MIDDLEFIELD BANC CORP
Form 10-Q
November 10, 2011

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

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

For the quarterly period ended September 30, 2011
Commission File Number 000-32561
Middlefield Banc Corp.
(Exact name of registrant as specified in its charter)

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

15985 East High Street, Middlefield, Ohio 44062-9263
(Address of principal executive offices)
(440) 632-1666
(Registrant s telephone number, including area code)

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

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

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

Large accelerated filer o	**Accelerated filer** o	**Non-accelerated filer** o	**Small reporting company** þ

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

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

Class: Common Stock, without par value
Outstanding at November 10, 2011: 1,754,856

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

	September 30, 2011	December 31, 2010
ASSETS		
Cash and due from banks	$ 21,269	$ 10,473
Federal funds sold	22,318	20,162
Cash and cash equivalents	43,587	30,635
Investment securities available for sale	204,455	201,772
Loans	388,558	372,498
Less allowance for loan losses	7,574	6,221
Net loans	380,984	366,277
Premises and equipment	8,042	8,179
Goodwill	4,559	4,559
Bank-owned life insurance	8,188	7,979
Accrued interest and other assets	10,864	12,796
TOTAL ASSETS	$ 660,679	$ 632,197
LIABILITIES		
Deposits:		
Noninterest-bearing demand	$ 60,806	$ 53,391
Interest-bearing demand	61,483	48,869
Money market	76,851	71,105
Savings	166,531	146,993
Time	221,567	244,893
Total deposits	587,238	565,251
Short-term borrowings	6,908	7,632
Other borrowings	17,955	19,321
Accrued interest and other liabilities	1,915	1,971
TOTAL LIABILITIES	614,016	594,175
STOCKHOLDERS EQUITY		
Common stock, no par value; 10,000,000 shares authorized, 1,944,386 and 1,780,553 shares issued	31,112	28,429
Retained earnings	17,335	15,840
Accumulated other comprehensive income	4,950	487
Treasury stock, at cost; 189,530 shares	(6,734)	(6,734)

TOTAL STOCKHOLDERS EQUITY		46,663		38,022
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	660,679	$	632,197

See accompanying notes to the unaudited consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
INTEREST INCOME				
Interest and fees on loans	$ 5,555	$ 5,325	$ 16,255	$ 15,721
Interest-bearing deposits in other institutions	4	3	8	10
Federal funds sold		15	13	38
Investment securities:				
Taxable interest	1,220	1,290	3,832	3,832
Tax-exempt interest	724	702	2,124	1,941
Dividends on stock	25	33	76	82
Total interest income	7,528	7,368	22,308	21,624
INTEREST EXPENSE				
Deposits	1,836	2,391	5,877	7,249
Short term borrowings	59	66	177	186
Other borrowings	100	147	313	520
Trust preferred securities	139	148	412	412
Total interest expense	2,134	2,752	6,779	8,367
NET INTEREST INCOME	5,394	4,616	15,529	13,257
Provision for loan losses	920	1,226	2,485	2,355
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	4,474	3,390	13,044	10,902
NONINTEREST INCOME				
Service charges on deposit accounts	455	473	1,299	1,321
Investment securities gains (losses), net	6	18	(16)	45
Earnings on bank-owned life insurance	70	72	209	204
Other income	155	132	487	419
Total noninterest income	686	695	1,979	1,989
NONINTEREST EXPENSE				
Salaries and employee benefits	1,754	1,543	5,388	4,767

Occupancy expense	242	224	737	717
Equipment expense	175	156	488	558
Data processing costs	162	160	515	575
Ohio state franchise tax	126	134	351	404
Federal deposit insurance expense	176	197	673	589
Professional fees	181	110	577	490
Losses on other real estate owned	195	536	498	750
Other expense	895	682	2,676	2,278
Total noninterest expense	3,906	3,742	11,903	11,128
Income before income taxes	1,254	343	3,120	1,763
Income taxes (benefit)	175	(120)	319	(60)
NET INCOME	$ 1,079	$ 463	$ 2,801	$ 1,823
EARNINGS PER SHARE				
Basic	$ 0.63	$ 0.29	$ 1.69	$ 1.16
Diluted	0.63	0.29	1.69	1.16
DIVIDENDS DECLARED PER SHARE	$ 0.26	$ 0.26	$ 0.78	$ 0.78

See accompanying notes to the unaudited consolidated financial statements.

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

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stockholders Equity	Comprehensive Income
Balance, December 31, 2010	$ 28,429	$ 15,840	$ 487	$ (6,734)	$ 38,022	
Net income		2,801			2,801	$ 2,801
Other comprehensive income:						
Unrealized gain on available for sale securities net of taxes of $2,299, net of reclassification adjustment			4,463		4,463	4,463
Comprehensive income						$ 7,264
Stock-based compensation expense (2,400 shares)	59				59	
Common stock issuance (138,150 shares)	2,210				2,210	
Dividend reinvestment and purchase plan (23,283 shares)	414				414	
Cash dividends ($0.78 per share)		(1,306)			(1,306)	
Balance, September 30, 2011	$ 31,112	$ 17,335	$ 4,950	$ (6,734)	$ 46,663	

See accompanying notes to the unaudited consolidated financial statements.

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

	Nine Months Ended September 30, 2011	2010
OPERATING ACTIVITIES		
Net income	$ 2,801	$ 1,823
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	2,485	2,355
Investment securities (gains) losses, net	16	(45)
Depreciation and amortization	639	581
Amortization of premium and discount on investment securities	247	(93)
Amortization of deferred loan fees, net	(120)	(37)
Earnings on bank-owned life insurance	(209)	(204)
Deferred income taxes	(173)	(384)
Stock based compensation expense	59	
Losses on other real estate owned	498	750
Increase in accrued interest receivable	(384)	(447)
Increase (decrease) in accrued interest payable	(73)	33
Decrease in prepaid federal deposit insurance	642	545
Other, net	(746)	(1,240)
Net cash provided by operating activities	5,682	3,637
INVESTING ACTIVITIES		
Investment securities available for sale:		
Proceeds from repayments and maturities	56,940	31,882
Proceeds from sale of securities	24,305	5,829
Purchases	(77,429)	(89,919)
Increase in loans, net	(18,217)	(14,431)
Proceeds from the sale of other real estate owned	777	923
Purchase of premises and equipment	(321)	(292)
Net cash used for investing activities	(13,945)	(66,008)
FINANCING ACTIVITIES		
Net increase in deposits	21,987	76,385
Increase (decrease) in short-term borrowings, net	(724)	962
Repayment of other borrowings	(1,366)	(3,830)
Common stock issuance	2,210	
Proceeds from dividend reinvestment & purchase plan	414	396
Cash dividends	(1,306)	(1,225)
Net cash provided by financing activities	21,215	72,688

Increase in cash and cash equivalents		12,952		10,317
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD		30,635		41,153
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$	43,587	$	51,470
SUPPLEMENTAL INFORMATION				
Cash paid during the year for:				
Interest on deposits and borrowings	$	6,852	$	8,334
Income taxes		515		850
Non-cash investing transactions:				
Transfers from loans to other real estate owned	$	1,146	$	1,525

See accompanying notes to the unaudited consolidated financial statements.

MIDDLEFIELD BANC CORP.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

The Consolidated Financial Statements of Middlefield Banc Corp. (Company) include its two bank subsidiaries The Middlefield Banking Company (MB) and Emerald Bank (EB) and a non-bank asset resolution subsidiary EMORECO, Inc. All significant inter-company items have been eliminated.

The accompanying financial statements have been prepared in accordance with U.S. generally accepted accounting principles and the instructions for Form 10-Q and Article 10 of Regulation S-X. In management s opinion, the financial statements include all adjustments, consisting of normal recurring adjustments, that the Company considers necessary to fairly state the Company s financial position and the results of operations and cash flows. The Consolidated Balance Sheet at December 31, 2010, has been derived from the audited financial statements at that date but does not include all of the necessary informational disclosures and footnotes as required by U. S. Generally Accepted Accounting Principles (GAAP). The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included with Middlefield s Form 10-K (File No. 000-32561). The results of Middlefield s operations for any interim period are not necessarily indicative of the results of Middlefield s operations for any other interim period or for a full fiscal year.

