30, 2009 compared to \$314.7 million for the same period in the prior year. Loan interest income was reduced by a decline in the yield on the loans to 6.12% for the six months ended June 30, 2009 from 6.91% for the same period in the prior year.

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Interest earned on securities increased \$302,000, or 28.1%, for the three months ended June 30, 2009, 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 \$6.3 million, or 6.5%, to \$103.8 million at June 30, 2009 from \$97.4 million for the same period in the prior year. Interest earned on securities was enhanced by an increase in the yield on the investments to 6.23% for the three months ended June 30, 2009 from 5.39% for the same period in the prior year.

Interest earned on securities increased \$578,000, or 27.5%, for the six months ended June 30, 2009, 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 \$8.5 million, or 8.9%, to \$104.4 million at June 30, 2009 from \$95.9 million for the same period in the prior year. Interest earned on securities was enhanced by an increase in the yield on the investments to 6.07% for the six months ended June 30, 2009 from 5.37% for the same period in the prior year.

Interest expense. Interest expense declined \$579,000, or 16.5%, for the three months ended June 30, 2009, compared to the same period in the prior year. The decrease in interest expense can be attributed to a combination of two factors:

1. A volume increase in the balance of interest-bearing liabilities of \$25.3 million resulting in \$104,000 of additional interest cost.
2. The interest rate on interest-bearing liabilities declining by 83 basis points from 3.80% for the second quarter of 2008 to 2.97% for the same period in 2009.

Interest expense decreased \$1.2 million, or 16.9%, for the six months ended June 30, 2009, compared to the same period in the prior year. The decrease in interest expense can be attributed to a combination of two factors:

1. A volume increase in the balance of interest-bearing liabilities of \$24.2 million resulting in \$332,000 of additional interest cost.
2. The interest rate on interest-bearing liabilities declining by 85 basis points from 3.96% for the first two quarters of 2008 to 3.11% for the same period in 2009.

Interest incurred on deposits, the largest component of the Company's interest-bearing liabilities, decreased \$540,000, or 17.4%, for the three months ended June 30, 2009, compared to the same period in the prior year. This reduced cost was primarily attributable to the average balance of interest-bearing deposits which increased by \$28.1 million, or 8.4%, to \$364.4 million for the three months ended June 30, 2009, compared to \$336.3 million for the same period in the prior year. Interest expense was positively affected by a reduction in the cost of interest-bearing deposits to 2.82% from 3.70% for the quarters ended June 30, 2009 and 2008, respectively. The Company diligently monitors the interest rates on its products as well as the rates being offered by its competition and utilize rate surveys to keep its total interest expense costs down.

For the six months ended June 30, 2009 interest incurred on deposits declined \$1.2 million, or 18.0%, compared to the same period in the prior year. This decrease was primarily attributable to an increase in the average balance of interest-bearing deposits of \$25.6 million, or 7.7%, to \$359.2 million for the six months ended June 30, 2009, compared to \$333.6 million for the same period in the prior year. Interest expense was positively affected by a reduction in the cost of interest-bearing deposits to 2.96% from 3.87% for the six months June 30, 2009 and 2008, respectively.

Interest incurred on borrowed funds, declined by \$39,000 or 9.4%, for the three months ended June 30, 2009, compared to the same period in the prior year. This decline was due to both a decrease in the average balance of borrowing and a reduction in the rate paid. The rate of the borrowings declined to 4.78% from 4.83% for the quarters ended June 30, 2009 and 2008, respectively. Adding to the reduction in the cost of these funds was a decline in the average balance of borrowed funds of \$2.8 million, or 8.3%, to \$31.6 million for the three months ended June 30, 2009, compared to \$34.4 million for the same period in the prior year.

For the six months ended June 30, 2009, interest incurred on borrowed funds decreased by \$69,000, or 8.2%, compared to the same period in the prior year. As with the quarterly results this decline was due to both a decrease in the average balance of borrowing and a reduction in the rate paid. The average balance of borrowed funds declined by \$1.4 million, or 4.1%, to \$33.1 million for the six months ended June 30, 2009, compared to \$34.5 million for the six months ended June 30, 2008.

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 \$260,000 was recorded for the quarter ended June 30, 2009 compared to \$95,000 for the quarter ended June 30, 2008. The provision for loan losses was higher for the current quarter due to increases in net charge-offs, increases in nonperforming and delinquent loans and the current distressed state of the economy. Nonperforming loans were \$14.0 million, or 4.18% of total loans at June 30, 2009 compared with \$6.5 million, or 2.04% at June 30, 2008. Net charge-offs were \$212,000 for the quarter ended June 30, 2009 compared with \$11,000 for the quarter ended June 30, 2008. Total loans were \$335.5 million at June 30, 2009 compared with \$319.4 million at June 30, 2008.

