CORVEL CORP
Form 10-K
June 08, 2012
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO SECTIONS 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

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

For the fiscal year ended March 31, 2012

OR

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

For the transition period from to

Commission File Number 0-19291

CorVel Corporation

(Exact name of registrant as specified in its charter)

Delaware	**33-0282651**
(State or other jurisdiction of	*(I.R.S. Employer*
incorporation or organization)	*Identification Number)*
2010 Main Street, Suite 600, Irvine, California	**92614**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code:

(949) 851-1473

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:	**Name of each exchange on which registered:**
Common Stock	The NASDAQ Global Select Market, LLC

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes ¨ No þ

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes ¨ No þ

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 ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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 definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer þ Non-accelerated filer ¨ Smaller 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 þ

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the Registrant s most recently completed second fiscal quarter:

As of September 30, 2011, the aggregate market value of the Registrant s voting and non-voting common equity held by non-affiliates of the Registrant was approximately $267,958,000 based on the closing price per share of $42.50 for the Registrant s common stock as reported on the Nasdaq Global Select Market on such date multiplied by 6,312,329 shares (total outstanding shares of 11,465,181 less 5,152,852 shares held by affiliates) of the Registrant s common stock which were outstanding on such date. For the purposes of the foregoing calculation only, all of the Registrant s directors, executive officers and persons known to the Registrant to hold ten percent or greater of the Registrant s outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

Indicate the number of shares outstanding of each of the Registrant s classes of common stock, as of the latest practicable date: As of June 3, 2012, there were 11,257,348 shares of the Registrant s common stock, par value $0.0001 per share, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Information required by Items 10 through 14 of Part III of this Form 10-K, to the extent not set forth herein, is incorporated herein by reference to portions of the Registrant s definitive proxy statement for the Registrant s 2012 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after the end of the fiscal year ended March 31, 2012. Except with respect to the information specifically incorporated by reference in this Form 10-K, the Registrant s definitive proxy statement is not deemed to be filed as a part of this Form 10-K.

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CORVEL CORPORATION

2012 FORM 10-K ANNUAL REPORT

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In this report, the terms CorVel , Company , we , us , and our refer to CorVel Corporation and its subsidiaries.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the Exchange Act), including, but not limited to, the statements about our plans, strategies and prospects under the headings Business and Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report. Words such as anticipates , expects , intends , plans , predicts , believes , seeks , estimates , may , will , should , would , could strive , ongoing and variations of these words or similar expressions are intended to identify forward-looking statements. These forward-looking statements are based on management s current expectations, estimates and projections about our industry, management s beliefs, and certain assumptions made by management, and we can give no assurance that we will achieve our plans, intentions or expectations. Certain important factors could cause actual results to differ materially from the forward-looking statements we make in this report. Representative examples of these factors include (without limitation):

- General industry and economic conditions;
- Cost of capital and capital requirements;
- Competition from other managed care companies;
- The Company s ability to renew and/or maintain contracts with its customers on favorable terms or at all;
- The ability to expand certain areas of the Company s business;
- Possible litigation and legal liability in the course of operations, and the Company s ability to settle or otherwise resolve such litigation;
- The ability of the Company to produce market-competitive software;
- Increases in operating expenses, including employee wages and benefits;
- Changes in regulations affecting the workers compensation, insurance and healthcare industries in general;
- The ability to attract and retain key personnel;
- Shifts in customer demands; and
- The availability of financing in the amounts, at the times, and on the terms necessary to support the Company s future business.

The section entitled Risk Factors set forth in this report discusses these and other important risk factors that may affect our business, results of operations and financial condition. The factors listed above and the factors described under the heading Risk Factors and similar discussions in our other filings with the Securities and Exchange Commission are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors also could have material adverse effects on our future results. Investors should consider these factors before deciding to make or maintain an investment in our securities. The forward-looking statements included in this annual report on Form 10-K are based on information available to us as of the date of this annual report. We expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances.

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PART I

Item 1. *Business.*

INTRODUCTION

CorVel is a national provider of risk management solutions to employers, third party administrators, insurance companies and government agencies. CorVel specializes in applying advanced communication and information technology to improve healthcare management for workers compensation, group health, auto and liability claims management. The Company s associates nationwide work side by side with customers to deliver innovative, tailored solutions to manage risk and keep customers ahead of their costs.

The Company s services include claims management, bill review, preferred provider networks, utilization management, claims management, case management, pharmacy services, directed care and Medicare services. CorVel offers its services as a bundled solution (i.e. claims management), as a standalone service, or as add-on services to existing customers. Customers of the Company that do not purchase a bundled solution generally use another provider, use an in-house solution, or choose not to utilize such a service to manage their workers compensation costs. When customers purchase several products from CorVel, the pricing of the products sold is generally the same as if the product were sold on an individual basis. Bundled products are generally delivered in the same accounting period.

The Company was incorporated in Delaware in 1987, and its principal executive offices are located at 2010 Main Street, Suite 600, Irvine, California, 92614. The Company s telephone number is 949-851-1473.

INDUSTRY OVERVIEW

Workers compensation is a federally mandated, state-legislated, insurance program that requires employers to fund medical expenses, lost wages and other costs resulting from work-related injuries and illnesses. Workers compensation benefits and arrangements vary extensively on a state-by-state basis and are often highly complex. State statutes and court decisions control many aspects of the compensation process, including claims handling, impairment or disability evaluation, dispute settlement, benefit amount guidelines and cost-control strategies.

In addition to the compensation process, cost containment and claims management continue to be significant employer concerns and many look to managed care vendors and third party administrators for cost savings solutions. The Company believes that cost drivers in workers compensation include: implementing effective return to work and transitional duty programs, coordinating medical care, medical cost management, recognizing fraud and abuse, and improving communications with injured workers. CorVel provides solutions using a holistic approach to cost containment and by looking at a complete savings solutions. Often one of the biggest cost drivers is not recognizing a complex claim at the onset of an injury often resulting in claims being open longer and resulting in delayed return to work. CorVel uses an integrated claims model that controls claims costs by advocating medical management at the onset of the injury to decrease administrative costs and to shorten the length of the disability.

Some states have adopted legislation for managed care organizations (MCO) in an effort to allow employers to control their worker s compensation costs. A managed care plan is organized to serve the medical needs of injured workers in an efficient and cost-effective manner by managing the delivery of medical services through appropriate health care professionals. CorVel is registered wherever legislation mandates, where it is beneficial for the Company to obtain a license, or where the MCO is an effective utilized mandate. Since MCO legislation varies by state, CorVel s state offerings vary as well. CorVel continually evaluates new legislation to ensure it is in compliance and can offer services to its customers and prospects.

FISCAL 2012 DEVELOPMENTS

Company Stock Repurchase Program

During fiscal 2012, the Company continued to repurchase shares of its common stock under a plan originally approved by the Company s Board of Directors in 1996. In February 2012, the Company s Board of Directors increased the number of shares authorized to be repurchased over the life of the plan by 1,000,000 shares to 16,000,000 shares. During fiscal 2012, the Company spent $21.6 million to repurchase 461,938 shares

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of its common stock. Since commencing this program in the fall of 1996, the Company has repurchased 14,953,101 shares of its common stock through March 31, 2012, at a cost of $271 million. These repurchases were funded primarily from the Company s operating cash flows.

BUSINESS SERVICES

The Company offers services in two general categories, network solutions and patient management, to assist its customers in managing the increasing medical costs of workers compensation, group health and auto insurance, and monitoring the quality of care provided to claimants. CorVel reduces claims costs by advocating medical management at the onset of an injury to decrease administrative costs and to shorten the length of the disability. These solutions offer personalized treatment programs that use precise treatment protocols to advocate timely, quality care for injured workers.

Network Solutions

CorVel offers a complete medical savings solution for all in-network and out-of-network medical bills including PPO management, medical bill repricing, true line item review, professional nurse review and automated adjudication. Each feature focuses on maximizing savings opportunities and increasing efficiencies.

Bill Review

Many states have adopted fee schedules, which regulate the maximum allowable fees payable under workers compensation, for procedures performed by a variety of health treatment providers. Developed in 1989, CorVel s proprietary bill review and claims management technology automates the review process to provide customers with a faster turnaround time, more efficient bill review and a higher total savings. CorVel s artificial intelligence engine includes over ten million individual rules, which creates a comprehensive review process and greater efficiencies than traditional bill review services.

Payors are able to review and approve bills online as well as access savings reports through an online portal, CareMC. The process is paperless, through scanning and electronic data interface (EDI), while proving to be cost effective and efficient. CorVel s solutions are fully customizable and can be tailored to meet unique payor requirements.

Bill Review Services include:

- Coding review and rebundling
- Reasonable and customary review
- Fee schedule analysis
- Out-of-network bill review
- Pharmacy review
- PPO management
- Repricing

PPO Management

PPOs are groups of hospitals, physicians and other healthcare providers that offer services at pre-negotiated rates to employee groups. The Company believes that PPO networks offer the employer an additional means of managing healthcare costs by reducing the per-unit price of medical services provided to employees. CorVel began offering a proprietary national PPO network in 1992 and today it is comprised of over 750,000 board certified providers. The Company provides the convenience of a PPO Provider look-up mobile application for use with iPhone, iPad and Android. The application is available to the public and makes it convenient to locate a provider in the CorVel network. Users can search providers based on current location and by specialty.

CorVel has a long-term strategy of network development, providing comprehensive networks to our customers and customization of networks to meet the specific needs of our customers. The Company believes

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that the combination of its national PPO director s strength and presence and the local PPO developers commitment and community involvement enables CorVel to build, support and strengthen its PPO in size, quality, depth of discount, and commitment to service.

The Company has a team of national, regional and local personnel supporting the CorVel network. This team includes a national PPO manager in addition to locally based PPO developers who are responsible for local recruitment, contract negotiations, credentialing and re-credentialing of providers, and working with customers to develop customer specific provider networks. Each bill review unit has provider relations support staff to address provider grievances and other billing issues.

Providers are selected from criteria based on quality, range of services, price and location. Each provider is thoroughly evaluated and credentialed, then re-credentialed every three years. Through this extensive evaluation process, we believe the PPO networks are able to provide significant hospital, physician and ancillary medical savings, while striving to maintain high quality care. Provider network services include a national network for all medical coverages, board certified physicians, provider credentialing, patient channeling, online PPO look-up, printable directories and driving directions, and Managed Care Organizations (MCO).

Enhanced Bill Review

CorVel s enhanced bill review program allows claim payors to adjust individual line item charges on all bills to reasonable and customary levels while removing all error and billing discrepancies with professional review. The enhanced bill review program scrutinizes each hospital line description and charge as a separate and distinct claim for reimbursement. CorVel s proprietary Universal Chargemaster defines each code and description, enabling its registered nurses to identify errors, duplicate charges, re-bundle exploded charges, correct quantity discrepancies and remove unused supplies.

Professional Review

CorVel s services offer a complete audit and validation of facility bill accuracy. This solution also includes review of in-network facility bills. The Company s nurse auditors have clinical backgrounds in all areas of medicine, medical billing and coding to ensure an accurate, consistent and thorough review. If a bill is identified for professional review, the bill image and its associated medical reports are routed within the system to an experienced medical nurse for review and auditing.

Provider Reimbursement

Through the bill review system, CorVel has the capability to provide check writing or provider reimbursement services for its customers. The provider payment check can be added to the bill analysis to produce one combined document.

