

MIDDLEFIELD BANC CORP

Form 10-Q

November 13, 2008

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

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

For the quarterly period ended September 30, 2008  
Commission File Number 000-32561

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

**Ohio** **34 - 1585111**  
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification No.)  
**15985 East High Street, Middlefield, Ohio 44062-9263**  
(Address of principal executive offices)  
**(440) 632-1666**  
(Registrant's telephone number, including area code)

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

YES  NO

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

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

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

YES  NO

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

**Class: Common Stock, without par value**  
**Outstanding at November 12, 2008: 1,529,292**

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MIDDLEFIELD BANC CORP.  
CONSOLIDATED BALANCE SHEET  
(Unaudited)

	September 30, 2008	December 31, 2007
<b>ASSETS</b>		
Cash and due from banks	\$ 8,263,756	\$ 9,072,972
Federal funds sold	4,570,826	8,631,963
Interest-bearing deposits in other institutions	112,215	110,387
Cash and cash equivalents	12,946,797	17,815,322
Investment securities available for sale	96,371,351	85,967,764
Loans	320,151,943	309,445,922
Less allowance for loan losses	3,613,857	3,299,276
Net loans	316,538,086	306,146,646
Premises and equipment	8,018,503	7,044,685
Goodwill	4,371,205	4,371,206
Bank-owned life insurance	7,371,180	7,153,381
Accrued interest and other assets	8,450,812	5,774,052
<b>TOTAL ASSETS</b>	<b>\$ 454,067,935</b>	<b>\$ 434,273,056</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing demand	\$ 40,929,373	\$ 41,348,219
Interest-bearing demand	27,409,745	19,566,035
Money market	26,831,740	22,684,041
Savings	69,835,964	76,895,857
Time	214,957,328	202,423,848
Total deposits	379,964,150	362,918,000
Short-term borrowings	1,693,699	1,510,607
Other borrowings	36,687,924	32,395,319
Accrued interest and other liabilities	2,340,455	2,487,746
<b>TOTAL LIABILITIES</b>	<b>420,686,228</b>	<b>399,311,672</b>
<b>STOCKHOLDERS EQUITY</b>		
Common stock, no par value; 10,000,000 shares authorized, 1,718,822 and 1,701,546 shares issued	27,159,602	26,650,123
Retained earnings	14,793,600	13,746,956
Accumulated other comprehensive loss	(1,837,888)	(52,969)
Treasury stock, at cost; 189,530 shares in 2008 and 151,745 shares in 2007	(6,733,607)	(5,382,726)

TOTAL STOCKHOLDERS EQUITY	33,381,707	34,961,384
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 454,067,935	\$ 434,273,056

See accompanying unaudited notes to the consolidated financial statements.

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MIDDLEFIELD BANC CORP.  
CONSOLIDATED STATEMENT OF INCOME  
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$ 5,425,266	\$ 5,604,206	\$ 16,273,630	\$ 15,449,822
Interest-bearing deposits in other institutions	1,949	22,159	10,790	127,772
Federal funds sold	22,181	122,029	124,467	383,464
Investment securities:				
Taxable interest	622,184	323,806	1,793,645	844,454
Tax-exempt interest	449,351	468,552	1,360,226	1,310,932
Dividends on FHLB stock	29,514	32,426	88,526	84,193
<b>Total interest income</b>	<b>6,550,445</b>	<b>6,573,178</b>	<b>19,651,284</b>	<b>18,200,637</b>
<b>INTEREST EXPENSE</b>				
Deposits	2,948,998	3,176,508	9,381,666	8,360,623
Short-term borrowings	17,610	35,750	34,793	75,420
Other borrowings	432,055	453,853	1,254,040	1,368,738
<b>Total interest expense</b>	<b>3,398,663</b>	<b>3,666,111</b>	<b>10,670,499</b>	<b>9,804,781</b>
<b>NET INTEREST INCOME</b>	<b>3,151,782</b>	<b>2,907,067</b>	<b>8,980,785</b>	<b>8,395,856</b>
Provision for loan losses	187,000	60,000	357,000	174,391
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>2,964,782</b>	<b>2,847,067</b>	<b>8,623,785</b>	<b>8,221,465</b>
<b>NONINTEREST INCOME</b>				
Service charges on deposit accounts	493,228	494,456	1,417,789	1,427,458
Investment securities gains, net	25,758		34,508	
Earnings on bank-owned life insurance	75,336	69,909	217,798	210,162
Other income	85,925	89,445	284,820	286,061
<b>Total noninterest income</b>	<b>680,247</b>	<b>653,810</b>	<b>1,954,915</b>	<b>1,923,681</b>
<b>NONINTEREST EXPENSE</b>				
Salaries and employee benefits	1,322,026	1,220,646	3,643,199	3,365,646
Occupancy expense	203,298	184,078	643,884	551,586
Equipment expense	150,334	139,197	435,770	393,411

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Data processing costs	193,033	186,213	591,098	498,932
Ohio state franchise tax	117,000	109,673	351,000	313,873
Other expense	743,890	577,126	2,159,276	1,888,020
Total noninterest expense	2,729,581	2,416,933	7,824,227	7,011,468
Income before income taxes	915,448	1,083,944	2,754,473	3,133,678
Income taxes	211,000	223,000	530,000	621,128
NET INCOME	\$ 704,448	\$ 860,944	\$ 2,224,473	\$ 2,512,550
EARNINGS PER SHARE				
Basic	\$ 0.46	\$ 0.54	\$ 1.45	\$ 1.61
Diluted	0.46	0.53	1.44	1.59
DIVIDENDS DECLARED PER SHARE	\$ 0.260	\$ 0.233	\$ 0.770	\$ 0.690

See accompanying unaudited notes to the consolidated financial statements.



