

MIDDLEFIELD BANC CORP  
Form 10-Q  
May 13, 2014

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20552**

**FORM 10 - Q**

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

**For the quarterly period ended March 31, 2014**

**Commission File Number 000-32561**

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

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

**15985 East High Street, Middlefield, Ohio 44062-9263**

**(Address of principal executive offices)**

**(440) 632-1666**

**(Registrant's telephone number, including area code)**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

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

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

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

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

YES  NO

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

Class: Common Stock, without par value

Outstanding at May 13, 2014: 2,038,143

MIDDLEFIELD BANC CORP.

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## MIDDLEFIELD BANC CORP.

## CONSOLIDATED BALANCE SHEET

(Dollar amounts in thousands, except share data)

(Unaudited)

	March 31,  2014	December 31,  2013
<b>ASSETS</b>		
Cash and due from banks	\$28,663	\$20,926
Federal funds sold	14,147	5,267
Cash and cash equivalents	42,810	26,193
Investment securities available for sale	155,940	157,143
Loans	443,729	435,725
Less Allowance for loan and lease losses	7,015	7,046
Net loans	436,714	428,679
Premises and equipment, net	9,797	9,828
Goodwill	4,559	4,559
Core deposit intangible	146	156
Bank-owned life insurance	8,883	8,816
Accrued interest and other assets	11,173	11,716
<b>TOTAL ASSETS</b>	<b>\$670,022</b>	<b>\$647,090</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing demand	\$88,988	\$85,905
Interest-bearing demand	60,673	53,741
Money market	75,296	77,473
Savings	179,805	177,303
Time	190,004	174,414
Total deposits	594,766	568,836
Short-term borrowings	5,320	10,809
Other borrowings	11,468	11,609
Accrued interest and other liabilities	1,774	2,363
<b>TOTAL LIABILITIES</b>	<b>613,328</b>	<b>593,617</b>
<b>STOCKHOLDERS' EQUITY</b>		
	35,115	34,979

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Common stock, no par value; 10,000,000 shares authorized, 2,226,889 and 2,221,834 shares issued; 2,037,359 and 2,032,304 shares outstanding

Retained earnings	28,699	27,465
Accumulated other comprehensive loss	(386 )	(2,237 )
Treasury stock, at cost; 189,530 shares	(6,734 )	(6,734 )
TOTAL STOCKHOLDERS' EQUITY	56,694	53,473
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$670,022	\$647,090

See accompanying notes to unaudited consolidated financial statements.

## MIDDLEFIELD BANC CORP.

## CONSOLIDATED STATEMENT OF INCOME

(Dollar amounts in thousands, except per share data)

(Unaudited)

	Three Months Ended	
	March 31, 2014	2013
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$5,694	\$5,572
Interest-bearing deposits in other institutions	5	8
Federal funds sold	3	4
Investment securities:		
Taxable interest	509	674
Tax-exempt interest	755	733
Dividends on stock	23	23
Total interest income	6,989	7,014
<b>INTEREST EXPENSE</b>		
Deposits	940	1,297
Short-term borrowings	35	52
Other borrowings	32	46
Trust preferred securities	26	34
Total interest expense	1,033	1,429
<b>NET INTEREST INCOME</b>	<b>5,956</b>	<b>5,585</b>
Provision for loan losses	180	313
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>5,776</b>	<b>5,272</b>
<b>NONINTEREST INCOME</b>		
Service charges on deposit accounts	441	447
Investment securities (losses) gains, net	(6 )	185
Earnings on bank-owned life insurance	67	68
Other income	213	168
Total noninterest income	715	868
<b>NONINTEREST EXPENSE</b>		
Salaries and employee benefits	2,016	1,871
Occupancy expense	321	274

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Equipment expense	220	189
Data processing costs	214	213
Ohio state franchise tax	83	154
Federal deposit insurance expense	132	154
Professional fees	287	276
(Gain) loss on sale of other real estate owned	(5 )	8
Advertising expense	123	112
Other real estate expense	63	106
Directors fees	86	105
Other expense	689	539
Total noninterest expense	4,229	4,001
Income before income taxes	2,262	2,139
Income taxes	499	482
NET INCOME	\$1,763	\$1,657
EARNINGS PER SHARE		
Basic	\$0.87	\$0.83
Diluted	0.86	0.82
DIVIDENDS DECLARED PER SHARE	\$0.26	\$0.26

See accompanying notes to unaudited consolidated financial statements.



## MIDDLEFIELD BANC CORP.

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Dollar amounts in thousands)

(Unaudited)

	Three Months Ended	
	March 31, 2014	2013
Net income	\$1,763	\$1,657
Other comprehensive income (loss):		
Net unrealized holding gain (loss) on available-for-sale securities	2,799	(1,521)
Tax effect	(952 )	517
Reclassification adjustment for investment securities losses (gains) included in net income	6	(185 )
Tax effect	(2 )	63
Total other comprehensive income (loss)	1,851	(1,126)
Comprehensive income	\$3,614	\$531

See accompanying notes to unaudited consolidated financial statements.

## MIDDLEFIELD BANC CORP.

## CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(Dollar amounts in thousands, except share data)

(Unaudited)

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2013	\$ 34,979	\$ 27,465	\$ (2,237 )	\$ (6,734 )	\$ 53,473
Net income		1,763			1,763
Other Comprehensive income			1,851		1,851
Dividend reinvestment and purchase plan (5,055 shares)	136				136
Cash dividends (\$0.26 per share)		(529 )			(529 )
Balance, March 31, 2014	\$ 35,115	\$ 28,699	\$ (386 )	\$ (6,734 )	\$ 56,694

See accompanying notes to unaudited consolidated financial statements.