Pharmacy Services

CorVel provides patients with a full-feature pharmacy program that offers discounted prescriptions, drug interaction monitoring and eligibility confirmation. Our pharmacy network of nationally recognized pharmacies provides savings off the retail price of prescriptions associated with a workers compensation claim. The Company s pharmacy services program includes preferred access to a national pharmacy network, streamlined processing for pharmacies at point of sale, mail order, 90-day retail, out of network, medication review services and clinical modeling.

Directed Care Services

CorVel has contracted with medical imaging, physical therapy and ancillary service networks to offer convenient access, timely appointments and preferred rates for these services. The Company manages the entire coordination of care from appointment scheduling through reimbursement, working to achieve timely recovery and increased savings. The Company has directed care networks for diagnostic imaging, physical and occupational therapy, independent medical evaluations, durable medical equipment and transportation and translation.

Medicare Solutions

The Company offers solutions to help manage the requirements mandated by the Centers for Medicare and Medicaid Services (CMS). Services include Medicare Set Asides and a new service, Agent Reporting Services, to help employers comply with new CMS reporting legislation. As an assigned agent, CorVel can provide services for Responsible Reporting Entities (RRE) such as insurers and employers. As an experienced information-processing provider, CorVel is able to electronically submit files to the CMS in compliance with timelines and reporting requirements.

Clearinghouse Services

CorVel s proprietary medical review software and claims management technology interfaces with multiple clearinghouses. The Company s clearinghouse services provides for medical review, conversion of electronic forms to appropriate payment formats, seamless submittal of bills for payments and rules engines used to help ensure jurisdictional compliance.

Patient Management

CorVel offers a unique approach to claims administration and patient management. This integrated service model controls claims by advocating medical management at the onset of the injury to decrease administrative costs and to shorten the length of the disability. The Company offers these services on a stand-alone basis or as an integrated component of its medical cost containment services.

Claims Management

CorVel has been a third party administrator (TPA) offering claims management services since January 2007. The Company serves customers in the self-insured or commercially insured markets. Incidents and injuries are reported through a variety of intake methods that include mobile applications, toll-free call centers and traditional methods of paper and fax reporting. They are immediately processed by CorVel s proprietary rules engine, which provides alerts and recommendations throughout the life of a claim. This technology instantly assigns an expert claims professional, while simultaneously determining if a claim requires any immediate attention for triage.

Through this service, the Company serves clients in the self-insured or commercially insured market through alternative loss funding methods, and provides them with a complete range of services, including claims administration, case management, and medical bill review. In addition to the field investigation and evaluation of claims, the Company also may provide initial loss reporting services for claims, loss mitigation services such as medical bill review and vocational rehabilitation, administration of trust funds established to pay claims and risk management information services.

Some of the features of claims management services include: automated first notice of loss, three-point contact within 24 hours, prompt claims investigations, detailed diary notes for each step of the claim, graphical dashboards and claim history scorecards, and litigation management and expert testimony.

Case Management

CorVel s case management and utilization review services address all aspects of disability management and recovery including utilization review (pre-certification, concurrent review and discharge planning), early intervention, telephonic, field and catastrophic case management as well as vocational rehabilitation.

The medical management components of CorVel s program focus on medical intervention, management and appropriateness. In these cases, the Company s case managers confer with the attending physician, other providers, the patient and the patient s family to identify the appropriate rehabilitative treatment and most cost-effective healthcare alternatives. The program is designed to offer the injured party prompt access to appropriate medical providers who will provide quality cost-effective medical care. Case managers may coordinate the services or care required and may arrange for special pricing of the required services.

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The Telephonic Case Manager (TCM) continues to impact the direction of the case, focusing on early return to work, maximum medical improvement (MMI) and appropriate duration of disability. Facilitation of appropriate treatment, assertive negotiation with medical providers and directing the care of the injured worker continues to be the Case Manager s role until the closure criteria is met. Utilization review of provider treatment remains ongoing until discharge from treatment.

In the event that a claim may require an onsite referral, a Field Case Manager (FCM) will be assigned to the claim. Cases can be referred to CorVel based on geographic location and injury type to the most appropriate FCM. Specialized case management services include catastrophic management, life care planning, and vocational rehabilitation services. All FCMs have iPads that provides access to the Company s proprietary mobile app that provides instant access to detailed case information and to enter case notes.

24/7 Nurse Triage

Injured workers can call at the time of injury or incident and speak with a nurse who specializes in occupational injuries. An assessment is immediately made to recommend self-care, or referral for further medical care if needed. CorVel is able to provide quick and accurate care intervention, often preventing a minor injury from becoming an expensive claim. The 24/7 nurse triage services provides channeling to a preferred network of providers, allows employer access to online case information, comprehensive incident gathering, and healthcare advocacy for injured workers.

Utilization Management

Utilization Management programs review proposed ambulatory care to determine appropriateness, frequency, duration and setting. These programs utilize experienced registered nurses, proprietary medical treatment protocols and systems technology to avoid unnecessary treatments and associated costs. Processes in Utilization Management include: injury review, diagnosis and treatment planning; contacting and negotiating provider treatment requirements; certifying appropriateness of treatment parameters, and responding to provider requests for additional treatment. Utilization management services include: prospective review, retrospective review, concurrent review, second opinion, peer review and independent medical evaluation.

Vocational Rehabilitation

CorVel s Vocational Rehabilitation program is designed for injured workers needing assistance returning to work or retaining employment. This comprehensive suite of services helps employees who are unable to perform previous work functions and who faces the possibility joining the open labor market to seek re-employment. These services are available unbundled, on an integrated basis as dictated by the requirement of each case and client preference, or by individual statutory requirements. Vocational rehabilitation services include ergonomic assessments, rehabilitation plans, transferable skills analysis, labor market services, resume -development, job analysis and development, job placement, and expert testimony.

Life Care Planning

Life Care Planning is used to project long-term future needs, services and related costs associated with catastrophic injury. CorVel s Life Care Plans summarize extensive amounts of medical data and compile it into a comprehensive report for future care requirements, aiding improved outcomes and timely resolution of claims. Some of the features of the Company s Life Care Planning services include: comprehensive documentation, projecting future care requirements, customized reporting, and costs specific to local areas.

Disability Management

CorVel s disability management programs offer a continuum of services for short and long-term disability coverages that advocate an employee s early return to work. Disability management services include absence reporting, disability evaluations, national preferred provider organizations, independent medical examinations, utilization review, medical case management, return to work coordination and integrated reporting.

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Liability Claims Management

CorVel also offers liability claims management services that can be sold as a stand-alone service or part of patient management. The Company s services include auto liability, general liability, product liability, personal injury, professional liability and property damage, accidents and weather-related damage. This service includes claims management, adjusting services, litigation management, claims subrogation, and investigations.

Auto Claims Management

Injury claims are one of the largest components of auto indemnity costs. Effective management of these claims and their associated costs, combined with an optimal healthcare management program, helps CorVel s customers reduce claim costs. The Company s auto claims services include national preferred provider organization, medical bill review, first and third party bill review, first notice of loss, demand packet reviews and reporting and analytics.

SYSTEMS AND TECHNOLOGY

Infrastructure and Data Center

The Company utilizes a Tier III-rated data center as its primary processing site. Redundancy is provided at many levels in power, cooling, and computing resources, with the goal of ensuring maximum uptime and system availability for the Company s production systems. The Company has also begun to implement use of server virtualization and consolidation techniques to push the fault-tolerance of systems even further. These technologies bring increased speed-to-production and scalability.

Adoption of Imaging Technologies and Paperless Workflow

Utilizing scanning and automated data capture processes allows the Company to process incoming paper and electronic claims documents, including medical bills, with less manual handling and which has improved the Company s workflow processes. This has benefitted both the Company, in terms of cost-savings, and the Company s customers, in improved savings results. Through the Company s internet portal, www.caremc.com, customers can review the bills as soon as they are processed and approve a bill for payment, streamlining the customer s own workflows and expediting the payment process.

Redundancy Center

The Company s national data center is located near Portland, Oregon. The Company also has a redundancy center located in Ft.Worth, Texas. The redundancy center is the Company s backup processing site in the event that the Portland data center suffers catastrophic loss. Currently, the Company s data is continually replicated to Ft. Worth in near-real time, so that in the event the Portland data center is offline, the redundancy center can be activated with current information quickly. The Ft. Worth data center also hosts duplicates of the Company s Websites. The Ft.Worth systems are maintained and exercised on a continuous basis as they host demonstration and pilot environments that mirror production, with the goal of ensuring their ongoing readiness.

Care^{MC}

Care^{MC} (www.caremc.com) has become the application platform for all of the Company s primary service lines and delivers immediate access to customers. Care^{MC} offers customers direct access to the Company s primary services. Care^{MC} allows for electronic communication and reporting between providers, payers, employers and patients. Features of the website include: report an incident/injury, request for service, appointment scheduling, online bill review, claims information management, treatment calendar, medical bill adjudication and automated provider reimbursement.

Through the Care^{MC} Website, users can:

- request services online;

manage files throughout the life of the claim;

receive and relay case notes from case managers; and

integrate information from multiple claims management sources into one database.

The Care^{MC} website facilitates healthcare transaction processing. Using artificial intelligence techniques, the website provides situation alerts and event triggers, to facilitate prompt and effective decisions. Users of Care^{MC} can quickly see where event outliers are occurring within the claims management process. If costs exceed pre-determined thresholds or activities fall outside expected timelines, decision-makers can be quickly notified. Large amounts of information are consolidated and summarized to help customers focus on the critical issues.

Scanning Services

We continue to leverage our scanning technologies which include scanning, optical character recognition and document management services. We continue to expand our existing office automation service line and all offices are selling scanning and document management. We have added scanning operations to most of the Company s larger offices around the country, designating them Capture Centers. Our scanning service also offers a web interface (www.onlinedocumentcenter.com) providing immediate access to documents and data called the Online Document Center (ODC). Secure document review, approval, transaction workflow and archival storage are available at subscription-based pricing.

Claims Processing

We continue to develop our claims system capabilities which fit well with the Company s preference for owning and maintaining our own software assets. Integration projects, some already completed, are underway to present more of this claims-centric information available through the CareMC web portal. The Company s goal is to continue to modernize user interfaces, and to streamline the delivery of this information to our customers, giving more rapid feedback and putting real-time information in the hands of our customers.

INDUSTRY, CUSTOMERS AND MARKETING

CorVel serves a diverse group of customers that include insurers, third party administrators, self-administered employers, government agencies, municipalities, state funds, and numerous other industries. CorVel is able to provide workers compensation services to virtually any size employer and in any state or region of the United States. No single customer of the Company represented more than 10% of revenues in fiscal 2010, 2011, or 2012. Many claims management decisions in workers compensation are the responsibility of the local claims office of national or regional insurers. The Company s national branch office network enables the Company to market and offer its services at both a local and national account level. The Company is placing increasing emphasis on national account marketing. The sales and marketing activities of the Company are conducted primarily by account executives located in key geographic areas.

COMPETITION AND MARKET CONDITIONS

The healthcare cost containment industry is competitive and is subject to economic pressures for cost savings and legislative reforms. CorVel s primary competitors in the workers compensation market include third party administrators, managed care companies, large insurance carriers and numerous independent companies. Many of the Company s competitors are significantly larger and have greater financial and marketing resources than the Company. Moreover, the Company s customers may establish the in-house capability of performing services offered by the Company. If the Company is unable to compete effectively, it will be difficult for the Company to add and retain customers, and the Company s business, financial condition and results of operations will be materially and adversely affected.