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Non-interest income. Non-interest income decreased \$1,000, or 0.2%, and \$15,000, or 1.2%, for the three and six months ended June 30, 2009, respectively, compared to the same periods of 2008. This decrease is primarily a result of lower earnings on bank-owned life insurance, precipitated by the lower interest rate environment and, for the six-month period, a decrease in the level of deposit service charges. Other non-interest income increased during both periods, led by revenue from investment services, which reflected an increase of \$21,000 for the six-month period.

Non-interest expense. Total operating expenses increased \$724,000, or 28.1%, and \$1,204,000, or 23.6%, for the respective three and six month periods ended June 30, 2009, when compared to the same periods of 2008. The higher FDIC insurance expenses contributed \$242,000 and \$397,000, respectively, to the quarter and year-to-date increase in operating expenses. Higher salary and benefit costs, which increased \$411,000, or 36.5%, and \$587,000, or 25.3%, over the three and six month periods ended June 30, 2008, were primarily driven by the addition of two banking offices. The Cortland office of The Middlefield Banking Company opened in June of 2008, while the Westerville office of Emerald Bank was acquired in November 2008. Increasing health insurance costs are reflected in an expense increase of \$133,000 for the six months of 2009 over that recorded for the same period of the prior year.

Data processing costs increased \$30,000 for the three-month period and \$70,000 for the six-month period over the 2008 level. These increases were driven by both the addition of the two banking offices and by an increase in the number of customers. Other non-interest expenses for 2009 reflected an increase of \$114,000 for the six-month period over 2008. The most significant factor in this change was the recognition of a \$55,000 loss on other real estate owned. Other increases over the 2008 six month period included \$23,000 for regulatory examinations and audits, \$18,000 for other insurance, and \$18,000 in ATM fees.

Provision for income taxes. The Company recognized \$67,000 in income tax expense, which reflected an effective tax rate of 6.0% for the six months, ended June 30, 2009, as compared to \$319,000 with an effective tax rate of 17.5% for the respective 2008 period. The reduction in income tax expense for the six month period was due to an increase in the percentage of tax-exempt income to total income before taxes. For the six months ending June 30, 2009 tax-exempt income represented 79.6% of total income before taxes compared to 49.5% for the same period in 2008.

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 June 30, 2009, have remained unchanged from December 31, 2008.

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.

Analysis of Changes in Net Interest Income. The following tables analyze the changes in interest income and interest expense, between the three and six month periods ended June 30, 2009 and 2008, 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.

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| | For the Three Months Ended June 30, | | | | | |
|--|-------------------------------------|--------------|------------------------------|------------------------|--------------|------------------------------|
| | 2009 | | | 2008 | | |
| | Average Balance | Interest (1) | (4) Average Yield/Cost | Average Balance | Interest (1) | (4) Average Yield/Cost |
| | (Dollars in thousands) | | | (Dollars in thousands) | | |
| Interest-earning assets: | | | | | | |
| Loans receivable | \$ 329,124 | \$ 4,906 | 5.98% | \$ 318,134 | \$ 5,393 | 6.80% |
| Investments securities (taxable equivalent) | 103,752 | 1,378 | 6.23% | 97,444 | 1,076 | 5.39% |
| Interest-bearing deposits with other banks | 7,493 | 21 | 1.12% | 4,785 | 53 | 4.41% |
| Total interest-earning assets | 440,369 | 6,305 | 5.96% | 420,363 | 6,522 | 6.45% |
| Noninterest-earning assets | 36,177 | | | 27,425 | | |
| Total assets | \$ 476,547 | | | \$ 447,788 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | \$ 31,315 | 76 | 0.97% | \$ 22,911 | 68 | 1.19% |
| Money market deposits | 33,097 | 170 | 2.06% | 24,419 | 186 | 3.06% |
| Savings deposits | 83,310 | 336 | 1.62% | 72,012 | 323 | 1.80% |
| Certificates of deposit | 216,641 | 1,977 | 3.66% | 216,920 | 2,522 | 4.66% |
| Borrowings | 31,606 | 376 | 4.78% | 34,448 | 415 | 4.83% |
| Total interest-bearing liabilities | 395,968 | 2,935 | 2.97% | 370,710 | 3,514 | 3.80% |
| Noninterest-bearing liabilities | | | | | | |
| Other liabilities | 45,359 | | | 42,708 | | |
| Stockholders equity | 35,220 | | | 34,370 | | |
| Total liabilities and stockholders equity | \$ 476,547 | | | \$ 447,788 | | |
| Net interest income | | \$ 3,370 | | | \$ 3,008 | |
| Interest rate spread (2) | | | 2.98% | | | 2.64% |
| Net yield on interest-earning assets (3) | | | 3.28% | | | 3.09% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 111.21% | | | 113.39% |

(1) Interest income
and expense are
for the period
that banking

operations were in effect.