## MIDDLEFIELD BANC CORP.

## CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollar amounts in thousands)

(Unaudited)

	Three Months Ended	
	March 31, 2014	2013
<b>OPERATING ACTIVITIES</b>		
Net income	\$1,763	\$1,657
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	180	313
Investment securities losses (gains), net	6	(185 )
Depreciation and amortization	202	222
Amortization of premium and discount on investment securities, net	182	183
Accretion of deferred loan fees, net	(76 )	(33 )
Earnings on bank-owned life insurance	(67 )	(68 )
Deferred income taxes	(156 )	58
(Gain) loss on sale of other real estate owned	(5 )	8
Increase in accrued interest receivable	(391 )	(529 )
Decrease in accrued interest payable	(19 )	(24 )
Other, net	(481 )	(128 )
Net cash provided by operating activities	1,138	1,474
<b>INVESTING ACTIVITIES</b>		
Investment securities available for sale:		
Proceeds from repayments and maturities	3,306	6,773
Proceeds from sale of securities	514	7,438
Purchases	-	(12,500)
(Increase) decrease in loans, net	(8,139 )	598
Proceeds from the sale of other real estate owned	47	137
Purchases of premises and equipment	(156 )	(191 )
Net cash (used for) provided by investing activities	(4,428 )	2,255
<b>FINANCING ACTIVITIES</b>		
Net (decrease) increase in deposits	25,930	(1,838 )
Decrease in short-term borrowings, net	(5,489 )	(1,298 )
Repayment of other borrowings	(141 )	(191 )
Common stock issuance	-	213
Stock options exercised	-	(111 )
Proceeds from dividend reinvestment and purchase plan	136	300

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Cash dividends paid	(529 )	(520 )
Net cash provided by (used for) financing activities	19,907	(3,445 )
Increase in cash and cash equivalents	16,617	284
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	26,193	45,346
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$42,810	\$45,630
SUPPLEMENTAL INFORMATION		
Cash paid during the year for:		
Interest on deposits and borrowings	\$1,052	\$1,453
Income taxes	610	555
Noncash investing transactions:		
Transfers from loans to other real estate owned	\$-	\$454

See accompanying notes to 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 bank subsidiary, The Middlefield Banking Company ("MB"), and a nonbank 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, 2013, has been derived from the audited financial statements at that date but does not include all of the necessary informational disclosures and footnotes as required by U. S. generally accepted accounting principles. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included with the Company's Form 10-K for the year ended December 31, 2013 (File No. 000-32561). The results of the Company's operations for any interim period are not necessarily indicative of the results of the Company's operations for any other interim period or for a full fiscal year.

Recent Accounting Pronouncements

In June 2013, the FASB issued ASU 2013-08, *Financial Services – Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*. The amendments in this Update affect the scope, measurement, and disclosure requirements for investment companies under U.S. GAAP. The amendments do all of the following: 1. Change the approach to the investment company assessment in Topic 946, clarify the characteristics of an investment company, and provide comprehensive guidance for assessing whether an entity is an investment Company. 2. Require an investment company to measure noncontrolling ownership interests in other investment companies at fair value rather than using the equity method of accounting. 3. Require the following additional disclosures: (a) the fact that the entity is an investment company and is applying the guidance in Topic 946, (b) information about changes, if any, in an entity's status as an investment company, and (c) information about financial support provided or contractually required to be provided by an investment company to any of its investees. The amendments in this Update are effective for an entity's interim and annual reporting periods in fiscal years that begin after December 15, 2013. This ASU became effective for the Company on January 1, 2014 and did not have a significant impact on the Company's financial statements.

In July 2013, the FASB issued ASU 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*. This Update applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. For nonpublic entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. This ASU became effective for the Company on January 1, 2014 and did not have a significant impact on the Company's financial statements.

In January 2014, FASB issued ASU 2014-01, *Investments – Equity Method and Join Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects*. The amendments in this Update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this Update should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. This ASU is not expected to have a significant impact on the Company's financial.

In January 2014, the FASB issued ASU 2014-04, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The amendments in this Update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this Update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in this Update using either a modified retrospective transition method or a prospective transition method. This ASU is not expected to have a significant impact on the Company's financial statements.

**NOTE 2 - STOCK-BASED COMPENSATION**

The Company had no unvested stock options outstanding or unrecognized stock-based compensation costs outstanding as of March 31, 2014 and 2013.

Stock option activity during the three months ended March 31 is as follows:

	2014	Weighted- average Exercise Price	2013	Weighted- average Exercise Price
Outstanding, January 1	58,581	\$ 28.38	79,693	\$ 27.25
Exercised	-	-	18,561	24.08
Outstanding, March 31	58,581	\$ 28.38	61,132	\$ 28.21
Exercisable, March 31	58,581	\$ 28.38	61,132	\$ 28.21



**NOTE 3 - EARNINGS PER SHARE**

The Company provides dual presentation of basic and diluted earnings per share. Basic earnings per share is calculated by dividing net income by the average shares outstanding. Diluted earnings per share adds the dilutive effects of options, warrants, and convertible securities to average shares outstanding.

The following table sets 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	
	March 31, 2014	2013
Weighted average common shares outstanding	2,223,010	2,189,175
Average treasury stock shares	(189,530 )	(189,530 )
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	2,033,480	1,999,645
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	6,035	10,647
Weighted average common shares and common stock equivalents used to calculate diluted earnings per share	2,039,515	2,010,292

Options to purchase 58,581 shares of common stock, at prices ranging from \$17.55 to \$40.24, were outstanding during the three months ended March 31, 2014. Of those options, 27,375 were considered dilutive based on the market price exceeding the strike price. The remaining options had no dilutive effect on earnings per share.

Options to purchase 61,132 shares of common stock, at prices ranging from \$17.55 to \$40.24, were outstanding during the three months ended March 31, 2013. Of those options, 59,617 were considered dilutive based on the market price exceeding the strike price. The remaining 1,515 options had no dilutive effect on earnings per share.



**NOTE 4 - 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 observability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

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

(Dollar amounts in thousands)	March 31, 2014			Total
	Level I	Level II	Level III	
Assets measured on a recurring basis:				
U.S. government agency securities	\$ -	\$25,905	\$ -	\$25,905
Obligations of states and political subdivisions	-	88,359	-	88,359
Mortgage-backed securities in government-sponsored entities		37,444		37,444
Private-label mortgage-backed securities	-	3,476	-	3,476
Total debt securities	-	155,184	-	155,184
Equity securities in financial institutions	5	751	-	756
Total	\$ 5	\$155,935	\$ -	\$155,940

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	December 31, 2013			
	Level I	Level II	Level III	Total
Assets measured on a recurring basis:				
U.S. government agency securities	\$ -	\$25,763	\$ -	\$25,763
Obligations of states and political subdivisions	-	88,614	-	88,614
Mortgage-backed securities in government- sponsored entities	-	38,323	-	38,323
Private-label mortgage-backed securities	-	3,693	-	3,693
Total debt securities	-	156,393	-	156,393
Equity securities in financial institutions	5	745	-	750
Total	\$ 5	\$157,138	\$ -	\$157,143

The Company obtains fair values from an independent pricing service which represent either quoted market prices for the identical securities (Level I inputs) or fair values determined by pricing models using a market approach that considers observable market data, such as interest rate volatilities, LIBOR yield curve, credit spreads and prices from market makers and live trading systems (Level II).