Recent Accounting Pronouncements

In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.* ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity s credit risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The Company has provided the necessary disclosure in note 7 to the financial statements.

In April 2011, the FASB issued ASU 2011-02, *Receivables (Topic 310): A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. The amendments in this Update provide additional guidance or clarification to help creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. The amendments in this Update are effective for the first interim or annual reporting period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning annual period of adoption. As a result of applying these amendments, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. This ASU is not expected to have a significant impact on the Company s financial statements.

In April 2011, the FASB issued ASU 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*. The main objective in developing this Update is to improve the accounting for repurchase agreements (repos) and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The amendments in this Update remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this Update apply to all entities, both public and nonpublic. The amendments affect all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The guidance in this Update is effective for the first interim or annual period beginning on or after December 15, 2011 and should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. This ASU is not expected to have a significant impact on the Company s financial statements.

In May 2011, the FASB issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The amendments in this Update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments in this Update are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for annual periods beginning after December 15, 2011. Early application by public entities is not permitted. This ASU is not expected to have a significant impact on the Company s financial statements.

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In June 2011, the FASB issued ASU 2011-05, Presentation of Comprehensive Income. The amendments in this Update improve the comparability, clarity, consistency, and transparency of financial reporting and increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. GAAP and IFRS, the option to present components of other comprehensive income as part of the statement of changes in stockholders equity was eliminated. The amendments require that all non-owner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. All entities that report items of comprehensive income, in any period presented, will be affected by the changes in this Update. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. The amendments in this Update should be applied retrospectively, and early adoption is permitted. The Company is currently evaluating the impact the adoption of this guidance will have on the Company s financial position or results of operations.

In September 2011, the FASB issued ASU 2011-08, *Intangibles Goodwill and Other Topics (Topic 350), Testing Goodwill for Impairment*. The objective of this update is to simplify how entities, both public and nonpublic, test goodwill for impairment. The amendments in the Update permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this Update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this Update apply to all entities, both public and nonpublic, that have goodwill reported in their financial statements and are effective for interim and annual goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity s financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. This ASU is not expected to have a significant impact on the Company s financial statements.

NOTE 2 STOCK-BASED COMPENSATION

The Company has no unrecognized stock-based compensation costs outstanding as of September 30, 2011.

Stock option activity during the nine months ended September 30, 2011 and 2010 is as follows:

	2011	Weighted-average Exercise Price	2010	Weighted-average Exercise Price
Outstanding, January 1	89,077	$ 27.87	99,219	$ 26.85
Granted				
Exercised				
Exercisable	9,000	17.55		
Forfeited	(7,549)	29.22		
Outstanding, September 30	90,528	$ 24.99	99,219	$ 26.85

NOTE 3 EARNINGS PER SHARE

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

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There are no convertible securities that would affect the denominator in calculating basic and diluted earnings per share. The following tables set forth the composition of the weighted-average common shares (denominator) used in the basic and diluted earnings per share computation.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
Weighted average common shares outstanding	1,894,207	1,768,362	1,847,945	1,761,292
Average treasury stock shares	(189,530)	(189,530)	(189,530)	(189,530)
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	1,704,677	1,578,832	1,658,415	1,571,762
Additional common stock equivalents (stock options) used to calculate diluted earnings per share				964
Weighted average common shares and common stock equivalents used to calculate diluted earnings per share	1,704,677	1,578,832	1,658,415	1,572,726

The average share price for the quarter-ended September 30, 2011 was $17.23 while the year-to-date price was $17.36. The options to purchase 90,528 shares of common stock at prices ranging from $17.55 to $40.24 were outstanding during the three and nine months ended September 30, 2011 but were not included in the computation of diluted earnings per share as they were anti-dilutive due to the strike price being greater than the average market price.

NOTE 4 COMPREHENSIVE INCOME

The components of comprehensive income consist exclusively of unrealized gains and losses on available for sale securities. For the nine months ended September 30, 2011, this activity is shown under the heading Comprehensive Income as presented in the Consolidated Statement of Changes in Stockholders Equity (Unaudited).

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The following shows the components and activity of comprehensive income during the periods ended September 30, 2011 and 2010 (net of the income tax effect):

(Dollar amounts in thousands)	For the Three Months Ended September 30, 2011	For the Three Months Ended September 30, 2010	For the Nine Months Ended September 30, 2011	For the Nine Months Ended September 30, 2010
Unrealized holding gains arising during the period on securities held	$ 2,114	$ 1,926	$ 4,452	$ 4,019
Reclassification adjustment for (gains) losses included in net income income, net of income taxes	(4)	(12)	11	(30)
Net change in unrealized gains during the period	2,110	1,914	4,463	3,989
Unrealized holding gains, beginning of period	2,840	2,637	487	562
Unrealized holding gains, end of period	$ 4,950	$ 4,551	$ 4,950	$ 4,551
Net income	$ 1,079	$ 463	$ 2,801	$ 1,823
Other comprehensive income, net of tax:				
Unrealized holding gains arising during the period	2,110	1,914	4,463	3,989
Comprehensive income	$ 3,189	$ 2,377	$ 7,264	$ 5,812

NOTE 5 FAIR VALUE MEASUREMENTS

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

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

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

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

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The following tables present the assets measured on a recurring basis on the Consolidated Balance Sheet at their fair value as of September 30, 2011 and December 31, 2010 by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

	September 30, 2011			
(Dollar amounts in thousands)	Level I	Level II	Level III	Total
Assets Measured on a Recurring Basis:				
U.S. government agency securities	$	$ 34,679	$	$ 34,679
Obligations of states and political subdivisions		89,235		89,235
Mortgage-backed securities in government-sponsored entities		71,699		71,699
Private-label mortgage-backed securities		8,088		8,088
Total debt securities		203,701		203,701
Equity securities in financial institutions	9	745		754
Total	$ 9	$ 204,446	$	$ 204,455

	December 31, 2010			
	Level I	Level II	Level III	Total
Assets Measured on a Recurring Basis:				
U.S. government agency securities	$	32,603		32,603
Obligations of states and political subdivisions		76,880		76,880
Mortgage-backed securities in government-sponsored entities		74,043		74,043
Private-label mortgage-backed securities		17,326		17,326
Total debt securities		200,852		200,852
Equity securities in financial institutions	920			920
Total	$ 920	200,852		201,772

Financial instruments are considered Level III when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. In addition to these unobservable inputs, the valuation models for Level III financial instruments typically also rely on a number of inputs that are readily observable either directly or indirectly. Level III financial instruments also include those for which the determination of fair value requires significant management judgment or estimation. The Company has no securities considered to be Level III as of September 30, 2011 and December 31, 2010.

The Company uses prices compiled by third party vendors due to the recent stabilization in the markets along with improvements in third party pricing methodology that have narrowed the variances between third party vendor prices and actual market prices.

The following tables present the assets measured on a nonrecurring basis on the consolidated balance sheet at their fair value as of September 30, 2011 and December 31, 2010, by level within the fair value hierarchy. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secure the impaired loan include: quoted market prices for identical assets classified as

Level I inputs; observable inputs, employed by certified appraisers, for similar assets classified as Level II inputs. In cases where valuation techniques included inputs that are unobservable and are based on estimates and assumptions developed by management based on the best information available under each circumstance, the asset valuation is classified as Level III inputs.

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(Dollar amounts in thousands)	September 30, 2011 Level I	Level II	Level III	Total
Assets Measured on a non-recurring Basis:				
Impaired loans	$	$	9,491	$ 9,491
Other real estate owned		2,173		2,173

	December 31, 2010 Level I	Level II	Level III	Total
Assets Measured on a non-recurring Basis:				
Impaired loans	$	$	$ 7,070	$ 7,070
Other real estate owned		2,302		2,302

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

(Dollar amounts in thousands)	September 30, 2011 Carrying Value	Fair Value	December 31, 2010 Carrying Value	Fair Value
Financial assets:				
Cash and cash equivalents	$ 43,587	$ 43,587	$ 30,635	$ 30,635
Investment securities Available for sale	204,455	204,455	201,772	201,772
Net loans	380,984	355,040	366,277	347,599
Bank-owned life insurance	8,188	8,188	7,979	7,979
Federal Home Loan Bank stock	1,887	1,887	1,887	1,887
Accrued interest receivable	2,643	2,643	2,259	2,259
Financial liabilities:				
Deposits	$ 587,238	$ 593,820	$ 565,251	$ 570,471
Short-term borrowings	6,908	6,908	7,632	7,632
Other borrowings	17,955	19,696	19,321	19,801
Accrued interest payable	717	717	790	790

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

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

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

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

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

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

The fair value is equal to the current carrying value.