The past few years have seen acceleration in the technology world, and advancements seem to be progressing at a pace that few, if any, have ever witnessed. The proliferation of smart phones and tablet computers allows the Company s clients to stay connected at any time, from anywhere. This capability provides immediate access and begins to present business opportunities that were previously predicated on a less connected environment. The Company continues to leverage the new wave of technology in order to connect all of the parties involved in the workers compensation process in ways that were unimaginable in the past. Despite the technology boom, medical costs still continue to increase in excess of the consumer price index and claims frequency is up for the first time in thirteen years (Source: National Council on Compensation Insurance), the Company will continue to focus the execution of its strategy to provide industry leading claims management and cost containment solutions to the market.

GOVERNMENT REGULATIONS

General

Managed healthcare programs for workers compensation are subject to various laws and regulations. Both the nature and degree of applicable government regulation vary greatly depending upon the specific activities involved. Generally, parties that actually provide or arrange for the provision of healthcare services, assume financial risk related to the provision of those services or undertake direct responsibility for making payment or payment decisions for those services. These parties are subject to a number of complex regulatory requirements that govern many aspects of their conduct and operations.

In contrast, the management and information services provided by the Company to its customers typically have not been the subject of regulation by the federal government or the states. Since the managed healthcare field is a rapidly expanding and changing industry and the cost of providing healthcare continues to increase, it is possible that the applicable state and federal regulatory frameworks will expand to have a greater impact upon the conduct and operation of the Company s business.

Under the current workers compensation system, employer insurance or self-funded coverage is governed by individual laws in each of the 50 states and by certain federal laws. The management and information services that make up the Company s managed care program serve markets that have developed largely in response to needs of insurers, employers and large TPAs, and generally have not been mandated by legislation or other government action. On the other hand, the vocational rehabilitation case management marketplace within the workers compensation system has been dependent upon the laws and regulations within those states that require the availability of specified rehabilitation services for injured workers. Similarly, the Company s fee schedule auditing services address market needs created by certain states enactment of maximum permissible fee schedules for workers compensation services. Changes in individual state regulation of workers compensation may create a greater or lesser demand for some or all of the Company s services or require the Company to develop new or modified services in order to meet the needs of the marketplace and compete effectively in that marketplace.

Medical Cost Containment Legislation

Historically, governmental strategies to contain medical costs in the workers compensation field have been generally limited to legislation on a state-by-state basis. For example, many states have implemented fee schedules that list maximum reimbursement levels for healthcare procedures. In certain states that have not authorized the use of a fee schedule, the Company adjusts bills to the usual and customary levels authorized by the payor. Opportunities for the Company s services could increase if more states legislate additional cost containment strategies. Conversely, the Company would be materially and adversely affected if states elect to reduce the extent of medical cost containment strategies available to insurance carriers and other payors, or adopt other strategies for cost containment that would not support a demand for the Company s services.

Healthcare Reform

There has been considerable discussion of healthcare reform at both the federal level and in numerous state legislatures in recent years. Due to uncertainties regarding the ultimate features of reform initiatives and the timing of their enactment, the Company cannot predict which, if any, reforms will be adopted, when they may be adopted, or what impact they may have on the Company. The Company is still evaluating the impact of the health reform legislation which was enacted by Congress in March 2010 on the future results and costs of the Company. The Company does not anticipate that this legislation will have a material impact on the Company s revenue. The legislation could increase the Company s future healthcare benefit costs.

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SHAREHOLDER RIGHTS PLAN

During fiscal 1997, the Company s Board of Directors approved the adoption of a Shareholder Rights Plan. The Shareholder Rights Plan provides for a dividend distribution to CorVel stockholders of one preferred stock purchase right for each outstanding share of CorVel s common stock under certain circumstances. In April 2002, the Board of Directors of CorVel approved an amendment to the Shareholder Rights Plan to extend the expiration date of the rights to February 10, 2012, set the exercise price of each right at $118, and enable Fidelity Management & Research Company and its affiliates to purchase up to 18% of the shares of common stock of the Company without triggering the stockholder rights, with the limitations under the Shareholder Rights Plan remaining in effect for all other stockholders of the Company. In November 2008, the Company s Board of Directors approved an amendment to the Shareholder Rights Plan to extend the expiration date of the rights to February 10, 2022, remove the ability of Fidelity Management & Research Company and its affiliates to purchase up to 18% of the shares of common stock of the Company without triggering the stockholder rights, substitute Computershare Trust Company, N.A. as the rights agent and effect certain technical changes to the Shareholder Rights Plan.

The rights are designed to assure that all shareholders receive fair and equal treatment in the event of any proposed takeover of the Company and to encourage a potential acquirer to negotiate with the Board of Directors prior to attempting a takeover. The rights have an exercise price of $118 per right, subject to subsequent adjustment. The rights trade with the Company s common stock and will not be exercisable until the occurrence of certain takeover-related events.

Generally, the Shareholder Rights Plan provides that if a person or group acquires 15% or more of the Company s common stock without the approval of the Board, subject to certain exception, the holders of the rights, other than the acquiring person or group, would, under certain circumstances, have the right to purchase additional shares of the Company s common stock having a market value equal to two times the then-current exercise price of the right.

In addition, if the Company is thereafter merged into another entity, or if 50% or more of the Company s consolidated assets or earning power are sold, then the right will entitle its holder to buy common shares of the acquiring entity having a market value equal to two times the then-current exercise price of the right. The Company s Board of Directors may exchange or redeem the rights under certain conditions.

EMPLOYEES

As of March 31, 2012, CorVel had 3,145 employees, including nurses, therapists, counselors and other employees. No employees are represented by any collective bargaining unit. Management believes the Company s relationship with its employees to be good.

AVAILABLE INFORMATION

Copies of our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, and other filings made with the Securities and Exchange Commission, are available free of charge through our Web site (http://www.corvel.com, under the Investor Relations section) as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the Securities and Exchange Commission. The inclusion of our Web site address and the address of any of our portals, such as www.caremc.com and www.onlinedocumentcenter.com, in this report does not include or incorporate by reference into this report any information contained on, or accessible through, such Web sites.

Item 1A. ***Risk Factors.***

Past financial performance is not necessarily a reliable indicator of future performance, and investors in our common stock should not use historical performance to anticipate results or future period trends. Investing in our common stock involves a high degree of risk. Investors should consider carefully the following risk factors, as

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well as the other information in this report and our other filings with the Securities and Exchange Commission, including our consolidated financial statements and the related notes, before deciding whether to invest or maintain an investment in shares of our common stock. If any of the following risks actually occurs, our business, financial condition and results of operations would suffer. In this case, the trading price of our common stock would likely decline. The risks described below are not the only ones we face. Additional risks that we currently do not know about or that we currently believe to be immaterial also may impair our business operations.

Legal

Exposure to possible litigation and legal liability may adversely affect our business, financial condition and results of operations.

We, through our utilization management services, make recommendations concerning the appropriateness of providers medical treatment plans of patients throughout the country, and as a result, could be exposed to claims for adverse medical consequences. We do not grant or deny claims for payment of benefits and we do not believe that we engage in the practice of medicine or the delivery of medical services. There can be no assurance, however, that we will not be subject to claims or litigation related to the authorization or denial of claims for payment of benefits or allegations that we engage in the practice of medicine or the delivery of medical services.

In addition, there can be no assurance that we will not be subject to other litigation that may adversely affect our business, financial condition or results of operations, including but not limited to being joined in litigation brought against our customers in the managed care industry. We maintain professional liability insurance and such other coverages as we believe are reasonable in light of our experience to date. If such insurance is insufficient or unavailable in the future at reasonable cost to protect us from liability, our business, financial condition or results of operations could be adversely affected.

On March 25, 2011, George Raymond Williams, MD. (Williams), as plaintiff, individually and on behalf of those similarly situated, filed a First Amended and Restated Petition for Damages and Class Certification in the 27th Judicial District Court, Parish of St. Landry, Louisiana, against CorVel Corporation (CorVel) and its insurance carriers, Homeland Insurance Company of New York and Executive Risk Specialty Insurance Company and several other unrelated parties. Williams alleges that CorVel violated Louisiana s Any Willing Provider Act (the AWPA), which requires a payor accessing a preferred provider contract to give 30 days advance written notice or point of service notice in the form of a benefit card before the payor accesses the discounted rates in the contract to pay the provider for services rendered to an insured under that payor s health benefit plan.

On March 31, 2011, CorVel entered into a Memorandum of Understanding with attorneys representing the plaintiffs and the class setting forth the terms of settlement of this class action lawsuit. The Memorandum of Understanding provides that subject to the execution of a mutually acceptable settlement agreement and final non-appealable approval of such settlement by the Louisiana state court, CorVel will pay $9 million to resolve claims for which CorVel recorded a $9 million pre-tax charge to earnings during the March 2011 quarter. In addition, CorVel will assign to the class certain rights it has to the proceeds of CorVel s insurance policies relating to the claims asserted by the class. The class action arbitration filed with the American Arbitration Association against CorVel in December 2006 by Southwest Louisiana Hospital Association dba Lake Charles Memorial Hospital as previously disclosed by CorVel is encompassed within the settlement terms of the Memorandum of Understanding. Pursuant to the Memorandum of Understanding, the parties have also agreed to request that the appropriate courts stay all related proceedings in State and Federal Court, as well as the Louisiana Office of Workers Compensation and the arbitration proceeding before the American Arbitration Association in which the parties are named, until the settlement agreement is prepared, executed and receives final court approval. The settlement does not constitute an admission of liability.

On June 23, 2011 CorVel and class counsel executed a definitive settlement agreement. The settlement agreement contains the same terms and conditions as were set forth in the Memorandum of Understanding. Accordingly, CorVel made a $9 million cash payment into escrow on July 6, 2011. As set forth in the settlement agreement, certain contingencies such as preliminary court approval, resolutions of objections filed by class members challenging the fairness of the settlement, class members excluded from the settlement not exceeding a materiality threshold, and final court approval, must be satisfied before the settlement can become final.

On June 23, 2011, the 27th Judicial District Court for the Parish of St. Landry, Louisiana granted preliminary approval of settlement and set a deadline of October 16, 2011 for parties to opt out of or object to the proposed settlement. Notice of the settlement was given to Class Members. The Court gave final approval of the settlement on November 4, 2011. No appeal has been filed since that time, so the judgment became final on January 17, 2012. CorVel has begun to move for dismissal of all claims covered by the settlement in state and federal court.

In exchange for the settlement payment by CorVel, class members will release CorVel and all of its affiliates and clients for any claims relating in any way to re-pricing, payment for, or reimbursement of a workers compensation bill, including but not limited to claims under the AWPA. Plaintiffs have also agreed to a notice procedure that CorVel may follow in the future to comply with the AWPA.