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 March 31, 2014 or December 31, 2013.

The Company uses prices compiled by third party vendors due to 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 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.

The Company values other real estate owned at the estimated fair value of the underlying collateral less expected selling costs. Such values are estimated primarily using appraisals and reflect a market value approach. Due to the significance of the Level III inputs, other real estate owned has been classified as Level III.

(Dollar amounts in thousands)	March 31, 2014			Total
	Level I	Level II	Level III	
Assets measured on a nonrecurring basis:				
Impaired loans	\$ -	\$-	\$15,510	\$15,510
Other real estate owned	-	-	2,656	2,656

(Dollar amounts in thousands)	December 31, 2013			Total
	Level I	Level II	Level III	
Assets measured on a nonrecurring basis:				
Impaired loans	\$ -	\$-	\$17,158	\$17,158
Other real estate owned	-	-	2,698	2,698

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Company uses Level III inputs to determine fair value:

<i>(Dollar amounts in thousands)</i>	Quantitative Information about Level III Fair Value Measurements		
	Fair Value Estimate		Valuation Unobservable Range (Weighted
	March 31, 2014	December 31, 2013	Techniques Input Average)
Impaired loans	\$15,510	\$17,158	Appraisal of Appraisal collateral (1) adjustments (2) 0% to -55.0% (-27.3%)
Other real estate owned	\$2,656	\$2,698	Appraisal of Appraisal collateral (1) adjustments (2) 0% to -10.0% (-7.5%)

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various level 3 inputs which are not identifiable.

Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated (2) liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

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

	March 31, 2014				Total
	Carrying	Level I	Level II	Level III	Fair
	Value				Value
	(Dollar amounts in thousands)				
<b>Financial assets:</b>					
Cash and cash equivalents	\$42,810	\$42,810	\$-	\$-	\$42,810
Investment securities					
Available for sale	155,940	5	155,935	-	155,940
Net loans	436,714	-	-	447,832	447,832
Bank-owned life insurance	8,883	8,883	-	-	8,883
Federal Home Loan Bank stock	1,887	1,887	-	-	1,887
Accrued interest receivable	2,526	2,526	-	-	2,526
<b>Financial liabilities:</b>					
Deposits	\$594,766	\$404,762	\$-	\$178,074	\$582,836
Short-term borrowings	5,320	5,320	-	-	5,320
Other borrowings	11,468	-	-	11,736	11,736
Accrued interest payable	345	345	-	-	345
	December 31, 2013				Total
	Carrying	Level I	Level II	Level III	Fair
	Value				Value
	(Dollar amounts in thousands)				
<b>Financial assets:</b>					
Cash and cash equivalents	\$26,193	\$26,193	\$-	\$-	\$26,193
Investment securities					
Available for sale	157,143	5	157,138	-	157,143
Net loans	428,679	-	-	430,502	430,502
Bank-owned life insurance	8,816	8,816	-	-	8,816
Federal Home Loan Bank stock	1,887	1,887	-	-	1,887
Accrued interest receivable	2,135	2,135	-	-	2,135
<b>Financial liabilities:</b>					
Deposits	\$568,836	\$394,422	\$-	\$175,854	\$570,276
Short-term borrowings	10,809	10,809	-	-	10,809
Other borrowings	11,609	-	-	11,787	11,787

Accrued interest payable	364	364	-	-	364
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Financial instruments are defined as cash, evidence of ownership interest in an entity, or a contract which creates an obligation or right to receive or deliver cash or another financial instrument from/to a second entity on potentially favorable or unfavorable terms.

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



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

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

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

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

The fair value is equal to the current carrying value.

**Bank-Owned Life Insurance**

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

**Investment Securities Available for Sale**

The fair value of investment securities is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities.

**Net 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 used as estimates for fair value.

**Deposits and Other Borrowings**

The fair values of certificates of deposit and other borrowings 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 period 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 5 – ACCUMULATED OTHER COMPREHENSIVE INCOME**

The following table presents the changes in accumulated other comprehensive income (loss) by component net of tax for the three months ended March 31, 2014 and 2013:

	Unrealized gains on  available for sale  securities (a)  (in thousands)
Balance as of December 31, 2013	\$ (2,237 )
Other comprehensive gain before reclassification	1,847
Amount reclassified from accumulated other comprehensive income (loss)	4
Total	1,851
Balance at March 31, 2014	\$ (386 )
Balance as of December 31, 2012	\$ 5,391
Other comprehensive loss before reclassification	(1,004 )
Amount reclassified from accumulated other comprehensive income (loss)	(122 )
Period change	(1,126 )
Balance at March 31, 2013	4,265

(a) All amounts are net of tax. Amounts in parentheses indicate debits.

The following table presents significant amounts reclassified out of each component of accumulated other comprehensive income (loss):

(Dollar amounts in thousands)	Amount Reclassified from	Affected Line Item in the Statement Where Net Income is
-------------------------------	--------------------------------	--

	Accumulated Other Comprehensive Income (Loss)For the  Three Months Ended  March 31,		
Details about other comprehensive income (a)	2014	2013	Presented
Unrealized gains on available for sale securities			
	\$ (6 )	\$ 185	Investment securities (losses) gains, net
	2	(63 )	Income taxes
	\$ (4 )	\$ 122	Net of tax

(a) Amounts in parentheses indicate debits to net income

**NOTE 6 - INVESTMENT SECURITIES AVAILABLE FOR SALE**

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

(Dollar amounts in thousands)	March 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency securities	\$26,938	\$ 209	\$ (1,242)	) \$25,905
Obligations of states and political subdivisions:				
Taxable	2,958	107	(4)	) 3,061
Tax-exempt	85,147	2,384	(2,233)	) 85,298
Mortgage-backed securities in government-sponsored entities	37,562	621	(739)	) 37,444
Private-label mortgage-backed securities	3,172	304	-	) 3,476
Total debt securities	155,777	3,625	(4,218)	) 155,184
Equity securities in financial institutions	750	6	-	) 756
Total	\$156,527	\$ 3,631	\$ (4,218)	) \$155,940
	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency securities	\$27,289	\$ 135	(1,661)	) \$25,763
Obligations of states and political subdivisions:				
Taxable	3,787	46	(38)	) 3,795
Tax-exempt	86,524	1,562	(3,267)	) 84,819
Mortgage-backed securities in government-sponsored entities	38,816	535	(1,028)	) 38,323
Private-label mortgage-backed securities	3,366	327	-	) 3,693
Total debt securities	159,782	2,605	(5,994)	) 156,393
Equity securities in financial institutions	750	-	-	) 750
Total	\$160,532	\$ 2,605	\$ (5,994)	) \$157,143

