

HARBOR BANKSHARES CORP

Form SC 13E3/A

September 25, 2006

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**Appendix D  
Form 10-KSB**

FORM 10-KSB SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the fiscal year ended December 31, 2005 Commission File Number: 0-20990 HARBOR BANKSHARES CORPORATION (Exact name of registrant as specified in its charter) Maryland 52-1786341 (State or other jurisdiction of (IRS Employer Identification No.) incorporation or organization) 25 West Fayette Street 21201 Baltimore, Maryland (Zip Code) (Address of principal executive officer) Registrant's telephone number, including area code: (410) 528-1800 Securities registered pursuant to Section 12(b) of the Act: None. Securities registered pursuant to Section 12(g) of the Act: Common Stock, par value \$0.01 per share (Title of Class) Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.  Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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  Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.  Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No  Issuer's revenues for its most recent fiscal year: As of March 3, 2006, the registrant had 675,579 shares of Common Stock issued and outstanding, including 33,795 non-voting shares. The aggregate market value of shares held by nonaffiliates on such date was \$12,060,050 based on the average of the bid and asked price of \$25.00 per share of the Registrant's Common Stock on that date. For purposes of this calculation, it is assumed that the 193,177 shares held by directors and executive officers of the Registrant, are shares held by affiliates. Documents Incorporated by Reference: Portions of the Registrant's Annual Report to Stockholders for the year ended December 31, 2005. Transitional small business disclosure format (check one): Yes  No  HARBOR BANKSHARES CORPORATION ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 SECURITIES AND EXCHANGE COMMISSION FORM 10-KSB TABLE OF CONTENTS PART I

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EXHIBITS ii PART I Forward Looking Statements Harbor Bankshares Corporation (the "Corporation") makes forward-looking statements in this Annual Report on Form 10-KSB that are subject to risks and uncertainties. These forward-looking statements include: statements of the Corporation's goals, intentions, and expectations; estimates of risks and of future costs and benefits; expectations regarding future financial performance of the Corporation;

assessments of loan quality, probable loan losses, and the amount and timing of loan payoffs; liquidity, contractual obligations, off-balance sheet risk, and market or interest rate risk; and statements of the Corporation's ability to achieve financial and other goals. These forward-looking statements are subject to significant uncertainties because they are based upon: the amount and timing of future changes in interest rates, market behavior, and other economic conditions; future laws, regulations and accounting principles; and a variety of other matters. Because of these uncertainties, the actual future results may be materially different from the results indicated by these forward-looking statements. In addition, the Corporation's past growth and performance do not necessarily indicate its future results.

Item 1. Description of Business Harbor Bankshares Corporation Harbor Bankshares Corporation (the "Corporation") is a bank holding company with one bank subsidiary and two Community Development financial subsidiaries, one for profit, The Harbor Bank of Baltimore LLC and a non-profit, The Harbor Bank CDC. Both were established during 2002. The Corporation has no investment in either subsidiary as of December 31, 2004. The Corporation was organized under the laws of the State of Maryland in 1992. On November 2, 1992, Harbor Bankshares Corporation acquired all outstanding stock of The Harbor Bank of Maryland (the "Bank"), headquartered in Baltimore, Maryland. The Harbor Bank of Maryland The Bank is a Maryland chartered commercial bank headquartered in Baltimore, Maryland. The Bank was opened on September 13, 1982. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation. The Bank conducts general banking business in seven (7) locations and serves primarily the Baltimore Metropolitan area. It offers checking, savings and time deposits, commercial, real estate, personal, home improvement, automobile and other installment loans, credit cards and term loans. The Bank is also a member of a local and national ATM network. The retail nature of the Bank allows for diversification of deposits and borrowers so it is not dependent upon a single or a few customers. Harbor Financial Services, a company dealing with the sale of mutual funds, stocks, insurance, etc., was established as a subsidiary of the Bank during May 1997 in order to compete with that expanding market. Competition The Corporation's subsidiary, The Harbor Bank of Maryland, competes with virtually all banks and savings institutions that offer services in its market area. The Bank directly competes with branches of most of the State's largest banks, each of which has greater financial and other resources to conduct large advertising campaigns and to allocate their investment assets to regions of higher yield and demand. To attract business in this competitive environment, the Bank relies heavily on local promotional activities and personal contact by its officers and directors and by its ability to provide personalized services. Supervision and Regulation Following is a brief summary of certain statutes and regulations that significantly affect the Corporation and the Bank. A number of other statutes and regulations affect the Corporation and the Bank but are not summarized below. Bank Holding Company Regulation. The Corporation is registered as a bank holding company under the Holding Company Act and, as such, is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). As a bank holding company, the Corporation is required to furnish to the Federal Reserve regular reports of its operations and additional information and reports. The Corporation is also subject to regular examination by the Federal Reserve. 1 Under the Holding Company Act, a bank holding company must obtain the prior approval of the Federal Reserve before (1) acquiring direct or indirect ownership or control of any class of voting securities of any bank or bank holding company if, after the acquisition, the bank holding company would directly or indirectly own or control more than 5% of the class; (2) acquiring all or substantially all of the assets of another bank or bank holding company; or (3) merging or consolidating with another bank holding company. Under the Holding Company Act, any company must obtain approval of the Federal Reserve prior to acquiring control of the Corporation or the Bank. For purposes of the Holding Company Act, "control" is defined as ownership of 25% or more of any class of voting securities of the Corporation or the Bank, the ability to control the election of a majority of the directors, or the exercise of a controlling influence over management or policies of the Corporation or the Bank. The Change in Bank Control Act and the related regulations of the Federal Reserve require any person or persons acting in concert (except for companies required to make application under the Holding Company Act), to file a written notice with the Federal Reserve before the person or persons acquire control of the Corporation or the Bank. The Change in Bank Control Act defines "control" as the direct or indirect power to vote 25% or more of any class of voting securities or to direct the management or policies of a bank holding company or an insured bank. The Holding Company Act also limits the investments and activities of bank holding companies. In general, a bank holding company is prohibited from acquiring direct or indirect ownership or control of more than 5% of the voting shares of a company that is not a bank or a bank holding company or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, providing services for its subsidiaries, non-bank activities that are

closely related to banking, and other financially related activities. The activities of the Corporation are subject to these legal and regulatory limitations under the Holding Company Act and Federal Reserve regulations. In general, bank holding companies that qualify as financial holding companies under federal banking law may engage in an expanded list of non-bank activities. Non-bank and financially related activities of bank holding companies, including companies that become financial holding companies, also may be subject to regulation and oversight by regulators other than the Federal Reserve. The Federal Reserve has the power to order a holding company or its subsidiaries to terminate any activity, or to terminate its ownership or control of any subsidiary, when it has reasonable cause to believe that the continuation of such activity or such ownership or control constitutes a serious risk to the financial safety, soundness, or stability of any bank subsidiary of that holding company. The Federal Reserve has adopted guidelines regarding the capital adequacy of bank holding companies, which require bank holding companies to maintain specified minimum ratios of capital to total assets and capital to risk-weighted assets. See "Regulatory Capital Requirements." The Federal Reserve has the power to prohibit dividends by bank holding companies if their actions constitute unsafe or unsound practices. The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the Federal Reserve's view that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the company's capital needs, asset quality, and overall financial condition. Bank Regulation. The Bank is subject to supervision by the Federal Deposit Insurance Corporation ("FDIC") and the State of Maryland. Deposits of the Bank are insured by the FDIC to the legal maximum of \$100,000 for each insured depositor. Deposits, reserves, investments, loans, consumer law compliance, issuance of securities, payment of dividends, establishment of branches, mergers and acquisitions, corporate activities, changes in control, electronic funds transfers, responsiveness to community needs, management practices, compensation policies, and other aspects of operations are subject to regulation by the appropriate federal and state supervisory authorities. In addition, the Bank is subject to numerous federal, state and local laws and regulations which set forth specific restrictions and procedural requirements with respect to extensions of credit (including to insiders), credit practices, disclosure of credit terms and discrimination in credit transactions. The FDIC regularly examines the operations and condition of the Bank, including, but not limited to, its capital adequacy, reserves, loans, investments, and management practices. These examinations are for the protection of the Bank's depositors and the FDIC's insurance fund. In addition, the Bank is required to furnish quarterly and annual reports to the FDIC. The FDIC's enforcement authority includes the power to remove officers and directors and the authority to issue cease-and-desist orders to prevent a bank from engaging in unsafe or unsound practices or violating laws or regulations governing its business. The FDIC has adopted regulations regarding the capital adequacy, which require FDIC supervised banks to maintain specified minimum ratios of capital to total assets and capital to risk-weighted assets. See "Regulatory Capital Requirements." Regulations limit the amount of dividends that the Bank may pay to the Corporation. See Note 15 "Regulatory Matters" on page 22 of the Audited Consolidated Financial Statements section of the Corporation's Annual Report to Shareholders. 2 The Bank is subject to restrictions under federal law which limit the transfer of funds by the Bank to the Corporation and its non-banking subsidiaries, whether in the form of loans, extensions of credit, investments, asset purchases, or otherwise. Such transfers by the Bank to the Corporation or any of the Corporation's non-banking subsidiaries are limited in amount to 10% of the Bank's capital and surplus and, with respect to the Corporation and all such non-banking subsidiaries, to an aggregate of 20% of the Bank's capital and surplus. Furthermore, such loans and extensions of credit are required to be secured in specified amounts. The Bank is subject to restrictions imposed by federal law on extensions of credit to, and certain other transactions with, the Corporation and other affiliates, and on investments in their stock or other securities. These restrictions prevent the Corporation and the Bank's other affiliates from borrowing from the Bank unless the loans are secured by specified collateral, and require those transactions to have terms comparable to terms of arms-length transactions with third persons. In addition, secured loans and other transactions and investments by the Bank are generally limited in amount as to the Corporation and as to any other affiliate to 10% of the Bank's capital and surplus and as to the Corporation and all other affiliates together to an aggregate of 20% of the Bank's capital and surplus. Certain exemptions to these limitations apply to extensions of credit and other transactions between the Bank and its subsidiaries. These regulations and restrictions may limit the Corporation's ability to obtain funds from the Bank for its cash needs, including funds for acquisitions and for payment of dividends, interest, and operating expenses. Under Federal bank regulations, banks must adopt and maintain written policies that establish appropriate limits and standards for

extensions of credit secured by liens or interests in real estate or are made for the purpose of financing permanent improvements to real estate. These policies must establish loan portfolio diversification standards; prudent underwriting standards, including loan-to-value limits, that are clear and measurable; loan administration procedures; and documentation, approval, and reporting requirements. A bank's real estate lending policy must reflect consideration of the Interagency Guidelines for Real Estate Lending Policies (the "Interagency Guidelines") adopted by the federal bank regulators. The Interagency Guidelines, among other things, call for internal loan-to-value limits for real estate loans that are not in excess of the limits specified in the Guidelines. The Interagency Guidelines state, however, that it may be appropriate in individual cases to originate or purchase loans with loan-to-value ratios in excess of the supervisory loan-to-value limits. The FDIC has established a risk-based deposit insurance premium assessment system for insured depository institutions. Under the system, the assessment rate for an insured depository institution depends on the assessment risk classification assigned to the institution by the FDIC, based upon the institution's capital level and supervisory evaluations. Institutions are assigned to one of three capital groups -- well-capitalized, adequately capitalized, or undercapitalized -- based on the data reported to regulators. Well-capitalized institutions are institutions satisfying the following capital ratio standards: (i) total risk-based capital ratio of 10% or greater; (ii) Tier 1 risk-based capital ratio of 6% or greater; and (iii) Tier 1 leverage ratio of 5% or greater. Adequately capitalized institutions are institutions that do not meet the standards for well-capitalized institutions but that satisfy the following capital ratio standards: (i) total risk-based capital ratio of 8% or greater; (ii) Tier 1 risk-based capital ratio of 4% or greater; and (iii) Tier 1 leverage ratio of 4% or greater. Institutions that do not qualify as either well-capitalized or adequately capitalized are deemed to be undercapitalized. Within each capital group, institutions are assigned to one of three subgroups on the basis of supervisory evaluations by the institution's primary supervisory authority and such other information as the FDIC determines to be relevant to the institution's financial condition and the risk it poses to the deposit insurance fund. Subgroup A consists of financially sound institutions with only a few minor weaknesses. Subgroup B consists of institutions with demonstrated weaknesses that, if not corrected, could result in significant deterioration of the institution and increased risk of loss to the deposit insurance fund. Subgroup C consists of institutions that pose a substantial probability of loss to the deposit insurance fund unless effective corrective action is taken. Deposit insurance rates may be increased during 2006 or later years.

**Regulatory Capital Requirements.** The Federal bank regulators have established guidelines for maintenance of appropriate levels of capital by bank holding companies and banks. The regulations impose two sets of capital adequacy requirements: minimum leverage rules, which require bank holding companies and banks to maintain a specified minimum ratio of capital to total assets, and risk-based capital rules, which require the maintenance of specified minimum ratios of capital to "risk-weighted" assets. The regulations require bank holding companies and banks to maintain a minimum leverage ratio of "Tier 1 capital" (as defined in the risk-based capital guidelines discussed in the following paragraphs) to total assets of 3.0%. The capital regulations state, however, that only the strongest bank holding companies and banks, with composite examination ratings of 1 under the rating system used by the federal bank regulators, would be permitted to operate at or near this minimum level of capital. All other bank holding companies and banks are expected to maintain a leverage ratio of at least 1% to 2% above the minimum ratio, depending on the assessment of an individual organization's capital adequacy by its primary regulator. A bank or bank holding company experiencing or anticipating significant growth is expected to maintain capital well above the minimum levels. In addition, the bank regulators have indicated that they also may consider the level of an organization's ratio of tangible Tier 1 capital (after deducting all intangibles) to total assets in making an overall assessment of capital. <sup>3</sup> The risk-based capital rules require bank holding companies and member banks to maintain minimum regulatory capital levels based upon a weighting of their assets and off-balance sheet obligations according to risk. The risk-based capital rules have two basic components: a core capital (Tier 1) requirement and a supplementary capital (Tier 2) requirement. Core capital consists primarily of common stockholders' equity, certain perpetual preferred stock (noncumulative perpetual preferred stock with respect to banks), and minority interests in the equity accounts of consolidated subsidiaries; less all intangible assets, except for certain mortgage servicing rights and purchased credit card relationships. Supplementary capital elements include, subject to certain limitations, the allowance for losses on loans and leases; perpetual preferred stock that does not qualify as Tier 1 capital; long-term preferred stock with an original maturity of at least 20 years from issuance; hybrid capital instruments, including perpetual debt and mandatory convertible securities; subordinated debt, intermediate-term preferred stock, and up to 45% of pre-tax net unrealized gains on available-for-sale equity securities. In 2003, the Corporation, through its

subsidiary, Harbor Bankshares Corporation Capital Trust, issued \$7.2 million in trust preferred securities in a private placement. These securities are shown as junior subordinated debentures on the Consolidated Balance Sheets of the Corporation. These trust preferred securities issued are believed to meet the Federal Reserve's regulatory criteria for Tier 1 capital, subject to Federal Reserve guidelines that limit the amount of trust preferred securities (and any cumulative perpetual preferred stock) that may be included in Tier 1 capital to an aggregate of 25% of Tier 1 capital. Any excess may be included as supplementary capital. See Note 12 "Junior Subordinated Debentures" on page 20 of the Audited Consolidated Financial Statements section of the Corporation's Annual Report to Shareholders. The risk-based capital regulations assign balance sheet assets and credit equivalent amounts of off-balance sheet obligations to one of four broad risk categories based principally on the degree of credit risk associated with the obligor. The assets and off-balance sheet items in the four risk categories are weighted at 0%, 20%, 50% and 100%. These computations result in the total risk-weighted assets. The risk-based capital regulations require all commercial banks and bank holding companies to maintain a minimum ratio of total capital to total risk-weighted assets of 8%, with at least 4% as core capital. For the purpose of calculating these ratios: (i) supplementary capital is limited to no more than 100% of core capital; and (ii) the aggregate amount of certain types of supplementary capital is limited. In addition, the risk-based capital regulations limit the allowance for credit losses that may be included in capital to 1.25% of total risk-weighted assets. The federal bank regulatory agencies have established a joint policy regarding the evaluation of commercial banks' capital adequacy for interest rate risk. Under the policy, the Federal Reserve's assessment of a bank's capital adequacy includes an assessment of the bank's exposure to adverse changes in interest rates. The Federal Reserve has determined to rely on its examination process for such evaluations rather than on standardized measurement systems or formulas. The Federal Reserve may require banks that are found to have a high level of interest rate risk exposure or weak interest rate risk management systems to take corrective actions. Management believes its interest rate risk management systems and its capital relative to its interest rate risk are adequate. Federal banking regulations also require banks with significant trading assets or liabilities to maintain supplemental risk-based capital based upon their levels of market risk. The Bank did not have significant levels of trading assets or liabilities during 2004, and was not required to maintain such supplemental capital. Well-capitalized institutions are not subject to limitations on brokered deposits, while an adequately capitalized institution is able to accept, renew, or rollover brokered deposits only with a waiver from the FDIC and subject to certain restrictions on the yield paid on such deposits. Undercapitalized institutions are not permitted to accept brokered deposits. The Federal bank regulators have established regulations that classify banks by capital levels and provide for the Federal Reserve to take various "prompt corrective actions" to resolve the problems of any bank that fails to satisfy the capital standards. Under these regulations, a well-capitalized bank is one that is not subject to any regulatory order or directive to meet any specific capital level and that has a total risk-based capital ratio of 10% or more, a Tier 1 risk-based capital ratio of 6% or more, and a leverage ratio of 5% or more. An adequately capitalized bank is one that does not qualify as well-capitalized but meets or exceeds the following capital requirements: a total risk-based capital ratio of 8%, a Tier 1 risk-based capital ratio of 4%, and a leverage ratio of either (i) 4% or (ii) 3% if the bank has the highest composite examination rating. A bank that does not meet these standards is categorized as undercapitalized, significantly undercapitalized, or critically undercapitalized, depending on its capital levels. A bank that falls within any of the three undercapitalized categories established by the prompt corrective action regulation is subject to severe regulatory sanctions. As of December 31, 2005, the Bank was well-capitalized as defined in the regulations. 4 For information regarding the Corporation's and the Bank's compliance with their respective regulatory capital requirements, see note 16 "Regulatory Matters" on page 22 of the Audited Consolidated Financial Statements section of the Corporation's Annual Report to Shareholders. Community Reinvestment Under the Community Reinvestment Act ("CRA"), a financial institution has a continuing and affirmative obligation to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions, or limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community. However, institutions are rated on their performance in meeting the needs of their communities. Performance is tested in three areas: (a) lending, to evaluate the institution's record of making loans in its assessment areas; (b) investment, to evaluate the institution's record of investing in community development projects, affordable housing, and programs benefiting low or moderate income individuals and business; and (c) service, to evaluate the institution's delivery of services through its branches, ATMs and other offices. The CRA requires each federal banking agency, in connection with its examination of a financial

institution, to assess and assign one of four ratings to the institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by the institution, including applications for charters, branches and other deposit facilities, relocations, mergers, consolidations, acquisitions of assets or assumptions of liabilities, and savings and loan holding company acquisitions. The CRA also requires that all institutions make public disclosure of their CRA ratings. The Bank was assigned an "outstanding" rating as a result of its last CRA examination. Bank Secrecy Act Under the Bank Secrecy Act ("BSA"), a financial institution is required to have systems in place to detect certain transactions, based on the size and nature of the transaction. Financial institutions are generally required to report cash transactions involving more than \$10,000 to the United States Treasury. In addition, financial institutions are required to file suspicious activity reports for transactions that involve more than \$5,000 and which the financial institution knows, suspects, or has reason to suspect involves illegal funds, is designed to evade the requirements of the BSA, or has no lawful purpose. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, commonly referred to as the "USA Patriot Act" or the "Patriot Act", enacted in response to the September 11, 2001, terrorist attacks, enacted prohibitions against specified financial transactions and account relationships, as well as enhanced due diligence standards intended to prevent the use of the United States financial system for money laundering and terrorist financing activities. The Patriot Act requires banks and other depository institutions, brokers, dealers and certain other businesses involved in the transfer of money to establish anti-money laundering programs, including employee training and independent audit requirements meeting minimum standards specified by the act, to follow standards for customer identification and maintenance of customer identification records, and to compare customer lists against lists of suspected terrorists, terrorist organizations and money launderers. The Patriot Act also requires federal bank regulators to evaluate the effectiveness of an applicant in combating money laundering in determining whether to approve a proposed bank acquisition... On May 18, 2005, the Bank executed a memorandum of understanding with the FDIC and the Maryland Commissioner of Financial Regulation, in which it agreed to take certain steps to improve its Bank Secrecy Act and anti-money laundering compliance programs, including independent testing of compliance. Management believes that the Bank is fully in compliance with the terms of the memorandum. Sarbanes-Oxley Act of 2002 The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") established a broad range of corporate governance and accounting measures intended to increase corporate responsibility and protect investors by improving the accuracy and reliability of disclosures under federal securities laws. The Corporation is subject to Sarbanes-Oxley because it is required to file periodic reports with the SEC under the Securities and Exchange Act of 1934. Among other things, Sarbanes-Oxley, its implementing regulations have established new membership requirements and additional responsibilities for the Corporation's audit committee, imposed restrictions on the relationship between the Corporation and its outside auditors (including restrictions on the types of non-audit services our auditors may provide to us), imposed additional financial statement certification responsibilities for the Company's chief executive officer and chief financial officer, expanded the disclosure requirements for corporate insiders, and require management to evaluate the Corporation's disclosure controls and procedures and report material changes in the Corporation's internal control over financial reporting. Under current regulations, in future periods, Sarbanes-Oxley will require the management to evaluate the Corporation's internal control over financial reporting and will require Corporation's auditors to issue a report on the Corporation's internal control over financial reporting. 5 Other Laws and Regulations Some of the aspects of the lending and deposit business of the Bank that are subject to regulation by the FDIC include reserve requirements and disclosure requirements in connection with personal and mortgage loans and deposit accounts. In addition, the Bank is subject to numerous federal and state laws and regulations that include specific restrictions and procedural requirements with respect to the establishment of branches, investments, interest rates on loans, credit practices, the disclosure of credit terms, and discrimination in credit transactions. Enforcement Actions Federal statutes and regulations provide financial institution regulatory agencies with great flexibility to undertake an enforcement action against an institution that fails to comply with regulatory requirements. Possible enforcement actions range from the imposition of a capital plan and capital directive to civil money penalties, cease and desist orders, receivership, conservatorship, or the termination of deposit insurance. Governmental Monetary Policies and Economic Controls The earnings and growth of the banking industry and ultimately of The Harbor Bank of Maryland, Harbor Bankshares Corporation's sole subsidiary, are affected by the credit policies of monetary authorities including the Federal Reserve System. An important function of the Federal Reserve System is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy

used by the Federal Reserve to implement these objectives are open market operations in U.S. Government securities, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans and investments and deposits, and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the Federal Reserve authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the Federal Reserve System, no prediction can be made as to possible future changes in interest rates, deposit levels, and loan demand, or their effect on the business and earnings of the Corporation and its subsidiary.