In February 2005, Kathleen Roche, D.C., as plaintiff, filed a putative class action in Circuit Court for the 20th Judicial District, St. Clair County, Illinois, against the Company. The case sought unspecified damages based on the Company s alleged failure to direct patients to medical providers who were members of the CorVel CorCare PPO network and also alleged that the Company used biased and arbitrary computer software to review medical providers bills. The Company denies that its conduct was improper in any way and denied all liability. On October 29, 2010, the Company entered into a settlement agreement providing for the payment of $2.1 million to class members and up to an additional $700,000 for attorneys fees and expenses, and as a result the Company accrued $2.8 million of estimated liability for this settlement agreement during the quarter ended September 30, 2010. In exchange for the settlement payment by the Company, class members consisting of Illinois medical providers (excluding hospitals) have released the Company and all of its affiliates for claims relating to any PPO or usual and customary reductions recommended by the Company on class members medical bills. On January 21, 2011, the Circuit Court gave final approval to the settlement and awarded class counsel $700,000 in attorneys fees and expenses. A modified final judgment approving the settlement and addressing certain class notice issues was approved on January 20, 2012; the modified judgment did not change the financial terms of the settlement or the release. Initial payments were sent to class members on July 18, 2011 and the remaining payments to class members should be completed by July 2012.

There can be no assurance that we will not be subjected to additional litigation similar to the proceedings described above. Any such additional litigation could have a material adverse effect on our business, financial condition and results of operations.

The increased costs of professional and general liability insurance may have an adverse effect on our profitability.

The cost of commercial professional and general liability insurance coverage has risen significantly in the past several years, and this trend may continue. In addition, if we were to suffer a material loss, our costs may increase over and above the general increases in the industry. If the costs associated with insuring our business continue to increase, it may adversely affect our business. We believe our current level of insurance coverage is adequate for a company of our size engaged in our business.

If lawsuits against us are successful, we may incur significant liabilities.

We provide to insurers and other payors of healthcare costs managed care programs that utilize preferred provider organizations and computerized bill review programs. Health care providers have brought, against us and our customers, individual and class action lawsuits challenging such programs. If such lawsuits are successful, we may incur significant liabilities.

We make recommendations about the appropriateness of providers proposed medical treatment plans for patients throughout the country. As a result, we could be subject to claims arising from any adverse medical consequences. Although plaintiffs have not to date subjected us to any claims or litigation relating to the granting or denial of claims for payment of benefits or allegations that we engage in the practice of medicine or the delivery of medical services, we cannot assure you that plaintiffs will not make such claims in future litigation.

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We also cannot assure you that our insurance will provide sufficient coverage or that insurance companies will make insurance available at a reasonable cost to protect us from significant future liability.

Regulatory

Changes in government regulations could increase our costs of operations and/or reduce the demand for our services.

Many states, including a number of those in which we transact business, have licensing and other regulatory requirements applicable to our business. Approximately half of the states have enacted laws that require licensing of businesses which provide medical review services such as ours. Some of these laws apply to medical review of care covered by workers compensation. These laws typically establish minimum standards for qualifications of personnel, confidentiality, internal quality control and dispute resolution procedures. These regulatory programs may result in increased costs of operation for us, which may have an adverse impact upon our ability to compete with other available alternatives for healthcare cost control. In addition, new laws regulating the operation of managed care provider networks have been adopted by a number of states. These laws may apply to managed care provider networks having contracts with us or to provider networks which we may organize. To the extent we are governed by these regulations, we may be subject to additional licensing requirements, financial and operational oversight and procedural standards for beneficiaries and providers.

Regulation in the healthcare and workers compensation fields is constantly evolving. We are unable to predict what additional government initiatives, if any, affecting our business may be promulgated in the future. Our business may be adversely affected by failure to comply with existing laws and regulations, failure to obtain necessary licenses and government approvals or failure to adapt to new or modified regulatory requirements. Proposals for healthcare legislative reforms are regularly considered at the federal and state levels. To the extent that such proposals affect workers compensation, such proposals may adversely affect our business, financial condition and results of operations.

In addition, changes in workers compensation, auto and managed health care laws or regulations may reduce demand for our services, require us to develop new or modified services to meet the demands of the marketplace or reduce the fees that we may charge for our services. One proposal which had been considered in the past, but not enacted by Congress or certain state legislatures, is 24-hour health coverage, in which the coverage of traditional employer-sponsored health plans is combined with workers compensation coverage to provide a single insurance plan for work-related and non-work-related health problems.

Business Environment

Growth Oriented

If we fail to grow our business internally or through strategic acquisitions we may be unable to execute our business plan, maintain high levels of service or adequately address competitive challenges.

Our strategy is to continue internal growth and, as strategic opportunities arise in the workers compensation managed care industry, to consider acquisitions of, or relationships with, other companies in related lines of business. As a result, we are subject to certain growth-related risks, including the risk that we will be unable to retain personnel or acquire other resources necessary to service such growth adequately. Expenses arising from our efforts to increase our market penetration may have a negative impact on operating results. In addition, there can be no assurance that any suitable opportunities for strategic acquisitions or relationships will arise or, if they do arise, that the transactions contemplated could be completed. If such a transaction does occur, there can be no assurance that we will be able to integrate effectively any acquired business. In addition, any such transaction would be subject to various risks associated with the acquisition of businesses, including, but not limited to, the following:

- an acquisition may negatively impact our results of operations because it may require incurring large one-time charges, substantial debt or liabilities; it may require the amortization or write down of amounts related to deferred compensation, goodwill and other intangible assets; or it may cause adverse tax consequences, substantial depreciation or deferred compensation charges;

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we may encounter difficulties in assimilating and integrating the business, technologies, products, services, personnel or operations of companies that are acquired, particularly if key personnel of the acquired company decide not to work for us;

an acquisition may disrupt ongoing business, divert resources, increase expenses and distract management;

the acquired businesses, products, services or technologies may not generate sufficient revenue to offset acquisition costs;

we may have to issue equity or debt securities to complete an acquisition, which would dilute the position of stockholders and could adversely affect the market price of our common stock; and

	acqui-LEFT: 0pt; TEXT-INDENT: 0pt; LINE-HEIGHT: 1.25; MARGIN-RIGHT: 0pt" align="right">62,912	221,664	185,482	
Legal and professional fees	30,000	49,087	102,712	122,335
Data processing and other outside services	165,953	133,391	517,788	416,051
Advertising and marketing related expenses	102,340	55,687	254,975	140,661
Other expenses	126,748	93,184	424,887	252,855
Total non-interest expenses	1,599,549	1,097,128	4,449,528	3,147,152
Income before income taxes	750,645	244,372	1,618,257	478,755
Income tax expense	-	-	-	-
NET INCOME	$ 750,645	$ 244,372	$1,618,257	$ 478,755
Per Share Data:				
Cash Dividends Paid	$ -	$ -	$ -	$ -
Net Income (basic)	$ .39	$ .13	$ .84	$ .26
Net Income (diluted)	$ .37	$ .13	$ .81	$ .25
Weighted Average shares outstanding (basic)	1,924,436	1,872,058	1,921,954	1,865,849
Effect of Dilution - Stock options and Warrants	80,192	60,799	75,231	60,416
Weighted Average shares outstanding (diluted)	2,004,628	1,932,857	1,997,185	1,926,265

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
For the nine-months ended September 30, 2005 and 2004
(Unaudited)

	Common Stock	Additional Paid in Capital	Accumulated Deficit	Total Stockholders' Equity
Balances at December 31, 2004	$ 19,177	$ 17,400,284	$ (4,000,697)	$ 13,418,764
Issuance of Common Stock	67	50,917	-	50,984
Net Income	-	-	1,618,257	1,618,257
Balances at September 30, 2005	$ 19,244	$ 17,451,201	$ (2,382,440)	$ 15,088,005

	Common Stock	Additional Paid in Capital	Accumulated Deficit	Total Stockholders' Equity
Balances at December 31, 2003	$ 18,627	$ 16,850,834	$ (4,802,961)	$ 12,066,500
Issuance of Common Stock	413	412,087	-	412,500
Net Income	-	-	478,755	478,755
Balances at September 30, 2004	$ 19,040	$ 17,262,921	$ (4,324,206)	$ 12,957,755

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
For the nine-months ended September 30, 2005 and 2004
(Unaudited)

	2005	2004
Cash Flows From Operating Activities		
Net income	$ 1,618,257	$ 478,755
Adjustments to reconcile net income to net cash used by operating activities:		
Depreciation	137,119	146,386
Accretion of investment discounts	(32,237)	(12,250)
Provision for credit losses	532,500	350,221
Gain on sale of loans held for sale	(352,745)	(181,697)
Origination of loans held for sale	(144,459,618)	(72,407,201)
Proceeds from sale of loans	135,329,248	66,431,935
Net increase in accrued interest receivable and other assets	(570,231)	(156,272)
Net increase in accrued expenses and other liabilities	395,513	134,441
Net cash used in operating activities	(7,402,194)	(5,215,682)
Cash Flows From Investing Activities		
Purchases of investment securities - AFS	(4,614,498)	(4,635,883)
Maturities of investment securities - AFS	4,650,000	4,650,000
Purchase of Federal Reserve Bank stock	(139,650)	-
Purchase of Federal Home Loan Bank of Atlanta stock	(211,200)	(56,600)
Loan disbursements in excess of principal payments	(26,236,067)	(27,439,466)
Capital expenditures	(303,322)	(139,964)
Net cash used in investing activities	(26,854,737)	(27,621,913)
Cash Flows From Financing Activities		
Net increase in deposits	26,425,928	33,753,944
Net increase in short-term borrowings	2,329,000	328,000
Proceeds from notes payable	850,000	500,000
Net proceeds from stock issuance	50,984	412,500
Net cash provided by financing activities	29,655,912	34,994,444
Net (decrease) increase in cash and cash equivalents	(4,601,019)	2,156,849
Cash and cash equivalents at beginning of period	18,111,952	18,060,105
Cash and cash equivalents at end of period	$ 13,510,933	$ 20,216,954
Cash paid for:		
Interest	$ 2,777,209	$ 1,678,360
Income taxes	$ -	$ -

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For The Three and Nine Months Ended September 30, 2005 and 2004
(Unaudited)

1. GENERAL

Organization

Bay National Corporation (the "Company") was incorporated on June 3, 1999 under the laws of the State of Maryland to operate as a bank holding company of a national bank with the name Bay National Bank (the "Bank"). On May 12, 2000, the Company purchased all the shares of common stock issued by the Bank. The Bank commenced operations on May 12, 2000 after successfully meeting the conditions of the Office of the Comptroller of the Currency (the "OCC") to receive its charter authorizing it to commence operations as a national bank, and obtaining the approval of the Federal Deposit Insurance Corporation to insure its deposit accounts, and meeting certain other regulatory requirements.

Basis of Presentation

The accompanying consolidated financial statements include the activity of Bay National Corporation and its wholly owned subsidiary, Bay National Bank. All significant intercompany transactions and balances have been eliminated in consolidation.

The foregoing consolidated financial statements are unaudited; however, in the opinion of management, all adjustments (comprising only normal recurring accruals) necessary for a fair presentation of the results of the interim periods have been included. The balances as of December 31, 2004 have been derived from audited financial statements. These statements should be read in conjunction with the financial statements and accompanying notes included in Bay National Corporation's 2004 Annual Report on Form 10-KSB. There have been no significant changes to the Company's Accounting Policies as disclosed in the 2004 Annual Report. The results shown in this interim report are not necessarily indicative of results to be expected for the full year 2005 or any other interim period.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to general practices in the banking industry.

Reclassifications

Certain reclassifications have been made to amounts previously reported to conform to the current presentation. These reclassifications had no effect on previously reported results of operations or accumulated deficit.

2. REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting and other factors.

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Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios. Management believes, as of September 30, 2005, that the Bank meets all capital adequacy requirements to which it is subject.

As of September 30, 2005, the Bank has been categorized as “Well Capitalized” by the OCC under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios.