The amortized cost and fair value of debt securities at March 31, 2014, 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 Fair	
	Cost	Value
Due in one year or less	\$ 1,052	\$ 1,071
Due after one year through five years	4,318	4,512
Due after five years through ten years	22,888	22,995
Due after ten years	127,519	126,606
Total	\$ 155,777	\$ 155,184

Proceeds from the sales of securities available for sale and the gross realized gains and losses for the three months ended March 31 are as follows:

(Dollar amounts in thousands)	For the Three Months Ended March 31,	
	2014	2013
Proceeds from sales	\$ 514	\$ 7,438
Gross realized gains	-	204
Gross realized losses	(6 )	(19 )

Investment securities with an approximate carrying value of \$65.8 million and \$66.3 million at March 31, 2014 and December 31, 2013, respectively, were pledged to secure deposits and other purposes as required by law.

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

(Dollar amounts in thousands)	March 31, 2014					
	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	\$4,573	\$ (247 )	\$12,738	\$ (995 )	\$17,311	\$ (1,242 )
Obligations of states and political subdivisions	7,753	(561 )	13,146	(1,676 )	20,899	(2,237 )
Mortgage-backed securities in government-sponsored entities	13,023	(399 )	8,738	(340 )	21,761	(739 )
Total	\$25,349	\$ (1,207 )	\$34,622	\$ (3,011 )	\$59,971	\$ (4,218 )

(Dollar amounts in thousands)	December 31, 2013					
	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	\$13,130	\$ (929 )	\$7,166	\$ (732 )	\$20,295	\$ (1,661 )
Obligations of states and political subdivisions						
Taxable	1,301	(38 )	-	-	1,301	(38 )
Tax-exempt	26,743	(2,883 )	2,678	(383 )	29,421	(3,267 )
Mortgage-backed securities in government-sponsored entities	18,082	(757 )	5,248	(271 )	23,330	(1,028 )
Total	\$59,255	\$ (4,608 )	\$15,092	\$ (1,386 )	\$74,347	\$ (5,994 )

There were 75 securities considered temporarily impaired at March 31, 2014.

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”). A debt security is considered impaired if the fair value is less than its amortized cost basis at the reporting date. The Company assesses whether the unrealized loss is other than temporary.

OTTI losses are recognized in earnings when the Company has the intent to sell the debt security or it is more likely than not that it will be required to sell the debt security before recovery of its amortized cost basis. However, even if 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 97% of the total available-for-sale portfolio as of March 31, 2014 and no credit



losses are expected, given the explicit and implicit guarantees provided by the U.S. federal government and the lack of prolonged 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 \$3.2 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 \$304,000 on March 31, 2014. 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 three months ended March 31, 2014 and 2013, there were no available-for-sale debt securities with an unrealized loss that suffered OTTI. Management does not believe any individual unrealized loss as of March 31, 2014 or December 31, 2013 represented an other-than-temporary impairment. The unrealized losses on debt securities are primarily the result of interest rate changes. These conditions will not prohibit the Company from receiving its contractual principal and interest payments on these debt securities. The fair value of these debt securities is expected to recover as payments are received on these securities and they approach maturity. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

#### NOTE 7 - LOANS AND RELATED ALLOWANCE FOR LOAN AND LEASE LOSSES

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

	March 31, 2014	December 31, 2013
Commercial and industrial	\$56,855	\$54,498
Real estate - construction	25,241	25,601
Real estate - mortgage:		
Residential	215,809	210,310
Commercial	140,543	141,171
Consumer installment	5,281	4,145
	443,729	435,725
Less Allowance for loan and lease losses	7,015	7,046
Net loans	\$436,714	\$428,679

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, loans outstanding to individuals and businesses are dependent upon the local economic conditions in the Company's immediate trade area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff generally are reported at their outstanding unpaid principal balances net of the allowance for loan and lease losses. Interest income is recognized as income when earned on the accrual method. The 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 interest is doubtful. Interest received on nonaccrual loans is recorded as income or applied against principal according to management's judgment as to the collectability of such principal.

Loan origination fees and certain direct loan origination costs are being deferred and the net amount amortized as an adjustment of the related loan's yield. Management is amortizing these amounts over the contractual life of the related loans.

The following tables summarize the primary segments of the loan portfolio and allowance for loan and lease losses (in thousands):

March 31, 2014	Commercial and industrial	Real estate- construction	Real Estate- Mortgage		Consumer installment	Total
			Residential	Commercial		
<b>Loans:</b>						
Individually evaluated for impairment	\$ 2,929	\$ 3,695	\$5,097	\$ 5,153	\$ 18	\$16,892
Collectively evaluated for impairment	53,926	21,546	210,712	135,390	5,263	426,837
Total loans	\$ 56,855	\$ 25,241	\$215,809	\$ 140,543	\$ 5,281	\$443,729

December 31, 2013	Commercial and industrial	Real estate- construction	Real estate- Mortgage		Consumer installment	Total
			Residential	Commercial		
<b>Loans:</b>						
Individually evaluated for impairment	\$ 1,891	\$ 4,011	\$5,882	\$ 7,175	\$ 6	\$18,965
Collectively evaluated for impairment	52,607	21,590	204,428	133,996	4,139	416,760
Total loans	\$ 54,498	\$ 25,601	\$210,310	\$ 141,171	\$ 4,145	\$435,725

March 31, 2014	Commercial and industrial	Real estate- construction	Real Estate- Mortgage		Consumer installment	Total
			Residential	Commercial		
<b>Allowance for loan and lease losses:</b>						
Ending allowance balance attributable to loans:						
Individually evaluated for impairment	\$ 221	\$ 153	\$798	\$ 198	\$ 12	\$1,382
Collectively evaluated for impairment	646	335	2,928	1,664	60	5,633
Total ending allowance balance	\$ 867	\$ 488	\$3,726	\$ 1,862	\$ 72	\$7,015

Real Estate-  
Mortgage

December 31, 2013	Commercial and industrial	Real estate- construction	Residential	Commercial	Consumer installment	Total
<b>Allowance for loan and lease losses:</b>						
Ending allowance balance attributable to loans:						
Individually evaluated for impairment	\$ 179	\$ 210	\$855	\$ 563	\$ -	\$1,807
Collectively evaluated for impairment	435	366	2,809	1,607	22	5,239
Total ending allowance balance	\$ 614	\$ 576	\$3,664	\$ 2,170	\$ 22	\$7,046

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 loans made for the purpose of financing the activities of residential homeowners. The commercial mortgage loan segment consists of loans made for the purpose 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 \$200,000 and if the loan either is in nonaccrual status, or is risk rated 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.