6 Employees At December 31, 2005, Harbor Bankshares Corporation and its subsidiaries employed 77 individuals, of which 27 were officers and 50 were full-time employees. Executive Officers Information concerning executive officers of the Corporation is listed below: Age Position Joseph Haskins, Jr. 58 Chairman, President and Chief Executive Officer of the Bank and Corporation John Paterakis 77 Chairman of the Executive Committee of the Corporation and the Bank Teodoro J. Hernandez 60 Treasurer of the Corporation and Senior Vice President and Cashier of the Bank Each of the executive officer has been employed in his current capacity for more than five years.

7 Tabular Information The information in this description of business should be read in conjunction with the information provided in the Management's Discussion and Analysis of Financial Condition and Operations, which is incorporated herein from the Annual Report...

Consolidated Five-Years Selected Financial Data (In thousands, except per share data) Year ended December 31, 2005 2004 2003 2002 2001

----- OPERATING DATA Interest Income \$15,014 \$12,648 \$11,886  
 \$11,647 \$13,609 Interest Expense 3,787 2,283 2,411 3,402 5,973 ----- Net Interest Income  
 11,227 10,365 9,475 8,245 7,636 Provision for Loan Losses 410 360 755 340 400 Non-Interest Income 1,771 1,514  
 2,506 2,220 2,329 Non-Interest Expenses 9,638 9,295 8,610 8,575 8,526 ----- Income  
 Before Taxes 2,950 2,224 2,616 1,550 1,039 Income Taxes 1,067 762 831 473 309 -----  
 Net Income \$ 1,883 \$ 1,462 \$ 1,785 \$ 1,077 \$ 730 ===== PER SHARE  
 DATA Net Income - Basic \$2.73 \$2.07 \$2.46 \$1.47 \$1.02 Net Income - Diluted 2.55 1.93 2.36 1.43 0.99 Cash and  
 Stock Dividends 0.40 0.35 0.25 0.25 -- Book Value \$24.73 \$23.04 \$21.69 \$19.23 \$16.72 BALANCE SHEET DATA  
 Total Assets \$256,636 \$235,464 \$219,547 \$210,234 \$186,586 Deposits 229,845 210,224 195,901 193,294 171,531  
 Total Net Loans 188,936 172,205 149,729 120,523 105,847 Total Stockholder's Equity 16,954 16,240 15,274 14,149  
 12,241 Return on Average Assets 0.78% 0.63% 0.84% 0.54% 0.37% Return on Average Equity 11.57% 9.33%  
 12.23% 8.20% 6.20% Tier 1 Regulatory Capital to Average Assets 7.31% 7.36% 7.46% 5.20% 5.40% Average Equity  
 to Average Assets 6.74% 7.27% 6.48% 5.24% 4.77% Dividend Paid to Diluted Net Income 15.69% 18.13% 10.59%  
 17.48% -- 8 Average Balances, Yields/Rates and Income/Expense Years ended December 31, 2005 2004 2003  
 Average Yields/ Income Average Yields/ Income Average Yields/ Income Balances Rates Expense Balances Rates  
 Expense Balances Rates Expense ----- ASSETS U. S. Treasury  
 Securities \$ -- --% \$ -- \$ 836 3.11% \$ 26 \$ 3,048 2.79% \$ 85 U.S. Government Agencies 27,230 3.11 848 35,824 3.08  
 1,104 39,878 3.39 1,354 Interest-Bearing Deposits with Other Banks 562 3.20 18 1,510 2.91 44 2,100 3.24 68 FHLB  
 Stock and Other Securities 507 4.14 21 550 3.82 21 1,051 3.61 38 Federal Funds Sold 6,440 3.35 216 7,776 1.21 94  
 9,397 1.03 97 ----- 34,739 3.18% 1,103 46,496 2.77% 1,289 55,474 2.96% 1,642  
 ----- Loans Commercial Loans 75,390 8.70 6,556 64,090 7.37 4,725 44,887 7.03  
 3,156 Real Estate Loans 102,932 6.67 6,863 91,544 6.68 6,113 85,226 7.16 6,102 Consumer Loans 6,052 8.11 491  
 8,032 6.49 521 10,263 9.61 986 ----- Loans Net of Unearned Income 184,374  
 7.54 13,910 163,666 6.94 11,359 140,376 7.30 10,244 ----- Total Earning Assets 219,113  
 6.85% \$15,013 210,162 6.02% \$12,648 195,850 6.07% \$11,886 ===== Allowance for  
 Possible Losses (2,059) (1,543) (1,488) Other Assets 24,183 23,461 18,909 ----- TOTAL ASSETS  
 \$241,237 \$232,080 \$213,271 ===== LIABILITIES AND STOCKHOLDERS' EQUITY  
 Non-Interest Bearing Deposits \$ 47,933 --% \$ -- \$ 40,646 --% \$ -- \$ 31,641 --% \$ -- Interest-Bearing Transaction  
 Accounts 26,020 .22 57 24,370 .18 43 23,515 .16 38 Savings 81,048 1.74 1,409 85,059 .79 670 84,715 .82 696 Time -  
 \$100,000 or more 28,268 2.35 664 22,627 2.02 456 25,172 2.63 662 Other Time 32,208 3.70 1,192 34,968 2.24 782  
 29,831 2.81 840 ----- Savings and Time Deposits 167,544 1.98% 3,322 167,024  
 1.17% 1,951 163,233 1.37% 2,236 ----- TOTAL Deposits 215,477 207,670 194,874 Junior  
 Subordinated Debentures 7,217 6.15% 444 7,217 4.41% 318 1,611 4.40% 71 Other Borrowed Money 611 3.44 21 720



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1.94 14 -- -- -- Notes payable -- -- -- -- -- 1,310 7.00 104 Other Liabilities 1,661 795 871 -----  
TOTAL Liabilities 224,966 2.15% \$ 3,787 216,402 1.30% \$ 2,283 198,666 1.45% \$ 2,411 =====  
===== STOCKHOLDERS' EQUITY 16,271 15,678 14,605 ----- TOTAL LIABILITIES AND  
STOCKHOLDERS' EQUITY \$241,237 \$232,080 \$213,271 ===== Net Yield on Interest  
Earning Assets 4.70% 4.72% 4.62% Benefit of Non-Interest Bearing Funds .45% .25% .22% Net Interest Margin  
5.15% 4.97% 4.84% Nonaccrual loans are included in the appropriate loan categories, above. 9 Interest Variance  
Analysis (dollars in thousands) 2005 Compared to 2004 2004 Compared to 2003 Increase (Decrease) Due to: Increase  
(Decrease) Due to: ----- Volume Rate Net Volume Rate Net -----  
----- INTEREST INCOME Loans \$ 1,437 \$ 1,114 \$ 2,551 \$ 1,700 \$ (585) \$ 1,115 Investment  
Securities (266) (16) (282) (227) (99) (326) Federal Funds Sold (16) 138 122 (17) 14 (3) Other Interest Bearing Assets  
(1) (25) -- (25) (21) (3) (24) ----- TOTAL Interest Income \$ 1,130 \$ 1,236 \$ 2,366 \$  
1,435 \$ (673) \$ 762 ===== INTEREST EXPENSE  
Interest-Bearing Transaction Accounts \$ 3 \$ 11 \$ 14 \$ 1 \$ 4 \$ 5 Savings (32) 771 739 3 (29) (26) Time - \$100,000 or  
more 114 94 208 (67) (139) (206) Other Time (62) 472 410 144 (202) (58) Other Borrowed Money (2) 9 7 14 -- 14  
Subordinate Debentures -- 126 126 246 2 248 Notes Payable -- -- -- (104) -- (104) -----  
----- TOTAL Interest Expense \$ 21 \$ 1,483 \$ 1,504 \$ 237 \$ (364) \$ (127) =====  
===== NET INTEREST INCOME \$ 1,108 \$ (247) \$ 862 \$ 1,198 \$ (309) \$ 889 =====  
===== Note: Loan fees, which were included in interest income, were \$981 in  
2005, \$1,024 in 2004, and \$814 in 2003. A change in Rate/Volume has been allocated to the change in rate. (1)  
Certificates of Deposit with other financial institutions. Maturity Distribution of Investment Securities (dollars in  
thousands) ----- U.S Treasuries U.S Agencies Other Securities TOTAL -----  
----- Maturing Within One Year \$ -- \$ 2,438 \$ -- \$ 2,438 Maturing After One But Within Five  
Years -- 23,544 -- 23,544 Maturing After Five But Within Ten Years -- -- -- -- Maturing After Ten Years -- 135 30  
165 ----- TOTAL \$ -- \$26,117 \$ 30 \$26,147 ===== 10  
Weighted Average Interest Rates of Investment Securities at December 31, 2005  
----- U.S Government Other U.S Treasuries Agencies  
Securities TOTAL ----- Maturing Within One Year --% 2.22% --% 2.22% Maturing After  
One But Within Five Years --% 3.07% --% 3.07% Maturing After Five But Within Ten Years --% --% --% --%  
Maturing After Ten Years --% 5.15% 7.25% 6.20% TOTAL --% 3.48% 7.25% 3.83% Amortized cost and the fair  
value of Investment Securities at 2005 , 2004 and 2003 (dollars in thousands) ----- 2005 2004  
2003 ----- Amortized Fair Amortized Fair Amortized Fair Cost Value  
Cost Value Cost Value ----- U.S. Treasuries, Government Agencies and Mortgage Backed  
Securities \$26,979 \$26,117 \$28,988 \$28,606 \$37,258 \$37,369 Other Securities 30 30 36 36 548 549 -----  
----- TOTAL \$27,009 \$26,147 \$29,024 \$28,642 \$37,806 \$37,918 =====  
===== 11 Loan Distribution Five-Year Loan Distribution at December 31, 2005 (dollars in  
thousands) 2005 2004 2003 2002 2001 ----- Commercial Loans \$ 82,845 \$ 72,414 \$ 55,184 \$ 30,964 \$  
23,126 Real Estate Loans 102,404 94,204 87,228 78,856 71,962 Consumer Loans 5,746 7,198 8,806 11,751 11,718  
----- TOTAL \$190,995 \$173,816 \$151,218  
\$121,571 \$106,806 =====  
===== Five-Year Loan Distribution at December 31 (expressed as  
percentages) 2005 2004 2003 2002 2001 ----- Commercial Loans 43.37% 38.87% 36.49% 25.47%  
21.65% Real Estate Loans 53.62% 56.90% 57.69% 64.86% 67.38% Consumer Loans 3.01% 4.23% 5.82% 9.67%  
10.97% ----- TOTAL 100.00% 100.00%  
100.00% 100.00% 100.00% =====  
===== Maturity and Repricing of Loans at December 31, 2005 (dollars in  
thousands) ----- Commercial Real Estate Consumer Loans  
Loans Loans TOTAL ----- Within One Year \$44,970 \$23,325 \$1,043 \$69,338 After One Year But  
Within Five Years 37,131 22,516 3,068 \$62,715 After Five Years 744 56,563 1,635 \$58,942 -----  
----- TOTAL \$82,845 \$102,404 \$5,746 \$190,995 =====  
===== Loans Classified by Sensitivity to Changes in Interest Rates (dollars in thousands)  
----- Adjustable Fixed Rate Interest Rate Loans Loans TOTAL ----- Within One Year \$18,221

\$51,742 \$69,963 After One Year But Within Five Years 62,719 -- \$62,719 After Five Years 58,313 -- \$58,313

----- TOTAL \$139,253 \$51,742 \$190,995 =====

===== The total amount of Real Estate Construction and Mortgage loans due after one year included above are \$2,600 and \$2,441 respectively. Asset Quality One of the Corporation's main objectives has been and continues to be the achievement of a high level of asset quality. We maintain a large portion of loans secured by residential one-to four- family properties and commercial properties. As of December 31, 2005, those loans totaled \$89 million or 46.35 percent of total outstanding loans. We set sound credit standards for new loan originations, and follow careful loan administration procedures. We strengthened our focus on credit risk by having independent reviews of all major credits with detailed reports to management. Delinquent Loans and Foreclosed Assets: The Corporation policies require that management continuously monitor the status of the loan portfolio and report to the Board of Directors on a monthly basis. These reports include information on delinquent loans and foreclosed real estate, and actions and plans to cure the delinquent status of the loans and to dispose of the foreclosed properties. 12 Interest on Non-accrual Loans. (dollars in thousands) ----- 2005

2004 ---- Interest Income that Would Have Been Recorded Under Original Terms \$ 27 \$ 52 ----- Interest Income Recorded during the Period \$ -- \$ -- -----

----- It is the policy of the Corporation to place a loan on non-accrual status whenever there is substantial doubt about the ability of a borrower to pay principal or interest on any outstanding credit. Management considers such factors as payment history, the nature of the collateral securing the loan, and the overall economic situation of the borrower when making a non-accrual decision. Non-accrual loans are closely monitored by management. A non-accruing loan is restored to accrual status when principal and interest payments have been brought current or it becomes well-secured or is in the process of collection and the prospects of future contractual payments are no longer in doubt. We generally stop accruing income when interest or principal payments are 90 days in arrears. We may stop accruing income on such loans earlier than 90 days when we consider the timely collectibility of interest or principal payment to be doubtful. When we designate non-accrual loans, we reverse all outstanding interest that we had previously credited. If we receive a payment on a non-accrual loan, we may recognize a portion of that payment as interest income if we determine that the ultimate collectibility of principal is no longer in doubt. However, such loans may remain in non-accrual status. Impaired Loans At December 31, 2005, the Corporation had \$576 thousand of impaired loans for which the borrowers were experiencing financial difficulties. Those loans are subject to constant management attention and their classification is reviewed monthly. Impaired loans are individually assessed to determine whether the carrying value exceeds the fair value of the collateral. Foreclosed Real Estate Foreclosed real estate consists of property we have acquired through foreclosed or deed in lieu of foreclosure. Foreclosed real estate properties are initially recorded at the lower of the recorded investment in the loan or fair value. At December 31, 2005 and 2004 we had no foreclosed real estate. Potential Nonperforming Loans Those performing loans considered potential nonperforming loans, loans which are not included in the past due, nonaccrual or restructured categories, but for which known information about possible credit problems cause management to be uncertain as to the ability of the borrowers to comply with the present loan repayment terms over the next six months, amounted to approximately \$7,149 thousand at December 31, 2005, compared to \$3,716 thousand at December 31, 2004, and \$3,502 thousand at December 31, 2003. These loans are subject to continuing management attention and are considered by management in determining the level of the allowance for loan losses. 13 Allowance for Loan Losses The Corporation's allowance for loan loss methodology is a loan classification-based system, based on the required allowance on a percentage of the loan balance for each type of loan and classification level. Allowance percentages are 3.0% and 5.0% for watch loans, 10.0% for special mention, 15.0% and 20.0% for substandard and 50.0% for doubtful loans. Allowance percentages are based on each individual lending program, its loss history and underwriting characteristics such as: loan to value, credit score, debt coverage, collateral, and capacity to service debt. This analysis is used to validate the loan loss allowance matrix as well as to assist in establishing overall lending direction. While management considers the Corporation's allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, management's assumptions as to future delinquencies or loss rates, and management's intent with regard to asset disposition options. In addition, the Corporation's allowance for loan losses is periodically reviewed by the bank regulatory agencies and an independent external loan review as an integral part of their examination process. Based on their reviews, the agencies may require the Corporation to adjust the allowance. 14 Allowance for Loan Losses (dollars in thousands) Year ended December 31, 2005 2004 2003 2002 2001 ---- Balance at Beginning

of Period	\$ 1,612	\$ 1,488	\$ 1,049	\$ 959	\$ 732	Loans Charged Off: Commercial Loans --	108	71	109	65	Real Estate Loans --	10	11	26	70	Consumer Loans	91	295	341	178	111	TOTAL Loans Charged Off	91	413	423	313	246	Recoveries of Loans: Commercial Loans	45	13	22	42	39	Real Estate Loans --	1	22	11	22	Consumer Loans	83	163	63	10	12	TOTAL Loans Recovered	128	177	107	63	73	Net Loans Charged Off (Recovered)	(37)	236	316	250	173	Provisions Charged to Operations	410	360	755	340	400	Balance at End of Period	\$ 2,059	\$ 1,612	\$ 1,488	\$ 1,049	\$ 959	Daily Average Amount of Loans	\$ 184,374	\$ 163,656	\$ 140,376	\$ 110,293	\$ 105,067	Allowance for Possible Loan Losses to Loans Outstanding	1.08%	.93%	.98%	.86%	.90%	Net Charge Offs (Recoveries) to Average Loans Outstanding	(.02%)	.14%	.22%	.22%	.16%
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A breakdown of the Allowance is provided in the table below; however, management does not believe that the Allowance can be segregated by category with precision. The breakdown of the Allowance is based primarily on those factors discussed previously in evaluating the Allowance as a whole. Since all of those factors are subject to change, the breakdown is not necessarily indicative of the category of actual or realized credit losses. The following table presents the allocation of the Allowance among the various loan categories at December 31: Allocation of Allowance for Loan Losses (dollars in thousands) As of December 31, 2005

% 2004	% 2003	% 2002	% 2001	%	Commercial Loans	\$573	45.1%	44.7%	\$825	36.9%																																																	
\$555	25.4%	\$557	21.7%	\$406	Real Estate Loans	702	52.8	746	54.1	151	57.3	138	64.9	110	67.4	Consumer Loans	65	2.2	83	3.7	35	5.2	76	8.9	80	9.9	Credit Cards	38	.4	41	.5	47	.6	46	.8	55	1.0	Unallocated	681	--	336	--	430	--	234	--	157	--	TOTAL Allowance for Loan Losses	\$ 2,059	100%	\$ 1,612	100%	\$ 1,488	100%	\$ 1,049	100%	\$ 959	100%

=====	15	Maturities of Time Certificates of Deposit of \$100,000 or More Outstanding at December 31, 2005 and 2004 (dollars in thousands)	2005	2004	Three months or less	\$7,145	\$5,804	Three to six months	2,111	2,746	Six to twelve months	13,315	8,187	Over twelve months	10,239	8,662	TOTAL	\$32,810	\$25,399
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Long And Short Term Borrowings Junior Subordinated Debt Security On October 9, 2003, Harbor Bankshares Corporation issued a Floating Rate Junior Subordinated Debt Securities due 2033 in the amount of \$7.2 million. The Debt Security was issued by the Corporation pursuant to an Indenture, dated as of October 9, 2003, between the Corporation and Wilmington Trust Company. The Capital Securities were issued by Harbor Bankshares Corporation Capital Trust pursuant to a Purchase Agreement dated September 18, 2003, among the Corporation, the Trust and Citigroup Global Markets Inc. Upon receipt of the funds, the corporation paid off its long-term debt to the National Community Investment Fund ("NCIF") in the amount of \$1.8 million and placed the remaining funds in its subsidiary, The Harbor Bank of Maryland, increasing the Bank's Tier One capital. This capital infusion increased the Bank's lending limit and allowed for future growth.

16	Borrowings for the Years Ended December 31, 2005 and 2004 (dollars in thousands)	2005	2004	Amount outstanding at period-end: Subordinated Debt Securities	7,217	7,217	Average outstanding: Subordinated Debt Securities	7,217	7,217	Weighted average interest rate during the period: Subordinated Debt Securities	6.15%	4.41%
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Off-Balance Sheet Arrangements Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds collateral supporting those commitments for which collateral is deemed necessary. The Harbor Bank of Maryland has not been required to perform on any financial guarantees and has not incurred any losses on its commitments. The issuance of letters of credit is not a significant activity of the Bank. Commitments to extend credit are agreements to lend funds to customers as long as there are no violations of any condition established in the loan contracts. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on credit evaluation by management. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment as well as income producing properties. We believe that we have adequate resources to fund all loan commitments. The Bank has entered into leases for some of its branches, most of which contain renewal options. For additional information regarding off-balance sheet arrangements, please

see Notes 7 and 17 to the Consolidated Financial Statements and the discussion of the Debt Security in "Long and Short Term Borrowings," above. Critical Accounting Policies The Corporation's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. 17 The most significant accounting policies followed by the Corporation are presented in Note 2 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for loan losses as the accounting area that requires the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available. The Corporation believes it has developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Corporation's assessments may be affected in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers which is not known to management at the time of the issuance of the consolidated financial statements. For additional discussion concerning the Corporation's allowance for loan losses and related matters, see "Provision for Loan Losses and Asset Quality" above and Note 2 to the Consolidated Financial Statements.