3. INCOME TAXES

The Company uses the liability method of accounting for income taxes as required by SFAS No. 109, “Accounting for Income Taxes.” Under the liability method, deferred-tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates that will be in effect when these differences reverse. Deferred income taxes will be recognized when it is deemed more likely than not that the benefits of such deferred income taxes will be realized; accordingly, no deferred income taxes or income tax benefits have been recorded by the Company.

4. EARNINGS PER SHARE

Earnings per common share are computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period, including any potential dilutive common shares outstanding, such as options and warrants.

5. STOCK-BASED COMPENSATION

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” (SFAS No. 123) and Statement of Financial Accounting Standards No. 148, “Accounting for Stock-Based Compensation - Transition and Disclosure” (SFAS No. 148), and applies Accounting Principles Board Opinion No. 25 and related interpretations in accounting for its stock option plan. No compensation expenses related to the Company’s stock option plan were recorded during the three-month and nine-month periods ended September 30, 2005 and 2004.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 and SFAS No. 148 to stock-based employee compensation for the three-month and nine-month periods ended September 30:

	Three Months Ending September 30		Nine Months Ending September 30	
	2005	2004	2005	2004
Net income, as reported	$ 750,645	$ 244,372	$ 1,618,257	$ 478,755
Less pro forma stock-based compensation expense determined under the fair value method	(1,404)	(1,404)	(75,882)	(73,076)
Pro forma net income	$ 749,241	$ 242,968	$ 1,542,375	$ 405,679
Net income per share:				
Basic - as reported	$ .39	$ .13	$ .84	$ .26
Diluted - as reported	$ .37	$ .13	$ .81	$ .25
Basic - pro forma	$ .39	$ .13	$ .80	$ .22
Diluted - pro forma	$ .37	$ .13	$ .77	$ .21

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

This discussion and analysis provides an overview of the financial condition and results of operations of Bay National Corporation (the “Parent”) and its national bank subsidiary, Bay National Bank (the “Bank”), collectively (the “Company”), as of September 30, 2005 and December 31, 2004 and for the three-month and nine-month periods ended September 30, 2005 and 2004.

General

On May 12, 2000, the Parent became a bank holding company by purchasing all of the common stock of the Bank. The Bank opened its first office on May 12, 2000 and its second office on May 26, 2000.

The Bank serves the business communities of North Baltimore and Salisbury, Maryland.

Overview

Strong asset growth continued for the three-month period ended September 30, 2005, while operating results continued to improve significantly over prior year results. Key measurements for the three-month and nine-month periods ended September 30, 2005 include the following:

- Total assets at September 30, 2005 increased to $202.4 million as compared to $170.8 million as of December 31, 2004.

- Net loans outstanding increased from $149.2 million as of December 31, 2004 to $184.4 million as of September 30, 2005.

- There were no nonperforming loans at September 30, 2005. Appropriate reserves for loan losses continue to be maintained.

- Deposits at September 30, 2005 were $180.4 million, an increase from $153.9 million as of December 31, 2004.

- The Company realized net income of $750,645 and $1,618,257 for the three-month and nine-month periods ended September 30, 2005, respectively. This represents increases of 207.2% and 238.0% over net income of $244,372 and $478,755 for the three-month and nine month periods ended September 30, 2004, respectively.

- Net interest income, the Company’s main source of income, was $2.4 million and $6.1 million during the three-month and nine-month periods ended September 30, 2005 compared to $1.3 million and $3.6 million for the same periods in 2004. This represents an increase of 79.6% and 69.5% for the three-months and nine-months ended September 30, 2005, respectively, as compared to the same periods in 2004.

- There were recoveries on prior charge-offs of $7,500 for the nine-month period ended September 30, 2005. Loan charge-offs were $6,221 for the nine-month period ended September 30, 2004.

- Non-interest income increased by $98,415, or 74.2%, and by $138,624, or 34.5%, for the three-month and nine-month periods September 30, 2005, respectively, as compared to the same periods in 2004.

- Non-interest expenses increased by $502,421 and $1,302,376, or 45.8% and 41.4%, for the three-month and nine-month periods ended September 30, 2005, respectively, as compared to the same periods ended September 30, 2004.

- The market price of common shares ended the quarter at $19.00, up 43.4% from the closing price of $13.25 on December 31, 2004.

A detailed discussion of the factors leading to these changes can be found in the discussion below.

Results of Operations

Overview

The Company recorded net income of $750,645 and $1,618,257 for the three-month and nine-month periods ended September 30, 2005, respectively. This compares to net income of $244,372 and $478,755 for the same periods in 2004. This is an improvement of $506,273, or 207.2%, for the three-month period and $1,139,502, or 238.0%, for the nine-month period. This significant improvement in results for the periods is due to the continued year over year growth of the loan portfolio, improvement in net interest margins, and prudent management of operating expenses.

Bay National Bank's mortgage origination operations, located in Lutherville and Salisbury, Maryland, originate conventional first and second lien residential mortgage loans. Bay National Bank sells most of its first and second lien residential mortgage loans in the secondary market and typically recognizes a gain on the sale of these loans after the payment of commissions to the loan origination officer. Since its inception in February 2001, the Salisbury mortgage division has been a significant contributor to operating results. The Lutherville mortgage operation was initiated in February 2005 and began to contribute to the Company's overall profitability during the second half of 2005. For the three-month periods ended September 30, 2005 and 2004, gains on the sale of mortgage loans totaled $160,592 and $50,576, respectively. For the nine-month periods ended September 30, 2005 and 2004, gains on the sale of mortgage loans totaled $352,745 and $181,697, respectively.

The level of gains on the sale of mortgage loans has increased from 2004 due to the addition of the Lutherville origination operation, which focuses on construction and rehabilitation loans that will be modified to permanent financing upon completion of the project. The permanent financing is then sold in the secondary market. We believe that this type of residential lending is less sensitive to the fluctuation of interest rates.

During the second quarter of 2004, the Company introduced a new loan program for conventional first and second lien residential mortgage loans. Under this program the Company purchases a 100% participation in mortgage loans originated by a mortgage company in the Baltimore metropolitan area. These participations are for loans which a secondary market investor has committed to purchase. The participations are typically held for a period of three to four weeks before being sold to the secondary market investor. This holding period represents the amount of time taken by the secondary market investor to review the loan files for completeness and accuracy. During this holding period, the Company earns interest on these loans at a rate indexed to the prime rate.

The primary risk to the Company is that the secondary market investor may decline to purchase the loans due to documentary deficiencies or errors. The Company attempts to manage this risk by conducting a thorough review of the documentation prior to purchasing the participation. If the secondary market investor declines to purchase the loan, the Company could attempt to sell the loan to other investors or hold the loan in its loan portfolio. As of September 30, 2005, the Company held $17.1 million of these loans which were classified as held for sale. The Company earned $262,621 and $496,004 of interest on this program for the three-month and nine-month periods ended September 30, 2005, respectively. This compares to $115,774 and $186,407 for the same periods in 2004.

Management expects continued strength in operating results over the remainder of 2005; however, actual results will be subject to the volatility of the provision for credit losses, which is related to loan growth, the continued success of the new Lutherville mortgage lending programs, and the volatility of existing mortgage loan production, which is sensitive to economic and interest rate fluctuations.

Net Interest Income

Net interest income is the difference between income on earning assets and the cost of funds supporting those assets. Earning assets are composed primarily of loans, investments, and federal funds sold. Interest-bearing deposits, other short-term borrowings and the note payable make up the cost of funds. Non-interest bearing deposits and capital are also funding sources. Changes in the volume and mix of earning assets and funding sources along with changes in associated interest rates determine changes in net interest income.

As previously stated, net interest income was $2.4 million and $6.1 million during the three-month and nine-month periods ended September 30, 2005 as compared to $1.3 million and $3.6 million for the same periods in 2004. This represents increases of 79.6% and 69.5% for the three-months and nine-months ended September 30, 2005 as compared to the same periods in 2004.

Interest income from loans and investments for the three-month and nine-month periods ended September 30, 2005 was $3.6 million and $9.0 million, respectively, compared to $2.0 million and $5.3 million, respectively, for the three-month and nine-month periods ended September 30, 2004. The 79.8% and 69.2% increases for the three and nine-month periods over the same periods in 2004 were directly related to the 28.3% increase in average interest-earning assets for the nine-months ended September 30, 2005 as compared to the same period in 2004. The increase in average interest-earning assets was also aided by a significant increase in average yields due to eight .25% increases in the target federal funds rate since September 30, 2004. The yields on these assets increased from 5.14% for the nine-months ended September 30, 2004 to 6.78% for the nine-months ended September 30, 2005.

The percentage of average interest-earning assets represented by loans was 92.1% and 87.1% for the nine-month periods ended September 30, 2005 and 2004, respectively. For the nine-month period ended September 30, 2005, the average yield on the loan portfolio increased to 7.18% from 5.76% for the nine-month period ended September 30, 2004. This increase is primarily due to the difference in the target federal funds rate in effect for the periods. The Federal Reserve has increased its target for the federal funds rate from 1.75% as of September 30, 2004 to 3.75% as of September 30, 2005. As can be seen by the yields discussed above, these increases had a significant effect on the Company's operating results. Yields on earning assets in future periods should continue to improve following any future increases in the target federal funds rate.

The average yield on the investment portfolio and other earning assets, such as federal funds sold, was 2.05% for the nine-month period ended September 30, 2005 as compared to .95% for the same period in 2004. The improvement in the average yield was a direct result of the Federal Reserve actions discussed above, as well as an increase in the holdings of Federal Reserve and Federal Home Loan bank stocks, which pay dividend yields greater than the prevailing federal funds rates. The percentage of average interest-earning assets represented by investments was 7.9% and 12.9% for the nine-month periods ended September 30, 2005 and 2004, respectively.

Interest expense from deposits and borrowings for the three-month and nine-month periods ended September 30, 2005 was $1,181,658 and $2,926,977, respectively. This compares to $655,710 and $1,737,834 for the comparable periods in 2004. The 80.2% and 68.4% increases over the three-month and nine-month periods in 2004 are a result of a 27.9% increase in average interest-bearing liabilities for the nine-month period ended September 30, 2005 as compared to the same period in 2004. The increase in interest expense was also related to the increase in average rates paid. Average rates paid on these liabilities increased from 2.12% for the nine-month period ended September 30, 2004 to 2.79% for the nine-month period ended September 30, 2005. The increase in rates paid is directly attributable to the Federal Reserve actions discussed above. Although market rates of interest have increased significantly since September 30, 2004, management has been able to carefully implement deposit rate increases, which has allowed for significantly improved margins. Management expects that pressure to increase rates paid on deposits will increase if the target for the federal funds rate continues to rise.

The following tables set forth, for the periods indicated, information regarding the average balances of interest-earning assets and interest-bearing liabilities, the amount of interest income and interest expense and the resulting yields on average interest-earning assets and rates paid on average interest-bearing liabilities. Average balances are also provided for non-interest-earning assets and non-interest-bearing liabilities.

No tax equivalent adjustments were made and no income was exempt from federal income taxes. All average balances are monthly average balances. We do not believe that the monthly averages differ materially from what the daily averages would have been. The amortization of loan fees is included in computing interest income; however, such fees are not material.