The following tables present impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary (in thousands):

March 31, 2014

Impaired Loans

	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:			
Commercial and industrial	\$ 2,402	\$ 2,402	\$ -
Real estate - construction	3,058	3,058	-
Real estate - mortgage:			
Residential	2,670	2,783	-
Commercial	4,073	4,073	-
Consumer installment	11	11	-
Total	\$ 12,214	\$ 12,327	\$ -
With an allowance recorded:			
Commercial and industrial	\$ 527	\$ 527	\$ 221
Real estate - construction	637	637	153
Real estate - mortgage:			
Residential	2,427	2,466	798
Commercial	1,080	1,080	198
Consumer installment	7	7	12
Total	\$ 4,678	\$ 4,717	\$ 1,382
Total:			
Commercial and industrial	\$ 2,929	\$ 2,929	\$ 221
Real estate - construction	3,695	3,695	153
Real estate - mortgage:			
Residential	5,097	5,249	798
Commercial	5,153	5,153	198
Consumer installment	18	18	12

Total	\$ 16,892	\$ 17,044	\$ 1,382
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December 31, 2013

## Impaired Loans

	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:			
Commercial and industrial	\$ 1,357	\$ 1,357	\$ -
Real estate - construction	124	124	-
Real estate - mortgage:			
Residential	2,704	2,892	-
Commercial	5,093	5,093	-
Consumer installment	6	6	-
Total	\$ 9,284	\$ 9,472	\$ -
With an allowance recorded:			
Commercial and industrial	\$ 534	\$ 534	\$ 179
Real estate - construction	3,887	3,887	210
Real estate - mortgage:			
Residential	3,178	3,217	855
Commercial	2,082	2,082	563
Consumer installment	-	-	-
Total	\$ 9,681	\$ 9,720	\$ 1,807
Total:			
Commercial and industrial	\$ 1,891	\$ 1,891	\$ 179
Real estate - construction	4,011	4,011	210
Real estate - mortgage:			
Residential	5,882	6,109	855
Commercial	7,175	7,175	563
Consumer installment	6	6	-
Total	\$ 18,965	\$ 19,192	\$ 1,807

The following tables present interest income by class, recognized on impaired loans (in thousands):

For the Three  
Months Ended

March 31, 2014

Average Interest

Recorded Income



Investments Recognized

Total:

Commercial and industrial	\$2,558	\$	37
Real estate - construction	3,719		41
Real estate - mortgage:			
Residential	5,239		57
Commercial	5,827		75
Consumer installment	15		-

For the Three  
Months Ended

March 31, 2013

Average Interest

Recorded Income

Investment Recognized

Total:

Commercial and industrial	\$2,975	\$ 55
Real estate - construction	3,772	37
Real estate - mortgage:		
Residential	5,642	74
Commercial	6,832	110
Consumer installment	18	-

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 used 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. Assets classified as “doubtful” have all the weaknesses inherent in those classified substandard, with the added characteristic that the weaknesses make collection of principal in full — on the basis of currently existing facts, conditions, and values — highly questionable and improbable. 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.

The primary risk of commercial and industrial loans is the current economic uncertainties. C & I loans are, by nature, secured by less substantial collateral than real estate-secured loans. The primary risk of real estate construction loans is potential delays and /or disputes during the completion process. The primary risk of residential real estate loans is current economic uncertainties along with the slow recovery in the housing market. The primary risk of commercial real estate loans is loss of income of the owner or occupier of the property and the inability of the market to sustain rent levels. Consumer installment loans historically have experienced higher delinquency rates. Consumer installments are typically secured by less substantial collateral than other types of credits.

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):

	Pass	Special Mention	Substandard	Doubtful	Total Loans
March 31, 2014					
Commercial and industrial	\$54,370	\$ 757	\$ 1,685	\$ 43	\$56,855
Real estate - construction	24,606	-	635	-	25,241
Real estate - mortgage:					
Residential	204,091	926	10,792	-	215,809
Commercial	134,433	2,060	4,050	-	140,543
Consumer installment	5,274	-	7	-	5,281
Total	\$422,774	\$ 3,743	\$ 17,169	\$ 43	\$443,729

	Pass	Special Mention	Substandard	Doubtful	Total Loans
December 31, 2013					
Commercial and industrial	\$52,078	\$ 772	\$ 1,605	\$ 43	\$54,498
Real estate - construction	24,052	907	642	-	25,601
Real estate - mortgage:					
Residential	198,479	774	11,057	-	210,310
Commercial	132,931	2,232	6,008	-	141,171
Consumer installment	4,129	-	16	-	4,145
Total	\$411,669	\$ 4,685	\$ 19,328	\$ 43	\$435,725

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.

Nonperforming assets includes nonaccrual loans, troubled debt restructurings (TDRs), loans 90 days or more past due, EMORECO assets, other real estate owned, and repossessed assets. A loan is classified as nonaccrual 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 applied against principal according to management's shadow accounting system.

The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans (in thousands):

	Current	Still Accruing			Total Past Due	Non- Accrual	Total Loans
		30-59 Days	60-89 Days	90 Days+			
March 31, 2014							
Commercial and industrial	\$55,801	\$196	\$141	\$117	\$454	\$600	\$56,855
Real estate - construction	24,562	17	663	-	679	-	25,241
Real estate - mortgage:							
Residential	205,292	2,020	210	1,125	3,355	7,162	215,809
Commercial	139,143	474	-	-	474	926	140,543
Consumer installment	5,245	30	-	-	30	6	5,281
Total	\$430,043	\$2,736	\$1,013	\$1,243	\$4,992	\$8,694	\$443,729

	Current	Still Accruing			Total	Non-	Total
		30-59 Days	60-89 Days	90 Days+			
		Past Due	Past Due	Past Due	Past Due	Accrual	Loans
December 31, 2013							
Commercial and industrial	\$53,366	\$521	\$359	\$ 38	\$918	\$ 214	\$54,498
Real estate - construction	24,945	17	639	-	656	-	25,601
Real estate - mortgage:	-						
Residential	200,041	2,079	481	143	2,703	7,566	210,310
Commercial	139,730	598	100	-	698	743	141,171
Consumer installment	4,083	38	16	-	54	8	4,145
Total	\$422,165	\$3,253	\$1,595	\$ 181	\$5,029	\$8,531	\$435,725

An allowance for loan and lease 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 nonperforming 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. Management also performs impairment analyses on TDRs, which may result in specific reserves.