Bank-Owned Life Insurance

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

Investment Securities Available for Sale

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

Loans

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

Deposits and Other Borrowed Funds

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

Commitments to Extend Credit

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

NOTE 6 INVESTMENT SECURITIES AVAILABLE FOR SALE

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

	September 30, 2011			
(Dollar amounts in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency securities	$ 34,229	$ 451	$ (1)	$ 34,679
Obligations of states and political subdivisions:				
Taxable	8,210	899		9,109
Tax-exempt	76,799	3,415	(88)	80,126
Mortgage-backed securities in government sponsored entities	69,107	2,592		71,699
Private-label mortgage-backed securities	7,703	450	(65)	8,088
Total debt securities	196,048	7,807	(154)	203,701
Equity securities in financial institutions	907		(153)	754
Total	$ 196,955	$ 7,807	$ (307)	$ 204,455

	December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency securities	$ 33,332	$ 111	$ (840)	$ 32,603
Obligations of states and political subdivisions:				
Taxable	7,371	80	(34)	7,417
Tax-exempt	69,363	1,058	(958)	69,463
Mortgage-backed securities in government sponsored entities	73,390	2,270	(654)	74,043
Private-label mortgage-backed securities	16,636	55	(328)	17,326
Total debt securities	200,092	3,574	(2,814)	200,852
Equity securities in financial institutions	944	80	(104)	920
Total	$ 201,036	$ 3,654	$ (2,918)	$ 201,772

The amortized cost and fair value of debt securities at September 30, 2011, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollar amounts in thousands)	Amortized Cost	Fair Value
Due in one year or less	$ 1,120	$ 1,125

Due after one year through five years	5,138	5,412
Due after five years through ten years	16,861	17,832
Due after ten years	172,929	179,332
Total	$ 196,048	$ 203,701

Proceeds from sales of investment securities available for sale were $24.3 and $5.8 million during the nine months ended September 30, 2011 and September 30, 2010, respectively. Net losses realized were $16,000 for the nine months ended September 30, 2011 and net gains realized were $45,000 for the nine months ended September 30, 2010.

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Proceeds from sales of investment securities available for sale were $14.2 million and $715,000 during the quarters ended September 30, 2011 and September 30, 2010, respectively. Net gains realized were $6,000 and $18,000 for the quarter ended September 30, 2011 and September 30, 2010, respectively.
Investment securities with an approximate carrying value of $55.8 and $51.7 million at September 30, 2011 and December 31, 2010, respectively, were pledged to secure deposits and other purposes as required by law.
The following table shows the Company s gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

	September 30, 2011					
	Less than Twelve Months		Twelve Months or Greater		Total	
(Dollar amounts in thousands)	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. government agency securities	$ 1,999	$ (1)	$	$	$ 1,999	$ (1)
Obligations of states and political subdivisions	4,642	(61)	719	(27)	5,361	(88)
Private-label mortgage-backed securities	1,634	(45)	446	(20)	2,080	(65)
Equity securities in financial institutions	174	(85)	580	(68)	754	(153)
Total	$ 8,449	$ (192)	$ 1,745	$ (115)	$ 10,194	$ (307)

	December 31, 2010					
	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. government agency securities	$ 24,406	$ (840)	$	$	$ 24,406	$ (840)
Obligations of states and political subdivisions	35,846	(940)	439	(52)	36,285	(992)
Mortgage-backed securities in government sponsored entities	27,792	(654)			27,792	(654)
Private-label mortgage-backed securities	510	(11)	2,480	(317)	2,990	(328)
Equity securities in financial institutions			590	(104)	590	(104)
Total	$ 88,554	$ (2,445)	$ 3,509	$ (473)	$ 92,063	$ (2,918)

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

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OTTI losses are recognized in earnings if the Company s intent is to sell the debt security or it is more likely than not that it will be required to sell the debt security before recovery of its amortized cost basis. However, even if the Company does not expect to sell a debt security, it must evaluate expected cash flows to be received and determine if a credit loss has occurred.

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

Debt securities issued by U.S. government agencies, U.S. government-sponsored enterprises, and state and political subdivisions accounted for more than 96% of the total available-for-sale portfolio as of September 30, 2011 and no credit losses are expected, given the explicit and implicit guarantees provided by the U.S. federal government and the lack of significant unrealized loss positions within the obligations of state and political subdivisions security portfolio. The Company s assessment was concentrated mainly on private-label collateralized mortgage obligations of approximately $8.1 million for which the Company evaluates credit losses on a quarterly basis. The gross unrealized gain position related to these private-label collateralized mortgage obligations amounted to $450,000 and the gross unrealized loss position was $65,000 on September 30, 2011. The Company considered the following factors in determining whether a credit loss exists and the period over which the debt security is expected to recover:

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

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

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

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

For the nine months ended September 30, 2011, there were no available-for-sale debt securities with an unrealized loss that suffered OTTI.

NOTE 7 LOANS AND RELATED ALLOWANCE FOR LOAN LOSSES

Major classifications of net loans are summarized as follows (in thousands):

	September 30, 2011	December 31, 2010
Commercial and industrial	$ 58,903	$ 57,501
Real estate construction	21,619	15,845
Real estate mortgage:		
Residential	209,449	209,863
Commercial	93,827	84,304
Consumer installment	4,760	4,985
	388,558	372,498
Less allowance for loan losses	(7,574)	(6,221)

Net loans	$	380,984	$	366,277

The Company s primary business activity is with customers located within its local trade area, eastern Geauga County, and contiguous counties to the north, east, and south. The company also serves the central Ohio market with offices in Dublin and Westerville, Ohio. Commercial, residential, consumer, and agricultural loans are granted. Although the Company has a diversified loan portfolio at September 30, 2011 and 2010, loans outstanding to individuals and businesses are dependent upon the local economic conditions in its immediate trade area.

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The following tables summarize the primary segments of the loan portfolio as of September 30, 2011 and December 31, 2010 (in thousands):

September 30, 2011	Commercial and industrial	Real estate- construction	Real Estate- Mortgage Residential	Real Estate- Mortgage Commercial	Consumer installment	Total
Total loans	$ 58,903	$ 21,619	$ 209,449	$ 93,827	$ 4,760	$ 388,558
Individually evaluated for impairment	$ 4,109	$ 873	$ 6,603	$ 5,722	$	$ 17,307
Collectively evaluated for impairment	54,794	20,746	202,846	88,105	4,760	371,251

December 31, 2010	Commercial and industrial	Real estate- construction	Real estate- Mortgage Residential	Real estate- Mortgage Commercial	Consumer installment	Total
Total loans	$ 57,501	$ 15,845	$ 209,863	$ 84,304	$ 4,985	$ 372,498
Individually evaluated for impairment	$ 5,477	$ 1,299	$ 4,329	$ 6,266	$ 17	$ 17,388
Collectively evaluated for impairment	52,024	14,546	205,534	78,038	4,968	355,110

The Company s loan portfolio is segmented to a level that allows management to monitor risk and performance. The portfolio is segmented into Commercial and Industrial (C & I), Real Estate Construction, Real Estate Mortgage which is further segmented into Residential and Commercial real estate, and Consumer Installment Loans. The C&I loan segment consists of loans made for the purpose of financing the activities of commercial customers. The residential mortgage loan segment consists of loan made for the purpose of financing the activities of residential homeowners. The commercial mortgage loan segment consists of loans made for the purposed of financing the activities of commercial real estate owners and operators. The consumer loan segment consists primarily of installment loans and overdraft lines of credit connected with customer deposit accounts.

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan is greater than $150,000 and if the loan either is in nonaccrual status, or is risk rated Special Mention or Substandard and is greater than 90 days past due. Loans are considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in evaluating impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. The Company does not separately evaluate individual consumer and residential mortgage loans for impairment, unless such loans are part of a larger relationship that is impaired.