- (2) Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.
- (3) Net yield on interest-earning assets represents net interest income as a percentage of average interest-earning assets.
- (4) Average yields are computed using annualized interest income and expense for the periods.

| | 2009 versus 2008 Increase (decrease) due to | | |
|--|--|-----------|-----------|
| | Volume | Rate | Total |
| | (Dollars in thousands) | | |
| Interest-earning assets: | | | |
| Loans receivable | \$ 186 | \$ (673) | \$ (487) |
| Investments securities | 85 | 217 | 302 |
| Interest-bearing deposits with other banks | 30 | (62) | (32) |
| Total interest-earning assets | 301 | (518) | (217) |
| Interest-bearing liabilities: | | | |
| Interest-bearing demand deposits | 25 | (17) | 8 |
| Money market deposits | 66 | (82) | (16) |
| Savings deposits | 51 | (38) | 13 |
| Certificates of deposit | (3) | (542) | (545) |
| Borrowings | (34) | (4) | (39) |

| | | | |
|------------------------------------|--------|--------|--------|
| Total interest-bearing liabilities | 104 | (683) | (579) |
| Net interest income | \$ 196 | \$ 165 | \$ 362 |

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| | For the Six Months Ended June 30, | | | | | |
|---|-----------------------------------|----------|------------|------------------------|-----------|------------|
| | 2009 | | | 2008 | | |
| | Average | (4) | Average | Average | (4) | Average |
| | Balance | Interest | Yield/Cost | Balance | Interest | Yield/Cost |
| | (Dollars in thousands) | | | (Dollars in thousands) | | |
| Interest-earning assets: | | | | | | |
| Loans receivable | \$ 326,223 | \$ 9,904 | 6.12% | \$ 314,668 | \$ 10,848 | 6.91% |
| Investments securities (taxable equivalent) | 104,362 | 2,678 | 6.07% | 95,862 | 2,100 | 5.37% |
| Interest-bearing deposits with other banks | 9,030 | 47 | 1.06% | 7,257 | 161 | 4.46% |
| Total interest-earning assets | 439,616 | 12,629 | 6.01% | 417,787 | 13,109 | 6.52% |
| Noninterest-earning assets | 34,167 | | | 27,171 | | |
| Total assets | \$ 473,783 | | | \$ 444,958 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | 29,519 | 137 | 0.94% | \$ 21,983 | 142 | 1.30% |
| Money market deposits | 30,947 | 321 | 2.09% | 23,732 | 391 | 3.31% |
| Savings deposits | 77,358 | 582 | 1.52% | 72,750 | 765 | 2.11% |
| Certificates of deposit | 221,374 | 4,235 | 3.86% | 215,103 | 5,134 | 4.79% |
| Borrowings | 33,063 | 770 | 4.70% | 34,460 | 839 | 4.88% |
| Total interest-bearing liabilities | 392,260 | 6,045 | 3.11% | 368,028 | 7,271 | 3.96% |
| Noninterest-bearing liabilities | | | | | | |
| Other liabilities | 46,303 | | | 42,632 | | |
| Stockholders equity | 35,220 | | | 34,298 | | |
| Total liabilities and stockholders equity | \$ 473,783 | | | \$ 444,958 | | |
| Net interest income | | \$ 6,584 | | | \$ 5,838 | |
| Interest rate spread (2) | | | 2.90% | | | 2.56% |
| Net yield on interest-earning assets (3) | | | 3.23% | | | 3.03% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 112.07% | | | 113.52% |

(1)

Interest income and expense are for the period that banking operations were in effect.

- (2) Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.
- (3) Net yield on interest-earning assets represents net interest income as a percentage of average interest-earning assets.
- (4) Average yields are computed using annualized interest income and expense for the periods.

| | 2009 versus 2008 | | |
|--|----------------------------|------------|----------|
| | Increase (decrease) due to | | |
| | Volume | Rate | Total |
| | (Dollars in thousands) | | |
| Interest-earning assets: | | | |
| Loans receivable | \$ 398 | \$ (1,342) | \$ (944) |
| Investments securities | 228 | 350 | 578 |
| Interest-bearing deposits with other banks | 39 | (153) | (114) |
| Total interest-earning assets | 665 | (1,145) | (480) |
| Interest-bearing liabilities: | | | |
| Interest-bearing demand deposits | 49 | (54) | (5) |
| Money market deposits | 119 | (189) | (70) |

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| | | | |
|------------------------------------|--------|---------|---------|
| Savings deposits | 48 | (232) | (183) |
| Certificates of deposit | 150 | (1,049) | (899) |
| Borrowings | (34) | (35) | (69) |
| Total interest-bearing liabilities | 332 | (1,558) | (1,226) |
| Net interest income | \$ 333 | \$ 413 | \$ 746 |

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LIQUIDITY

Management's objective in managing liquidity is maintaining the ability to continue meeting the cash flow needs of its customers, such as borrowings or deposit withdrawals, as well as its 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 depositors. Management feels that it has the capital adequacy, profitability and reputation to meet the current and projected needs of its customers.