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 using the last four consecutive historical 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 nonaccrual 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.

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 tables summarize the primary segments of the loan portfolio (in thousands):

	Commercial and industrial	Real estate- construction	Real estate- residential mortgage	Real estate- commercial mortgage	Consumer installment	Total
ALLL balance at December 31, 2013	\$ 614	\$ 576	\$ 3,664	\$ 2,170	\$ 22	\$7,046
Charge-offs	(12 )	-	(315 )	-	(23 )	(350 )
Recoveries	1	-	136	-	2	139
Provision	264	(88 )	241	(308 )	71	180
ALLL balance at March 31, 2014	\$ 867	\$ 488	\$ 3,726	\$ 1,862	\$ 72	\$7,015

	Commercial and industrial	Real estate- construction	Real estate- residential mortgage	Real estate- commercial mortgage	Consumer installment	Total
ALLL balance at December 31, 2012	\$ 1,732	\$ 1,123	\$ 2,872	\$ 1,991	\$ 61	\$7,779
Charge-offs	(325 )	(61 )	(67 )	-	(17 )	(470 )
Recoveries	1	33	24	46	6	110
Provision	(178 )	(47 )	377	164	(3 )	313
ALLL balance at March 31, 2013	\$ 1,230	\$ 1,048	\$ 3,206	\$ 2,201	\$ 47	\$7,732

The negative provision in the real estate commercial mortgage segment is related to the payoff of a loan with \$352,000 specifically reserved. A provision in any loan portfolio is not necessarily related to current charge-offs, but is a result of the evaluation of the loans in that category.

The following tables summarize troubled debt restructurings and subsequent defaults (in thousands):

	For the three months ended March 31, 2014				March 31, 2013			
	Number of Contracts		Pre-Modification Outstanding Recorded Investment	Term	Number of Contracts		Pre-Modification Outstanding Recorded Investment	Term
Troubled Debt Restructurings	Other Modification	Total			Other Modification	Total		
Commercial and industrial	-	-	\$ -	-	-	4	\$ 735	4
Real estate- mortgage:								
Residential	1	-	49	2	1	3	383	3
Commercial	-	-	-	1	-	1	644	1
Consumer	-	1	7	1	-	1	644	1

There were no changes to the recorded investment post modification. No TDRs, modified in the past twelve months, subsequently defaulted in the three months ended March 31, 2014.



For the three  
months ended

March 31,  
2013

Troubled Debt Restructurings	Number of	Recorded
subsequently defaulted		Investment Contracts
Commercial and industrial	6	\$ 248
Real estate- mortgage:		
Residential	1	68
Commercial	1	5

## 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 March 31, 2014 quarter at \$670.0 million, an increase of \$22.9 million or 3.5% from December 31, 2013. For the same time period, cash and cash equivalents increased \$16.6 million, or 63.4% while loans increased \$8.0 million, or 1.9%. Total liabilities increased \$19.7 million, or 3.3% while stockholders' equity grew \$3.2 million, or 6.0%.

**Cash on hand and due from banks.** Cash and due from banks and Federal funds sold represent cash and cash equivalents. Cash and cash equivalents increased \$16.6 million at March 31, 2014 from \$26.2 million at December 31, 2013. Deposits from customers into savings and checking accounts, loan and securities repayments and proceeds from borrowed funds typically increase these accounts. Decreases result from customer withdrawals, new loan originations, purchases of investment securities and repayments of borrowed funds.

**Investment securities.** Investment securities available for sale on March 31, 2014 totaled \$155.9 million, a decrease of \$1.2 million or 0.8% from \$157.1 million at December 31, 2013. During this period the Company recorded repayments, calls, and maturities of \$3.3 million. Sales of securities were \$0.5 million with a gross realized loss of \$6,000. No purchases were made during this period.

**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, construction and consumer loans. Net loans receivable increased \$8.0 million or 1.9% to \$436.7 million as of March 31, 2014 from \$428.7 million at December 31, 2013. Included in this amount were increases in the residential real estate, commercial and industrial, and consumer installment portfolios of \$5.5 million, or 2.6%, \$2.4 million, or 4.3%, and \$1.1 million, or 27.4%, respectively. These amounts were partially offset by decreases in the commercial real estate and construction segments of \$0.6 million, or 0.4%, and \$0.4, or 1.4%, respectively.

**Allowance for loan and lease losses and Asset Quality.** The Company maintained the allowance for loan and lease losses at \$7.0 million, or 1.6% of total loans, at March 31, 2014. Net loan charge-offs totaled \$211,000, or 0.2% of average loans, compared to \$360,000, or 0.4%, for the first quarter of 2013. To maintain the adequacy of the allowance for loan and lease losses, the Company recorded a provision for loan losses of \$180,000, versus \$313,000 for the first quarter of 2013.

Management analyzes the adequacy of the allowance for loan and lease 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 and lease losses is a significant 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 and lease losses. Future additions to the allowance for loan and lease losses will be dependent on these factors. Additionally, the Company uses 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 and lease losses allocated to these types of loans. Management believes the allowance for loan and lease losses is appropriately stated at March 31, 2014. Based on the variables involved and management's judgments about uncertain outcomes, the determination of the allowance for loan and lease losses is considered a critical accounting policy.

**Nonperforming assets.** Nonperforming assets includes nonaccrual loans, troubled debt restructurings (TDRs), loans 90 days or more past due, EMORECO assets, other real estate, and repossessed assets. Real estate owned is written down to fair value at its initial recording and continually monitored for changes in fair value. A loan is classified as nonaccrual 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 applied against principal until doubt about collectability ceases. 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 29 TDRs with a total balance of \$3.6 million as of March 31, 2014. Nonperforming loans amounted to \$10.7 million, or 2.4% of total loans, and \$12.3 million, or 2.8% of total loans, at March 31, 2014 and December 31, 2013, respectively. A TDR that yields market interest rate at the time of restructuring and is in compliance with its modified terms is no longer reported as TDR in calendar years after the year in which the restructuring took place. To be in compliance with its modified terms, a loan that is a TDR must not be in nonaccrual status and must be current or less than 30 days past due on its contractual principal and interest payments under the modified repayment terms. Nonperforming loans secured by real estate totaled \$9.4 million as of March 31, 2014, down \$2.0 million from \$11.4 million at December 31, 2013.