Item 2. Description of Property The Corporation's Headquarters is located at 25 West Fayette Street, Baltimore, Maryland 21201. This location is approximately 60,000 square feet and was bought by the Corporation during September 2003 for \$2.9 million. The renovation of the building is completed. The Bank also maintains another six (6) branch offices, five (5) are leased; three (3) located in Baltimore City, 1000 Lancaster Street Baltimore, Maryland 21202, 5000 Park Heights Avenue Baltimore, Maryland 21215 and 800 West Baltimore Street, Baltimore, Maryland 21201, one (1) located in Prince George's County, Maryland at 6820 Riverdale Road Riverdale, Maryland 20737 and one (1) located in Baltimore County, Maryland at 3825 Liberty Plaza Randallstown, Maryland 21133. The Bank owns another branch facility in Baltimore City located at 3240 Belair Road Baltimore, Maryland 21213.

Item 3. Legal Proceedings In the normal course of business, the Corporation is at all times subject to various pending and threatened legal actions. The relief or damages sought in some of these actions may be substantial. After reviewing pending and threatened actions with counsel, management considers that the outcome of such actions will not have a material adverse effect on the Corporation's financial position; however, the Corporation is not able to predict whether the outcome of such actions may or may not have a material adverse effect on results of operations in a particular future period as the timing and amount of any resolution of such actions and relationship to the future results of operations are not known.

Item 4. Submission of Matters to a Vote of Security Holders None

PART II

Item 5. Market for Common Equity and Related Stockholder Matters. Harbor Bankshares Corporation is traded privately and is not listed on any exchange. During 2005 and 2004, there was little trading activity in the stock. The bid and ask price during 2005 and 2004 was \$25.00 per share. On December 31, 2005 the Corporation had 626 common stockholders of record. A cash dividend of \$.40 per share was paid during the first quarter of 2005. The following table presents disclosure regarding equity compensation plans in existence at December 31, 2005, consisting only of the stock option plan arrangements described further under the caption "Stock Options" in Note 14 to the consolidated financial statements.

Equity Compensation Plan Information	Plan Category
-----	-----

Number of securities to be Weighted average exercise Number of securities issued upon exercise of price of  
 outstanding remaining available for outstanding options, options, warrants and future issuance under warrants and  
 rights rights equity compensation plans (a) (b) excluding securities reflected in column (a) (c)

	Equity	
compensation plans -- -- -- approved by security holders -----		
----- Equity compensation plans not approved by	132,741	\$18.80 94,145
security holders -----		
Total	132,741	\$18.80 94,145

----- 19 Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with Item 1. Business, and Item 7, Financial Statements, of this Report. OVERVIEW - 2005 COMPARED TO 2004 All references to Harbor Bankshares Corporation (the "Corporation") should be interpreted to include The Harbor Bank of Maryland (the "Bank") whenever appropriate, except when specifically noted otherwise. The Corporation earnings increased for the year 2005 when compared to the prior year. Earnings for the year were \$1.9 million in comparison to \$1.5 million earned during 2004, an increase of \$421 thousand or 28.8 %. The 2005 earnings did not include any securities gains or Federal agency awards. The earnings for 2004 reflected only \$17 thousand of securities gains and no awards. The Harbor Bank of Maryland, the Corporation's subsidiary, achieved earnings of \$2.5 million in comparison to \$1.9 million for the prior year, an increase of \$564 thousand or 29.0%. Returns on average assets (ROAA) and average equity (ROAE) for the Corporation in 2005 were .78% and 11.57%, respectively, compared to the .63% and 9.33% achieved during the prior year. The return on average assets for the Bank in 2005 was 1.04%, compared to .84% for the prior year. NET-INTEREST INCOME Net interest income is the difference between interest income and related fees on earning assets and the interest expense incurred on deposits and other borrowings. Net interest income continues to be the Corporation's main source of earnings. Net interest income for 2005 increased by \$862 thousand or 8.3 %. The increase reflects the growth of the loan portfolio during 2005, mainly in the commercial and commercial real estate categories. Total interest income increased by \$2.4 million or 18.7% to \$15.0 million for 2005 in comparison to the \$12.7 million earned during 2004. As stated above, the growth of the loan portfolio combined with higher rates were the main reasons for the increase. Total interest expense increased by \$1.5 million or 6.6 % to \$3.8 million in 2005 from \$2.3 million in 2004. Higher interest rates combined with interest bearing deposit increases resulted in the increase. Net interest margin for 2005 was 5.15% compared to 4.97% for 2004. PROVISION FOR LOAN LOSSES AND ASSET QUALITY For the year 2005, the Corporation recorded a \$410 thousand provision for loan losses, compared to \$360 for the year 2004. Gross charge-offs totaled \$91 thousand for the year ended December 31, 2005, compared to the prior year total of \$413 thousand. These charge-offs in 2004 primarily relate to credit card, consumer and commercial loans. The allowance for loan losses as of December 31, 2005, was 1.08% of total loans and .93% at the end of the comparable 2004 period. Future provisions for loan losses will continue to be based upon our assessment of the overall loan portfolio and its underlying collateral, the mix of loans within the portfolio, delinquency trends, economic conditions, current and prospective trends in real estate values, and other relevant factors. 20 The table below shows the non-performing assets for a five-year period: Non-Performing Assets (in thousands except percentages) 2005 2004 2003 2002 2001 -----

	2005	2004	2003	2002	2001	-----	-----	-----
Non-accrual Loans	\$558	\$799	\$ 220	\$409	\$620	Accruing Loans	past due	90 days or more
Foreclosed Real Estate	70	14	Total Non-performing Assets and	-----	-----	-----	-----	-----
	\$726	\$1,225	\$769	=====	=====	=====	=====	=====
	.22%	.34%	.33%	.58%	.41%	Total Non-performing Assets and past due Loans to year-end	Assets	.30%
						Loans	.46%	.48%
						Loans	1.01%	.72%

The Corporation's allowance for loan loss methodology is a loan classification-based system, based on the required allowance on a percentage of the loan balance for each type of loan and classification level. Allowance percentages are 3.0% and 5.0% for watch loans, 10.0% for special mention, 15.0% and 20.0% for substandard and 50.0% for doubtful loans. Allowance percentages are based on each individual lending program, its loss history and underwriting characteristics such as: loan to value, credit score, debt coverage, collateral, and capacity to service debt. This analysis is used to validate the loan loss allowance matrix as well as to assist in establishing overall lending direction. While management considers the Corporation's allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, management's assumptions as to future delinquencies or loss rates, and management's intent with regard to asset

disposition options. In addition, the Corporation's allowance for loan losses is periodically reviewed by the bank regulatory agencies and an independent external loan review as an integral part of their examination process. Based on their reviews, the agencies may require the Corporation to adjust the allowance. **NON-INTEREST INCOME**

Non-interest income increased by \$257 thousand or 17.0% to \$1.8 million in 2005. Included in the 2004 non-interest income were \$6 thousand in gain on sale of loans, \$17 thousand in securities gains and no Community Development Financial Institution Fund ("CDFI") awards. In 2005, there were no gains on the sale of securities or loans, and no CDFI awards. Service charges on deposit accounts increased by \$98 thousand or 12.2% and other non-interest income by \$152 thousand or 31.9%. Included in other non-interest income are fees in the amount of \$82 thousand for reimbursement for services and expenses incurred by the Bank in the formation of one of the Holding Company unconsolidated subsidiaries in 2002.

Non-Interest Income Summary (in thousands)	2005	2004	2003	2002	2001
Service charges on deposit accounts	\$900	\$802	\$855	\$910	\$965
ATM fees	224	195	216	274	166
Awards & Grants	664	214	229		
Gain on sale of real estate					
Gain on sale of loans		6	51	54	45
Gain on sale of securities	17	225	226	197	
Servicing fees	18	17	16	26	27
Other non-interest income	629	477	479	517	700
<b>Total non-interest income</b>	<b>\$1,771</b>	<b>\$1,514</b>	<b>\$2,506</b>	<b>\$2,221</b>	<b>\$2,329</b>

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 ===== 21 **NON-INTEREST EXPENSES** Non-interest expenses of \$9.6 million in 2005 increased by \$343 thousand or 3.7 % when compared to the prior year. Salaries and benefits of \$4.4 million in 2005 reflected a decrease of \$85 thousand or 1.9% when compared to the prior year salaries and benefits cost. Advertising expenses increased by \$69 thousand or 23.0%. Occupancy expense increased by \$414 thousand or 61.0% due to the renovation of the Corporation's Headquarters building and the opening of a new branch facility. Equipment expense decreased by \$32 thousand or 9.0% due to lower depreciation. Professional fees, which include legal expenses, decreased by \$98 thousand or 19.0%. In 2005, the Bank settled its claims against third parties in connection with a 2004 ATM cash shortage upon payment to the Bank of \$575,000. The Bank recorded losses of \$225,000 in 2005 and \$275,000 in 2004 relating to this cash shortage. The amortization expense in 2002 through 2005 includes amortization of core deposit intangibles recorded in the purchase of a branch facility during 2002. Amortization in 2001 and 2002 reflects amortization of goodwill. Other non-interest expenses increased by \$46 thousand or 3.0 %.

Non-Interest Expenses Summary (In thousands)	2005	2004	2003	2002	2001
Salaries and Employee Benefits	\$4,425	\$4,510	\$4,368	\$4,230	\$3,989
Occupancy Expense, net	1,093	679	720	785	778
Advertising	369	300	344	287	115
Equipment Expenses	324	356	386	478	654
Data Processing Fees	1,110	1,031	973	976	918
Professional Fees	420	518	303	399	327
Amortization of Intangible Assets	81	81	81	47	331
Amortization ATM Loss	225	275			
Other Non-Interest Expense	1,590	1,544	1,435	1,373	1,414
<b>Total Non-Interest Expense</b>	<b>\$9,637</b>	<b>\$9,294</b>	<b>\$8,610</b>	<b>\$8,575</b>	<b>\$8,526</b>

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 ===== **APPLICABLE INCOME TAXES** Applicable income taxes include current and deferred portions, which are detailed in Note 10 of the audited consolidated financial statements. Taxes for 2005 were \$1,067 thousand compared to \$762 thousand for 2004. The effective tax rate for the year 2005 was 36.2% compared to 34.3% for the year 2004.

**CREDIT RISK ANALYSIS** The Corporation, through its subsidiary, The Harbor Bank of Maryland, has in place credit policies and procedures designed to control and monitor credit risk. Credit analysis and loan review functions have provided a check and balance system for assessing initial and on-going risk associated with the lending process. Credit risk is mitigated through portfolio diversification, limiting exposure to any single industry or customer, requiring collateral and employing standard lending policies and underwriting criteria across the Corporation. Independent third party credit reviews are performed quarterly. During 2005, 70.0% of the loan portfolio was analyzed. During these reviews, any weaknesses are brought to management's attention for corrective action. Note 2 to the consolidated financial statements describes the Corporation's accounting policies related to nonperforming loans and charge-offs and describes the methodologies used to develop the allowance, including both the allocated and unallocated components. The Corporation's policies are consistent with regulatory standards.

**22 ASSET AND LIABILITY MANAGEMENT INTRODUCTION** The Investment Committee of the Corporation reviews policies regarding the sources and uses of funds, maturity distribution, and associated interest rate sensitivities. This effort is aimed at minimizing risks associated with fluctuating interest rates, as well as maintaining sufficient liquidity. **LIQUIDITY** Liquidity describes the ability of the Corporation to meet financial obligations, including lending commitments and contingencies that arise during the normal course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of the customers of the Corporation, as well as to meet current and planned expenditures. The Corporation, through the Bank, is required to maintain adequate sources of cash in order to meet its financial

commitments in an organized manner without incurring substantial losses. These commitments relate principally to changes in the Bank's deposit base through withdrawals and changes in funds required to meet normal and seasonal loan demands. The Bank, and thereby the Corporation, derives liquidity through the maturity distribution of the investment portfolio, loan repayments and income from earning assets. The Bank maintains a portion of its investment portfolio as a liquidity reserve, which can be converted to cash on an immediate basis. The Bank has also established secured lines of credit with the Federal Home Loan Bank as an additional source of liquidity. Collateral must be pledged to the FHLB before advances can be obtained. At December 31, 2005, the Corporation had sufficient collateral in order to borrow up to an aggregate of \$25.7 million from the FHLB under the established lines of credit, if necessary. Liquidity is also provided through the Corporation's portfolio of liquid assets, consisting of cash and due from banks, interest-bearing deposits in other banks and investment securities available for sale. Such assets totaled \$49.1 million or 19.1% of total assets at December 31, 2005. The Corporation derives its cash from a combination of operating activities, investing activities and financing activities as disclosed in the consolidated statement of cash flows. Cash flows from operating activities consist of interest income collected on loans and investments, interest expense paid on deposits and other borrowings, other income collected, such as cash received relating to service charges, and cash payments for other operating expenses including income taxes. Cash flows from investing activities include the purchase, sale and maturity of investments and interest bearing deposits in other banks, the net decrease in the level of loans, and purchases of premises and equipment. Cash flows from financing activities consist of movements in the level of deposits and other borrowings, and proceeds from the issuance of stock. For the year ended December 31, 2005, net cash provided by operating activities totaled \$4.6 million. Net cash used by investing activities totaled \$16.5 million resulting primarily from a net increase in loans of \$16.7 million and net purchases of premises and equipment of \$3.1 million, offset in part by the proceeds of maturities and principal payments of investment securities of \$2.0 million and a decrease in deposits at other banks of \$1.3 million. Net cash provided by financing activities totaled \$18.7 million, mainly resulting from the net increase in total deposits of \$19.6 million.

**INTEREST RATE SENSITIVITY** The Corporation's net income is largely dependent on its net interest income. The Corporation seeks to maximize its net interest margin within an acceptable level of interest rate risk. Interest rate risk can be defined as the amount of forecasted net interest income that may be gained or lost due to favorable or unfavorable movements in interest rates. Interest rate risk, or sensitivity, arises when the maturity or repricing characteristics of assets differ significantly from the maturity or repricing characteristics of liabilities. Net interest income is also affected by changes in the portion of interest-earning assets that are funded by interest-bearing liabilities rather than by other sources of funds, such as noninterest-bearing deposits and stockholders' equity. The Corporation attempts to manage interest rate risk while enhancing net interest margin by adjusting its asset/liability position. At times, depending on the level of general interest rates, the relationship between long-term and short-term interest rates, market conditions and competitive factors, the Corporation may determine to increase its interest rate risk position somewhat in order to increase its net interest margin. The Corporation monitors interest rate risk and adjust the composition of its interest-related assets and liabilities in order to limit its exposure to changes in interest rates on net interest income over time. The Corporation's Investment Committee reviews its interest rate risk position and profitability, and recommends adjustments. The Investment Committee also reviews the securities portfolio, formulates investment strategies, and oversees the timing and implementation of transactions. Notwithstanding The Corporation's interest rate risk management activities, the potential for changing interest rates is an uncertainty that can have an adverse effect on net income. 23

The Bank also analyzes interest rate risk based upon quantitative measures of the percentage changes in fair value of equity capital resulting from a hypothetical immediate change (or shock) of plus or minus 100 and 200 basis points in interest rate levels. This analysis is based upon models, which are based upon a number of significant assumptions regarding reactions of interest rates. These models also provide an analysis of interest rate shock effects on net interest income. The maximum decrease of net interest income, based upon the Bank's December 31, 2005 asset/liability position, was 1.3% from a 200 basis point rate shock. One measure of interest rate sensitivity is the difference between interest sensitive assets and interest sensitive liabilities called the "interest sensitivity gap." The following table shows an analysis of the Corporation's cumulative interest sensitivity gap position.

Cumulative Interest Sensitivity Gap 1 YEAR	Interest sensitive assets	\$ 28.5	Interest sensitive liabilities	12.4
Interest sensitivity gap	\$ 16.1	Gap to total assets	6.3%	LONG AND SHORT

**TERM BORROWINGS** On October 9, 2003, Harbor Bankshares Corporation issued a Floating Rate Junior Subordinated Debt Security due 2033 in the amount of \$7.2 million. The Debt Security was issued by the Corporation

pursuant to an Indenture, dated as of October 9, 2003, between the Corporation and Wilmington Trust Company. The Capital Securities were issued by Harbor Bankshares Corporation Capital Trust pursuant to a Purchase Agreement dated September 18, 2003, among the Corporation, the Trust and Citigroup Global Markets Inc. Upon the receipt of the funds, the Corporation paid off its long-term debt to National Community Investment Fund in the amount of \$1.9 million and placed the remaining funds in the amount of \$4.9 million in its subsidiary, The Harbor Bank of Maryland, increasing the Bank's Tier One capital. There were no other borrowings as of December 31, 2005. 24

**CONTRACTUAL OBLIGATIONS, COMMITMENTS, CONTINGENT LIABILITIES, AND OFF-BALANCE SHEET ARRANGEMENTS**

Contractual Obligations: The following table presents, as of December 31, 2005, significant fixed and determinable contractual obligations to third parties by payment date. (In thousands)

	One Year or Less	One to Three Years	Three to Five Years	Over Five Years
Deposits without a stated maturity	\$163,495	\$ --	\$ --	\$ --
Certificates of deposit	43,038	19,814	3,498	--
Operating leases	203	311	227	506
Junior Subordinated Debentures	--	--	--	7,217
<b>Total</b>	<b>\$206,736</b>	<b>\$20,125</b>	<b>\$3,725</b>	<b>\$7,723</b>

Off-Balance Sheet Arrangements: Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds collateral supporting those commitments for which collateral is deemed necessary. The Bank has not been required to perform on any financial guarantees and has not incurred any losses on its commitments. The issuance of letters of credit is not a significant activity of the Bank. Commitments to extend credit are agreements to lend funds to customers as long as there are no violations of any condition established in the loan contracts. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on credit evaluation by management. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment as well as income producing properties. We believe that we have adequate resources to fund all loan commitments. The Bank has entered into leases for its branch and office space, most of which contain renewal options. For additional information regarding off-balance sheet arrangements, please see Notes 7, 11 and 17 to the Consolidated Financial Statements.

**CAPITAL RESOURCES** Stockholders' equity increased by \$714 thousand or 4.4% to \$16.9 million. This increase was mainly due to net income of \$1.9 million, and proceeds from the sale of common stock of \$172 thousand, offset by the unrealized loss of securities held for sale, which was \$522 thousand at December 31, 2005, compared to a loss of \$238 thousand for 2004 and retirement of common stock of \$775 thousand. As of year-end, based on borrowing arrangements with the Federal Home Loan Bank with unused credit availability of \$25.6 million, the Corporation had sufficient liquidity to withstand any unusual demand of funds without liquidating its investment securities. Stockholders' equity was 6.6% of total assets as of the year-end. The Tier 1 capital ratio as of December 31, 2005, was 7.3%, and the risk-based capital ratio was 11.67%. The minimum requirements established by regulators are 4.0% for Tier 1 capital and 8.0% for total risk-based capital. The book value of each share of common stock was \$24.73 as of December 31, 2005. The Tier I capital ratio for the Corporation's subsidiary, The Harbor Bank of Maryland as of December 31, 2005, was 8.8% and the risk-based total capital ratio was 11.6%, both above the established regulatory requirements.