Once the determination has been made that a loan is impaired, the determination of whether a specific allocation of the allowance is necessary is measured by comparing the recorded investment in the loan to the fair value of the loan using one of three methods: (a) the present value of expected future cash flows discounted at the loan s effective interest rate; (b) the loan s observable market price; or (c) the fair value of the collateral less selling costs. The method is selected on a loan-by loan basis, with management primarily utilizing the fair value of collateral method. The evaluation of the need and amount of a specific allocation of the allowance and whether a loan can be removed from impairment status is made on a quarterly basis. The Company s policy for recognizing interest income on impaired loans does not differ from its overall policy for interest recognition.

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The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of September 30, 2011 and 2010 (in thousands):

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowance	Recorded Investment	Recorded Investment	Unpaid Principal Balance
September 30, 2011					
Commercial and industrial	$ 526	$ 184	$ 1,726	$ 2,252	$ 2,253
Real estate construction	276	125	367	643	643
Real estate mortgage:					
Residential			1,423	1,423	1,427
Commercial	2,858	627	3,177	6,035	6,054
Consumer installment			50	50	50
Total impaired loans	$ 3,660	$ 936	$ 6,743	$ 10,403	$ 10,427
December 31, 2010					
Commercial and industrial	$ 655	$ 203	$ 1,874	$ 2,529	$ 2,540
Real estate construction			618	618	614
Real estate mortgage:					
Residential	594	221		594	594
Commercial	1,879	188	1,441	3,320	3,314
Consumer installment					
Total impaired loans	$ 3,128	$ 612	$ 3,933	$ 7,681	$ 7,062

Management uses a nine point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first five categories are considered not criticized, and are aggregated as Pass rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The Special Mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a Substandard classification. Loans in the Substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are considered Substandard. Any portion of a loan that has been charged off is placed in the Loss category.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Company has a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. The Company s Commercial Loan Officers are responsible for the timely and accurate risk rating of the loans in their portfolios at origination and on an ongoing basis. The Credit Department performs an annual review of all commercial relationships $200,000 or greater. Confirmation of the appropriate risk grade is included in the review on an ongoing basis. The Company has an experienced Loan Review Department that continually reviews and assesses loans within the portfolio. The Company engages an external consultant to conduct loan reviews on a semi-annual basis. Generally, the external consultant reviews commercial relationships greater than $250,000 and/or criticized relationships greater than $125,000. Detailed reviews, including plans for resolution, are performed on loans classified as Substandard on a quarterly basis. Loans in the Special Mention and Substandard categories that are collectively evaluated for impairment are given separate consideration in the determination of the allowance.

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The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard and Doubtful within the internal risk rating system (in thousands):

September 30, 2011	Pass	Special Mention	Substandard	Doubtful	Total Loans
Commercial and industrial	$ 53,593	$ 880	$ 4,357	$ 73	$ 58,903
Real estate construction	20,950		669		21,619
Real estate mortgage:					
Residential	192,366	1,413	15,670		209,449
Commercial	86,626	452	6,749		93,827
Consumer installment	4,735	7	18		4,760
Total	$ 358,270	$ 2,752	$ 27,463	$ 73	$ 388,558

December 31, 2010	Pass	Special Mention	Substandard	Doubtful	Total Loans
Commercial and industrial	$ 52,008	$ 903	$ 4,366	$ 224	$ 57,501
Real estate construction	14,481		1,364		15,845
Real estate mortgage:					
Residential	192,823	1,601	15,439		209,863
Commercial	76,979	353	6,972		84,304
Consumer installment	4,937	11	37		4,985
Total	$ 341,228	$ 2,868	$ 28,178	$ 224	$ 372,498

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Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans (in thousands):

		Still Accruing					
	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Non-Accrual	Total Loans
September 30, 2011							
Commercial and industrial	$ 56,521	$ 321	$ 19	$	$ 340	$ 2,042	$ 58,903
Real estate construction	21,226					393	21,619
Real estate mortgage:							
Residential	192,684	3,739	1,562	583	5,884	10,881	209,449
Commercial	89,468	91	57		148	4,211	93,827
Consumer installment	4,659	101			101		4,760
Total	$ 364,558	$ 4,252	$ 1,638	$ 583	$ 6,473	$ 17,527	$ 388,558

		Still Accruing					
	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Non-Accrual	Total Loans
December 31, 2010							
Commercial and industrial	$ 53,712	$ 473	$ 776	$	$ 1,249	$ 2,540	$ 57,501
Real estate construction	15,197					648	15,845
Real estate mortgage:							
Residential	193,647	2,950	1,580		4,530	11,686	209,863
Commercial	78,361	1,607	824		2,431	3,513	84,304
Consumer installment	4,841	120	12		132	12	4,985
Total	$ 345,757	$ 5,150	$ 3,192	$	$ 8,342	$ 18,399	$ 372,498

An allowance for loan losses (ALLL) is maintained to absorb losses from the loan portfolio. The ALLL is based on management s continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience, and the amount of non-performing loans.

The Company s methodology for determining the ALLL is based on the requirements of ASC Section 310-10-35 for loans individually evaluated for impairment (discussed above) and ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as the Interagency Policy Statements on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Company s ALLL.

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. For general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors.

The classes described above, which are based on the purpose code assigned to each loan, provide the starting point for the ALLL analysis. Management tracks the historical net charge-off activity at the purpose code level. A historical charge-off factor is calculated utilizing a defined number of consecutive historical quarters. Consumer and Commercial pools currently utilize a rolling 8 quarters.

Management has identified a number of additional qualitative factors which it uses to supplement the historical charge-off factor because these factors are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors that are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources are: national and local economic trends and conditions; levels of and trends in delinquency rates and non-accrual loans; trends in volumes and terms of loans; effects of changes in lending policies; experience, ability, and depth of lending staff; value of underlying collateral; and concentrations of credit from a loan type, industry and/or geographic standpoint.

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Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALLL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALLL.

The following table summarizes the primary segments of the loan portfolio as of September 30, 2011 (in thousands):

	Commercial and industrial	Real estate- construction	Real estate- residential mortgage	Real estate- commercial mortgage	Consumer installment	Total
ALL balance at December 31, 2010	962	$ 188	$ 3,434	$ 1,543	94	$ 6,221
Charge-offs	(503)	(6)	(461)	(266)	(11)	(1,247)
Recoveries	75		18		22	115
Provision	384	75	1,372	616	38	2,485
ALL balance at September 30, 2011	$ 918	$ 257	$ 4,363	$ 1,893	143	$ 7,574

The following table summarizes the troubled debt restructurings as of September 30, 2011 (in thousands):

Modifications
As of September 30, 2011

Troubled Debt Restructurings	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial and industrial	7	668	668
Real estate- construction			
Real estate- mortgage:			
Residential	8	1,230	1,230
Commercial	3	2,025	2,025
Consumer Installment	3	43	43

Troubled Debt Restructurings subsequently defaulted	Number of Contracts	Recorded Investment
Commercial and industrial	1	15
Real estate- construction		
Real estate- mortgage:		
Residential	1	98

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

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

CHANGES IN FINANCIAL CONDITION

General. The Company s total assets ended the September 30, 2011 quarter at $660.7 million, an increase of $28.5 million or 4.5% from December 31, 2010. Investment securities available for sale increased $2.7 million and net loans increased $14.7 million. Total liabilities increased by $19.8 million or 3.3% and stockholders equity increased $8.6 million or 22.7%. The increase in total liabilities was the result of deposit growth of $22.0 million or 3.9%. The increase in stockholders equity was largely the result of an increase in accumulated other comprehensive income of $4.5 million. Retained earnings and common stock also increased by $1.5 million, and $2.7 million, respectively.

Cash on hand and due from banks. Cash on hand and due from banks and Federal funds sold represent cash and cash equivalents. Cash and cash equivalents increased $13.0 million or 42.3% to $43.6 million at September 30, 2011 from $30.6 million at December 31, 2010. Deposits from customers into savings and checking accounts, loan and security repayments and proceeds from borrowed funds typically increase these accounts. Decreases result from customer withdrawals, new loan originations, security purchases and repayments of borrowed funds.