## Asset Quality History

(Dollar amounts in thousands)	3/31/2014	12/31/2013	9/30/2013	6/30/2013	3/31/2013
Nonperforming loans	\$10,741	\$ 12,290	\$ 13,607	\$ 12,869	\$ 13,899
Real estate owned	2,656	2,698	2,719	2,361	2,155
Nonperforming assets	13,397	14,988	16,326	15,230	16,054
Allowance for loan and lease losses	7,015	7,046	7,821	7,749	7,732
<b>Ratios</b>					
Nonperforming loans to total loans	2.42 %	2.82 %	3.25 %	3.12 %	3.41 %
Nonperforming assets to total assets	2.00 %	2.32 %	2.48 %	2.32 %	2.41 %
Allowance for loan and lease losses to total loans	1.58 %	1.62 %	1.87 %	1.88 %	1.90 %
Allowance for loan and lease losses to nonperforming loans	65.31 %	57.33 %	57.48 %	60.21 %	55.63 %

A major factor in determining the appropriateness of the allowance for loan and lease losses is the type of collateral which secures the loans. Of the total nonperforming loans at March 31, 2014, 87.1% were secured by real estate. Although this does not insure against all losses, the real estate typically provides for at least partial 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 minimize the future loss exposure to the Company.

**Deposits.** The Company considers various sources when evaluating funding needs, including but not limited to deposits, which are a significant source of funds totaling \$597.8 million or 97.3% of the Company's total funding sources at March 31, 2014. Total deposits increased \$25.9 million or 4.6% at March 31, 2014 from \$568.8 million at December 31, 2013. The increase in deposits is primarily related to the increase in time deposits, interest-bearing demand deposits, noninterest-bearing demand and savings deposits accounts of \$15.6 million or 8.9%, \$6.9 million or 12.9%, \$3.1 million or 3.6%, and \$2.5 million or 1.4%, respectively, at March 31, 2014. These increases were partially offset by a decrease in money market accounts of \$2.2 million, or 2.8%, respectively, during the three months ended March 31, 2014.

**Borrowed funds.** The Company uses short and long-term borrowings as another source of funding used for asset growth and liquidity needs. These borrowings primarily include FHLB advances, junior subordinated debt, short-term borrowings from other banks, federal funds purchased, and repurchase agreements. Short-term borrowings decreased \$5.5 million, or 50.8%, to \$5.3 million as of March 31, 2014. Other borrowings, representing advances from the Federal Home Loan Bank of Cincinnati, declined \$141,000, or 1.2%, for the three months ended March 31, 2014 as a result of scheduled principal payments.

**Stockholders' equity.** Stockholders' equity increased \$3.2 million, or 6.0%, to \$56.7 million at March 31, 2014 from \$53.5 million at December 31, 2013. This growth was the result of increases in accumulated other comprehensive income ("AOCI") and retained earnings of \$1.9 million, or 82.7%, \$1.2 million, or 4.5%, respectively. The change to AOCI is due to available-for-sale securities fair value adjustments.

## RESULTS OF OPERATIONS

**General.** Net income for the three months ended March 31, 2014, was \$1.8 million, a \$106,000, or 6.4% increase from the amount earned during the same period in 2013. Diluted earnings per share for the quarter was \$0.86 compared to \$0.83 for the same period in 2013.

The Company's annualized return on average assets (ROA) and return on average equity (ROE) for the quarter were 1.08% and 13.10%, respectively, compared with 1.01% and 12.18% for the same period in 2013.

The Company's year-to-date earnings were positively impacted by decreases in interest expense and provision for loan losses. This was partially offset by an increase in noninterest expense coupled with decreases in both noninterest income and interest income.

**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 for the three months ended March 31, 2014 totaled \$6.0 million, an increase of 6.6% from that reported in the comparable period of 2013. The net interest margin was 4.20% for the first quarter of 2014, up from the 3.92% reported for the same quarter of 2013. The increase is attributable to lower interest-bearing liability costs, which decreased 28 basis points to 0.81%.

**Interest income.** Interest income decreased \$25,000, or 0.4%, for the three months ended March 31, 2014, compared to the same period in the prior year. This is attributable to decreases in interest earned on taxable investment securities, partially offset by interest and fees on loans.

Interest earned on loans receivable increased \$122,000, or 2.2%, for the three months ended March 31, 2014, compared to the same period in the prior year. This increase is attributable to an increase in the average balance of \$37.1 million, or 9.1% from March 31, 2013, partially offset by a 35 basis point decline in the average yield.

Interest earned on securities decreased \$143,000, or 10.2%, for the three months ended March 31, 2014, compared to the same period in the prior year. The average balance decreased \$33.7 million, or 17.7% while the 4.28% yield on the investment portfolio was an increase of 48 basis points, from 3.80%, for the same period in the prior year.

**Interest expense.** Interest expense decreased \$396,000, or 27.7%, for the three months ended March 31, 2014, compared to the same period in the prior year. The decline was mostly attributed to a 28 basis point decline in total interest-bearing liabilities when compared to the same period in the prior year. It was further impacted by a decrease in the average balance of interest-bearing liabilities of \$15.8 million, or 2.9%, compared to the same period in the prior year.

Interest incurred on deposits, the largest component of the Company's interest-bearing liabilities, declined \$357,000, or 27.5%, for the three months ended March 31, 2014, compared to the same period in the prior year. This decrease was attributed to a decline in the average rate paid on deposits to 0.78% from 1.02% for the same period in the prior year. This improvement was exacerbated by a decrease in the average balance of interest-bearing deposits of \$23.4 million, or 4.6%, to \$490.1 million when compared to \$513.4 million for the same period in the prior year.

Interest incurred on borrowings decreased \$39,000, or 29.6%, for the three months ended March 31, 2014, compared to the same period in the prior year.

**Provision for loan losses.** The provision for loan losses represents the charge to income necessary to adjust the allowance for loan and lease 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 \$180,000 was recorded for the quarter ended March 31, 2014 compared to \$313,000 for the quarter ended March 31, 2013. The year-to-date provision for loan losses was lower due to decreases in nonperforming loans. Nonperforming loans were \$10.7 million, or 2.42% of total loans at March 31, 2014 compared with \$13.9 million, or 3.41% at March 31, 2013. Net charge-offs were \$211,000 for the quarter ended March 31, 2014 compared with \$360,000 for the quarter ended March 31, 2013.