**CHANGES IN FINANCIAL POSITION** The Corporation, through its subsidiary, The Harbor Bank of Maryland, continued its growth during 2005. Total assets increased by \$21.1 million or 9.0%. Deposits increased from \$210.2 million in 2004 to \$229.8 million in 2005, an increase of \$19.6 million or 9.3%. Net loans reached to \$188.9 million in 2005 from \$172.2 million in 2004, an increase of \$16.7 million or 8.8%. The Corporation plans to continue its expansion through marketing efforts by its Management and Board of Directors. **OTHER INFORMATION** The Harbor Bank Community Development Corporation ("CDC") and The Harbor Bank of Baltimore LLC ("LLC") were established in 2003. The CDC is a non-profit company established with the purpose of bringing financial assistance to underserved areas in the City of Baltimore. The Corporation has no investments in this company. The Harbor Bank of Maryland, one of the Corporation's subsidiaries has a \$1.8 million loan to the CDC. As of December 31, 2005, the CDC had earnings of \$3.0 thousand and a \$28 thousand accumulated deficit since inception. These numbers exclude any tax benefit that may be available. The Harbor Bank of Baltimore LLC was established with the purpose of taking advantage of the New Markets Tax Credit program offered by the U.S. Treasury Department for the development of



certain targeted markets in the country. In the case of the LLC, the targeted market is the City of Baltimore. The LLC received a \$50 million New Market Tax Credit award in September 2004, and has written commitments from various investors in the amount of \$64 million. The Corporation has no investment in this company. The financial data from these companies is not included in the Corporation's financial statements, in accordance with FIN 46 (R)

"Consolidation of Variable Interest Entities." For a complete discussion of recent accounting pronouncements and their effect on the Corporation's financial statements, please refer to Note 3 of the Corporation's audited consolidated financial statements. 26 ITEM 7. FINANCIAL STATEMENTS HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES REPORT ON AUDITS OF FINANCIAL STATEMENTS FOR THE YEARS ENDED

DECEMBER 31, 2005 AND 2004 No extracts from this report may be published without our written consent. Stegman & Company 27 TABLE OF CONTENTS REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM CONSOLIDATED FINANCIAL STATEMENTS Page ---- Balance Sheets 30 - 31 Statements of Income 32 Statements of Changes in Stockholders' Equity 33 Statements of Cash Flows 34 - 35 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS 36 - 55 28 REPORT OF INDEPENDENT REGISTERED PUBLIC

ACCOUNTING FIRM Audit Committee of the Board of Directors and Stockholders of Harbor Bankshares

Corporation We have audited the accompanying consolidated balance sheets of Harbor Bankshares Corporation and subsidiaries as of December 31, 2005 and 2004 and the related consolidated statements of income, changes in stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the management of Harbor Bankshares Corporation. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Harbor Bankshares Corporation and subsidiaries as of December 31, 2005 and 2004 and the results of their operations and cash flows for the years then ended in conformity with U.S. generally accepted accounting principles. Stegman & Company Baltimore, Maryland February 18, 2006 29 HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS DECEMBER 31, 2005 AND 2004

ASSETS	2005	2004	
Cash and due from banks	\$ 7,259,358	\$ 6,867,063	Federal funds sold
15,624,890	9,845,813	Interest bearing deposits in other banks	74,996 1,352,791
Investment securities: Available for sale - at fair value	26,116,631	26,600,079	Held to maturity - at amortized cost (fair value of \$30,402 in 2005 and \$2,042,147 in 2004)
30,402	2,036,622	Total investment securities	26,147,033 28,636,701
Loans	190,994,929	173,816,465	Allowance for loan losses (2,058,561) (1,611,880)
Net loans	188,936,368	172,204,585	Premises and equipment, net
7,526,340	5,137,720	Federal Home Loan Bank of Atlanta stock - at cost	470,000 438,200
Goodwill	2,506,226	2,506,226	Other intangible assets
462,667	547,040	Bank-owned life insurance	4,178,774 4,023,808
Other assets	3,449,790	3,903,752	TOTAL ASSETS
\$256,636,442	\$235,463,699		

=====  
See accompanying notes. 30 LIABILITIES AND STOCKHOLDERS' EQUITY 2005 2004

LIABILITIES:	2005	2004	
Deposits: Noninterest bearing demand	\$ 50,433,169	\$ 49,342,950	Interest bearing transaction accounts
25,562,641	22,981,734	Savings	87,498,709 78,610,482
Time, \$100,000 or more	32,810,327	25,339,116	Other time
33,539,740	33,949,621	Total deposits	229,844,586
210,223,903	Accrued interest payable	683,762	356,184
Junior subordinated debentures	7,217,000	7,217,000	Other liabilities
1,937,184	1,426,651	Total liabilities	239,682,532 219,223,738

STOCKHOLDERS' EQUITY: Common stock (par value \$0.01): Authorized 10,000,000 shares; issued 685,579 and 704,934, including 33,795 common nonvoting at December 31, 2005 and 2004, respectively 6,856 7,049 Additional paid-in capital 6,615,906 7,218,340 Retained earnings 10,853,086 9,252,307 Accumulated other comprehensive loss (521,938) (237,735) Total stockholders' equity 16,953,910 16,239,961

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY \$256,636,442 \$235,463,699

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31 HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004 2005 2004

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----- INTEREST INCOME: Interest and fees on loans \$13,909,841 \$11,359,107 Interest on investments - taxable 850,262 1,135,744 Interest on deposits in other banks 18,200 44,488 Interest on federal funds sold 216,379 93,993 Other interest income 19,164 14,528 ----- Total interest income 15,013,846 12,647,860  
----- INTEREST EXPENSE: Interest bearing transaction accounts 57,097 43,147 Savings 1,408,670 669,696 Time, \$100,000 or more 664,051 456,056 Other time 1,192,439 783,198 Interest on junior subordinated debentures 443,779 317,690 Federal funds purchased 20,738 13,095 ----- Total interest expense 3,786,774 2,282,882 ----- NET INTEREST INCOME 11,227,072 10,364,978  
PROVISION FOR LOAN LOSSES 410,000 360,000 ----- NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES 10,817,072 10,004,978 ----- NONINTEREST INCOME: Service charges on deposit accounts 899,883 802,192 Other service charges 455,230 279,464 Gain on sale of securities - 16,733 Gain on sales of loans - 6,027 Cash surrender value life insurance 175,547 197,900 Loan servicing fees 9,747 16,729 Other income 230,696 195,095 ----- Total noninterest income 1,771,103 1,514,140 ----- NONINTEREST EXPENSES: Salaries and employee benefits 4,425,478 4,510,208 Advertising 368,689 300,130 Occupancy expense of premises 1,093,193 679,386 Equipment expense 323,747 355,698 Data processing fees 1,110,060 1,031,317 Professional fees 420,564 518,180 Amortization of intangible assets 80,460 80,460 ATM loss 225,000 275,000 Other expenses 1,590,433 1,544,358 ----- Total noninterest expense 9,637,624 9,294,737 ----- INCOME BEFORE INCOME TAXES 2,950,551 2,224,381 APPLICABLE INCOME TAXES 1,067,377 762,326 ----- NET INCOME \$1,883,174 \$ 1,462,055 ===== BASIC EARNINGS PER SHARE \$2.73 \$2.07 ===== DILUTED EARNINGS PER SHARE \$2.55 \$1.93 ===== See accompanying notes. 32  
HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004  
Accumulated Other Comprehensive Total Common Paid-in Retained Income Stockholders' Stock Capital Earnings (Loss) Equity ----- Balance at January 1, 2004 \$7,041 \$7,210,178 \$8,036,714 \$ 20,835 \$15,274,768 Comprehensive income: Net income - - 1,462,055 - 1,462,055 Reclassification adjustment, net of taxes of \$6,462 - - (10,271) (10,271) Unrealized losses on securities available-for-sale, net of taxes of \$156,228 - - (248,299) (248,299) ----- Total comprehensive income 1,203,485 Payment of cash dividends \$0.35 per share - - (246,462) - (246,462) Stock options exercised 8 8,162 - - 8,170 ----- Balance at December 31, 2004 7,049 7,218,340 9,252,307 (237,735) 16,239,961 Comprehensive income: Net income - - 1,883,174 - 1,883,174 Unrealized losses on securities available-for-sale, net of taxes of \$112,260 - - (284,203) (284,203) ----- Total comprehensive income 1,598,971 Retirement of stock (310) (774,690) - - (775,000) Payment of cash dividends \$.40 per share - - (282,395) - (282,395) Stock options exercised 117 172,256 - - 172,373 ----- Balance at December 31, 2005 \$6,856 \$6,615,906 \$10,853,086 \$(521,938) \$16,953,910 =====  
See accompanying notes. 33 HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004 2005 2004  
----- CASH FLOWS FROM OPERATING ACTIVITIES: Net income \$ 1,883,174 \$ 1,462,055 Adjustments to reconcile net income to net cash provided by operating activities: Depreciation and amortization 761,363 492,332 Provision for loan losses 410,000 360,000 Deferred income taxes (323,885) 40,388 Increase in cash surrender value of life insurance (154,966) (165,183) Gains on sales of loans - (6,027) Gain on sale securities - (16,733) Origination of loans held for sale - (2,802,440) Proceeds from sales of loans held for sale - 2,808,467 Increase in accrued interest receivable and other assets 718,666 (285,590) Increase in accrued interest payable and other liabilities 838,111 629,267 ----- Net cash provided by operating activities 4,132,463 2,516,536  
----- CASH FLOWS FROM INVESTING ACTIVITIES: Net decrease in deposits at other banks 1,277,795 547,209 Purchases of investment securities available-for-sale - (13,999,000) Proceeds from calls, maturities and principal payments of investment securities available-for-sale 2,008,765 15,694,410 Proceeds from sales of securities available-for-sale - 7,032,625 Net increase in loans (16,298,793) (22,475,090) Purchases of premises and equipment - net (3,069,523) (1,829,589) ----- Net cash used in investing activities (16,081,756) (15,029,435)  
----- CASH FLOWS FROM FINANCING ACTIVITIES: Net increase in deposits 19,620,683 14,322,479 Proceeds from sale of common stock 172,373 8,170 Cash dividends paid (282,395) (246,462) Retirement of stock (775,000) - ----- Net cash provided by financing activities 18,735,661 14,084,187

-----	-----	INCREASE IN CASH AND CASH EQUIVALENTS	6,786,368	1,571,288	CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	16,172,876	15,141,588	-----	-----	CASH AND CASH EQUIVALENTS AT END OF YEAR	\$22,959,244	\$16,712,876	=====	=====	34
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HARBOR BANKSHARES CORPORATION Consolidated Statements of Cash Flows (Continued) For the Years Ended December 31, 2005 and 2004 2005 2004 ----- Supplemental disclosure of cash flows information: Cash paid for income taxes \$1,075,000 \$ 825,000 ===== Cash paid for interest \$3,459,196 \$2,160,463 ===== See accompanying notes. 35 HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

1. NATURE OF OPERATIONS Harbor Bankshares Corporation (the "Corporation") is a bank holding company organized under the laws of the State of Maryland in 1992. The Corporation owns all of the outstanding stock of the Harbor Bank of Maryland (the "Bank") which owns all of the outstanding stock of the Bank's subsidiary, Harbor Financial Services. The Bank is a commercial bank headquartered in Baltimore, Maryland. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation. The Bank conducts general banking business in six locations and primarily serves the Baltimore, Maryland metropolitan area. The Bank also has a branch in Riverdale, Prince George's County, Maryland. It offers checking, savings and time deposits, commercial real estate, personal, home improvement, automobile, and other installment and term loans. The Bank is also a member of a national ATM network. The retail nature of the Bank allows for diversification of depositors and borrowers so it is not dependent upon a single or a few customers.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES The accounting and reporting policies of the Corporation and its subsidiary conform to U.S. generally accepted accounting principles. Certain reclassifications have been made to amounts previously reported to conform to the classifications made in 2005. The following is a summary of the more significant accounting policies: Use of Estimates The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Cash and Cash Equivalents For purposes of the consolidated statements of cash flows, the Corporation considers all highly liquid debt instruments with original maturities of three months or less and money market funds to be cash equivalents. 36 Investment Securities Debt securities that the Corporation has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Debt and equity securities are classified as trading securities if bought and held principally for the purpose of selling them in the near term. Trading securities are reported at estimated fair value, with unrealized gains and losses included in earnings. Debt securities not classified as held to maturity and debt and equity securities not classified as trading securities are considered available for sale and are reported at estimated fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity, net of tax effects, in accumulated other comprehensive income. The Corporation designates securities into one of the three categories at the time of purchase. If a decline in value of an individual security classified as held to maturity or available for sale is judged to be other than temporary, the cost basis of that security is reduced to its fair value and the amount of the write-down is reflected in earnings. Estimated fair value is determined based on bid prices published in financial newspapers or bid quotations received from securities dealers. Gains or losses on the sales of investments are calculated using a specific identification basis and are determined on a trade-date basis. Premiums and discounts on investment and mortgage-backed securities are amortized over the term of the security using methods that approximate the interest method. Loans Held for Sale The Corporation engages in sales of residential mortgage loans originated by the Bank. Loans held for sale are carried at the lower of aggregate cost or fair value. Gains and losses on sales of these loans are recorded as a component of non-interest income in the accompanying consolidated statements of income. The amount of loans held for sale as of December 31, 2005 and 2004 was not considered material. Loans Loans are stated at their principal balance outstanding net of any deferred fees and costs. Interest income on loans is accrued at the contractual rate based on the principal outstanding. The Corporation places loans, on non-accrual when any portion of the principal or interest is ninety days past due and collateral is insufficient to discharge the debt in full. Interest accrual may also be discontinued earlier if, in management's opinion, collection is unlikely. Loans are considered impaired when, based on current information, it is probable that the Corporation will not collect all principal and interest payments according to contractual terms. Generally, loans are considered impaired once principal or interest payments

become ninety days or more past due and they are placed on non-accrual. Management also considers the financial condition of the borrower, cash flows of the loan and the value of the related collateral. Impaired loans do not include large groups of smaller balance homogeneous credits such as residential real estate and consumer installment loans, which are evaluated collectively for impairment. Loans specifically reviewed for impairment are not considered impaired during periods of "minimal delay" in payment 37 (ninety days or less) provided eventual collection of all amounts due is expected. The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if repayment is expected to be provided by the collateral. Generally, the Corporation's impairment on such loans is measured by reference to the fair value of the collateral. Income on impaired loans is recognized on the cash basis and is first applied against the principal balance outstanding. Discounts and premiums on purchased loans are amortized to income using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments.

**Allowance for Loan Losses** The allowance for loan losses represents an amount which, in management's judgment, will be adequate to absorb probable losses on existing loans that may become uncollectible. The allowance for loan losses consists of an allocated component and an unallocated component. The components of the allowance for loan losses represent an estimation done pursuant to either Statement of Financial Accounting Standards ("SFAS") No. 5, Accounting for Contingencies, or SFAS No. 114, Accounting by Creditors for Impairment of a Loan. The adequacy of the allowance for loan losses is determined through careful and continuous review and evaluation of the loan portfolio and involves the balancing of a number of factors as outlined below to establish a prudent level. Loans deemed uncollectible are charged against, while recoveries are credited to, the allowance. Management adjusts the level of the allowance through the provision for loan losses, which is recorded as a current period operating expense. The Corporation's methodology for assessing the appropriateness of the allowance consists of several key elements, which include the formula allowance, specific allowances and the unallocated allowance. The formula allowance is calculated by applying loss factors to corresponding categories of outstanding loans. Loss factors are based on the Corporation's historical loss experience. The use of these loss factors is intended to reduce the difference between estimated losses inherent in the portfolio and observed losses. Specific allowances are established in cases where management has identified significant conditions or circumstances related to a loan that management believes indicate the probability that a loss may be incurred in an amount different from the amount determined by application of the formula allowance. For other problem graded credits, allowances are established according to the application of credit risk factors. These factors are set by management to reflect its assessment of the relative level of risk inherent in each grade. The unallocated allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. Such conditions include general economic and business conditions affecting key lending areas, credit quality trends (including trends in delinquencies and nonperforming loans expected to result from existing conditions), loan volumes and concentrations, specific industry conditions within portfolio categories, recent loss experience in particular loan categories, duration of the current business cycle, bank regulatory examination results, findings of internal loan examiners, and management's judgment with respect to various other conditions including loan administration and management and the quality of risk identification systems. Executive management reviews these conditions quarterly.

38 Management believes that the allowance for loan losses is adequate. However, the determination of the allowance requires significant judgment, and estimates of probable losses inherent in the loan portfolio can vary significantly from the amounts actually observed. While management uses available information to recognize probable losses, future additions to the allowance may be necessary based on changes in the loans comprising the loan portfolio and changes in the financial condition of borrowers, such as may result from changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's loan portfolio and allowance for loan losses. Such review may result in recognition of additions to the allowance based on their judgments of information available to them at the time of their examination. Premises and Equipment Premises and equipment are stated at cost less accumulated depreciation and amortization computed using the straight-line method. Premises and equipment are depreciated over the useful lives of the assets, except for leasehold improvements which are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Useful lives range from three to seven years for furniture, fixtures and equipment and forty years for buildings. The costs of major renewals and betterments are capitalized, while the costs of ordinary maintenance and repairs are expensed as incurred.

Federal Home Loan Bank of Atlanta Stock The Bank, as a member of the Federal Home Loan Bank System,

is required to maintain an investment in capital stock of the Federal Home Loan Bank of Atlanta ("FHLB") in varying amounts based on balances of outstanding home loans and on amounts borrowed from the FHLB. Because no ready market exists for this stock and it has no quoted market value, the Bank's investment in this stock is carried at cost.

**Other Real Estate Owned (OREO)** OREO comprises properties acquired in partial or total satisfaction of problem loans. The properties are recorded at the lower of cost or fair value at the date acquired. Losses arising at the time of acquisition of such properties are charged against the allowance for loan losses. Subsequent write-downs that may be required are added to a valuation reserve. Gains and losses realized from the sale of OREO, as well as valuation adjustments, are included in noninterest income. Expenses of operation are included in noninterest expense. There was no OREO as of December 31, 2005 and 2004.

**Goodwill** Goodwill represents the excess of the cost of assets acquired in business combinations accounted for under the purchase method over the fair value of the net assets at dates of acquisition and is annually tested for impairment in accordance with SFAS No. 142.

**39 Core Deposit Intangibles** Upon acquiring the branches of another financial institution, the Bank engages an independent third party of experts to analyze and prepare a core deposit study. This study reflects the cumulative present value benefit of acquiring deposits versus an alternative source of funding. Based upon this analysis, the amount of the premium related to the core deposits of the business purchased is calculated along with the estimated life of the acquired deposits. The core deposit intangible is being amortized over an approximate life of 9 years.

**Loan Servicing** The cost of mortgage servicing rights is amortized in proportion to, and over the period of, estimated net servicing revenue. Impairment of mortgage servicing rights is assessed based on the fair value of those rights. Fair values are estimated using discounted cash flows based on a current market interest rate. The amount of impairment recognized is the amount by which the capitalized mortgage servicing rights exceed their fair value. When participating interests in loans sold have an average contractual interest rate, adjusted for normal servicing fees, that differs from the agreed yield to the purchaser, gains or losses are recognized equal to the present value of such differential over the estimated remaining life of such loans. The resulting "excess servicing receivable" or "deferred servicing revenue" is amortized over the estimated life using a method approximating the interest method. Quoted market prices are not available for the excess servicing receivables. Thus, the excess servicing receivables and the amortization thereon are periodically evaluated in relation to estimated future servicing revenue, taking into consideration changes in interest rates, current repayment rates, and expected future cash flows. The Corporation evaluates the carrying value of the excess servicing receivables by estimating the future servicing income of the excess servicing receivables based on management's best estimate of remaining loan lives and discounted at the original discount rate.

**Bank-Owned Life Insurance** The Bank is the beneficiary of insurance policies on the lives of certain officers of the Bank. The Bank has recognized the amount that could be realized under the insurance policies as an asset in the consolidated balance sheets. Appreciation in the value of the insurance policies is classified in non-interest income.

**Income Taxes** Income tax expense is based on the results of operations, adjusted for permanent differences between items of income or expense reported in the financial statements and those reported for tax purposes. Under the liability method, deferred income taxes are determined based on the differences between the financial statement carrying amounts and the income tax basis of assets and liabilities and are measured at the enacted tax rates that will be in effect when these differences reverse.

**40 Earnings Per Share** Basic earnings per share is computed by dividing net income by the weighted-average number of shares outstanding during the period. Diluted earnings per share is determined using the weighted-average number of shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents, consisting of shares that might be issued upon exercise of common stock options.

**Stock Based Compensation** The Corporation's stock-based compensation plan is accounted for based on the intrinsic value method set forth in Accounting Principles Board Opinion ("APB") No. 25, Accounting for Stock Issued to Employees, and related interpretations. Compensation expense for stock options is generally not recognized if the exercise price of the option equals or exceeds the fair market value of the stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Corporation had applied the fair value recognition provisions of SFAS No. 123 to all stock option awards.