For the six months ended June 30, 2009, 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 securities and net changes in other assets and liabilities. Cash and cash equivalents increased as a result of the purchasing of government agency securities. For a more detailed illustration of sources and uses of cash, refer to the condensed 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.

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.

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The following table illustrates the Company's risk-weighted capital ratios at June 30, 2009:

| | Middlefield Banc Corp. | | The Middlefield Banking Co. | | Emerald Bank | |
|---|------------------------|--------|-----------------------------|-----------|--------------|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital (to Risk-weighted Assets) | | | | | | |
| Actual | \$ 42,962,580 | 12.61% | \$ 33,444,950 | \$ 11.41% | \$ 7,243,864 | 15.29% |
| For Capital Adequacy Purposes | 27,246,720 | 8.00 | 23,443,360 | 8.00 | 3,789,033 | 8.00 |
| To Be Well Capitalized | 34,058,400 | 10.00 | 29,304,200 | 10.00 | 4,736,292 | 10.00 |
| Tier I Capital (to Risk-weighted Assets) | | | | | | |
| Actual | \$ 39,289,407 | 11.54% | \$ 30,550,188 | \$ 10.43% | \$ 6,649,589 | 14.04% |
| For Capital Adequacy Purposes | 13,623,360 | 4.00 | 11,721,680 | 4.00 | 1,894,517 | 4.00 |
| To Be Well Capitalized | 20,435,040 | 6.00 | 17,582,520 | 5.00 | 2,841,775 | 6.00 |
| Tier I Capital (to Average Assets) | | | | | | |
| Actual | \$ 39,289,407 | 8.42% | \$ 30,550,188 | \$ 7.56% | \$ 6,649,589 | 11.20% |
| For Capital Adequacy Purposes | 18,657,991 | 4.00 | 16,168,517 | 4.00 | 2,375,816 | 4.00 |
| To Be Well Capitalized | 23,322,489 | 5.00 | 20,210,646 | 5.00 | 2,969,769 | 5.00 |

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 repricing and maturity of interest-earning assets and the repricing 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

single-family residential adjustable-rate mortgages (ARMs), 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.

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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 June 30, 2009 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 June 30, 2009 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 June 30, 2009 for portfolio equity:

| | Increase 200 Basis Points | Decrease 200 Basis Points |
|--|------------------------------|------------------------------|
| Net interest income increase (decrease) | (2.14)% | 6.97% |
| Portfolio equity increase (decrease) | (6.97)% | (3.56)% |

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.

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, 2008. 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

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Item 3. Defaults by the Company on its senior securities

None

Item 4. Submission of matters to a vote of security holders

The following represents the results of matters submitted to a vote of the stockholders at the annual meeting held on May 13, 2009:

(a) The following directors were elected to a three year term expiring in 2012:

| Name | Shares For | Shares Withheld |
|---------------------|-------------------|------------------------|
| Richard T. Coyne | 1,066,174 | 14,323 |
| James R. Heslop, II | 1,068,820 | 11,676 |
| Robert Toth | 1,073,156 | 7,341 |

(b) The recommendation of the Board of Directors to ratify the appointment of S. R. Snodgrass, A.C. as the Company's independent auditors, as described in the Proxy Statement for the Annual Meeting, was approved with 1,077,415 shares in favor, 922 shares against, and 2,160 shares abstaining.

Item 5. Other information

None

Item 6. Exhibits

Exhibit list for Middlefield Banc Corp. s Form 10-Q Quarterly Report for the Period Ended June 30, 2009

| 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 |

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| exhibit number | description | location |
|---------------------------|---|--|
| 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* | 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 |
| 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 | | |

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| | | |
|-------|---|---|
| | 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 |

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| exhibit number | description | location |
|-----------------------|---|---|
| 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* | DBO Agreement with Nancy C. Snow | Incorporated by reference to Exhibit 10.17 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004 |
| 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

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| exhibit number | description | location |
|-----------------------|--|--|
| 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 June 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 | |

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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: August 13, 2009

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

Date: August 13, 2009

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

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EXHIBIT INDEX

| exhibit number | description | location |
|---------------------------|---|-----------------|
| 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 |