**Noninterest income.** Noninterest income decreased \$153,000 for the three months ended March 31, 2014 over the comparable 2013 period. This decrease was largely the result of a decline in net investment security gains of \$191,000, or 103.2%, partially offset by an increase in other income of \$45,000, or 26.8%. This change in other income was the result of increases in miscellaneous fees and charges of \$26,000, or 187.0%, and revenue from investment services of \$12,000, or 12.5%.

**Noninterest expense.** Noninterest expense of \$4.2 million for the first quarter of 2013 was 5.7% or \$228,000 more than the first quarter of 2013. Other expense and salaries and benefits increased \$150,000, or 27.8%, and \$145,000, or 7.7% respectively. These were partially offset by decreases in Ohio state franchise tax and other real estate expense of \$71,000, or 46.1%, and \$43,000, or 40.6%.

**Provision for income taxes.** The Company recognized \$499,000 in income tax expense, which reflected an effective tax rate of 22.1% for the three months ended March 31, 2014, as compared to \$482,000 with an effective tax rate of 22.5% for the comparable 2013 period. The increase in the tax provision can be attributed to an increase in income before taxes of \$123,000 or 5.8% when compared to the same quarter in the prior year. The increase in income before taxes is attributable to an increase in net interest income after provision for loan losses of \$504,000, or 9.6%, partially offset by an increase in total noninterest expense of \$228,000, or 5.7%, and a decrease in total noninterest income of \$153,000, or 17.6%.

## 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 March 31, 2014, have remained unchanged from December 31, 2013.



**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 nonaccrual loans and exclude the allowance for loan and lease 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.

(Dollar amounts in thousands)	For the Three Months Ended March 31,							
	2014			2013				
	Average Balance	Interest	Average Yield/Cost	Average Balance	Interest	Average Yield/Cost		
Interest-earning assets:								
Loans receivable	\$444,331	\$5,694	5.20	% \$407,236	\$5,572	5.55	%	
Investment securities (3)	156,775	1,264	4.28	% 190,457	1,407	3.80	%	
Interest-bearing deposits with other banks	11,727	31	1.07	% 18,642	35	0.76	%	
Total interest-earning assets	612,833	6,989	4.88	% 616,335	7,014	4.86	%	
Noninterest-earning assets	46,664			47,713				
Total assets	\$659,497			\$664,048				
Interest-bearing liabilities:								
Interest-bearing demand deposits	\$54,215	42	0.31	% \$63,647	58	0.37	%	
Money market deposits	75,927	76	0.41	% 78,659	81	0.42	%	
Savings deposits	177,044	138	0.32	% 177,649	158	0.36	%	
Certificates of deposit	182,879	684	1.52	% 193,476	1,000	2.10	%	
Borrowings	26,634	93	1.42	% 18,839	132	2.84	%	
Total interest-bearing liabilities	516,699	1,033	0.81	% 532,270	1,429	1.09	%	
Noninterest-bearing liabilities								
Other liabilities	88,222			76,600		0.23	%	
Stockholders' equity	54,576			55,178				
Total liabilities and stockholders' equity	\$659,497			\$664,048				
Net interest income		\$5,956			\$5,585			
Interest rate spread (1)			4.07	%		3.78	%	
Net interest margin (2)			4.20	%		3.92	%	
Ratio of average interest-earning assets to average interest-bearing liabilities			118.61	%		115.79	%	

(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 \$389 and \$378 for 2014 and 2013, respectively.

**Analysis of Changes in Net Interest Income.** The following table analyzes the changes in interest income and interest expense, between the three month periods ended March 31, 2014 and 2013, 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.

## 2014 versus 2013

(Dollar amounts in thousands)	Increase (decrease) due to		
	Volume	Rate	Total
Interest-earning assets:			
Loans receivable	\$508	\$(386)	\$122
Investment securities	(316)	173	(143)
Interest-bearing deposits with other banks	(13 )	9	(4 )
Total interest-earning assets	179	(204)	(25 )
Interest-bearing liabilities:			
Interest-bearing demand deposits	(9 )	(7 )	(16 )
Money market deposits	(3 )	(2 )	(5 )
Savings deposits	(1 )	(19 )	(20 )
Certificates of deposit	(55 )	(261)	(316)
Borrowings	55	(94 )	(39 )
Total interest-bearing liabilities	(13 )	(383)	(396)
Net interest income	\$192	\$179	\$371

## **LIQUIDITY**

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

For the three months ended March 31, 2014, 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 Condensed Consolidated statements of Cash Flows.

## **INFLATION**

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

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

## **REGULATORY MATTERS**

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

The Federal Reserve Board and the FDIC have extensive authority to prevent and to remedy unsafe and unsound practices and violations of applicable laws and regulations by institutions and holding companies. The agencies may assess civil money penalties, issue cease-and-desist or removal orders, seek injunctions, and publicly disclose those actions. In addition, the Ohio Division of Financial Institutions possesses enforcement powers to address violations of Ohio banking law by Ohio-chartered banks.

## **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.

The following tables illustrate the Company's and Bank's capital ratios:

	Middlefield Banc Corp.		The Middlefield Banking Co.	
	March 31, 2014		March 31, 2014	
	Amount	Ratio	Amount	Ratio
	(Dollar amounts in thousands)			
<b>Total Capital</b>				
<b><u>(to Risk-weighted Assets)</u></b>				
Actual	\$66,016	14.68 %	\$64,433	14.37 %
For Capital Adequacy Purposes	35,986	8.00	35,863	8.00
To Be Well Capitalized	44,982	10.00	44,829	10.00
<b>Tier I Capital</b>				
<b><u>(to Risk-weighted Assets)</u></b>				
Actual	\$60,376	13.42 %	\$58,830	13.12 %
For Capital Adequacy Purposes	17,993	4.00	17,931	4.00
To Be Well Capitalized	26,989	6.00	26,897	5.00
<b>Tier I Capital</b>				
<b><u>(to Average Assets)</u></b>				
Actual	\$60,376	9.29 %	\$58,830	9.06 %
For Capital Adequacy Purposes	25,985	4.00	25,985	4.00
To Be Well Capitalized	32,481	5.00	32,481	5.00