Investment securities. Investment securities available for sale ended the September 30, 2011 quarter at $204.5 million, an increase of $2.7 million or 1.3% from $201.8 million at December 31, 2010. The Company experienced repayments and maturities of $56.9 million and sales of securities totaling $24.3 million during the nine months ended September 30, 2011. Offsetting sales, calls, repayments, and maturities, the Company recorded purchases of available for sale securities of $77.4 million, consisting of purchases of mortgage-backed securities, municipal and U. S. government bonds. In addition, the securities portfolio increased approximately $6.8 million due to an increase in the fair value. These fair value adjustments represent temporary fluctuations resulting from changes in market rates in relation to average yields in the available for sale portfolio. If securities are held to their respective maturity dates, no fair value gain or loss is realized.

Loans receivable. The loans receivable category consists primarily of single family mortgage loans used to purchase or refinance personal residences located within the Company s market area and commercial real estate loans used to finance properties that are used in the borrowers businesses or to finance investor-owned rental properties, and to a lesser extent commercial and consumer loans. Net loans receivable increased $14.7 million or 4.0% to $381.0 million as of September 30, 2011 from $366.3 million at December 31, 2010. Included in this amount was an increase in the commercial real estate mortgage segment of $9.5 million or 11.3% as well as the real estate construction loan portfolio of $5.8 million or 36.4% during the nine months ended September 30, 2011. The Company s lending philosophy centers around the growth of the commercial loan portfolio. The Company has taken a proactive approach in servicing the needs of both new and current clients. These relationships generally offer more attractive returns than residential loans and also offer opportunities for attracting larger balance deposit relationships. However, the shift in loan portfolio mix from residential real estate to commercial oriented loans may increase credit risk.

Allowance for Loan Losses and Asset Quality. In the three quarters of 2011, the combination of sustained weakness in commercial real estate values and a recessionary economy continued to have an adverse impact on the financial condition of commercial borrowers. These factors resulted in the Company downgrading loan quality ratings of several commercial loans. The distressed commercial real estate market also caused certain existing impaired commercial real estate loans to become under-collateralized, resulting in the loans being charged down to the estimated net realizable value of the underlying collateral.

The Company increased the allowance for loan losses to $7.6 million, or 1.9% of total loans, at September 30, 2011, compared to $6.2 million, or 1.7%, at December 31, 2010. The increase in the allowance for loan losses was necessitated by loan downgrades and an increase to specific reserves for impaired commercial real estate loans as discussed above, coupled with the impact of charge-offs remaining at an elevated level. For the quarter-ended September 30, 2011 net loan charge-offs totaled $373,000, or 0.1% of average loans, compared to $1.1 million, or 0.3%, for the third quarter of 2010. Year-to-date net loan charge-offs totaled $1.1 million, or .30%, of average loans, compared to $1.3 million, or .37% for the same period in the prior year. To maintain the adequacy of the allowance for loan losses, the Company recorded a third quarter provision for loan losses of $920,000, versus $1.2 million for the third quarter of 2010.

Management analyzes the adequacy of the allowance for loan losses regularly through reviews of the performance of the loan portfolio considering economic conditions, changes in interest rates and the effect of such changes on real estate values and changes in the amount and composition of the loan portfolio. The allowance for loan losses is a material estimate that is particularly susceptible to significant changes in the near term. Such evaluation, which includes a review of all loans for which full collectability may not be reasonably assured, considers among other matters, historical loan loss experience, the estimated fair value of the underlying collateral, economic conditions, current interest rates, trends in the borrower s industry and other factors that management believes warrant recognition in providing for an appropriate allowance for loan losses. Future additions to the allowance for loan losses will be dependent on these factors. Additionally, the Company utilizes an outside party to conduct an independent review of commercial and commercial real estate loans. The Company uses the results of this review to help determine the effectiveness of the existing policies and procedures, and to provide an independent assessment of the allowance for loan losses allocated to these types of loans. Management believes that the allowance for loan losses was appropriately stated at September 30, 2011. Based on the variables involved and the fact that management must make judgments about outcomes that are uncertain, the determination of the allowance for loan losses is considered a critical accounting policy.

Non-performing assets. Non-performing assets includes non-accrual loans, troubled debt restructurings (TDR), loans 90 days or more past due, assets purchased by EMORECO from Emerald Bank, other real estate, and repossessed assets. A loan is classified as non-accrual when, in the opinion of management, there are serious doubts about collectability of interest and principal. Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions, the borrower s financial condition is such that collection of principal and interest is doubtful. Payments received on nonaccrual loans are recorded as income or applied against principal according to management s judgment as to the collectability of principal.

TDRs are those loans which the Company, for economic or legal reasons related to a borrower s financial difficulties, grants a concession to the borrower that the Company would not otherwise consider. The Company has 39 TDRs with a total balance of $6.4 million as of September 30, 2011 compared to 13 TDRs totaling $1.6 million as of December 31, 2010. Non-performing loans amounted to $22.7 million or 5.9% of total loans and $20.0 million or 5.4% of total loans at September 30, 2011 and December 31, 2010, respectively. Non-performing loans secured by real estate totaled $21.3 million as of September 30, 2011, up $5.1 million from $16.2 million at December 31, 2010. The depressed state of the economy and heightened unemployment have contributed to this level, as well as the decline in the housing market across our geographic footprint that continue to suppress home prices and maintain elevated inventories of houses for sale. Real estate owned is written down to fair value at its initial recording and continually monitored.

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

Asset Quality History
(Dollar amounts in thousands)

(Dollar amounts in thousands)	9/30/2011	6/30/2011	3/31/2011	12/31/2010	9/30/2010
Nonperforming loans	$ 22,725	$ 22,469	$ 22,014	$ 19,986	$ 20,983
Real estate owned	2,173	2,145	2,248	2,302	2,016
Nonperforming assets	24,898	24,614	24,262	22,288	22,999
Allowance for loan losses	7,574	7,027	6,685	6,221	5,971
Ratios					
Nonperforming loans to total loans	5.85%	5.83%	5.85%	5.37%	5.75%
Nonperforming assets to total assets	3.77%	3.85%	3.82%	3.53%	3.61%
Allowance for loan losses to total loans	1.95%	1.82%	1.78%	1.67%	1.63%
Allowance for loan losses to nonperforming loans	33.33%	31.27%	30.37%	31.13%	28.46%

A major factor in determining the appropriateness of the allowance for loan losses is the type of collateral which secures the loans. Of the total nonperforming loans at September 30, 2011, 93.7% were secured by real estate. Although this does not insure against all losses, the real estate provides substantial recovery, even in a distressed-sale and declining-value environment. In response to the poor economic conditions which have eroded the performance of the Company s loan portfolio, additional resources have been allocated to the loan workout process. The Company s objective is to work with the borrower to minimize the burden of the debt service and to minimize the future loss exposure to the Company.

Deposits. The Company considers various sources when evaluating funding needs, including but not limited to deposits, which are a significant source of funds equaling 95.9% of the Company s total funding sources at September 30, 2011. Total deposits increased $22.0 million or 3.9% to $587.2 million at September 30, 2011 from $565.3 million at December 31, 2010, due to the perceived safety of these accounts. The increase in deposits is primarily related to the growth of interest-bearing demand, non-interest bearing demand, and savings accounts of $12.6 million or 25.8%, $7.4 million or 13.9% and $19.5 million or 13.3%, respectively, at September 30, 2011. These increases were largely offset by a decline in certificates of deposit accounts of $23.3 million or 9.5%, during the nine months ended September 30, 2011. This decline is the result of a migration of customers from maturing to non-maturing deposits.

Borrowed funds. The Company utilizes short and long-term borrowings as another source of funding used for asset growth and liquidity needs. These borrowings primarily include Federal Home Loan Bank of Cincinnati (FHLB) advances, junior subordinated debt, short-term borrowings from other banks and repurchase agreements. Short-term borrowings decreased $724,000 or 9.5% to $6.9 million as of September 30, 2011. Other borrowings, representing advances from the FHLB, declined $1.4 million or 7.1% as of September 30, 2011. The decline in FHLB advances was the result of scheduled principal payments.