For the Year Ended -----	2005	2004	-----	-----
				Net income, as reported
	\$1,462,055			\$1,883,174
	Less: total option expense determined under fair value method for all option awards, net of related tax effects (10,937)	(103,150)	-----	
				Pro forma net income
				\$1,872,237 \$1,358,905 =====
	=====			Pro forma net income per share: Basic - as reported
	\$2.73	\$2.07	=====	===== Basic - pro forma
	\$2.72	\$1.93	=====	\$1.93 =====
				Diluted - as reported
	\$2.55	\$1.93	=====	===== Diluted - pro forma
				\$2.53 \$1.80 =====

The fair values of stock options granted were estimated at the date of grant using the Black-Scholes option pricing

model. The Black-Scholes option pricing model was originally developed for use in estimating the fair value of traded options, which have different characteristics from the Corporation's employee stock options. The model is also sensitive to changes in assumptions, which can materially affect the fair value estimate. The following weighted-average assumptions were used to determine the fair value of options granted on the Corporation's common stock: For the Year Ended ----- 2005 2004 ----- Risk-free interest rate 4.23% 5.0% Expected volatility 20% 20% Expected life (in years) 10 10 Expected dividend yield 1.50% 1.50% 41 The Corporation expects to adopt the provisions of SFAS No. 123(R), Share-Based Payment (Revised 2005), on January 1, 2006. Among other things, SFAS 123(R) eliminates the ability to account for stock-based compensation using APB No. 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the date of the grant. Advertising Advertising costs are expensed as incurred. Advertising expense was \$368,689 and \$300,130 for the years ended December 31, 2005 and 2004, respectively. Awards and Grants Income from awards and grants represents awards from the Community Development Financial Institution Fund and is recognized when a definitive commitment from the federal government agency is received. There were no awards or grants in 2005 or 2004. Business Segments The Corporation has determined that its current business and operations consist of one business segment. 3. RECENT ACCOUNTING PRONOUNCEMENTS In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement No. 123(R), Share-Based Payment. This statement replaces SFAS No. 123, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123(R) will require compensation costs related to share-based payment transactions to be recognized in the financial statements (with limited exceptions). The amount of compensation cost will be measured based on the grant-date fair value of the equity or liability instruments issued. Compensation cost will be recognized over the period that an employee provides service in exchange for the award. The Company is evaluating the requirements of implementation and plans to adopt the provisions under the prospective method beginning January 1, 2006. The impact of this Statement on the Corporation in 2006 and beyond will depend upon various factors, among them being the Corporation's future compensation strategy. As of December 31, 2005, all stock options outstanding are fully vested. In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement No. 154, ("SFAS No. 154") Accounting Changes and Error Corrections - a Replacement of APB Opinion No. 20 and FASB Statement No. 3. This new standard replaces Accounting Principles Board ("APB") Opinion No. 20, Accounting Changes, and FASB Statement No. 3 Reporting Accounting Changes in Interim Financial Statements. Among other changes, SFAS No. 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. SFAS No. 154 also provides that (1) a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a "restatement". The new standard is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Corporation does not anticipate this revision will have a material effect on its financial statements. 42 On November 3, 2005, the FASB issued FSP Nos. FAS 115-1 and FAS 124-1 to address the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of the impairment loss. The FSPs also includes guidance on the accounting subsequent to the recognition of an other-than-temporary impairment and requires additional disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FAS amends FASB Statements No. 115 Accounting for Certain Investments in Debt and Equity Securities. The guidance in this FSP shall be applied to reporting periods beginning after December 15, 2005. This revision will not have a material effect on the Corporation's financial statements. 4. RESTRICTIONS ON CASH AND DUE FROM BANKS The Bank is required by the Federal Reserve to maintain a reserve balance based principally on deposit liabilities. The balance maintained is included in cash and due from banks. The reserve balances kept at the Federal Reserve Bank as of December 31, 2005 were \$25,000. 5. INVESTMENT SECURITIES The amortized cost and estimated fair values of investments securities are as follows: Gross Gross Amortized Unrealized Unrealized Estimated Cost Gains Losses Fair Value ----- Balance at December 31, 2005: Available-for-sale: U.S. Treasury and government agencies \$ 26,847,870 \$ - \$(865,740) \$25,982,130 Mortgage-backed securities 131,468 3,033 - 134,501 ----- Total \$ 26,979,338 \$ 3,033 \$(865,740) \$26,116,631 ===== Held-to-maturity: Other \$ 30,402 \$ - \$ - \$ 30,402 ===== Gross

Gross Amortized Unrealized Estimated Cost Gains Losses Fair Value -----  
 Balance at December 31, 2004: Available-for-sale: U.S. Treasury and government agencies \$ 26,847,162 \$ -  
 \$(390,740) \$26,456,422 Mortgage-backed securities 140,233 3,424 - 143,657 State and political subdivisions - - -  
 ----- Total \$ 26,987,395 \$ 3,424 \$(390,740) \$26,600,079 =====  
 ===== Held-to-maturity: U.S. Government agencies 2,000,735 5,525 - 2,006,260  
 Other 35,887 - - 35,887 ----- Total \$ 2,036,622 \$ 5,525 \$ - \$ 2,042,147  
 ===== 43 Securities, with unrealized losses segregated by  
 length of impairment, were as follows: Less than 12 Months More than 12 Months Total -----  
 ----- Estimated Unrealized Estimated Unrealized Estimated Unrealized  
 Fair Value Losses Fair Value Losses Fair Value Losses -----  
 ----- Available-for-sale: U.S. Government agencies and corporations \$2,438,275 \$(61,725) \$23,543,855  
 \$(804,015) \$26,982,130 \$(865,740) =====  
 ===== Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are  
 deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary  
 impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair  
 value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent and  
 ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any  
 anticipated recovery in fair value. Management has the ability and intent to hold the securities classified as  
 held-to-maturity until they mature, at which time the Corporation will receive full value for the securities.  
 Furthermore, as of December 31, 2005, management also had the ability and intent to hold the securities classified as  
 available-for-sale for a period of time sufficient for a recovery of cost. The unrealized losses are largely due to  
 increases in market interest rates over the yields available at the time the underlying securities were purchased. The  
 fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such  
 investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality.  
 Accordingly, as of December 31, 2005, management believes the impairments detailed in the table above are  
 temporary and no impairment loss has been realized in the Corporation's consolidated statement of income. The  
 amortized cost and estimated fair value of debt securities at December 31, 2005, by contractual maturity, are shown  
 below. Expected maturities may differ from contractual maturities because borrowers have the right to call or repay  
 obligations without call or prepayment penalties. Estimated Amortized Fair Cost Value -----  
 Available-for-sale: Due after one year through five years \$26,847,870 \$25,982,130 Due after five years through ten  
 years - - Mortgage-backed securities 131,468 134,501 ----- Total \$26,979,338 \$26,116,631  
 ===== Held-to-maturity: Due after one year through five years \$ - \$ - Due after ten years  
 30,402 30,402 ----- Total \$ 30,402 \$ 30,402 ===== 44 During the year ended  
 December 31, 2005 no available-for-sale securities were sold. During 2004, the gross proceeds for the sale of  
 available securities were \$7,032,625 and gains of \$16,733. Securities with a fair value of \$14,975,010 at December  
 31, 2005 have been pledged as collateral for money market and certificate of deposit accounts. The only investments  
 to a single issuer that exceeds 10% of stockholders' equity are to government sponsored entities. 6. LOANS AND  
 ALLOWANCE FOR LOAN LOSSES The composition of loans, net of unearned income at December 31 is as  
 follows: 2005 2004 ----- Real estate \$102,404,253 \$ 94,543,110 Commercial 82,844,979 72,075,164  
 Consumer 4,980,479 6,368,380 Credit card loans 765,218 829,811 ----- \$190,994,929 \$173,816,465  
 ===== Transactions in the allowance for loan losses are summarized as follows: 2005  
 2004 ----- Balance at January 1 \$ 1,611,880 \$ 1,488,212 ----- Provision charged to  
 operating expense 410,000 360,000 ----- Loans charged-off (91,302) (413,390) Recovery on loans  
 previously charged-off 127,983 177,058 ----- Net recovery (charged-off) 36,681 (236,332) -----  
 ----- Balance at December 31 \$ 2,058,561 \$ 1,611,880 ===== Information with respect  
 to impaired loans at December 31, 2005 and 2004 and for the years then ended is as follows: 2005 2004 -----  
 ----- Impaired loans with a valuation allowance \$ 558,128 \$ 749,794 Impaired loans without a valuation  
 allowance 17,805 49,355 ----- Total impaired loans \$ 575,933 \$ 799,149 =====  
 ===== Allowance for loan losses related to impaired loans \$ 50,808 \$ 102,127 Allowance for loan losses  
 related to other than impaired loans 2,007,753 1,509,753 ----- Total allowance for loan losses \$  
 2,058,561 \$ 1,611,880 ===== Average impaired loans for the year \$ 752,271 \$ 746,909

===== 45 Approximately \$34,700 and \$9,157 of interest income was recognized on impaired loans for the years ended December 31, 2005 and 2004, respectively. Interest income recognized on impaired loans on a cash basis during 2005 and 2004 was not considered material. The Bank has sold certain real estate mortgage loans without recourse and in some cases retained the related servicing rights. The principal balances of these serviced loans, which are not included in the accompanying consolidated balance sheets, totaled \$4,331,326 and \$4,988,951 at December 31, 2005 and 2004, respectively. There were \$716,000 of loans held for sale at December 31, 2005 and \$1,149,000 at December 31, 2004. At December 31, 2005 and 2004 the net carrying amount of mortgage servicing rights was \$-0- and \$3,913, respectively, which approximated fair value and are included in other assets. The Bank has granted loans to certain officers and directors of the Bank and their associates. Related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than the normal risk of collectibility. The aggregate dollar amount of these loans was \$13,465,670 and \$11,508,543 at December 31, 2005 and 2004, respectively. During 2005, \$7,851,906 of new loans were made while repayments totaled \$5,894,779. During 2004, \$5,116,420 of new loans were made while repayments totaled \$2,306,545. The 2004 numbers for loans to officers and directors include two directors that no longer serve on the Board. As of December 31, 2005 and 2004, the Bank had outstanding loans to the Harbor Bank of Maryland Community Development Corporation amounting to \$1,795,444 and \$2,000,000, respectively.

7. PREMISES AND EQUIPMENT The major classes of premises and equipment at December 31 are summarized as follows: 2005 2004 ----- Land \$ 661,900 \$ 661,900 Buildings 2,400,196 3,947,253 Furniture, fixtures and equipment 2,575,067 2,111,982 Leasehold improvements 4,778,883 625,877 ----- 10,416,046 7,347,012 Less accumulated depreciation and amortization 2,889,706 2,209,292 ----- Total \$ 7,526,340 \$5,137,720 ===== Depreciation expense was \$680,903 and \$427,497 for the years ended December 31, 2005 and 2004. The Bank leases branch and office facilities. The lease agreements provide for the payment of utilities and taxes by the lessee. Future minimum payments for each of the five succeeding years under noncancelable operating leases consisted of the following at December 31, 2005: 2006 \$203,216 2007 196,999 2008 113,542 2009 113,542 2010 113,542 Thereafter 506,572 46 Total rental expense under operating leases amounted to \$212,914 and \$168,096 for the years ended December 31, 2005 and 2004, respectively.

8. CORE DEPOSIT INTANGIBLE The Corporation has a finite-lived core deposit intangible asset created in 2002 which is being amortized over a 9-year period beginning in 2002. Annual amortization expense related to this intangible is expected to be \$80,460 per year through 2010 and \$60,367 in 2011.

9. TIME DEPOSITS At December 31, 2005, time deposits with a remaining maturity of one year or more amounted to \$21,924,052. Maturities of all time deposits are as follows: 2007 \$10,071,533 2008 9,742,793 2009 1,398,195 2010 482,009 2011 229,522 Deposits are the Corporation's primary funding source for loans and investment securities. The mix and repricing alternatives can significantly affect the cost of this source of funds and, therefore, impact the margin.

10. INCOME TAX The Corporation's provision for income taxes for the years ended December 31, is summarized as follows: 2005 2004 ----- Taxes currently payable \$1,205,592 \$868,436 Deferred taxes (138,225) (106,110) ----- Income tax expense for the year \$1,067,367 \$762,326 ===== A reconciliation of the difference between the statutory federal income tax rate and the effective tax rate for the Corporation is as follows: 2005 2004 ----- Federal income tax rate 34.00% 34.00% State income taxes, net of federal income tax effect 4.02 2.30 Increase (decrease) resulting from: Increase in value of bank-owned life insurance (2.50) (2.50) Other 0.65 .50 ----- Effective tax rate 36.17% 34.30% =====

47 Significant components of the Corporation's deferred tax liabilities and assets at December 31 are as follows: 2005 2004 ----- Deferred tax liabilities - Goodwill \$ 511,749 \$383,812 ----- Deferred tax assets: Accrued liability - 106,205 Allowance for loan losses 598,506 440,988 Deferred loan origination fees - 14,457 Depreciation 120,884 19,189 Deferred compensation 333,716 237,865 Deposit premium 90,121 63,890 ----- Total gross deferred tax assets 1,143,227 882,594 ----- Net deferred tax assets attributable to operations 631,478 498,782 Unrealized loss (gain) on investments charged to other comprehensive income 340,769 149,581 ----- Net deferred income tax assets \$ 972,247 \$648,363 =====

11. SHORT-TERM BORROWINGS As of December 31, 2005, the Bank had an unused available line-of-credit from the Federal Home Loan Bank of Atlanta ("FHLB") of \$25,610,000.

12. JUNIOR SUBORDINATED DEBENTURES On October 9, 2004, the Corporation issued floating rate junior subordinated debt securities due 2033 in the amount of \$7.2 million. The debt security was issued by the Corporation pursuant to an indenture, dated as of October 9, 2004, between the Corporation and Wilmington Trust



Company. The capital securities will be issued by Harbor Bankshares Corporation Capital Trust (the "Trust") pursuant to a purchase agreement dated September 18, 2004, among the Corporation, the Trust and Citigroup Global Markets Inc. Upon the receipt of the funds, the Corporation paid off its long-term debt in the amount of \$1.8 million and invested the remaining funds in the amount of \$4.9 million as capital in the Bank, increasing the Bank's tier one capital. The interest rate on the debentures was 7.25% at December 31, 2005.

13. EMPLOYEE BENEFIT PLANS

Stock Options The Corporation has stock option award arrangements which provide for the granting of options to acquire common stock by directors and key employees. Option prices are equal to or greater than the estimated fair market value of the common stock at the date of the grant. Options are generally exercisable immediately after the date of the grant.

48 A summary of the Corporation's stock options as of December 31, 2005 and 2004 and changes during the years ended on those dates is presented below:

	2005	2004		2005	2004
Weighted Average Exercise Price	\$15.93	\$15.49	Granted	4,891	9,820
Outstanding at the beginning of the year	150,826	151,843	Exercised	(11,645)	(758)
Outstanding at end of year	132,741	150,826	Forfeited	(11,331)	(10,079)
Options exercisable at year-end	132,741	150,826	Weighted average fair value of options granted during the year	\$6.78	\$10.50

The following table summarizes information about stock options outstanding at December 31, 2005:

Options Outstanding and Exercisable	Weighted-Average Exercise Price	Weighted-Average Remaining Life	Weighted-Average Exercise Price Range
132,741	\$15.24 - \$23.04	3.6	\$16.24

14. CONCENTRATIONS OF CREDIT RISK

Real estate loans comprise \$102,903,065 and \$94,543,110 of the total loan portfolio at December 31, 2005 and 2004, respectively. All real estate mortgage loans are collateralized by real property and/or other assets.

15. REGULATORY MATTERS

The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Corporation's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). As of December 31, 2005, the capital levels of the Corporation and the Bank exceed all minimum capital adequacy requirements to which they are subject. There are no conditions or events since December 31, 2005 that management believes have changed the Bank's capital rating. The Corporation's and the Bank's actual capital amounts and ratios are also presented in the table: (in thousands)

	Actual	Minimum Required	Amount	Ratio	Actual	Minimum Required	Amount	Ratio
Total Capital (to risk-weighted total assets)	\$23,566	\$16,154	11.67%	8.0%	\$20,192	\$16,154	11.59%	8.0%
Tier 1 Capital (to risk weighted assets)	\$18,321	\$16,150	9.07%	8.0%	\$18,321	\$16,150	9.07%	8.0%

8,077 4.0% \$12,116 6.0% Harbor Bank of Maryland 21,297 9.47% 8,060 4.0% 12,080 6.0% Tier 1 Capital (to average assets) Harbor Bankshares Corporation \$18,321 7.31% \$ 9,666 4.0% \$12,083 5.0% Harbor Bank of Maryland 21,297 8.83% 9,649 4.0% 12,062 5.0% 50 To Be Well Capitalized Under For Capital Prompt Corrective Actual Adequacy Purposes Action Provisions ----- Minimum Required

Minimum Required Amount Ratio Amount Ratio Amount Ratio ----- As of December 31, 2004: Total Capital (to risk-weighted total assets) Harbor Bankshares Corporation \$22,040 12.10% \$14,535 8.0% \$18,169 10.0% Harbor Bank of Maryland 21,830 12.01% 14,535 8.0% 18,169 10.0% Tier 1 Capital (to risk weighted assets) Harbor Bankshares Corporation \$17,242 9.47% \$ 7,267 4.0% \$10,901 6.0% Harbor Bank of Maryland 20,218 9.47% 7,267 4.0% 10,901 6.0% Tier 1 Capital (to average assets) Harbor Bankshares Corporation \$17,242 7.36% \$9,365 4.0% \$11,707 5.0% Harbor Bank of Maryland 20,218 8.63% 9,365 4.0% 11,707 5.0% Bank and holding company regulations, as well as Maryland law, impose certain restrictions on dividend payments by the Bank, as well as restricting extensions of credit and transfers of assets between the Bank and the Company. At December 31, 2005, the Bank could have paid additional dividends of \$10,008,477 to its parent company without regulatory approval.

16. EARNINGS PER SHARE Basic and diluted earnings per common share calculations for the years ended December 31, 2005 and 2004 are as follows: 2005 2004 ----- BASIC: Net income \$1,883,174 \$1,462,055 ----- Average common shares outstanding 689,134 704,602 ----- Earnings per common share - basic \$2.73 \$2.07 ===== DILUTED: Net income \$1,883,174 \$1,462,055 ----- Average common shares outstanding 689,134 704,569 Stock option adjustment 49,488 51,654 ----- Average common shares outstanding - diluted 738,622 756,223 ----- Earnings per common share - diluted \$2.55 \$1.93 ===== Basic earnings per common share is calculated by dividing net income by the weighted- average number of common shares outstanding for the period. Diluted earnings per common shares takes into consideration the pro forma dilution assuming the Corporation's outstanding in-the-money stock options were converted or exercised into common shares. The average price of the Corporation's common stock for the period is used to determine the dilutive effect of outstanding stock options. As of December 31, 2005 none of the Corporation's 132,741 outstanding stock options were excluded from the computation of diluted earnings per share.

17. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK In the normal course of business, the Corporation has various outstanding credit commitments which are properly not reflected in the financial statements. These commitments are made to satisfy the financing needs of the Corporation's clients. The associated credit risk is controlled by subjecting such activity to the same credit and quality controls as exist for the Corporation's lending and investing activities. The commitments are generally variable rate and involve diverse business and consumer customers and are generally well collateralized. Management does not anticipate that losses, if any, which may occur as a result of these commitments would materially affect the stockholders' equity of the Corporation. Since a portion of the commitments have some likelihood of not being exercised, the amounts do not necessarily represent future cash requirements. Loan and credit line commitments, totaled \$27,913,000 at December 31, 2005 and \$24,301,000 at December 31, 2004. These commitments are contingent upon continuing customer compliance with the terms of the agreement. Commercial letters of credit, totaling \$907,810 at December 31, 2005 and \$1,744,640 at December 31, 2004, are obligations to make payments under certain conditions to meet contingencies related to customers' contractual agreements. They are primarily used to guarantee a customer's contractual and/or financial performance, and are seldom exercised.

18. FAIR VALUE OF FINANCIAL INSTRUMENTS SFAS No. 107, Disclosure About Fair Value of Financial Instruments requires the Corporation to disclose fair value information about financial instruments for which it is practicable to estimate, whether or not such fair values are reflected in the consolidated balance sheets. Estimated fair value amounts have been determined using available market information and other valuation methodologies. However, considerable judgment is required to interpret market data in developing the estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of the amount that could be realized in a current market exchange. The use of different market assumptions and estimation methodologies may have a material effect on the estimated fair value amounts. Cash and Due from Banks and Federal Funds Sold The carrying amount approximated fair value. Interest-Bearing Deposits in Other Banks Due to their short-term nature, the carrying amount approximated fair value. 52 Investment Securities The fair values of securities are based upon quoted market prices when available. If quoted market prices are not available, fair values are based upon quoted market prices of comparable instruments. Loans The fair values of variable-rate loans and fixed-rate loans that reprice within one year, with no significant credit risk, are based upon their carrying amounts. The fair values of all other loans are

estimated using discounted cash flow analysis, which utilizes interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The reserve for possible loan losses is allocated to the various components of the loan portfolio in determining the fair value. FHLB of Atlanta Stock Due to its restrictive nature, the fair value of FHLB of Atlanta Stock approximates its carrying value. Accrued Interest Receivable The carrying amount reported in the consolidated balance sheets is a reasonable estimate of fair value. Bank-Owned Life Insurance The carrying amount reported in the consolidated balance sheets represents cash to be received on the surrender value of life insurance policies and is a reasonable estimate of value. Deposits The fair value for demand deposits is, by definition, equal to the amount payable on demand at the reporting date. The carrying amounts for variable rate deposits and fixed-rate certificates of deposit that reprice within one year approximate their fair values at the reporting date. Fair values for longer-term fixed-rate certificates of deposit are estimated using discounted cash flow analysis that applies interest rates currently being offered on certificates. Accrued Interest Payable Accrued interest payable includes interest expensed but not yet paid for deposits and notes payable. The carrying amount approximates its fair value. Long-Term Debt Long-term debt is discounted on a cash flow approach based on market rates as of December 31, 2005 and 2004. Off-Balance Sheet Financial Instruments The fair value of loan commitments and letters of credit was estimated based upon the estimated amount of unamortized fees collected or paid incident to granting or receiving the commitment. 53 The carrying values and estimated fair values of the Corporation's financial assets and liabilities are as follows: December 31, 2005 December 31, 2004 -----

	Estimated	Estimated	Carrying	Fair	Carrying	Fair	Value	Value	Value	Value																																												
----- Financial assets: Cash and due from banks	\$ 7,259,358	\$ 7,259,358	\$ 6,867,063	\$ 6,867,063	Federal funds sold	15,624,890	15,624,890	9,845,813	9,845,813	Interest bearing deposits in other banks	74,996	74,996	1,352,791	1,352,791	Investment securities	26,147,033	26,147,033	28,636,701	28,642,226	Loans, net of reserves	188,936,368	190,388,999	172,204,585	172,904,585	FHLB of Atlanta stock	470,000	470,000	438,200	438,200	Accrued interest receivable	1,101,742	1,101,742	1,034,913	1,034,913	Bank-owned life insurance	4,178,774	4,178,774	4,023,808	4,023,808	Financial liabilities: Deposits	229,844,586	229,843,382	210,223,903	210,030,821	Accrued interest payable	683,762	683,762	356,184	356,184	Junior subordinated debentures	7,217,000	7,217,000	7,217,000	7,217,000

	2005	2004	-----	Assets:	Balance with subsidiary	\$ 95,867	\$ 66,968						
Investment in bank subsidiary	23,960,910	23,245,961	Prepaid placement fee	193,665	201,666	-----	-----						
Total assets	\$24,250,442	\$23,514,595	=====	Liabilities: Accrued interest payable	\$ 79,532	\$ 57,634	Junior subordinated debentures	7,217,000	7,217,000	Stockholders' equity	16,953,910	16,239,961	-----
Total liabilities and stockholders' equity	\$24,250,442	\$23,514,595	=====	=====	54	-----	-----						

CONDENSED STATEMENT OF INCOME Years Ended December 31 2005 2004 ----- Dividend from subsidiary \$1,681,445 \$ 731,715 Interest and other expenses (625,052) (485,838) Income tax benefit 212,518 165,802 Equity in undistributed income of subsidiary 614,263 1,050,376 ----- Net income \$1,883,174 \$1,462,055