	Nine Months Ended September 30, 2005		
	Average Balance	**Interest and fees**	**Yield/ Rate**
ASSETS			
Loans and loans held for sale	$162,883,257	$8,772,889	7.18%
Investment securities	2,325,834	53,923	3.09
Federal funds sold and other overnight investments	11,643,564	160,401	1.84
Total earning assets	176,852,655	8,987,213	6.78%
Less: Allowance for credit losses	(1,959,675)		
Cash and due from banks	1,316,501		
Premises and equipment, net	683,184		
Accrued interest receivable and other assets	793,880		
Total assets	$177,686,545		
LIABILITIES AND STOCKHOLDERS' EQUITY			
Interest-bearing demand deposits	$ 55,137,766	695,691	1.68%
Regular savings deposits	5,460,498	26,457	.65
Time deposits	74,127,589	2,052,169	3.69
Short-term borrowings	3,960,879	90,859	3.06
Note payable	1,337,363	61,801	6.16
Total interest-bearing liabilities	140,024,095	2,926,977	2.79%
Net interest income and spread		$6,060,236	3.99%
Non-interest-bearing demand deposits	22,888,519		
Accrued expenses and other liabilities	767,178		
Stockholders' equity	14,006,753		
Total liabilities and stockholders' equity	$177,686,545		

Interest income/earning assets	6.78%
Interest expense/earning assets	2.21
Net interest margin	4.57%
Return on Average Assets (Annualized)	1.21%
Return on Average Equity (Annualized)	15.40%
Average Equity to Average Assets	7.88%

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Nine Months Ended September 30, 2004	Average Balance	Interest and fees	Yield/ Rate
ASSETS			
Loans and loans held for sale	$120,097,860	$5,186,493	5.76%
Investment securities	2,022,488	26,820	1.77
Federal funds sold and other overnight investments	15,729,612	99,224	.84
Total earning assets	137,849,960	5,312,537	5.14%
Less: Allowance for credit losses	(1,406,395)		
Cash and due from banks	859,704		
Premises and equipment, net	650,349		
Accrued interest receivable and other assets	556,700		
Total assets	$138,510,318		
LIABILITIES AND STOCKHOLDERS' EQUITY			
Interest-bearing demand deposits	$ 44,806,717	359,507	1.07%
Regular savings deposits	4,015,492	19,556	.65
Time deposits	59,201,495	1,346,153	3.03
Short-term borrowings	1,456,369	12,618	1.16
Total interest-bearing liabilities	109,480,073	1,737,834	2.12%
Net interest income and spread		$3,574,703	3.02%
Non-interest-bearing demand deposits	16,306,404		
Accrued expenses and other liabilities	463,110		
Stockholders' equity	12,260,731		
Total liabilities and stockholders' equity	$138,510,318		

Interest income/earning assets	5.14%
Interest expense/earning assets	1.68
Net interest margin	3.46%
Return on Average Assets (Annualized)	.46%
Return on Average Equity (Annualized)	5.21%
Average Equity to Average Assets	8.85%

Provision for Credit Losses

The provision for credit losses was $297,000 and $532,500 for the three-month and nine-month periods ended September 30, 2005, respectively, as compared to $136,500 and $350,221 for the three-month and nine-month periods ended September 30, 2004. The provisions for each period were reflective of the growth in loan balances outstanding in all segments of the portfolio. The provisions for the three-month and nine-month periods ended September 30, 2005 were higher than the same periods in the prior year due to the fact that the Company began to establish a reserve against loans held for sale to reflect the additional risk associated with loans originated through a third party mortgage company. For additional information regarding the methodology used to determine the provision for credit losses, see the Management Discussion and Analysis section entitled "Allowance for Credit Losses and Credit Risk Management."

Non-Interest Income

Non-interest income consists primarily of gains on the sale of mortgage loans, deposit account service charges, and cash management fees. For the three-month period ended September 30, 2005, the Company realized non-interest income in the amount of $231,017 as compared to

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$132,602 for the three-month period ended September 30, 2004. Gains on the sale of mortgage loans of $160,592 comprised 69.5% of the total for the three-month period ended September 30, 2005. This compares to gains on the sale of mortgage loans of $50,576, or 38.1% of total non-interest income, for the three-month period ended September 30, 2004.

For the nine-month period ended September 30, 2005, the Company realized non-interest income in the amount of $540,049 as compared to $401,425 for the nine-month period ended September 30, 2004. Gains on the sale of mortgage loans of $352,745 comprised 65.3% of the total for the nine-month period ended September 30, 2005. This compares to gains on the sale of mortgage loans of $181,697, or 45.3% of total non-interest income, for the nine-month period ended September 30, 2004.

The level of gains on the sale of mortgage loans has increased in the three-months and nine-months ended September 30, 2005 because the Company added additional residential construction and mortgage capabilities with the opening of the Lutherville mortgage operation in February 2005. This was achieved through the hiring of a team of eight individuals, including originators, processors and servicers who have extensive experience in the industry and the Company’s market area. It is expected that these additional capabilities will increase future levels of gains on the sale of mortgage loans, while also providing interest income on construction loans.

Service charges on deposit accounts totaled $58,267 and $152,209 for the three-month and nine-month periods ended September 30, 2005, as compared to $66,447 and $178,025 for the three-month and nine-month periods ended September 30, 2004. The decreases of 12.3% and 14.5% for the periods, as compared to the same periods in 2004, can be directly attributed to a decline in analysis fees charged on commercial deposit accounts. This decline occurred as the rate used for the calculation of analysis credits increased in conjunction with the increase in the target federal funds rate discussed earlier. Analysis credits are fee reductions provided based upon the analysis credit rate and the average balance of the account subject to analysis fees.

The Company will continue to seek ways to expand its sources of non-interest income. In the future, the Company may enter into fee arrangements with strategic partners that offer investment advisory services, risk management and employee benefit services. No assurance can be given that such fee arrangements will be obtained or maintained.

Non-Interest Expense

Non-interest expense for the three-month and nine-month periods ended September 30, 2005 totaled $1,599,549 and $4,449,528, respectively. This compares to non-interest expense for the comparable periods in 2004 of $1,097,128 and $3,147,152, respectively. The increases of $502,421, or 45.8%, and $1,302,376, or 41.4%, for the three-month and nine-month periods, respectively, primarily resulted from an increase in salaries and benefits of $380,670, or 61.2%, and $824,677, or 45.7%, for the same periods. The increases in salaries and benefits related to staffing growth, including the addition of an eight-person mortgage lending operation in February 2005, as well as the addition of commercial account portfolio managers and other operational support personnel. These additions were made to continue to expand the Bank’s market presence, as well as to manage the growth of the loan and deposit portfolios and support increased operational volume.

Occupancy expenses increased by $21,189 and $73,057 for the three-months and nine-months ended September 30, 2005, respectively, as compared to the same periods in 2004. The 26.2% and 32.6% increases for the periods, as compared to the same periods in 2004, were due in part to scheduled rent increases as well as the acquisition of new space obtained to facilitate the expansion of the Company’s corporate offices and to accommodate the new Lutherville mortgage lending group.

The $32,562, or 24.4%, and $101,737, or 24.5%, increases in data processing and other outside services for the three-months and nine-months ended September 30, 2005, respectively, as compared to the same period in 2004 is the result of increased data and item processing costs and other costs paid to external service providers. The costs include one-time expenses of approximately $45,000 incurred in conjunction with the Bank's planned change of core processors that occurred in May 2005, approximately $24,000 of recruiting fees paid to hire additional staff, and approximately $8,000 of systems support costs incurred to facilitate network infrastructure changes required for a bank processing system upgrade. The remaining increase is due to the costs associated with purchasing additional hardware and software to support increased staffing, as well as the fact that systems and item processing costs are volume-driven based upon the number of customer accounts and related transaction volume. As a result, these costs increase with the growth of the Company.

Advertising and marketing-related expenses increased $46,653, or 83.8%, and $114,314, or 81.3%, for the three-months and nine-months ended September 30, 2005, respectively, as compared to the same periods in 2004. The increases were related to an increase in the number of marketing events conducted and the number of business development professionals on staff as well as increases of $30,000 and $50,000 in funds set aside for charitable contributions to The Baltimore Community Foundation account established by the Bank for the three-month and nine-month periods, respectively.

The increases of $33,564, or 36.0%, and $172,032, or 68.0%, in other expenses for the three-month and nine-month periods ended September 30, 2005, respectively, includes increases in director fees of approximately $12,000 and $52,000, respectively, related to the director compensation plan adopted in the second half of 2004 and an increase in regulatory fees related to the growth of the Bank. The remaining increase in non-interest expense relates to various costs associated with the increased size and complexity of the Company.

The banking industry utilizes the "efficiency ratio" as a key measure of expense management and overall operating efficiency. This ratio is computed by dividing non-interest expense by the sum of net interest income before the loan loss provision and non-interest income. The Company's efficiency ratio was 60.42% and 67.41% for the three-month and nine-month periods ended September 30, 2005, respectively. This compares to 74.23% and 79.15% for the same periods in 2004. The improved ratios from the prior year were driven by strong revenue growth and prudent management of the Company's cost structure.

As previously discussed, non-interest expense for the three-month and nine-month periods ended September 30, 2005 increased by 45.8% and 41.4%, respectively. The rate of increase in non-interest expenses, including non-recurring expenses, is substantially less than the 79.6% and 69.5% increases in net interest income for the three-month and nine-month periods ended September 30, 2005, respectively, as compared to the same periods in 2004. Management believes this indicates that the Company is continuing to effectively leverage its cost structure to generate profitable growth. While management expects that the ongoing growth of the Company's customer base will continue to require additional staffing in order to appropriately service customers and manage the business effectively, management believes that additional growth in the customer base can continue to be accomplished without proportionate increases in these costs.

Income Taxes

When the realization of deferred income taxes is deemed to be more likely than not, the recordation of previously unrecorded net deferred income tax assets will have a positive effect on the earnings in the period when such determination is made. As of December 31, 2004, the Company had net deferred tax assets of approximately $1.4 million that were eliminated through a valuation allowance. Subsequent to the recordation of deferred taxes, the Company will begin to record income tax expense at the statutory rate. Since inception, the Company has not recorded any income tax expense or benefit. Recognizing income tax expense in future periods will have a detrimental effect on reported earnings.

Financial Condition

Composition of the Balance Sheet

As of September 30, 2005, total assets were $202,433,156. This represents growth of $31,669,682, or 18.5%, since December 31, 2004. The growth in total assets included increases of $259,821 in cash and due from banks, $350,850 in other equity securities, $35,186,682 in loans net of the allowance for credit losses and $736,434 in other non-earning assets. These increases were offset by decreases of $4,860,840 in federal funds sold and other overnight investments and $3,265 in investment securities available for sale.

During the second quarter of 2004, the Company introduced a new loan program for conventional first lien and second lien residential mortgage loans. Under this program, the Company purchases a 100% participation in mortgage loans originated by a mortgage company in the Baltimore metropolitan area. These participations are for loans that a secondary market investor has committed to purchase. The participations are typically held for a period of three to four weeks before being sold to the secondary market investor. The Company earns interest on these loans at a rate indexed to the prime rate. As of September 30, 2005, the Company held $17.1 million of these loans which were classified as held for sale, a significant increase from the $8.0 million held as of December 31, 2004.