Stockholders equity. Stockholders equity increased $8.6 million or 22.7% to $46.7 million at September 30, 2011 from $38.0 million at December 31, 2010. This increase was the result of increases in accumulated other comprehensive income, common stock, and retained earnings of $4.5 million, $2.7 million, and $1.5 million, respectively. The increase in accumulated other comprehensive income is due to increases in the fair value of the Company s securities available for sale portfolio of $6.8 million since December 31, 2010. The increase in common stock was the result of issuing 138,150 shares through private placement of the Company s stock at a price of $16.00 per share along with 23,283 shares issued within the Company s dividend reinvestment plan at an average price of $17.78 since December 31, 2010.

RESULTS OF OPERATIONS

General. Net income for the third quarter of 2011 totaled $1.1 million, a $616,000 or 133.0% increase from the $463,000 earned during the third quarter of 2010. Net income for the nine months ended September 30, 2011, was $2.8 million, a $978,000, or 53.6% increase from the $1.8 million earned during the same period in 2010. Diluted earnings per share for the third quarter of 2011 was $.63 compared to $.29 in 2010. Diluted earnings per share for the nine months ended September 30, 2011 was $1.69 compared to $1.16 for the same period in 2010.

The Company s annualized return on average assets (ROA) and return on average equity (ROE) for the third quarter of 2011 were 0.66% and 11.11%, respectively, compared with 0.29% and 4.54% for the third quarter of 2010. For the first nine months of 2011, the Company s annualized ROA was 0.59% compared to 0.41% in 2010, while the ROE was 9.82% compared to 6.31% for the same period of 2010.

The Company s earnings for the three and nine months ended were positively impacted by a decrease in deposit and other borrowings interest expense. This was partially offset by increases in non-interest expense.

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

Net interest income totaled $5.4 million for the third quarter of 2011, an increase of 16.9% from the $4.6 million reported for the comparable period of 2010. The net interest margin of 3.75% for the third quarter of 2011 showed improvement over the 3.39% reported for the same quarter of 2010. The increase in the net interest margin is primarily attributable to the reduced cost of interest-bearing liabilities by $618,000 compared to the same period in 2010.

Net interest income increased $2.3 million, or 17.1%, to $15.5 million, for the nine months ended September 30, 2011 compared to the same period in the prior year. The net interest margin of 3.69% for the nine months ended September 30, 2011, showed improvement over the 3.39% reported for the same period of 2010. The increase in the net interest margin is primarily attributable to the reduced cost of interest- bearing liabilities by $1.6 million compared to the same period in 2010.

Interest income. Interest income increased $160,000, or 2.2%, for the three months ended September 30, 2011, compared to the same period in the prior year. This increase can be attributed to an increase in interest earned on loans receivable of $230,000 for the quarter.

Interest income increased $684,000, or 3.2%, for the nine months ended September 30, 2011, compared to the same period in the prior year. This increase can be attributed to an increase in interest earned on loans receivable of $534,000 along with a $183,000 increase in interest earned on tax-exempt investment securities for the quarter.

The interest earned on loans receivable increase of $230,000, or 4.3%, for the three months ended September 30, 2011, compared to the same period in the prior year, is attributable to a $22.6 million or a 6.2% increase in the average balance of loans receivable from September 30, 2010. This increase was partially offset by a decline in the yield on the total loan portfolio of 10 basis points to 5.70% for the three months ended September 30, 2011 from 5.80% for the same period in the prior year.

Interest earned on loans receivable increased $534,000, or 3.4%, for the nine months ended September 30, 2011, compared to the same period in the prior year. This increase was attributable to a $19.9 million or 5.5% increase in the average balance of loans receivable from September 30, 2010. This increase was partially offset by a decline in the yield on the total loan portfolio of 12 basis points to 5.71% for the nine months ended September 30, 2011 from 5.83% for the same period in the prior year.

Interest earned on securities decreased $48,000, or 2.4%, for the three months ended September 30, 2011, compared to the same period in the prior year. This was primarily the result of a decrease in yield of 45 basis points to 4.65% on September 30, 2011 from 5.10% same period in the prior year. The decrease in yield was partially offset by an increase in the average balance of investments of $14.5 million or 7.9% to $197.7 million on September 30, 2011 from $183.2 million during the same period of the prior year.

Interest earned on securities increased $183,000, or 9.4%, for the nine months ended September 30, 2011, compared to the same period in the prior year. This increase was primarily the result of an increase in the average balance of the securities portfolio of $24.7 million, or 14.6%, to $194.3 million at September 30, 2011 from $169.5 million for the same period in the prior year. Interest income on investment securities was adversely affected by a decrease in the portfolio yield. The total investment securities portfolio yield of 4.85% for the nine months ended September 30, 2011 decreased by 49 basis points from 5.34% for the same period in the prior year.

Interest expense. Interest expense decreased $618,000, or 22.5%, for the three months ended September 30, 2011, compared to the same period in the prior year. This decline in interest expense can be attributed to decreases in interest incurred on deposits and other borrowings of $555,000 and $47,000, respectively. This reduction in interest cost was mainly due to the 52 basis point decline in the rate paid on interest-bearing liabilities when comparing the two quarters.

Interest expense decreased $1.6 million, or 19.0%, for the nine months ended September 30, 2011, compared to the same period in the prior year. The decline in interest expense can be attributed to decreases in interest incurred on deposits and other borrowings of $1.3 million and $207,000, respectively. This reduction in interest cost was mainly due to the decline of 51 basis points in the rate paid on interest-bearing liabilities when comparing the two quarters.

Interest incurred on deposits, the largest component of the Company s interest-bearing liabilities, decreased $555,000, or 23.2%, for the three months ended September 30, 2011, compared to the same period in the prior year. Interest expense was positively affected by a reduction in the cost of deposits to 1.41% from 1.91% for the quarters ended September 30, 2011 and 2010, respectively. The reduced cost was partially offset by the average balance of interest-bearing deposits which increased by $22.9 million or 4.63%, to $518.4 million for the three months ended September 30, 2011, compared to $495.5 million for the same period in the prior year. The Company diligently monitors the interest rates on its products as well as the rates being offered by its competition and utilizing rate surveys to keep its total interest expense costs down.

Interest incurred on deposits declined $1.4 million or 18.9%, for the nine months ended September 30, 2011, compared to the same period in the prior year. This decrease was attributed to a decline in average rate paid on deposits of 49 basis points for the nine months ended September 30, 2011 to 1.53% from 2.02% for the same period in the prior year. The improvement in interest cost was partially offset by an increase in the average balance of interest-bearing deposits of $35.3 million, or 7.4%, to $514.4 million for the nine months ended September 30, 2011, compared to $479.1 million for the same period in the prior year. This increase is reflected in the quarterly rate volume report presented below depicting the cost decrease associated with interest-bearing liabilities. The Company diligently monitors the interest rates on its products as well as the rates being offered by its competition and utilizing rate surveys to minimize total interest expense.

Interest incurred on borrowings declined by $64,000, for the three months ended September 30, 2011, compared with the same period in the prior year. The change was driven by a reduction of $47,000 in interest paid on FHLB advances when compared to September 30, 2010.

Interest incurred on borrowings declined by $217,000, for the nine months ended September 30, 2011, compared with the same period in the prior year. The change was driven by reduction of $207,000 in interest paid on FHLB advances when compared to September 30, 2010.

Provision for loan losses. The provision for loan losses represents the charge to income necessary to adjust the allowance for loan losses to an amount that represents management s assessment of the estimated probable incurred credit losses inherent in the loan portfolio. Each quarter management performs a review of estimated probable incurred credit losses in the loan portfolio. Based on this review, a provision for loan losses of $920,000 was recorded for the quarter ended September 30, 2011 compared to $1.2 million for the quarter ended September 30, 2010. The year-to-date provision for loan losses increased $130,000 or 5.5% compared to the same period in 2010. The provision for loan losses was lower for the current quarter due to decreases in net charge-offs. Nonperforming loans were $22.8 million, or 5.9% of total loans at September 30, 2011 compared with $21.0 million, or 5.8% at September 30, 2010. Net charge-offs were $373,000 for the quarter ended September 30, 2011 compared with $1.1 million for the quarter ended September 30, 2010. Total loans were $388.6 million at September 30, 2011 compared with $365.2 million at September 30, 2010.