===== CONDENSED STATEMENTS OF CASH FLOWS Years Ended December 31 2005 2004 ----- Operating activities: Net income \$ 1,883,174 \$ 1,462,055 Adjustment to reconcile net income to net cash provided by operating activities Change in other assets and liabilities, net (354,990) (176,979) Equity in undistributed income of subsidiary (614,263) (1,050,376) ----- Net cash provided by operating activities 913,921 234,700 ----- Investing activities - Investment in subsidiary - - ----- Financing activities: Retirement of stock (775,000) - Proceeds from sale of common stock 172,373 8,170 Payments of cash dividends (282,395) (246,462) ----- Net cash (used) provided by financing activities (885,022) (238,292) ----- Change in cash and cash equivalents 28,899 (3,592) Cash and cash equivalents at beginning of year 66,968 70,560 ----- Cash and cash equivalents at end of year \$ 95,867 \$ 66,968 =====

===== 55 Item 8. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure None Item 8A. Controls and Procedures The Corporation's management, under the supervision and with the participation of it Chief Executive Officer and the Chief Financial Officer, evaluated as of the last day of the period covered by this report, the effectiveness of the design and operation of the Corporation's

disclosure controls and procedures, as defined in Rule 13a-15 under the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Corporation's disclosure controls and procedures were adequate. There were no significant changes in the Corporation's internal controls over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) during the quarter ended December 31, 2005, that have materially effected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting. Item 8B. Other Information. Not applicable. PART III Item 9. Directors, Executive Officers and Control Persons; Compliance with Section 16(a) of the Exchange Act Information required by this item is listed below and on page 7 of this report under the caption of "Executive Officers" of the Registrant. The charter and by-laws of the Company provide that the directors shall be classified into three classes as equal in number as possible, with each director serving a three-year term. Currently, the Board of Directors is composed of 13 members with Classes I and II each consisting of four member and Class III consisting of five members. The Board of Directors currently also has three open board seats which will remain open until suitable candidates are located. The terms of the Class II directors are scheduled to expire at the 2006 annual meeting or until their respective successors have been duly elected and qualified. Directors are elected by a plurality of the votes cast by the holders of shares of Common Stock present in person or represent

NAME OF NOMINEES INFORMATION REGARDING CLASS II DIRECTORS ----- Nathaniel Higgs Reverend Higgs is 75 years old and has served as a director of the Corporation since its formation in 1992 and of the Bank since 1981. From December 1966 to December 2002, he served as the Pastor of Southern Baptist Church and has now retired. Delores G. Kelley Dr. Kelley is 69 years old and has served as a director of the Corporation since its formation in 1992 and of the Bank since 1980. She is a retired educator and Senator in the Maryland State Senate. Erich March Mr. March is 54 years old and has served as a director of the Corporation since its formation in 1992 and of the Bank since 1981. His is Vice President of March Funeral Homes, Inc. Stanley W. Tucker Mr. Tucker is 58 years old and has served as a director of the Corporation and of the Bank since 1996. He is President of Meridian management Company, Inc., which is the managing general partner of MMG Ventures, L.P., an investment management company. 56 Directors to serve until 2007 Annual Meeting (Class III) NAME OF CLASS III DIRECTORS INFORMATION REGARDING CLASS III DIRECTORS ----- John Paterakis Mr. Paterakis is 77 years old and has served as a director of the Corporation since its formation in 1992 and of the Bank since 1982. He is President and Chief Executive Officer of H & S Bakery, Inc. and Northeast Foods, Inc. James Scott, Jr. Mr. Scott is 48 years old and has served a s director of the Corporation and the Bank since November 2000. He is a principal of Pennan & Scott P.C., an accounting firm. Mr. Scott is a certified public accountant. Edward St. John Mr. St. John is 68 years old and has served as a director of the Corporation since its formation in 1992 and of the Bank since 1990. He is President and Chief Executive Officer of M.I.E. Investment Company, a real estate development company. Walter S. Thomas Pastor Thomas is 55 years old and has served as a director of the Corporation and the Bank since November 2000. He is the Pastor of New Psalmist Church. George F. Vaeth, Jr. Mr. Vaeth is 72 years old and has served as a director of the Corporation since its formation in 1992 and of the Bank since 1981. He has served as Secretary of the Company since its formation and of the Bank since 1986. He is an architect with G.V.A., an architectural and interior design firm. 2008 Annual Meeting (Class I) NAME OF CLASS I DIRECTORS INFORMATION REGARDING CLASS I DIRECTORS ----- James H. Degraffereidt, Jr. Mr. Degraffenreidt is 52 years old and has served as a director of the Corporation and of the Bank since 1996. He is Chairman and Chief Executive Officer of WGL Holdings, Inc., distributors of natural gas. Louis J. Grasmick Mr. Grasmick is 76 years old and has served as a director of the Corporation since its formation in 1992 and of the Bank since 1982. He is Chief Executive Officer of Louis J. Grasmick Lumber Company, Inc. Joseph Haskins, Jr. Mr. Haskins is 58 years old and has served as a director of the Corporation since its formation in 1992 and of the Bank since 1980. He has served as Chief Executive Officer of the Company since its formation in 1992, Chairman of the Board of the Company Bank since 1995 and Chief Executive Officer of the Bank since 1987. John D. Ryder Mr. Ryder is 58 years old and has served as a director of the Corporation and the Bank since January 2000. He was President and Chief Operating Officer of Metro Food Markets, a supermarket chain, until 2000. He was President of AXS Technologies, a software company, until July 2003. Currently, he is President of Tree Top Kids, Inc. 57 CONTINUING DIRECTORS The following information is provided with respect directors who will continue to serve as directors of the Company until the expiration of their terms at the times indicated. COMPANY CORPORATE GOVERNANCE GENERAL The Corporation's business is managed under the direction of its Board of Directors. The Board of Directors seeks to

increase stockholder value and promote the Corporation's long-term growth. The Board of Directors establishes Corporation policies and strategies and regularly monitors the effectiveness of the Corporation's management in carrying out these policies and strategies. As part of the Board of Director's commitment to these principles, the Board of Directors regularly reviews the Corporation's corporate governance policies and practices. This review includes comparing the Corporation's current policies and practices to the policies and practices suggest by various groups and authorities active in corporate governance and policies and practices of public companies in general. The Board of Directors will continue to consider the adoption of changes, as appropriate, to enhance the Corporation's corporate governance policies and practices and to comply with any rule changes made by the SEC.

**BOARD ORGANIZATION AND OPERATION** Members of the Board of Directors are kept informed of the Corporation business through discussions with key member of the Corporation's management team, by reviewing materials provided to the Board of Directors and by participating in meetings of the Board and its committees. The Board of Directors has adopted standards for director independence that are in accordance with the standards adopted by the National Association of Securities Dealers, Inc. (the "NASD") and utilized by companies with securities quoted on Nasdaq. The Board of Directors is not required to adhere to the independence standards adopted by the NASD because the common Stock is not quoted or listed on Nasdaq or any other quotation system or exchange. The Board of Directors believes, however, that a board with at least a majority of independent directors is an important part of good corporate governance principles. Based on the Board of Directors' adopted standards, the Board of Directors has determined that none of its members has a material relationship with the Corporation and that all of its members are independent directors, except for Messrs. Haskins and Paterakis who are not independent directors because each is an executive officer of the Corporation. As a result, a significant majority of the members of the Board of Directors is independent. During 2005, the Board of Directors met 12 times. Each of the nominees and the other directors attended at least 75% of the total Board of Directors meetings and meetings of the board committees on which he or she served, with the exception of Mr. Thomas who attended 60% of these meetings. When necessary or appropriate, the Corporation's independent directors meet in executive sessions without the presence of the Corporation's management. This gives the independent directors the opportunity to discuss management's performance and any other matter that one or more independent directors would like to discuss.

**BOARD COMMITTEES** Each director who serves on the Board of Directors is also a director on the Bank's Board of Directors. The Board of Directors has one standing committee: the Audit Committee (the "Audit Committee"). The Bank's Board of Directors has a Compensation Committee (the "Compensation Committee") and an Executive Committee (the "Executive Committee")

**Audit Committee.** The Audit Committee responsibilities include the appointment of the Corporation's independent accountants, the preapproval of all audit services and permitted non-audit services provided to the Corporation by the Corporation's independent accountants, reviews of the independence of the Corporation's independent accountants, and review of the adequacy of internal accounting and disclosure controls of the Corporation. The Audit Committee operates under a written charter adopted by the Board of Directors. In 2005, the Audit Committee met four times. The current members of the Audit Committee are: Messrs. Vaeth, Chair, Higgs, March, Scott and Tucker. Each member of the Audit Committee is an independent director as defined by the current NASD rules. Mr. Scott has the professional experience deemed necessary o qualify as an audit committee financial expert under the SEC's rules and regulations.

**Compensation Committee.** The Compensation Committee structures the compensation of the Corporation's executive officers and administers the Corporation's employee benefit plans. The Compensation Committee currently does not operate under written charter. The Compensation Committee met once in 2005. The current members of the Compensation Committee are: Messrs. Grasmick, Chair, DeGraffenreidt and St. John. Each member of the Compensation Committee is an independent director as defined by the current NASD rules.

**58 Executive Committee.** The Executive Committee generally has the authority to exercise all of the power of the Bank's Board of Director in the management and direction of the business affairs of the Bank, subject to specific directions of the Bank's Board of Directors and the limitation of Maryland law. The Executive Committee met 13 times in 2005. The current members of the Executive Committee are: Messrs. Paterakis, Chair, Haskins, Degraffenreidt, Grasmick, March, Vaeth and Dr. Kelley. A majority of the members of the Executive Committee is independent as defined by the current NASD rules.

**NOMINATION PROCESS** The Board of Directors does not have a nominating committee. The full Board of Directors performs the functions of a nominating committee. The Board of Directors does not believe it needs a separate nominating committee because the full Board is comprised predominantly of independent directors and has the time and resources to perform the function of selecting board nominees. When the Board of Directors performs

nominating function, the Board of Directors acts in accordance with the Corporation's corporate charter and bylaws but does not have a separate charter related to the nomination process. Under the Corporation's charter, nominations for director may be made by the Board of Directors or by a stockholder of record who delivers notice along with the additional information and materials required by the Corporation's charter to the Corporation Corporate Secretary not less than 30 days and no more than 60 days before the annual meeting date. For the Corporation's annual meeting in 2007, the Corporation must receive this notice on or after February 18, 2007 and on or before March 20, 2007. The Corporation's stockholders may obtain a copy of the Corporation charter by writing to the Corporation Corporate Secretary, Harbor Bankshares Corporation, 25 West Fayette Street, Baltimore, Maryland 21201. The Corporation's directors have a critical role in guiding the Corporation's strategic direction and in overseeing the Corporation's management. The Board of Directors considers candidates for the Board based upon several criteria, including their broad-based business and professional skills and experiences, concern for the long-term interests of stockholders, and personal integrity and judgment. Candidates should have reputations, both personal and professional, consistent with the Corporation's image and reputation. Because diversity is important, the Board of Directors seeks to ensure that its directors reflect the gender and ethnic diversity of the Corporation's community. The majority of directors on the Board of Directors should be "independent," not only as that term may be legally defined, but also without the appearance of any conflict in serving as a director. In addition, directors must have time available to devote to Board activities and to enhance their knowledge of the banking industry. Accordingly, the Board of Directors seeks to attract and retain highly qualified directors who have sufficient time to attend to their substantial duties and responsibilities to the Corporation. The Board of Directors utilizes the following process for identifying and evaluating nominees to the Board. In the case of incumbent directors whose terms of office are set to expire, the Board of Directors review such directors' overall service to the company during their term, including the number of meetings attended, level of participation and quality of performance. In the case of new director candidates, the directors on the Board of Directors are polled for suggestions as to potential candidates that may meet the criteria above, discuss candidates suggested by the Corporation's stockholders and may also engage, if the Board of Directors deems appropriate, a professional search firm. To date, the Board of Directors has not engaged professional search firms to identify or evaluate potential nominees but may do so in the future, if necessary. The Board of Directors then meets to discuss and consider these candidates' qualifications and then chooses a candidate by a majority vote.

**DIRECTOR ATTENDANCE AT THE CORPORATION ANNUAL MEETING** The Corporation does not have a formal policy regarding attendance by members of the Board of Director at the Corporation's annual meetings of stockholders. The Corporation has always encouraged its directors to attend its annual meetings of stockholders and expects to continue this policy. In 2005, 13 Corporation directors attended the Corporation's annual meeting of stockholders.

**STOCKHOLDER COMMUNICATION WITH THE BOARD** The Corporation does not have a formal process for stockholder communications with the Board of Directors. The Corporation has made an effort to ensure that the Board of Directors or individual directors, as applicable, hear the views of Corporation's stockholders. The Corporation believes that it has been responsive regarding conveying stockholder communications to the Board of Directors.

**SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE.** Based solely on the Corporation's review of the copies of initial statements of beneficial ownership on Form 3 and reports of changes in beneficial ownership on Form 4 that it has received in the past year, annual statements of changes in beneficial ownership on Form 5 with respect to the last fiscal year, and written representations that no such annual statement of change in beneficial ownership was required, all directors, executive officers, and beneficial owners of more than 10% of its common stock have timely filed those reports with respect to 2005, except for a Form 4 reporting acquisition of shares upon option exercise by Director Grasmick, which was inadvertently filed 1 day late. . The Corporation makes no representation regarding persons who have not identified themselves as being subject to the reporting requirements of Section 16(a) of the Securities Exchange Act of 1934, or as to the appropriateness of disclaimers of beneficial ownership.

**Item 10. Executive Compensation Information** required by this item is listed below.

**CODE OF ETHICS AND BUSINESS CONDUCT** For years the Corporation has had policies regarding conflicts of interest and securities law compliance. The Corporation has adopted a Code of Ethics and Business Conduct that reflects these longstanding policies and contains additional policy initiatives. The Corporation requires all its directors, executive officers and employees to adhere to the Code of Ethics and Business Conduct in addressing the legal and ethical issues encountered in conducting their work. The Code of Ethics and Business Conduct requires that the Corporation's directors, executive officers and employees avoid conflict of interest, comply with securities laws and other legal

requirements and conduct business in an honest and ethical manner. The Corporation conveys to its directors, executive officers and employees both their obligations and responsibilities under and the importance of the Code of Ethics and Business Conduct. Directors, executive officers and employees are required to report any conduct that they believe in good faith to be an actual or apparent violation of the Code of Ethics and Business Conduct. The Corporation has established procedures for receiving, retaining and treating complaints received regarding accounting, internal accounting controls or auditing matters and for the confidential and anonymous submission by employees of concerns regarding questionable accounting or auditing matters. The Corporation's stockholders may obtain a copy of the Code of Ethics and Business conduct by writing to the Corporation's Corporate Secretary, Harbor Bankshares Corporation, 25 West Fayette Street, Baltimore, Maryland 21201. A Copy of the Code of Ethics and Business Conduct has been filed with the SEC as an exhibit to the Corporation's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2004.

**COMPENSATION OF DIRECTORS AND EXECUTIVE OFFICERS SUMMARY**  
**COMPENSATION TABLE** The following table shows compensation paid to certain executive officers of the Corporation for the three-year period ended December 31, 2005. No other executive officer of the Corporation received total annual compensation in excess of \$100,000 during such period.

NAME AND POSITION	YEAR	SALARY	BONUS	COMPENSATION
Joseph Haskins, Jr.	(1)(2) 2005	\$213,383	170,706	\$6,191
Chairman, President and	2004	207,168	165,734	6,191
Chief Executive Officer	2003	203,105	182,795	6,191
Teodoro J. Hernandez	2005	99,548	14,955	--
Vice President and Treasurer	2004	91,781	9,179	--
2003	90,000	17,000	--	
Darius L. Davis	2005	101,904	15,000	--
Executive Vice President/Bank	2004	86,797	15,000	--

(1) Bonus paid pursuant to the terms of Mr. Haskins' employment agreement. (2) All other compensation represents premiums for term life benefit paid by the Corporation. 60

**OPTION GRANTS IN LAST FISCAL YEAR** The Corporation has adopted stock option plans, pursuant to which it has reserved 226,886 shares of its Common Stock for the issuance of options. The following table sets forth information regarding the options granted to the named executive officers during 2005.

NAME	NUMBER OF OPTIONS GRANTED	PERCENT OF TOTAL	EXERCISE OR MARKET PRICE PER SHARE	UNDERLYING OPTIONS GRANTED	BASE PRICE SHARE ON DATE	EXPIRATION DATE
Joseph Haskins, Jr.	2,560	42.3%	\$25.00	\$25.00	1/1/2016	
Teodoro J. Hernandez	796	13.2	25.00	25.00	1/1/2016	
Darius L. Davis	1,223	20.2	25.00	25.00	1/1/2016	

**AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND YEAR END VALUE OF OPTIONS** The following table set for the aggregated option exercises in 2005 and the option values at December 31, 2005, based upon a market value for Company Common Stock of \$25.00 per share:

NUMBER OF UNEXERCISED OPTIONS IN-THE-MONEY	NUMBER OF UNEXERCISED OPTIONS	VALUE OF UNEXERCISED OPTIONS	SHARES ACQUIRED	VALUE REALIZED AT FISCAL YEAR-END
4,053	41,330	50,938	\$345,989	
3,048	5,024	--	8,775	59,085
--	--	--	--	--

(1) Currently exercisable options. **COMPENSATION OF DIRECTORS** Directors of the Corporation receive a fee of \$533 for each board meeting attended (\$1,066 if the director is a member of the Corporation's Executive Committee), but do not receive a fee for attendance at the committee meetings. Mr. Vaeth received an additional fee of 4,340 for acting as secretary at each of the board and board committee meetings. Total fees paid to directors of the Corporation during 2005 were \$104,605. Directors who are not employed by the Corporation or the Bank are permitted to elect whether to receive their fees in the form of cash or in the form of options to purchase Common Stock of the Corporation under the 1995 Director Stock Option Plan which has been approved by the Corporation's stockholders. The exercise prices of the options will equal the market price of the Common Stock on the date of grant. The Corporation did not grant any options to its directors in 2005.

**MR. HASKINS' EMPLOYMENT AGREEMENT AND RETIREMENT BENEFIT** Joseph Haskins, Jr. has an employment agreement with the Corporation and the Bank for a four-year term commencing as of January 1, 2000, which term may be automatically renewed for additional three-year terms unless earlier terminated. The employment agreement provides that Mr. Haskins will serve as Chairman of the Board, President and Chief Executive Officer of the Corporation and Chairman of the Board and Chief Executive Officer of the Bank at an annual salary of \$182,330, subject to annual increases approved by the Corporation and the Bank. Under the employment agreement, Mr. Haskins may also receive an annual incentive bonus based upon the attainment of goals and objectives set by the Corporation's Board of Directors. If the minimum level of such goals and objectives is not met, Mr. Haskins will not

be entitled to an incentive bonus. If the Corporation's Board of Directors awards Mr. Haskins an incentive bonus, the amount of the bonus will range from 60% to 100% of Mr. Haskins's then current salary, as determined by the Board of Directors. In addition to the benefit programs, plans, and arrangements of the Corporation and the Bank generally available to their employees and the normal perquisites provided to their senior executive officers, the employment agreement provides that Mr. Haskins will receive long-term disability insurance, life insurance, and an automobile allowance. Further, the Corporation must maintain a key man life insurance policy on the life of Mr. Haskins in order to provide the funds necessary to buy his shares of Corporation Common Stock from his estate or his heirs. 61 If the Corporation terminates Mr. Haskins' employment because he becomes disabled, the Corporation will continue to provide Mr. Haskins with long-term disability insurance and medical and group life insurance until he attains age 65. Upon termination without cause or resignation with good reason (as those terms are used in the employment agreement), Mr. Haskins would be entitled to (1) severance pay equal to three times his base salary at the time of termination, payable in three equal annual installments, the first of which is due within 30 day of termination, (2) a prorated bonus based upon the bonus paid in the year prior to termination or resignation, and (3) immediate vesting of his outstanding options. If Mr. Haskins voluntarily resigns without good reason or if the Corporation terminates his employment for cause, the Corporation would not have any further obligations to Mr. Haskins under his employment agreement. The Corporation must pay a change of control benefit to Mr. Haskins if either (1) within 12 months after a change of control of the Corporation, the Corporation terminates Mr. Haskins' employment without cause or Mr. Haskins terminate his employment for good reason or (2) within 30 days after the expiration of six month after the change in control, Mr. Haskins' terminates his employment for any reason. The change of control benefit would equal the greater of (1) 2.99 times the average of Mr. Haskins' gross compensation from the Corporation over the five-year period before the termination or (2) the amount Mr. Haskins would receive if he was terminated without cause, as described in the prior paragraph. Further, in such event, Mr. Haskins would be entitled to the immediate vesting of his options. Mr. Haskins may be entitled to receive a retirement benefit under an executive supplemental retirement plan. Mr. Haskins will receive 15 annual payment of the greater of (1) 63% of his final base salary or (2) \$200,000, payable at the time of retirement, if he retires at or after age 62. Mr. Haskins will receive 15 annual payments, each payment being equal to 63% of his final base salary, payable at the time of retirement or termination (or in the case of a disability, at the age of 65), if before age 62: o Mr. Haskins terminates his employment for good reason or, within 30 days after the expiration of six months after a change of control of the Corporation, Mr. Haskins terminates his employment with or without good reason; or o the Corporation terminates Mr. Haskins' employment without cause or because of a disability. If Mr. Haskins terminates his employment before age 62 without good reason, Mr. Haskins will be entitled to a prorated amount of 63% of his final base salary based upon the number of years he provided services to the Corporation from the year 2000 until such time has he retires. However, if the Corporation terminates Mr. Haskins' employment for cause, Mr. Haskins will forfeit his retirement benefit. In the event of Mr. Haskins' death, Mr. Haskins' beneficiaries would be entitled to receive the remainder of the retirement benefit should he die before receipt of the full retirement benefit. INFORMATION REGARDING MR. HERNANDEZ Mr. Hernandez is 61 years old and has served as Vice President and Cashier of the Bank since 1982 and Vice President and Treasurer of the Corporation since its formation in 1992. He became a Senior Vice President of the Bank in 1998. Mr. Hernandez may be entitled to receive a retirement benefit under an executive supplemental retirement plan. Mr. Hernandez will receive 15 annual payments of \$40,000, payable at the time of retirement, if he retires at or after age 65. Mr. Hernandez will receive 15 annual payments, in amounts ranging from \$5,309 to \$40,000, if Mr. Hernandez retires before age 65. In the event of a change of control of the Bank, if Mr. Hernandez's employment is terminated for any reason (other than a Bank-approved leave of absence), Mr. Hernandez will be entitled to receive the same benefit as if he retired at or after age 65. Mr. Hernandez's beneficiaries would be entitled to receive the remainder of the retirement benefit should he die before receipt of the full retirement benefit. In the event of Mr. Hernandez's death while in active services of the Bank, Mr. Hernandez's beneficiaries would be entitled to receive a lump sum payment ranging from \$38,676 to \$396,987, depending upon the year of his death. However, if the Board of Directors terminates Mr. Hernandez's employment for cause, Mr. Hernandez will forfeit his retirement benefit. 62 Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters Information required by this item is listed below: STOCK OWNERSHIP There were 641,784 shares of the Common Stock issued and outstanding on March 3, 2006. The following table shows the beneficial ownership of the Common Stock as of this dates by: (1) each of the Corporation's current named executive officers and directors and (2) all of the Corporation's current directors