As of September 30, 2005, loans, excluding loans held for sale, totaled $167,657,004. This represents an increase of $26,243,567, or 18.6%, from a balance of $141,413,437 as of December 31, 2004. Approximately $23 million of this growth is a result of residential construction and rehabilitation lending generated by the Lutherville residential lending group established in February 2005. Loan growth excluding Lutherville residential construction and rehabilitation loans was impacted by significant pay downs and payoffs. A total of approximately $34.6 million in loans that were outstanding as of December 31, 2004 were paid off during the first nine months of 2005. This activity combined with normal fluctuations in revolving credit balances and installment payments on amortizing loans offset most of the approximately $51.2 million in new loans funded during that same period. The Company continues to emphasize prudent growth through the identification of new market segments, hiring of experienced commercial lenders, and the development and use of referral sources including accountants, lawyers and existing customers, as well as members of the Board of Directors and the Baltimore and Salisbury Advisory Boards.

The composition of the loan portfolio as of September 30, 2005 was approximately $74.3 million of commercial loans, $2.1 million of consumer loans, and $91.3 million of real estate loans (excluding mortgage loans held for sale). The composition of the loan portfolio as of December 31, 2004 was approximately $73.8 million of commercial loans, $2.2 million of consumer loans, and $65.4 million of real estate loans (excluding mortgage loans held for sale). Mortgage loans held for sale were $19.1 million and $9.6 million as of September 30, 2005 and December 31, 2004, respectively.

Funds not extended in loans are invested in cash and due from banks and various investments including federal funds sold and other overnight investments, U.S. Treasury securities, Federal Reserve Bank stock and Federal Home Loan Bank stock. These investments totaled approximately $16.0 million as of September 30, 2005 compared to approximately $20.2 million as of December 31, 2004. At September 30, 2005, the Company had federal funds sold and other overnight investments totaling $11,847,688 as compared to $16,708,528 as of December 31, 2004. The Company held $452,340 of Federal Reserve Bank stock as of September 30, 2005 and $312,690 as of December 31, 2004. The Company also held Federal Home Loan Bank of Atlanta stock of $454,600 and $243,400 as of September 30, 2005 and December 31, 2004, respectively, and United States Treasury bills with a maturity value of $1,550,000 as of both September 30, 2005 and December 31, 2004. The Treasury securities are used to collateralize repurchase agreements, which are classified as short-term borrowings under which $1,210,000 and $1,381,000 were outstanding as of September 30, 2005 and December 31, 2004, respectively. Management has made a decision to maintain an appropriate level of liquidity in the investment portfolio in order to ensure that funds are readily available to fund the growth of the loan portfolio and to meet the needs of deposit customers.

The increase in total assets was funded with operating earnings and an increase in deposits of $26,425,928, or 17.2%, since December 31, 2004. Short-term borrowings increased by $2,329,000.

Deposits at September 30, 2005 were $180,352,970, of which approximately $15.4 million, or 8.6%, were related to two customers in one industry and a third customer in another industry. Deposits at December 31, 2004 were $153,927,042, of which deposits for these same customers stood at approximately $16.6 million, or 10.8%, of total deposits. The deposits for these customers tend to fluctuate significantly; as a result, management monitors these deposits on a daily basis to ensure that liquidity levels are adequate to compensate for these fluctuations. Management was able to manage the rate of deposit growth to closely match loan growth by actively managing the level of certificates of deposit obtained by listing rates on the internet.

The market in which the Company operates is very competitive; therefore, the rates of interest paid on deposits are affected by rates paid by other depository institutions. Management closely monitors rates offered by other institutions and seeks to be competitive within the market. The Company has chosen to selectively compete for large certificates of deposits. The Company will choose to pursue such deposits when expected loan growth provides for adequate spreads to support the cost of those funds. As of September 30, 2005, the Company had outstanding certificates of deposit of approximately $34.2 million that were obtained through the listing of certificate of deposit rates on two Internet-based listing services (such deposits are sometimes referred to herein as national market certificates of deposit). These certificates of deposit were issued with an average yield of 3.97% and an average term of 27.8 months. Included in the $34.2 million of Internet-originated certificates of deposit is one certificate of deposit in the amount of $96,626 that has been classified as a “Brokered Deposit” for bank regulatory purposes. This “Brokered Deposit” was issued with a yield of 2.75% and matures in October 2006. As of December 31, 2004, the total certificates of deposit obtained through the listing of certificate of deposit rates on the Internet-based listing services were approximately $28.9 million, of which $394,666 were classified as “Brokered Deposits.” The Company has never paid broker fees for deposits. Additionally, the Company has not accepted any new “Brokered Deposits” since August 2002.

Core deposits, which management categorizes as all deposits other than national market certificates of deposit and all but $5.0 million of deposits from the three large customers described above (which management considers to be a stable deposit amount from these customers based upon historical trends), stood at $135,682,965 as of September 30, 2005, up

19.6% from $113,412,507 as of December 31, 2004. Core deposits are closely monitored by management because they consider such deposits not only a relatively stable source of funding but also reflective of the growth of commercial and consumer depository relationships.

Short-term borrowings consist of repurchase agreements collateralized by pledges of U.S. Government Treasury Securities, based upon their market values, equal to 100% of the principal and accrued interest of its short-term borrowings. The outstanding balance of repurchase agreements decreased from $1,381,000 at December 31, 2004 to $1,210,000 at September 30, 2005 due to decreases in the balance of available funds for customers participating in this program. In addition, short-term borrowings include $2.5 million borrowed from the Federal Home Loan Bank of Atlanta with approximately $16.2 million remaining in borrowing capacity.

Note payable consists of $2.1 million borrowed under a $5 million, three-year unsecured non-revolving credit facility executed on September 28, 2004 with another financial institution. Borrowings under the credit facility are used to provide regulatory capital to the Bank. The loan bears interest at the prime rate.

Total stockholders' equity at September 30, 2005 was $15,088,005 as compared to $13,418,764 at December 31, 2004. The increase in stockholders' equity is a result of the positive operating results for the nine-months ended September 30, 2005 and $50,984 received upon the issuance of shares of common stock upon the exercise of options.

Management believes that the Company will need additional capital, in excess of the $2.9 million still available under the credit facility, to support projected asset growth over the next 12 months. Management and the Capital Committee of the Board of Directors are currently evaluating available alternatives. Any additional capital, if available at all, may be on terms which are not as favorable to the Company as that desired by management and may result in dilution to the Company's shareholders. If adequate capital is not available, the Company may be required to curtail its expected growth strategy.

Allowance for Credit Losses and Credit Risk Management

Originating loans involves a degree of risk that credit losses will occur in varying amounts according to, among other factors, the type of loans being made, the credit-worthiness of the borrowers over the term of the loans, the quality of the collateral for the loan, if any, as well as general economic conditions. The Company charges the provision for credit losses to earnings to maintain the total allowance for credit losses at a level considered by management to represent its best estimate of the losses known and inherent in the portfolio that are both probable and reasonable to estimate based on, among other factors, prior loss experience, volume and type of lending conducted, estimated value of any underlying collateral, economic conditions (particularly as such conditions relate to the Company's market area), regulatory guidance, peer statistics, management's judgment, past due loans in the loan portfolio and concentrations of risk (if any). The Company charges losses on loans against the allowance when it is believed that collection of loan principal is unlikely. Recoveries on loans previously charged off are added back to the allowance.

Management uses a loan grading system where all loans are graded based upon management's evaluation of the risk associated with each loan. A factor, based on the loan grading, is applied to the loan balance to reserve for potential losses. In addition, management judgmentally establishes an additional nonspecific reserve. The nonspecific portion of the allowance reflects management's estimate of probable inherent, but undetected losses, within the portfolio due to uncertainties in economic conditions, delays in obtaining information, including unfavorable information about a borrower's financial condition, the difficulty in identifying triggering events that correlate perfectly to subsequent loss rates and risk factors that have not yet manifested themselves in loss allocation factors.

The reserve factors used are based on management's judgment as to appropriate reserve percentages for various categories of loans, and adjusting those values based on the following: historical losses in each category; historical and current delinquency in each category; underwriting standards in each category; comparison of losses and delinquencies to peer group performance; and an assessment of the likely impact of economic and other external conditions on the performance of each category.

A test of the adequacy of the allowance for credit losses is performed and reported to the Board of Directors on a monthly basis. Management uses the information available to make a determination with respect to the allowance for credit losses, recognizing that the determination is inherently subjective and that future adjustments may be necessary depending upon, among other factors, a change in economic conditions of specific borrowers, or generally in the economy, and new information that becomes available. However, there are no assurances that the allowance for credit losses will be sufficient to absorb losses on nonperforming assets, or that the allowance will be sufficient to cover losses on nonperforming assets in the future.

The allowance for credit losses as of September 30, 2005 and December 31, 2004 was $2,350,000 and $1,810,000, respectively. The amount equates to 1.26% and 1.20% of outstanding loans as of September 30, 2005 and December 31, 2004, respectively. The increased percentage was directly related to an increase in the mix of loans with a higher risk factor based on management's current loan grading system, which is discussed above. No additional information has indicated that the overall level of reserves is inappropriate. The Company has no exposure to foreign countries or foreign borrowers. Management believes that the allowance for credit losses is adequate for each period presented.

As of September 30, 2005, the Company had no loans more than 90 days past due and no loans classified as non-accrual loans. The Company had $7,500 of recoveries on past loan charge-offs during the nine-months ended September 30, 2005. The Company had loan charge-offs of $6,221 during the nine-months ended September 30, 2004.

Liquidity

The Company's overall asset/liability strategy takes into account the need to maintain adequate liquidity to fund asset growth and deposit runoff. Management monitors the liquidity position daily.

The Company's primary sources of funds are deposits, short-term borrowings in the form of repurchase agreements, borrowings under the credit facility, scheduled amortization and prepayment of loans, funds provided by operations and capital. While scheduled principal repayments on loans are a relatively predictable source of funds, deposit flows and loan prepayments are greatly influenced by market interest rates, economic conditions, and rates offered by our competition.

The Company's most liquid assets are cash and assets that can be readily converted into cash, including investment securities maturing within one year. As of September 30, 2005, the Company had $1,663,245 in cash and due from banks, $11,847,688 in federal funds sold and other overnight investments, $1,541,231 in three-month U.S. Treasury Securities, and $19,096,277 in loans expected to be sold within 60 days. As of December 31, 2004, the Company had $1,403,424 in cash and due from banks, $16,708,528 in federal funds sold and other overnight investments, $1,544,496 in three-month U.S. Treasury Securities, and $9,613,162 in loans expected to be sold within 60 days.

The stability in the overall level of liquid assets is the result of an ongoing effort by management to maintain adequate liquidity to fund loan growth and declines in deposit levels. Growth in the Company's loan portfolio, without corresponding growth in deposits, would reduce liquidity, as would reductions in the level of customer deposits.

The Company has commitments for a total of $7.0 million of borrowing availability under unsecured Federal funds lines of credit with three separate financial institutions. The Company also has approximately $16.2 million of borrowing capacity with the Federal Home Loan Bank of Atlanta as of September 30, 2005 and $2.9 million of borrowing capacity under its three-year note payable. These credit facilities can be used in conjunction with the normal deposit strategies, which include pricing changes to increase deposits as necessary. From time to time, the Company may sell or participate out loans to create additional liquidity as required.

The Company has sufficient liquidity to meet its loan commitments as well as fluctuations in deposits. The Company will choose to retain maturing certificates of deposit, when necessary, by offering competitive rates.

Management is not aware of any known trends, events or uncertainties that will have or are reasonably likely to have a material effect on liquidity, capital or operations, nor is management aware of any current recommendation by regulatory authorities, which if implemented, would have a material effect on liquidity, capital or operations.