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Non-interest income. Non-interest income decreased $9,000, or 1.3%, and $10,000, or .5%, for the three and nine months ended September 30, 2011, respectively, compared to the same periods of 2010. This decrease was the result of diminished revenue from investment security gains and service charges on deposit accounts.

Non-interest expense. Non-interest expense of $3.9 million for the third quarter of 2011 was 4.4%, or $164,000, higher than the third quarter of 2010.

Non-interest expense of $11.9 million for the nine months ended September 30, 2011 was 7.0%, or $775,000, higher than the same period in 2010. The increase in salaries and employee benefits of $621,000 is primarily attributable to the sustained growth of the Company and a 33.8% increase in employee health insurance premiums from the same period in 2010. FDIC premiums increased by $84,000 over the same period last year due to deposit growth. The loss on the sale of other real estate owned is $498,000 compared to $750,000 in the comparable 2010 period. Included in this total is the Company s non-bank asset resolution subsidiary EMORECO which had $456,000 in other real estate owned-related losses as of September 30, 2011, and $693,000 for the same period in 2010.

Provision for income taxes. The Company recognized $319,000 in income tax expense, which reflected an effective tax rate of 10.2% for the nine months ended September 30, 2011, as compared to a $60,000 benefit for the comparable 2010 period. The increase in the tax provision can be attributed to an increase in income before taxes of $1.4 million or 77.0% when compared to the same period in the prior year.

CRITICAL ACCOUNTING ESTIMATES

The Company s critical accounting estimates involving the more significant judgments and assumptions used in the preparation of the consolidated financial statements as of September 30, 2011, have remained unchanged from December 31, 2010.

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

	For the Three Months Ended September 30,					
	2011			2010		
(Dollars in thousands)	Average Balance	Interest	Average Yield/Cost	Average Balance	Interest	Average Yield/Cost
Interest-earning assets:						
Loans receivable	$ 386,788	$ 5,555	5.70%	$ 364,216	$ 5,325	5.80%
Investment securities (3)	197,654	1,944	4.65%	183,191	1,992	5.10%
Interest-bearing deposits with other banks	25,284	29	0.46%	35,461	51	0.57%
Total interest-earning assets	609,726	7,528	5.14%	582,868	7,368	5.26%
Noninterest-earning assets	36,781			40,421		
Total assets	$ 646,507			$ 623,289		
Interest-bearing liabilities:						
Interest bearing demand deposits	$ 60,197	90	0.59%	$ 43,613	108	0.98%
Money market deposits	75,734	151	0.79%	68,688	236	1.36%
Savings deposits	163,178	298	0.72%	136,499	426	1.24%
Certificates of deposit	219,262	1,298	2.35%	246,659	1,621	2.61%
Borrowings	25,379	297	4.64%	30,776	361	4.65%
Total interest-bearing liabilities	543,750	2,134	1.56%	526,235	2,752	2.08%
Noninterest-bearing liabilities						
Other liabilities	61,066			56,597		
Stockholders equity	41,691			40,457		
Total liabilities and stockholders equity	$ 646,507			$ 623,289		
Net interest income		$ 5,394			$ 4,616	
Interest rate spread (1)			3.58%			3.19%
Net yield on interest-earning assets (2)			3.75%			3.39%

Ratio of average interest-earning assets to average interest-bearing liabilities	112.13%	110.76%

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

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

(3) Tax equivalent adjustments to interest income for tax-exempt securities were $373 and $361 for 2011 and 2010, respectively.

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Analysis of Changes in Net Interest Income. The following tables analyzes the changes in interest income and interest expense, between the three month periods ended September 30, 2011 and 2010, in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Company s interest income and interest expense are attributable to changes in rate (change in rate multiplied by prior period volume), changes in volume (changes in volume multiplied by prior period rate) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances. Changes in interest income on securities reflect the changes in interest income on a fully tax-equivalent basis.

	2011 versus 2010 Increase (decrease) due to		
(Dollars in thousands)	Volume	Rate	Total
Interest-earning assets:			
Loans receivable	$ 330	$ (100)	$ 230
Investment securities	186	(234)	(48)
Interest-bearing deposits with other banks	(15)	(7)	(22)
Total interest-earning assets	501	(341)	160
Interest-bearing liabilities:			
Interest bearing demand deposits	41	(59)	(18)
Money market deposits	24	(109)	(85)
Savings deposits	83	(211)	(128)
Certificates of deposit	(180)	(143)	(323)
Borrowings	(63)	(1)	(64)
Total interest-bearing liabilities	(95)	(523)	(618)
Net interest income	$ 596	$ 182	$ 778

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	For the Nine Months Ended September 30,					
	2011			2010		
(Dollars in thousands)	Average Balance	Interest	Average Yield/Cost	Average Balance	Interest	Average Yield/Cost
Interest-earning assets:						
Loans receivable	$ 380,668	$ 16,255	5.71%	$ 360,751	$ 15,721	5.83%
Investment securities (3)	194,250	5,956	4.85%	169,536	5,773	5.34%
Interest-bearing deposits with other banks	27,122	97	0.48%	31,906	130	0.54%
Total interest-earning assets	602,040	22,308	5.20%	562,193	21,624	5.38%
Noninterest-earning assets	33,524			39,112		
Total assets	$ 635,564			$ 601,305		
Interest-bearing liabilities:						
Interest bearing demand deposits	$ 55,314	265	0.64%	$ 41,202	303	0.98%
Money market deposits	73,963	515	0.93%	64,762	744	1.54%
Savings deposits	157,538	995	0.84%	125,524	1,248	1.33%
Certificates of deposit	227,613	4,103	2.41%	247,637	4,954	2.67%
Borrowings	25,953	901	4.64%	31,750	1,118	4.71%
Total interest-bearing liabilities	540,381	6,779	1.68%	510,875	8,367	2.19%
Noninterest-bearing liabilities						
Other liabilities	55,672			51,801		
Stockholders equity	39,511			38,629		
Total liabilities and stockholders equity	$ 635,564			$ 601,305		
Net interest income		$ 15,529			$ 13,257	
Interest rate spread (1)			3.52%			3.19%
Net interest margin (2)			3.69%			3.39%
Ratio of average interest-earning assets to average interest-bearing liabilities			111.41%			110.05%

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

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

(3) Tax equivalent adjustments to interest income for tax-exempt securities was $1,094 and $1,000 for 2011 and 2010, respectively.

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Analysis of Changes in Net Interest Income. The following tables analyzes the changes in interest income and interest expense, between the nine month periods ended September 30, 2011 and 2010, in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Company s interest income and interest expense are attributable to changes in rate (change in rate multiplied by prior period volume), changes in volume (changes in volume multiplied by prior period rate) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances. Changes in interest income on securities reflects the changes in interest income on a fully tax-equivalent basis.

	2011 versus 2010 Increase (decrease) due to		
(Dollars in thousands)	Volume	Rate	Total
Interest-earning assets:			
Loans receivable	$ 868	$ (334)	$ 534
Investment securities	987	(804)	183
Interest-bearing deposits with other banks	(19)	(14)	(33)
Total interest-earning assets	1,836	(1,152)	684
Interest-bearing liabilities:			
Interest bearing demand deposits	104	(142)	(38)
Money market deposits	106	(335)	(229)
Savings deposits	318	(571)	(253)
Certificates of deposit	(401)	(450)	(851)
Borrowings	(204)	(13)	(217)
Total interest-bearing liabilities	(77)	(1,511)	(1,588)
Net interest income	$ 1,913	$ 359	$ 2,272

LIQUIDITY

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

For the nine months ended September 30, 2011, the adjustments to reconcile net income to net cash from operating activities consisted mainly of depreciation and amortization of premises and equipment, the provision for loan losses, net amortization of securities and net changes in other assets and liabilities. For a more detailed illustration of sources and uses of cash, refer to the Consolidated Statements of Cash Flows.