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NAME OF BENEFICIAL OWNER(1)(2)	NUMBER OF SHARES OWNED(3)	PERCENTAGE OF SHARES BENEFICIALLY OWNED
Joseph Haskins, Jr. (4)	95,538	13.79%
Teodoro J. Hernandez (5)	8,775	1.35%
James H. Degraffereidt, Jr. (6)	13,928	2.13%
Louis J. Grasmick (7)	23,227	3.42%
Nathaniel Higgs (8)	9,545	1.47%
Delores G. Kelley (9)	16,923	2.60%
Erich March (10)	26,093	4.00%
John Paterakis (11)	58,789	9.16%
John D. Ryder	3,219	*
James Scott, Jr. (12)	3,747	*
Edward St. John	13,488	2.10%
Walter S. Thomas (13)	228	*
Stanley W. Tucker (14)	13,268	2.07%
George F. Vaeth, Jr. (15)	20,725	3.18%
All directors and executive officers As a group (14 persons) (16)	307,493	40.40%

\* Less Than 1% (1) Unless otherwise specified, the address of these persons is c/o Harbor Bankshares Corporation, 25 West Fayette Street, Baltimore, Maryland 21201. (2) The Corporation uses the SEC's definition of beneficial ownership. This means that the person named in this table have sole or shared voting and/or investment power over the shares shown. Beneficial ownership also includes shares underlying options currently exercisable or exercisable within 60 days. (3) Unless otherwise specified, the number of shares shown represents shares of Common Stock. (4) Represents 44,600 shares of Common Stock and 50,938 shares of Common Stock issuable upon the exercise of options. (5) Represents 8,775 shares of Common Stock issuable upon the exercise of options. (6) Represents 4,325 hares of Common Stock and 9,603 shares of Common Stock issuable upon the exercise of options. (7) Represents 13,227 shares of Common Stock (including 3,848 shares jointly owned with Mr. Grasmick and his son and 8,780 shares jointly owned by Mr. Grasmick and his wife) and 10,000 shares of Common Stock issuable upon the exercise of options. (8) Represents 4,545 shares of Common Stock (including 4,175 shares jointly owned by Reverend Higgs and his wife) and 5,000 shares of Common Stock issuable upon the exercise of options. (9) Represents 6,923 shares of Common Stock (including 619 shares jointly owned by Dr. Kelley and her husband) and 10,000 shares of Common Stock issuable upon the exercise options. (10) Represents 16,093 shares of Common Stock (including 15,435 shares owned by a corporation over which Mr. March has the power to vote) and 10,000 shares of Common Stock issuable upon the exercise of options. (11) Includes 32,874 shares of Common Stock owned by three corporations controlled by Mr. Paterakis (J and B Associates, Inc. - 16,437 shares; H & S Bakery, Inc. - 6,164 shares; Northeast Food, Inc. 10,273 shares) and 11,300 shares of Common Stock owned by Paterakis Limited Partnership, LLP. (12) Includes 3,430 shares of Common Stock jointly owned by Mr. Scott and his wife. (13) The number of shares of Common Stock owned does not include 3,757 shares owned by a religious organization over which Pastor Thomas has the power to vote. (14) Includes 13,234 shares of Common Stock owned by MMG ventures L.P. over which Mr. Tucker has authority to vote. (15) Represents 10,725 shares of Common Stock and 10,000 shares of Common Stock issuable upon the exercise of options. (16) Represents 193,177 shares of Common Stock and 114,316 shares of Common Stock issuable upon the exercise of options. 63 Item 12. Certain Relationships and Related Transactions During the past year the Bank has had loan transactions in the ordinary course of its banking business with directors and executive officers of the Bank and with their affiliates. Loans to such persons were made in the ordinary course of business and did not and do not currently involve more than the normal risk of collectibility or present other unfavorable features. All such loans were made on substantially the same terms including interest rates and collateral requirements, as those prevailing at the time for comparable transactions with non-affiliates. The bank expects to enter into such transaction in the future. As of December 31, 2005, loans to directors and executive officers of the Bank, and their affiliates, including loans guaranteed by such persons and unfunded commitments made in 2005, aggregated \$13,468,000 or approximately 63.2% of tangible stockholders' equity of the Bank. Item 13. Exhibits The following is a list of exhibits filed as part of this Annual Report on Form 10-KSB. No. Exhibit 3.1 Articles of Incorporation of Harbor Bankshares Corporation (incorporated by reference to Exhibit 3(a) to Registration Statement on Form S-4 filed July 17, 1992. 3.2 Bylaws of Harbor Bankshares Corporation (incorporated by reference to Exhibit 3(b) to Registration Statement on Form S-4 filed July 17, 1992. 10.1\* Harbor Bankshares Corporation Stock Option Plan (incorporated by reference to Exhibit 10(b) to Registration Statement on Form S-4 filed July 17, 1992. 10.2\* Employment Agreement by and between Joseph Haskins, Jr., Harbor Bankshares Corporation, and the Harbor Bank of Maryland effective January 1, 2000. 10.3 1995 Directors Stock Option Plan 10.4,10.5 Deferred Compensation Agreements. 13 Portions of the Annual Report to Shareholders for the Year Ended December 31, 2005 14 Code of Ethics 23 Consent of Independent Registered Public Accounting Firm 31(a),(b) Rule 13a-14(a)/15d-14(a)

Certifications 32(a),(b) 18 U.S.C. Section 1350 Certifications \* Management contract or compensatory plan or arrangement. The Corporation will furnish copies of the exhibits to this report upon request of its stockholders upon payment of a reasonable fee upon request to Teodoro J. Hernandez, Treasurer, Harbor Bankshares Corporation, 25 West Fayette Street, Baltimore, Maryland 21201. 64 Item 15. Principal Accountant Fees and Services GENERAL The Audit Committee has retained Stegman & Company as independent public accountants to audit the Corporation's 2006 consolidated financial statements. Stegman & Company also audited the Corporation's consolidated financial statements for 2004 and 2005. A representative of Stegman & Company is expected to be present at the Annual Meeting, with the opportunity to make a statement if he or she decides, and will respond to appropriate questions.

AUDIT AND NON-AUDIT FEES 2005 2004 ---- ---- Audit Fees \$60,500 \$59,950 Audit-Related Fees 1,950 2,250 Tax Fees 10,425 10,725 All Other Fees -- -- Total \$72,875 \$72,925 Fees that the Corporation paid to Stegman & Company in 2004 and 2005 are set forth in the above table. Audit fees are fees the Corporation paid Stegman & Company for the audit and quarterly reviews of the Corporation's consolidated financial statements, assistance with the review of documents filed with the SEC, consent procedures and accounting consultation related to transaction and the adoption of new accounting pronouncements. Audit-related fees are fees for services that are reasonably related to the performance of the audit or the review of the Corporation's consolidated financial statements and principally included consultation concerning financial accounting and reporting standards. Tax fee primarily included tax compliance services. Stegman & Company did not provide any other services to the Corporation in 2004 and 2005.

POLICY ON AUDIT COMMITTEE PRE-APPROVAL OF AUDIT AND NON-AUDIT SERVICES The Audit committee's policy is to pre-approve all audit and non-audit services provided by the independent public accountants. These services may include audit services, and audit-related services, tax services and other services. Pre-approval is generally provided for up to one year and any pre-approval is derelict as to the particular service or category of services and is generally subject to a specific budget. The Audit Committee has delegated pre-approval authority to its Chair when expedition of services is necessary. The Chair is required to report any decision to pre-approve such services to the full Audit Committee at its next meeting. The independent public accountants and management are required to periodically report to the full Audit Committee regarding the extent of services provided by the independent public accountants in accordance with this pre-approval, and the fees for the services performed to date.

65 SIGNATURES In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized. HARBOR BANKSHARES CORPORATION By: /s/ Teodoro J. Hernandez Title: Vice President and Treasurer Date: March 8, 2006 In accordance with Section 13 or 15(d) of the Exchange Act, this report has been signed by the following persons on behalf of the Registrant, and in the capacities, and on the dates indicated: By: /s/ Joseph Haskins, Jr. Title: Chairman of the Board, President, and Chief Executive Officer Date: March 8, 2006 ----- By: /s/ Nathaniel Higgs By: /s/ James H. DeGraffenreidt Title: Director Title: Director Date: March 8, 2006 Date: March 8, 2006 ----- By: /s/ George F. Vaeth, Jr. By: /s/ Louis Grasmick Title: Director Title: Director Date: March 8, 2006 Date: March 8, 2006 ----- By: /s/ Stanley W. Tucker By: /s/ John D. Ryder Title: Director Title: Director Date: March 8, 2006 Date: March 8, 2006 ----- By: James Scott, Jr. By: /s/ Erich W. March Title: Director Title: Director Date: March 8, 2006 Date: March 8, 2006 ----- By: /s/ John Paterakis By: /s/ Edward St. John Title: Director Title: Director Date: March 8, 2006 Date: March 8, 2006 ----- By: /s/ Walter S. Thomas, Sr. Title: Director Date: March 8, 2006 ----- By: /s/ Delores J. Kelly Title: Director Date: March 8, 2006 ----- 66

**Appendix E  
Form 10-QSB**

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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**FORM 10-QSB**

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

For the quarterly period ended June 30, 2006.

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-20990

HARBOR BANKSHARES CORPORATION

\_\_\_\_\_  
(Exact name of registrant as specified in its charter)

Maryland

52-1786341

\_\_\_\_\_  
(State of other jurisdiction of incorporation or organization)

\_\_\_\_\_  
(IRS Employer identification No.)

25 W. Fayette Street, Baltimore, Maryland

21201

\_\_\_\_\_  
(Address of principal executive office)

\_\_\_\_\_  
(Zip code)

Registrants' telephone number, including area code: (410) 528-1800

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or such shorter period that the registrant was required to file such reports); and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act.

Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS: Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common stock, non-voting, \$.01 Par value  33,795 shares as of August 9, 2006.

Common stock, \$.01 Par value  641,784 shares as of August 9, 2006.

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**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES**

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Consolidated Statements of Income, (Unaudited) □ Three months Ended June 30, 2006 and 2005

Consolidated Statement of Income, (Unaudited) Six months Ended June 30, 2006 and 2005.

Consolidated Statement of Cash Flows (Unaudited) -Six months Ended June 30, 2006 and 2005

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	<b>June 30, 2006</b>	<b>December 31, 2005</b>
	<b>(Unaudited)</b>	
	<b>Dollars in Thousands</b>	
<b>ASSETS</b>		
Cash and Due from Banks	\$ 6,665	\$ 7,334
Federal Funds Sold	2,255	15,625
Investment Securities:		
Held to maturity at amortized cost (fair value of \$23 as of June 30, 2006 and \$30 as of December 31, 2005)	23	30
Available for Sale, at fair value	26,006	26,117
	<hr/>	<hr/>
Total Investment Securities	26,029	26,147
	<hr/>	<hr/>
Loans Held for Sale	□	716
Loans	205,605	190,279
Allowance for Loan Losses	(2,145)	(2,059)
	<hr/>	<hr/>
Net Loans	203,460	188,220
Property and Equipment □ Net	7,518	7,526
Goodwill	2,506	2,506
Intangible Assets	423	463
Bank-owned Life Insurance	4,257	4,179
Accrued Interest Receivable and Other Assets	5,061	3,920
	<hr/>	<hr/>
<b>TOTAL ASSETS</b>	<b>\$ 258,174</b>	<b>\$ 256,636</b>
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDER'S EQUITY</b>		
Deposits:		
Non-Interest Bearing Demand	\$ 46,770	\$ 50,433
Interest Bearing Transaction Accounts	23,587	25,562
Savings	81,861	87,499
Time, \$100,000 or more	42,558	32,810
Other Time	33,699	33,540
	<hr/>	<hr/>
Total Deposits	228,475	229,844
	<hr/>	<hr/>
Short Term Borrowings	3,000	
Junior Subordinated Debentures	7,217	7,217
Accrued Interest and Other Liabilities	2,252	2,621
	<hr/>	<hr/>
<b>TOTAL LIABILITIES</b>	<b>240,944</b>	<b>239,682</b>
	<hr/>	<hr/>
<b>STOCKHOLDERS' EQUITY</b>		

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Common stock, □ par value \$.01 per share:

Authorized 10,000,000 shares; issued and outstanding 641,784 at June 30, 2006 and 651,784 at December 31, 2005 and 33,795 common non-voting at June 30, 2006 and December 31, 2005

	6	7
Paid-in Capital	6,405	6,616
Retained Earnings	11,405	10,853
Accumulated other comprehensive loss	(586)	(522)
	<u>17,230</u>	<u>16,954</u>
<b>TOTAL STOCKHOLDERS' EQUITY</b>		
	<u>\$ 258,174</u>	<u>\$ 256,636</u>
<b>TOTAL LIABILITIES and STOCKHOLDERS' EQUITY</b>		

See Notes to Unaudited Consolidated Financial Statements

[Back to Contents](#)**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME**

	<b>Three Months Ended June 30</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Unaudited) Dollars in Thousands Except Per Share Data</b>	
<b>INTEREST INCOME</b>		
Interest and Fees on Loans	\$ 4,047	\$ 3,393
Interest on Investment Securities (Taxable)	209	209
Interest on Deposits in Other Banks	□	9
Interest on Federal Funds Sold	27	20
Other Interest Income	9	3
<b>TOTAL INTEREST INCOME</b>	<b>4,292</b>	<b>3,634</b>
<b>INTEREST EXPENSE</b>		
Interest on Deposits:		
Savings	614	316
Interest Bearing Transaction Accounts	13	13
Time \$100,000 or More	316	150
Other Time	344	281
Interest Other Borrowed Money	40	9
Interest on Junior Subordinated Debentures	141	106
<b>TOTAL INTEREST EXPENSE</b>	<b>1,468</b>	<b>875</b>
<b>NET INTEREST INCOME</b>	<b>2,824</b>	<b>2,759</b>
Provision for Loan Losses	80	120
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>2,744</b>	<b>2,639</b>
<b>NON-INTEREST INCOME</b>		
Service Charges on Deposit Accounts	188	249
Other Income	221	198
<b>TOTAL NON-INTEREST INCOME</b>	<b>409</b>	<b>447</b>
<b>NON-INTEREST EXPENSE</b>		
Salaries and Employee Benefits	1,158	1,077
Advertising	107	109
Occupancy Expense of Premises	319	246
Equipment Expense	84	79
Professional Cost	74	53
Data Processing Expense	275	265
Other Expenses	448	398

<b>TOTAL NON-INTEREST EXPENSES</b>	2,465	2,227
<b>INCOME BEFORE INCOME TAXES</b>	688	859
Applicable Income Taxes	240	321
<b>NET INCOME</b>	\$ 448	\$ 538
<b>BASIC EARNINGS PER SHARE</b>	\$ 0.66	\$ 0.78
<b>DILUTED EARNINGS PER SHARE</b>	\$ 0.62	\$ 0.72
Dividends Declared per Share	□	□
See notes to unaudited consolidated Financial Statements		



[Back to Contents](#)**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME**

	<b>Six Months Ended June 30</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Unaudited) Dollars in Thousands Except Per Share Data</b>	
<b>INTEREST INCOME</b>		
Interest and Fees on Loans	\$ 7,824	\$ 6,560
Interest on Investment Securities (Taxable)	416	428
Interest on Deposits in Other Banks	1	18
Interest on Federal Funds Sold	178	46
Other Interest Income	17	10
<b>TOTAL INTEREST INCOME</b>	<b>8,436</b>	<b>7,062</b>
<b>INTEREST EXPENSE</b>		
Interest on Deposits:		
Savings	1,223	579
Interest Bearing Transaction Accounts	26	27
Time \$100,000 or More	575	285
Other Time	678	511
Interest Other Borrowed Money	41	13
Interest on Junior Subordinated Debentures	271	203
<b>TOTAL INTEREST EXPENSE</b>	<b>2,814</b>	<b>1,618</b>
<b>NET INTEREST INCOME</b>	<b>5,622</b>	<b>5,444</b>
Provision for Loan Losses	135	240
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>5,487</b>	<b>5,204</b>
<b>NON-INTEREST INCOME</b>		
Service Charges on Deposit Accounts	356	487
Other Income	430	452
Loss on Sale of Loans	(2)	□
<b>TOTAL NON-INTEREST INCOME</b>	<b>784</b>	<b>939</b>
<b>NON-INTEREST EXPENSE</b>		
Salaries and Employee Benefits	2,344	2,198
Advertising	196	196
Occupancy Expense of Premises	649	460
Equipment Expense	170	166

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Professional Cost	129	241
Data Processing Expense	549	526
ATM Loss	□	225
Other Expenses	843	813
	<hr/>	<hr/>
<b>TOTAL NON-INTEREST EXPENSES</b>	4,880	4,825
	<hr/>	<hr/>
<b>INCOME BEFORE INCOME TAXES</b>	1,391	1,318
Applicable Income Taxes	496	486
	<hr/>	<hr/>
<b>NET INCOME</b>	\$ 895	\$ 832
	<hr/>	<hr/>
<b>BASIC EARNINGS PER SHARE</b>	\$ 1.32	\$ 1.20
<b>DILUTED EARNINGS PER SHARE</b>	\$ 1.24	\$ 1.11
Dividends Declared per Share	\$ 0.50	\$ 0.40
See notes to unaudited consolidated Financial Statements		

[Back to Contents](#)**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Six Months Ended June 30</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Unaudited) Dollars in Thousands</b>	
<b>OPERATING ACTIVITIES</b>		
Net Income	\$ 895	\$ 832
Adjustments to Reconcile Net Income to Net Cash And Cash Equivalents Provided by Operating Activities:		
Origination of Loans Held for Sale	□	(152)
Proceeds from the Sale of Loans Held for Sale	714	□
Increase in bank-owned life insurance policies	(78)	(78)
Loss on sale of loans	2	□
Provisions for loan losses	135	240
Depreciation and Amortization	480	330
(Increase) Decrease in Interest Receivable and Other Assets	(1,171)	1,214
(Decrease) Increase in Interest Payable and Other Liabilities	(369)	322
Net Cash Provided by Operating Activities	<u>608</u>	<u>2,708</u>
<b>INVESTING ACTIVITIES</b>		
Net decrease in Deposits at Other Banks	□	1,294
Proceeds from Matured Securities and Principal Payments	12	2,005
Net Increase in Loans	(15,265)	(8,224)
Purchase of Premises and Equipment	(432)	(1,885)
Net Cash Used in Investing Activities	<u>(15,685)</u>	<u>(6,810)</u>
<b>FINANCING ACTIVITIES</b>		
Net (Decrease) Increase in Non-Interest Bearing Transaction Accounts	(3,663)	1,440
Net (Decrease) Increase in Interest Bearing Transaction Accounts	(1,975)	4,827
Net Decrease in Savings Deposits	(5,638)	(1,938)
Net Increase in Time Deposits	9,907	3,352
Short Term Borrowings	3,000	□
Payment of Cash Dividends	(343)	(282)
Retirement of Common Stock	(250)	(525)
Proceeds from the Sale of Common Stock	□	63
Net Cash Provided by Financing Activities	<u>1,038</u>	<u>6,937</u>

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(Decrease) Increase in Cash and Cash Equivalents	(14,039)	2,835
Cash and Cash Equivalents at Beginning of Period	22,959	16,714
Cash and Cash Equivalents at End of Period	\$ 8,920	\$ 19,549

See notes to unaudited consolidated Financial Statements

[Back to Contents](#)**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES****Notes to Unaudited Consolidated Financial Statements  
For the Three Months and Six Months Ended June 30, 2006**Note A: Basis of Presentation

The accompanying unaudited consolidated financial statements of Harbor Bankshares Corporation and subsidiaries (The "Company") have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all the information required for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair presentation have been included. All such adjustments are of a normal recurring nature. Operating results for the three month and six month periods ended June 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The enclosed unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto incorporated by reference in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2005. Certain reclassifications have been made to amounts previously reported to conform to the classifications made in 2006.