Interest Rate Sensitivity

The primary objective of asset/liability management is to ensure the steady growth of the Company's primary earnings component, net interest income. Net interest income can fluctuate with significant interest rate movements. To minimize the risk associated with these rate swings, management works to structure the Company's balance sheet so that the ability exists to adjust pricing on interest-earning assets and interest-bearing liabilities in roughly equivalent amounts at approximately the same time intervals. Imbalances in these repricing opportunities at any point in time constitute interest rate sensitivity.

The measurement of the Company's interest rate sensitivity, or "gap," is one of the principal techniques used in asset/liability management. The interest sensitive gap is the dollar difference between assets and liabilities subject to interest rate pricing within a given time period, including both floating rate or adjustable rate instruments and instruments which are approaching maturity.

The following table sets forth the amount of the Company's interest-earning assets and interest-bearing liabilities as of September 30, 2005, which are expected to mature or reprice in each of the time periods shown:

			Maturity or repricing within			
	Amount	Percent of Total	0 to 3 Months	4 to 12 Months	1 to 5 Years	Over 5 Years
Interest-earning assets						
Federal funds sold and other overnight investments	$ 11,847,688	5.89%	$ 11,847,688	$ -	$ -	$ -
Loans held for sale	19,096,277	9.50%	19,096,277	-	-	-
Loans - Variable rate	110,292,053	54.86%	110,292,053	-	-	-
Loans - Fixed rate	57,364,951	28.53%	2,864,244	23,788,169	29,586,307	1,126,231
Other earning assets	2,448,171	1.22%	1,541,231	-	-	906,940
Total interest-earning assets	$ 201,049,140	100.00%	$ 145,641,493	$ 23,788,169	$ 29,586,307	$ 2,033,171
Interest-bearing liabilities						
Deposits - Variable rate	$ 66,931,193	41.51%	$ 66,931,193	$ -	$ -	$ -
Deposits - Fixed rate	88,511,676	54.89%	12,734,395	31,253,091	44,524,190	-
Short-term borrowings - Variable rate	3,710,000	2.30%	3,710,000	-	-	-
Note Payable	2,100,000	1.30%	2,100,000	-	-	-
Total interest-bearing liabilities	$ 161,252,869	100.00%	$ 85,475,588	$ 31,253,091	$ 44,524,190	$ -
Periodic repricing differences						
Periodic gap			60,165,905	(7,464,922)	(14,937,883)	2,033,171
Cumulative gap			60,165,905	52,700,983	37,763,100	39,796,271
Ratio of rate sensitive assets to rate sensitive liabilities			170.39%	76.11%	66.45%	N/A

The Company has 71.47% of its interest-earning assets and 45.11% of its interest-bearing liabilities in variable rate balances. Interest-earning assets exceed interest-bearing liabilities by $39,796,271. The majority of this gap is concentrated in items maturing or repricing within 5 years. This gap is generally reflective of the Company’s emphasis on originating variable rate loans and the demand in the market for higher yielding fixed rate deposits. This analysis indicates that the Company generally will benefit from increasing market rates of interest. However, since all interest rates and yields do not adjust at the same pace, the gap is only a general indicator of interest rate sensitivity. The analysis of the Company's interest-earning assets and interest-bearing liabilities presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration the fact that changes in interest rates do not affect all assets and liabilities equally. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

Management constantly monitors and manages the structure of the Company's balance sheet, seeks to control interest rate exposure, and evaluate pricing strategies. Strategies to better match maturities of interest-earning assets and interest-bearing liabilities include structuring loans with rate floors and ceilings on variable-rate notes and providing for repricing opportunities on fixed rate notes. Management believes that a lending strategy focusing on variable-rate loans and short-term fixed rate loans will best facilitate the goal of minimizing interest rate risk. However, management will opportunistically enter into longer term fixed-rate loans and/or investments when, in management’s judgment, rates adequately compensate the Company for the interest rate risk. The Company's current investment concentration in federal funds sold and other overnight investments provides the most flexibility and control over rate sensitivity since it generally can be restructured more quickly than the loan portfolio. On the liability side, deposit products can be restructured so as to offer incentives to attain the maturity distribution desired although competitive factors sometimes make control over deposit maturity difficult.

In theory, maintaining a nominal level of interest rate sensitivity can diminish interest rate risk. In practice, this is made difficult by a number of factors, including cyclical variation in loan demand, different impacts on interest sensitive assets and liabilities when interest rates change, and the availability of funding sources. Management generally attempts to maintain a balance between rate-sensitive assets and liabilities as the exposure period is lengthened to minimize the overall interest rate risk to the Company.

Off-Balance Sheet Arrangements

In the normal course of business, the Company is a party to financial instruments with off-balance sheet risk. These financial instruments primarily include commitments to extend credit, lines of credit and standby letters of credit. The Company uses these financial instruments to meet the financing needs of its customers. These financial instruments involve, to varying degrees, elements of credit, interest rate, and liquidity risk.

Outstanding loan commitments and lines and letters of credit as of September 30, 2005 and December 31, 2004 are as follows:

	September 30, 2005	**December 31, 2004**
Loan commitments	$ 22,514,982	$ 9,867,893
Unused lines of credit	43,250,442	40,423,986
Letters of credit	3,685,563	1,578,379

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have interest rates fixed at current market amounts, fixed expiration dates or other termination clauses and may require payment of a fee. Unused lines of credit represent the unused portion of lines of credit previously extended and available to the customer as long as there is no violation of any contractual condition. These lines generally have variable interest rates. Since many of the commitments are expected to expire without being drawn upon, and since it is unlikely that customers will draw upon their line of credit in full at any time, the total commitment amount or line of credit amount does not necessarily represent future cash requirements. The Company is not aware of any loss it would incur by funding its commitments or lines of credit.

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. The Company’s exposure to credit loss in the event of nonperformance by the customer is the contract amount of the commitment.

In general, loan commitments, lines of credit and letters of credit are made on the same terms, including with respect to collateral, as outstanding loans. Each customer’s credit-worthiness and collateral requirement is evaluated on a case-by-case basis.

The increase in the overall level of loan commitments and unused lines of credit as of September 30, 2005 as compared to loan commitments and unused lines of credit as of December 31, 2004, is consistent with the overall increase in outstanding loans.

Capital Resources

The Company had stockholders’ equity at September 30, 2005 of $15,088,005 as compared to $13,418,764 at December 31, 2004. The increase in capital is a result of the positive operating results for the nine-months ended September 30, 2005, and $50,984 received upon the issuance of shares of common stock upon the exercise of options. Management believes that the Company will need additional capital, in excess of the $2.9 million still available under the credit facility, to support projected asset growth over the next 12 months. Management and the Capital Committee of the Board of Directors are currently evaluating available alternatives. Any additional capital, if available at all, may be on terms which are not favorable to the Company as that desired by management and may result in dilution to the Company’s shareholders. If adequate capital is not available, the Company may be required to curtail significantly its expected growth strategy.

Banking regulatory authorities have implemented strict capital guidelines directly related to the credit risk associated with an institution’s assets. Banks and bank holding companies are required to maintain capital levels based on their "risk adjusted” assets so that categories of assets with higher "defined” credit risks will require more capital support than assets with lower risks. The Bank has exceeded its capital adequacy requirements to date.

Banking regulations also limit the amount of dividends that may be paid without prior approval of the Bank's regulatory agencies. Regulatory approval is required to pay dividends that exceed the Bank’s net profits for the current year plus its retained net profits for the preceding two years. The Bank could not have paid dividends to the Company without approval from bank regulatory agencies at September 30, 2005.

Reconciliation of Non-GAAP Measures

Below is a reconciliation of total deposits to core deposits as of September 30, 2005 and December 31, 2004, respectively:

	September 30, 2005	**December 31, 2004**
Total deposits	$ 180,352,970	$ 153,927,042
National market certificates of deposit	(34,248,440)	(28,908,592)
Variable balance accounts (3 customers)	(15,421,565)	(16,605,943)
Portion of variable balance accounts considered to be core	5,000,000	5,000,000
Core deposits	$ 135,682,965	$ 113,412,507

Application of Critical Accounting Policies

The Company’s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such, have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must

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be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for credit losses as the accounting area that requires the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

Management has significant discretion in making the judgments inherent in the determination of the provision and allowance for credit losses. The establishment of allowance factors is a continuing exercise and allowance factors may change over time, resulting in an increase or decrease in the amount of the provision or allowance based upon the same volume and classification of loans. Changes in allowance factors or in management's interpretation of those factors will have a direct impact on the amount of the provision and a corresponding effect on income and assets. Also, errors in management's perception and assessment of the allowance factors could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs, which would adversely affect income and capital.

For additional information regarding the allowance for loan and lease losses, see the "Allowance for Credit Losses and Credit Risk Management" section of this financial review.

Item 3. Controls and Procedures

As of the end of the period covered by this quarterly report on Form 10-QSB, Bay National Corporation's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of Bay National Corporation's disclosure controls and procedures. Based upon that evaluation, Bay National Corporation's Chief Executive Officer and Chief Financial Officer concluded that Bay National Corporation's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed by Bay National Corporation in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

In addition, there were no changes in Bay National Corporation's internal controls over financial reporting (as defined in Rule 13a-15 or Rule 15d-15 under the Securities Act of 1934, as amended) during the quarter ended September 30, 2005, that have materially affected, or are reasonably likely to materially affect, Bay National Corporation's internal control over financial reporting.

Information Regarding Forward-Looking Statements

In addition to the historical information contained in Part I of this Quarterly Report on Form 10-QSB, the discussion in Part I of this Quarterly Report on Form 10-QSB contains certain forward-looking statements. Forward-looking statements often use words such as "believe," "expect," "plan," "may," "will," "should," "project," "contemplate," "anticipate," "intend" or other words of similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts.

The statements presented herein with respect to, among other things, Bay National Corporation's plans, objectives, expectations and intentions, including statements regarding profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk and financial and other goals are forward looking. These statements are based on Bay National Corporation's beliefs and assumptions, and on information available to Bay National Corporation as of the date of this filing, and involve risks and uncertainties. These risks and uncertainties include, among others, those discussed in this Quarterly Report on Form 10-QSB; Bay National Corporation's limited operating history; dependence on key personnel; risks related to Bay National Bank's choice of loan portfolio; risks related to Bay National Bank's lending limit; risks of a competitive market; impact of government regulation on operating results; and effect of developments in technology. For a more complete discussion of these risks and uncertainties, see the discussion under the caption "Factors Affecting Future Results" in Bay National Corporation's Form 10-KSB for the year ended December 31, 2004. Bay National Corporation's and Bay National Bank's actual results and the actual outcome of our expectations and strategies could differ materially from those anticipated or estimated because of these risks and uncertainties and you should not put undue reliance on any forward-looking statements. All forward-looking statements speak only as of the date of this filing, and Bay National Corporation undertakes no obligation to update the forward-looking statements to reflect factual assumptions, circumstances or events that have changed after the forward-looking statements are made.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

None

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

(a) None

(b) None

(c) None

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

None

Item 5. Other Information.

None

Item 6. Exhibits.

(a)	Exhibits.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

	Bay National Corporation	
Date: November 11, 2005	By:	/s/ Hugh W. Mohler Hugh W. Mohler, President (Principal Executive Officer)
Date: November 11, 2005	By:	/s/ Mark A. Semanie Mark A. Semanie, Treasurer (Principal Accounting and Financial Officer)