INFLATION

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

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

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REGULATORY MATTERS

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

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

Compliance with the terms of the MOU is a high priority for the Company. In anticipation of the requirements that would be imposed by the MOU executed February 11, 2010, management devoted significant resources to the preceding matters during the fiscal year ended December 31, 2010, and intends to continue to do so during 2011. Specific actions taken included the evaluation and reorganization of lending and credit administration personnel, retention of collection and workout personnel, and the sale of $4.6 million of nonperforming assets to a sister, nonbank-asset resolution subsidiary established late in the fourth quarter of 2009. In 2009 and 2010, the Company invested $1.75 million in EB in the form of capital infusions to maintain Tier I capital at the level expected by the FDIC and the Ohio Division of Financial Institutions. In April 2011 the Company invested an additional $500,000 in EB in the form of capital infusion in order to maintain Tier I capital at the level expected by the FDIC and the Ohio Division of Financial Institutions.

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

The following table sets forth the capital requirements for EB under the FDIC regulations and EB s capital ratios at September 30, 2011 and December 31, 2010:

	FDIC Regulations			
Capital Ratio	Adequately Capitalized	Well Capitalized	September 30, 2011	December 31, 2010
Tier I Leverage Capital	4.00%	5.00%(1)	8.91%	9.45%
Risk-Based Capital:				
Tier I	4.00	6.00	11.53	13.26
Total	8.00	10.00	12.78	14.55

(1) 9 percent required by the MOU.

REGULATORY CAPITAL REQUIREMENTS

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

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

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The following table sets forth the Company s and its subsidiaries actual capital ratios at September 30, 2011:

	Middlefield Banc Corp. September 30, 2011		The Middlefield Banking Co. September 30, 2011		Emerald Bank September 30, 2011	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(in thousands)			
Total Capital (to Risk-weighted Assets)						
Actual	$ 48,683	12.09%	$ 41,006	11.67%	$ 6,654	12.78%
For Capital Adequacy Purposes	32,205	8.00	28,106	8.00	4,165	8.00
To Be Well Capitalized	40,257	10.00	35,132	10.00	5,207	10.00
Tier I Capital (to Risk-weighted Assets)						
Actual	$ 43,619	10.84%	$ 36,614	10.42%	$ 6,003	11.53%
For Capital Adequacy Purposes	16,103	4.00	14,053	4.00	2,083	4.00
To Be Well Capitalized	24,154	6.00	21,079	5.00	3,124	6.00
Tier I Capital (to Average Assets)						
Actual	$ 43,619	7.02%	$ 36,614	6.61%	$ 6,003	8.91%
For Capital Adequacy Purposes	24,869	4.00	22,152	4.00	2,696	4.00
To Be Well Capitalized	31,086	5.00	27,690	5.00	3,371	5.00

Both MB and the Company are implementing plans to reduce substandard assets and to maintain regulatory capital at elevated levels. The goal of the elevated capital levels is to account for the ongoing economic stress in the markets in which the Company and its subsidiary banks operate and to account for the growth that has already occurred in substandard and other nonperforming assets. MB has also hired additional staff to enhance the ongoing monitoring and management of the credit portfolio generally as well as nonperforming assets in particular. In addition, in January of 2011, the Company s board established a goal to achieve by December 31, 2011, and to maintain indefinitely thereafter Tier I leverage capital of 7.25 percent and total risk-based capital of 12 percent, both at the level of the Company and at MB. The parent company board also affirmed the goal of restraining growth at the level of the subsidiary banks to promote achievement of these elevated capital level targets. The Company s Tier I leverage capital was 6.74 percent as of September 30, 2011, with total risk-based capital of 12.09 percent. MB s Tier I leverage capital was 6.61 percent as of September 30, 2011, with total risk-based capital of 11.67 percent. No assurance can be given at capital enhancement and capital maintenance measures taken already or that are being taken will enable the Company and MB to achieve their 7.25 percent Tier I leverage capital ratio and 12 percent total risk-based capital ratio goals as of year-end 2011, along with EB s minimum 9 percent Tier I leverage capital requirement. Additional measures to achieve the capital goals could potentially be necessary, such as a reduction of dividends, but the Company is optimistic that the Company, MB, and EB will achieve their capital goals based on the capital enhancement and maintenance measures taken already and being taken in 2011.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

ASSET AND LIABILITY MANAGEMENT

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

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

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

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

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

The following table presents the simulated impact of a 200 basis point upward and a 200 basis point downward shift of market interest rates on net interest income and the change in portfolio equity. This analysis was done assuming that the interest-earning asset and interest-bearing liability levels at September 30, 2011 remained constant. The impact of the market rate movements was developed by simulating the effects of rates changing gradually over a one-year period from the September 30, 2011 levels for net interest income. The impact of market rate movements was developed by simulating the effects of an immediate and permanent change in rates at June 30, 2011 for portfolio equity:

	Increase 200 Basis Points	Decrease 200 Basis Points
Net interest income increase (decrease)	3.36%	1.39%
Portfolio equity increase (decrease)	(13.41)%	(17.81)%

Item 4. Controls and Procedures

Controls and Procedures Disclosure

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

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

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

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Changes in Internal Control over Financial Reporting

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

PART II OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 1a. There are no material changes to the risk factors set forth in Part I, Item 1A, Risk Factors, of the Company s Annual Report on Form 10-K for the year ended December 31, 2010. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company s business.

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

None

Item 3. Defaults by the Company on its senior securities

None

Item 4. Reserved

Item 5. Other information

None

Item 6. Exhibits

Exhibit list for Middlefield Banc Corp. s Form 10-Q Quarterly Report for the Period Ended September 30, 2011

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

10.4.0*	Severance Agreement between Middlefield Banc Corp. and Jay P. Giles, dated January 7, 2008	Incorporated by reference to Exhibit 10.4 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008
10.4.1*	Severance Agreement between Middlefield Banc Corp. and Teresa M. Hetrick, dated January 7, 2008	Incorporated by reference to Exhibit 10.4.1 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008
10.4.2*	Severance Agreement between Middlefield Banc Corp. and Jack L. Lester, dated January 7, 2008	Incorporated by reference to Exhibit 10.4.2 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008
10.4.3*	Severance Agreement between Middlefield Banc Corp. and Donald L. Stacy, dated January 7, 2008	Incorporated by reference to Exhibit 10.4.3 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008
10.4.4*	Severance Agreement between Middlefield Banc Corp. and Alfred F. Thompson Jr., dated January 7, 2008	Incorporated by reference to Exhibit 10.4.4 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008

exhibit number	description	location
10.5	Federal Home Loan Bank of Cincinnati Agreement for Advances and Security Agreement dated September 14, 2000	Incorporated by reference to Exhibit 10.4 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001
10.6*	Amended Director Retirement Agreement with Richard T. Coyne	Incorporated by reference to Exhibit 10.6 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008
10.7*	Amended Director Retirement Agreement with Frances H. Frank	Incorporated by reference to Exhibit 10.7 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008
10.8*	Amended Director Retirement Agreement with Thomas C. Halstead	Incorporated by reference to Exhibit 10.8 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008
10.9*	Director Retirement Agreement with George F. Hasman	Incorporated by reference to Exhibit 10.9 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.10*	Director Retirement Agreement with Donald D. Hunter	Incorporated by reference to Exhibit 10.10 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.11*	Director Retirement Agreement with Martin S. Paul	Incorporated by reference to Exhibit 10.11 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.12*	Amended Director Retirement Agreement with Donald E. Villers	Incorporated by reference to Exhibit 10.12 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 9, 2008
10.13*	Executive Survivor Income Agreement (aka DBO agreement [death benefit only]) with Donald L. Stacy	Incorporated by reference to Exhibit 10.14 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.14*	DBO Agreement with Jay P. Giles	Incorporated by reference to Exhibit 10.15 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.15*	DBO Agreement with Alfred F. Thompson Jr.	

		Incorporated by reference to Exhibit 10.16 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.16*	Reserved	
10.17*	DBO Agreement with Theresa M. Hetrick	Incorporated by reference to Exhibit 10.18 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004

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

* management contract or compensatory plan or arrangement

SIGNATURES

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

	MIDDLEFIELD BANC CORP.
Date: November 10, 2011	By: /s/ Thomas G. Caldwell Thomas G. Caldwell President and Chief Executive Officer
Date: November 10, 2011	By: /s/ Donald L. Stacy Donald L. Stacy Principal Financial and Accounting Officer