Note B: Comprehensive Income

The Company's comprehensive income consists of its net income and unrealized holding losses on its available for sale securities, net of taxes.

Presented below is a reconciliation of net income to comprehensive income.

	<b>Three Months Ended March 31</b>		<b>Six Months Ended June 30</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net Income	\$ 448	\$ 538	\$ 895	\$ 832
Unrealized (loss) gains on securities Available-for-sale	(35)	164	(106)	(524)
Related Income Tax (benefit) expense	(14)	65	(42)	(207)
	(21)	99	(64)	(317)
Total Comprehensive Income	\$ 427	\$ 637	\$ 831	\$ 515

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[Back to Contents](#)**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES****EARNINGS PER SHARE**

Note C: Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Basic earnings per share does not include the effect of potentially dilutive transactions or conversions. The computation of diluted earnings per share reflects the potential dilution of earnings per share under the treasury stock method, which could occur if contracts to issue common stock, such as stock options, were exercised and shared in corporate earnings. At June 30, 2006 and 2005, there were no antidilutive options to purchase common shares.

The following table presents a summary of per share data and amounts for the period indicated:

(amount in thousands except per-share data)

	<b>Three Months Ended June 30</b>		<b>Six Months Ended June 30</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Basic:</b>				
Net income applicable to common stock	\$ 448	\$ 538	\$ 895	\$ 832
Average common shares outstanding	675	691	678	694
Basic earnings per share	\$ .66	\$ .78	\$ 1.32	\$ 1.20
<b>Diluted:</b>				
Net income applicable to common stock	\$ 448	\$ 538	\$ 895	\$ 832
Average common shares outstanding	675	691	678	694
Stock option adjustment	41	55	41	55
Diluted average common shares outstanding	716	746	719	749
Diluted earnings per share	\$ .62	\$ .72	\$ 1.24	\$ 1.11

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Note D:

**EMPLOYEE STOCK-BASED COMPENSATION**

Effective on January 1, 2006, the Company adopted Financial Accounting Standards Board Statement No. 123R, "Share-Based Payment" (Statement 123R), which requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. Previously, the Company accounted for stock-based compensation plans and the employee stock purchase plan in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees" and related Interpretations and provided the required pro forma disclosures of Financial Accounting Standards Board Statement No. 123, "Accounting for Stock-Based Compensation". The Company elected to adopt the modified prospective-transition method as provided by Statement 123R. Under this transition method, compensation cost recognized during 2006 includes (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006 based on the grant-date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of Statement 123R. The effect of applying Statement 123R was a decrease in net income of \$17 and \$26 thousand net of taxes for the three and six month period ended June 30, 2006, or \$0.02 and \$0.04 per basic and diluted share respectively. Results for prior periods have not been restated.

The following table illustrates the effect on net loss and loss per share as if the Company had applied the fair value recognition provisions of Statement 123R to stock-based employee compensation for the period ended June 30, 2005:

	<b>Three months Ended June 30, 2005</b>	<b>Six Months Ended June 30, 2005</b>
Net income, as reported	\$ 538	\$ 832
Add: Stock-based compensation cost included in net loss, net of taxes	□	
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of taxes	(12)	(24)
Pro forma net income attributable to common stockholders	<u>\$ 526</u>	<u>\$ 808</u>
Net income attributable to common stockholders:		
Basic □ as reported	<u>\$ 0.78</u>	<u>\$ 1.20</u>
Diluted □ as reported	<u>\$ 0.76</u>	<u>\$ 1.16</u>
Basic □ pro forma	<u>\$ 0.72</u>	<u>\$ 1.11</u>
Diluted □ pro forma	<u>\$ 0.71</u>	<u>\$ 1.08</u>

[Back to Contents](#)**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES****The following are the assumptions made in computing the fair value of stock-based awards:**

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Average risk-free interest rate	4.36%	5.00%	4.36%	5.00%
Dividend yield	1.50%	1.50%	1.50%	1.50%
Expected term	10	10	10	10
Average expected volatility	20%	20%	20%	20%
Weighted average fair value of granted options	7.44	6.78	7.44	6.78

Expected volatilities are based on historical volatility of the Company's stock. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

**A summary of stock option activity during the six months ended June 30, 2006 and related information is included in the table below:**

	Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value
Outstanding at January 1, 2006	132,741	16.24	\$ 2,159,300
Granted	6,043	25.00	151,075
Exercised	□		
Forfeited	(15,500)	16.19	(250,945)
Outstanding at June 30, 2006	123,284	16.70	2,059,430
Exercisable at June 30, 2006	123,284	16.70	2,059,430
Weighted-average remaining contractual life	7.6		

The weighted average grant date fair value of options granted during the six month period ended June 30, 2006 was \$25.00 per share. All options granted have an exercise price equal to the fair value of the Company's common stock on the date of grant. Exercise prices for options outstanding as of June 30, 2006 ranged from \$15.24 to \$25.00 as follows:



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<b>Range of Exercise Prices</b>	<b>Options Outstanding</b>	<b>Weighted Average Exercise Prices of Options Outstanding</b>	<b>Weighted Average Remaining Contractual Life of Options Outstanding</b>
\$15.24 – \$17.35	99,853	\$ 15.45	5.35
\$18.00 – \$21.69	12,497	\$ 20.24	7.65
\$23.04 – \$25.00	10,934	\$ 24.44	9.73
	<u>123,284</u>		

Note E:

**NEW ACCOUNTING PRONOUNCEMENTS**

SFAS No. 154, "Accounting Changes and Error Corrections, a Replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. Previously, most changes in accounting principle were recognized by including the cumulative effect of changing to the new account principle in net income of the period of the change. Under SFAS 154, retrospective application requires (i) the cumulative effect of the change to the new accounting principle on periods prior to those presented to be reflected in the carrying amounts of assets and liabilities as of the beginning of the first year presented, (ii) an offsetting adjustment, if any, to be made to the opening balance of retained earnings (or other appropriate complements of equity) for that period, and (iii) financial statements for each individual prior period presented to be adjusted to reflect the direct period-specific effects of applying the new accounting principle. Special retroactive application rules apply in situation where it is impracticable to determine either the period of specific effects or the cumulative effect of the change. Indirect effects of a change in accounting principle are required to be reported in the period in which the accounting change is made. SFAS 154 carries forward the guidance in APB Opinion 20 "Accounting Changes," requiring justification of a change in accounting principle on the basis of preferability. SFAS 154 also carries forward without change the guidance contained in APB Opinion 20, for reporting the correction of an error in previously issued financial statements and for a change in an accounting estimate. SFAS is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 did not significantly impact the Company's financial statements.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments", an amendment of SFAS No. 133 and SFAS No. 140. This statement permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. It establishes a requirement to evaluate interests in securitized financial assets to identify interest that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. In addition, SFAS 155 clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133. It also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. SFAS 155 amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company is evaluating the impact, if any, of the adoption of this Statement on its financial results.

In March 2006, the FASB issued SFAS No. 156 "Accounting for Servicing of Financial Assets": This Statement amends SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities", and requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable and permits the entities to elect either fair value measurement with changes in fair value reflected in earnings or the amortization and impairment requirements of SFAS No. 140 for

subsequent measurement. The subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value eliminates the necessity for entities that manage the risks inherent in servicing assets and servicing liabilities with derivative to qualify for hedge account treatment and eliminates the characterization of declines in fair value as impairments or direct write-downs. This Statement is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company is evaluating the impact, if any, of the adoption of this Statement on its financial results.

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## HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES

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### **Part I. FINANCIAL INFORMATION**

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

**Forward-Looking Statements.** This management's discussion and analysis of financial condition and results of operations and other portions of this report include forward-looking statements such as: statements of the Company's goals, intentions, and expectations; estimates of risks and of future costs and benefits; assessments of loan quality, and probable loan losses, liquidity, and interest risk; and statements of the Company's ability to achieve financial and other goals. These forward-looking statements are subject to significant uncertainties because they are based upon: the amount and timing of future changes in interest rates, market behaviors, and other economic conditions; future laws and regulations; and a variety of other matters. Because of these uncertainties, the actual future results may be materially different from the results indicated by these forward-looking statements. In addition, the Company's past growth and performance do not necessarily indicate its future results.

Harbor Bankshares Corporation earnings for the second quarter of 2006 totaled \$448 thousand, a decrease of \$90 thousand or 16.7 percent when compared to the second quarter of 2005. Net interest income increased by \$65 thousand or 2.4 percent. Non-interest income decreased by \$38 thousand or 8.5 percent and non-interest expenses increased by \$238 thousand or 10.7 percent. The provisions for loan losses decreased by \$40 thousand or 33.3 percent.

Year to date earning as of June 30, 2006 were \$895 thousand, reflecting an increase of \$63 thousand or 7.6 percent when compared to the first six months of 2005. The annualized return on average assets (ROAA) and average stockholders equity (ROAE) were .70 percent and 10.6 percent respectively, compared to .71 percent and 10.3 percent achieved during the first six months of 2005.

For the first six months of 2006, net interest income increased by \$178 thousand or 3.3 percent. Interest and fees on loans increased by \$1.2 million or 19.3 percent as a result of the growth in the portfolio and interest rate increases. Investment income decreased by \$12 thousand or 2.8 percent. Interest on federal funds sold increased by \$132 thousand or 74.2 percent resulting from higher balances and rates. Interest expense increased by \$1.2 million or 73.9 percent. Interest on time deposits increased by \$457 thousand or 57.4 percent. Interest expense on saving accounts increased by \$644 thousand or 111.2 percent. Time deposits increased by \$9.9 million or 14.9 percent when compared to December 31, 2005. This increase, combined with higher rates for both, time and savings deposits were the main reason for overall increase in interest expense. The interest expense on borrowed funds was \$41 thousand. The interest expense for the junior subordinated floating rate debentures increased by \$68 thousand or 33.5 percent due to higher interest rates.

For the second quarter of 2006, when compared to the same period for 2005, net interest income increased by \$65 thousand or 2.4 percent. Interest and fees on loans increased by \$654 thousand or 19.3 percent resulting from portfolio growth and rate increases. Investment income at \$209 thousand remained the same for both periods. Federal fund sold income increased by \$7 thousand or 35.0 percent. Interest expense increased by \$593 thousand or 67.8 percent mainly due to higher rates on time and savings deposits. Interest expense on time deposits increased by \$229 thousand or 53.1 percent due to higher rates and increased balances. Interest expense on savings accounts increased by \$298 thousand or 94.3 percent mainly due to higher interest rates. The interest expense on borrowed funds for the period was \$40 thousand. The interest expense for the junior subordinated debentures increased by \$35 thousand or 33.0 percent due to higher interest rates.

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As of June 30, 2006, the provision for loan losses was \$135 thousand compared to \$240 thousand for the same period in 2005. Charge-offs totaled \$58 thousand reflecting an increase of \$24 thousand when compared to the \$34 thousand charged-off during the same period in 2005. Recoveries for the period were \$9 thousand, compared to \$72 thousand recovered during the first six months of 2005.

Future provisions for loan losses will continue to be based upon our assessment of the overall loan portfolio and its underlying collateral, the mix of loans within the portfolio, delinquency trends, economic conditions, current and prospective trends in real estate values, and other relevant factors under our allowance methodology.

Our allowance for loan loss methodology is a loan classification-based system. We base the required allowance on a percentage of the loan balance for each type of loan classification level. Allowance percentages are based on each individual lending program, its loss history and underwriting characteristics including loan value, credit score, debt coverage, collateral, and capacity to service debt.

This analysis is used to validate the loan loss reserve matrix as well as assist in establishing overall lending direction. In Management's opinion, the allowance for loan losses as of June 30, 2006 is adequate. There were no changes in estimation methods or assumptions that affected the methodology for assessing the appropriateness of the allowance during the period.

Non-performing assets consist of non-accruing loans, loans past due 90 days or more but still accruing, restructured loans, and foreclosed real estate.

The following table shows the non-performing assets as of June 30, 2006 compared to December 31, 2005.

	<b>June 30, 2006</b>	<b>December 31, 2005</b>
	<u>          </u>	<u>          </u>
	<b>(In Thousands)</b>	
Non-accruing Loans	\$ 349	\$ 558
Past Due 90 days or more	21	18
Restructured loans	□	□
	<u>370</u>	<u>576</u>
Total non-performing loans		
Foreclosed real estate	□	□
	<u>370</u>	<u>576</u>
Total non-performing assets	\$ 370	\$ 576
	<u>          </u>	<u>          </u>
Non-performing loans to total loans	0.18%	0.30%
Non-performing assets to total assets	0.14%	0.22%
Allowance for loan losses to non-performing loans	579.73%	357.50%

Non-interest income decreased by \$155 thousand or 16.5 percent. Service charges on deposit accounts decreased by \$131 thousand or 26.9 percent, mainly related to decreases in the returned check fees charges. Other income decreased by \$22 thousand or 4.9 percent. There was a loss of \$2 thousand on the sale of loans. Salary and employee benefits at \$2.3 million increased by \$146 thousand or 6.6 percent when compared to the same period of 2005. Advertising cost of \$196 thousand remained the same for both periods. Occupancy expense increased by \$189 thousand or 41.1 percent reflecting the cost associated with the renovation of the Company's headquarters building and the opening of a new branch facility in October, 2005. Equipment expenses increased by \$4 thousand or 2.4 percent. Professional costs decreased by \$112 thousand or 46.5 percent. Data processing fees increased by \$23 thousand or 4.4 percent. Included in this non-interest expense for 2005, is a loss of \$255 thousand resulting from the final settlement of the ATM shortage matter.



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## **HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES**

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For the second quarter of 2006, when compared to the same period for 2005, non-interest income decreased by \$38 thousand or 8.5 percent. Service charges on deposit accounts decreased by \$61 thousand or 24.5 percent mainly related to the returned check fees charges. Other income increased by \$23 thousand or 11.6 percent. Salary and employee benefits increased by \$81 thousand or 7.5 percent and advertising cost decreased by \$2 thousand or 1.8 percent. Occupancy expenses increased by \$73 thousand or 29.7 percent reflecting the cost associated with renovation expenses and branch expansion. Equipment expenses increased by \$5 thousand or 6.3 percent. Professional costs increased by \$21 thousand or 39.6 percent. Data processing expense increased by \$10 thousand or 3.8 percent and other expenses increased by \$50 thousand or 12.6 percent.

As of June 30, 2006, total deposits were \$228.5 million, reflecting a decrease of \$1.3 million when compared to deposits as of December 31, 2005. Non-interest bearing deposits decreased by \$3.7 million or 7.3 percent. Interest bearing transaction accounts decreased by \$2.0 million or 7.7 percent. Savings accounts which included money market accounts decreased by \$5.6 million or 6.4 percent and time deposits increased by \$9.9 million or 14.9 percent. There was a \$3.0 million short term borrowing from the Federal Home Loan Bank as of June 30, 2006.

Total loans, including loans held for sale, increased by \$15.2 million or 8.1 percent. The increase was mainly the result of growth in the commercial loans and commercial real estate categories. Stockholders' equity increased by \$276 thousand, resulting from earnings of \$895 thousand offset by an increase of \$64 thousand of unrealized losses on available-for-sale securities, cash dividend paid in the amount of \$343 thousand, and the retirement of 10,000 shares or \$250 thousand of common stock. Primary and risk based capital were 7.4 percent and 11.1 percent, respectively.

As of June 30, 2006, based on borrowing arrangements with the Federal Home Loan Bank there was unused credit availability of \$22.8 million, the Company has sufficient liquidity to withstand any unusual demand for funds without the liquidation of its securities.

The Harbor Bank CDC ("CDC") and The Harbor Bank of Baltimore LLC ("LLC") were established in 2003. The Harbor Bank CDC is a non-profit company established for the purpose of bringing financial assistance to underserved areas in the City of Baltimore. The Corporation has no investments in this company. The Harbor Bank of Maryland, one of the Company's subsidiaries has a \$1.3 million loan to the CDC. As of June 30, 2006, the CDC had \$9 thousand in operating income and a \$25 thousand loss since inception. These numbers exclude any tax benefit that may be available.

The Harbor Bank of Baltimore LLC was established for the purpose of taking advantage of the New Markets Tax Credit program offered by the U.S. Treasury Department for the development of certain targeted markets in the country. In the case of the LLC, the targeted market is the City of Baltimore. The LLC received a \$50 million New Market Tax Credit award in September 2004. The LLC funded a \$25.0 million loan through a partnership with General Motors Corporation. The Corporation has no investment in this company.

The financial data from these companies is not included in the Company's financial statements.

The Corporation's stock is traded from time to time over the counter, but is not listed on Nasdaq or any exchange or quoted on the OTC Bulletin Board. The last trade of which the Corporation is aware was on June 14, 2006 at a price of \$28.00. During the first six months of 2006, other trades are believed to have been made at prices ranging from \$25.00 to \$29.73.

### **ITEM 3 Controls and Procedures**

The Company's management, under the supervision and with the participation of its Chief Executive Officer and the Chief Financial Officer, evaluated as of the last day of the period covered by this report, the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Rule 13a-15 under the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Treasurer concluded that the Company's disclosure controls and procedures were effective. There were no significant changes in the Company's internal controls over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) for the period ending June 30, 2006 that have materially affected, or are reasonably likely

to materially affect, the Company's internal control over financial reporting.

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## HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES

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### **Part II. OTHER INFORMATION**

Item Legal Proceedings  
1.

The Company and its Bank subsidiary, at times and in the ordinary course of business, are subject to various pending and threatened legal actions. The relief or damages sought in some of these actions may be substantial. Management considers that the outcome of such actions will not have a material adverse effect on the Company's financial position; however, the Company is not able to predict whether the outcome of such actions may or may not have a material adverse effect on results of operations in a particular future period as the timing and amount of any resolution of such actions and relationship to the future results of operations are not known.

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

None

Item Defaults Upon Senior Securities  
3.

None

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

None

Item Other Information  
5.

None

Item Exhibits  
6.

Exhibit 31(a),(b), Rule 13a-14(a)/15d-14(a) Certifications

Exhibit 32(a), (b), 18 U.S.C Section 1350 Certifications



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**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES**

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**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**HARBOR BANKSHARES CORPORATION**

Date: August 9, 2006 /s/ Joseph Haskins, Jr.

Joseph Haskins, Jr.  
Chairman and Chief Executive Officer

Date: August 9, 2006 /s/ Teodoro J. Hernandez

Teodoro J. Hernandez  
Vice President and Treasurer

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PRELIMINARY  
-FORM OF PROXY-

REVOCABLE PROXY  
HARBOR BANKSHARES CORPORATION  
ANNUAL MEETING OF SHAREHOLDERS  
\_\_\_\_\_, 2006

The undersigned hereby constitutes and appoints Joseph Haskins, Jr. and George F. Vaeth, Jr. and each of them the proxies of the undersigned, with full power of substitution, to attend the annual meeting of shareholders (the "Annual Meeting") of Harbor Bankshares Corporation (the "Company") to be held at the offices of the Company at 25 West Fayette Street, Baltimore, Maryland 21201 on Wednesday, \_\_\_\_\_ 2006, at 12:00 noon Eastern Time, or at any adjournment thereof, and to vote all the shares of stock of the Company that the undersigned may be entitled to vote, upon the following matters:

THE BOARD OF DIRECTORS RECOMMENDS A VOTE "FOR" APPROVAL OF THE AGREEMENT AND PLAN OF MERGER, "FOR" ADJOURNMENT OF THE ANNUAL MEETING IF NECESSARY TO SOLICIT ADDITIONAL VOTES FOR APPROVAL OF THE AGREEMENT AND PLAN OF MERGER, AND "FOR" THE ELECTION OF ALL DIRECTOR NOMINEES. PLEASE SIGN, DATE AND RETURN PROMPTLY IN THE ENCLOSED ENVELOPE. PLEASE MARK YOUR VOTE IN BLUE OR BLACK INK

1. Approval of the Agreement and Plan of Merger, dated as of \_\_\_\_\_, 2006, by and between Harbor Bankshares Corporation and Harbor Merger Corporation, a Maryland corporation and wholly-owned subsidiary of Harbor Bankshares Corporation (the "merger subsidiary"), pursuant to which the merger subsidiary will merge with and into Harbor Bankshares Corporation, with Harbor Bankshares Corporation being the surviving corporation.

FOR                      AGAINST                      ABSTAIN

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2. The adjournment of the Annual Meeting to solicit additional votes for approval of the Agreement and Plan of Merger, if necessary.

FOR                    AGAINST                    ABSTAIN

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3. The election of four Class II Directors, each to serve for a three-year term.

\_\_\_\_\_ For all nominees listed below (except as marked to the contrary below).

\_\_\_\_\_ Withhold authority to vote for all nominees listed below.

Nominees: Nathaniel Higgs, Delores G. Kelley, Erich March, and Stanley W. Tucker

(TO WITHHOLD AUTHORITY TO VOTE FOR ANY INDIVIDUAL NOMINEE, STRIKE OUT THE NOMINEE'S NAME.)

4. The transaction of such other matters as may properly come before the Annual Meeting or any adjournments or postponements thereof.

THIS PROXY WILL BE VOTED IN ACCORDANCE WITH THE INSTRUCTIONS MARKED HEREIN. IF NO INSTRUCTIONS TO THE CONTRARY ARE MARKED HEREIN, THIS PROXY WILL BE VOTED FOR APPROVAL OF THE AGREEMENT AND PLAN OF MERGER, FOR ADJOURNMENT OF THE ANNUAL MEETING, IF NECESSARY, AND FOR THE ELECTION OF DIRECTORS, AND AS DETERMINED BY A MAJORITY OF THE BOARD OF DIRECTORS AS TO OTHER MATTERS.