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

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Stockholders Equity	Comprehensive Income (Loss)
Balance, December 31, 2007	\$ 26,650,123	\$ 13,746,956	\$ (52,969)	\$ (5,382,726)	\$ 34,961,384	
Net income		2,224,473			2,224,473	\$ 2,224,473
Other comprehensive income:						
Unrealized loss on available for sale securities net of tax benefit of \$919,483			(1,784,919)		(1,784,919)	(1,784,919)
Comprehensive income						\$ 439,554
Stock based compensation expense recognized in earnings	11,286				11,286	
Purchase of treasury stock (37,785 shares)				(1,350,881)	(1,350,881)	
Dividend reinvestment and purchase plan	498,193				498,193	
Cash dividends (\$0.77 per share)		(1,177,829)			(1,177,829)	
Balance, September 30, 2008	\$ 27,159,602	\$ 14,793,600	\$ (1,837,888)	\$ (6,733,607)	\$ 33,381,707	

See accompanying unaudited notes to the consolidated financial statements.

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

	Nine Months Ended September 30,	
	2008	2007
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 2,224,473	\$ 2,512,550
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	357,000	174,391
Depreciation and amortization	393,883	378,749
Amortization of premium and discount on investment securities	158,650	168,622
Amortization of deferred loan fees, net	(104,138)	(49,492)
Earnings on bank-owned life insurance	(217,799)	(210,163)
Compensation for stock option expense	11,286	
Increase in accrued interest receivable	(364,938)	(827,231)
Increase (decrease) in accrued interest payable	(223,246)	410,189
Other, net	(123,615)	(540,786)
Net cash used for operating activities	2,077,047	2,016,829
<b>INVESTING ACTIVITIES</b>		
Investment securities available for sale:		
Proceeds from repayments and maturities	11,598,563	5,402,909
Proceeds from sale of securities	2,929,439	
Purchases	(27,760,155)	(24,059,580)
Investment securities held to maturity:		
Proceeds from repayments and maturities		5,954
Increase in loans, net	(11,751,849)	(18,373,626)
Acquisition of subsidiary bank		(1,828,301)
Purchase of Federal Home Loan Bank stock	(85,200)	(56,100)
Purchase of premises and equipment	(1,367,701)	(396,347)
Deposit acquisition premium		(2,120,612)
Net cash used for investing activities	(26,436,903)	(41,425,703)
<b>FINANCING ACTIVITIES</b>		
Net increase in deposits	17,046,151	28,361,018
Increase in short-term borrowings, net	183,092	902,844
Repayment of other borrowings	(7,707,395)	(8,260,732)
Proceeds from other borrowings	12,000,000	
Purchase of Treasury Stock	(1,350,881)	(1,083,895)
Proceeds from dividend reinvestment & purchase plan	498,193	462,825
Cash dividends	(1,177,829)	(1,060,659)
Net cash received from deposit acquisition		19,270,054

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Net cash provided by financing activities	19,491,331	38,591,455
Increase (decrease) in cash and cash equivalents	(4,868,525)	(817,419)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	17,815,322	13,639,602
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 12,946,797	\$ 12,822,183
SUPPLEMENTAL INFORMATION		
Cash paid during the year for:		
Interest on deposits and borrowings	\$ 10,901,695	\$ 9,314,016
Income taxes	400,000	750,000
Summary of business acquisition:		
Fair value of tangible assets acquired	\$	\$ 42,657,925
Fair value of core deposit intangible acquired		103,781
Fair value of liabilities assumed	(38,408,610)	
Stock issued for the purchase of acquired company's common stock		(3,662,750)
Cash paid in the acquisition		(3,887,110)
Goodwill recognized	\$	\$ (3,196,764)

See accompanying notes to unaudited consolidated financial statements.

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MIDDLEFIELD BANC CORP.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

The consolidated financial statements of Middlefield Banc Corp. ( Company ) includes its two subsidiaries The Middlefield Banking Company and Emerald Bank. All significant inter-company items have been eliminated in consolidation.

The accompanying financial statements have been prepared in accordance with U.S. generally accepted accounting principles and the instructions for Form 10-Q and Article 10 of Regulation S-X. In management's opinion, the financial statements include all adjustments, consisting of normal recurring adjustments, that the Company considers necessary to fairly state the Company's financial position and the results of operations and cash flows. The balance sheet at December 31, 2007, has been derived from the audited financial statements at that date but does not include all of the necessary informational disclosures and footnotes as required by U. S. generally accepted accounting principles. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included with the Company's Form 10-K (File No. 33-23094). The results of the Company's operations for any interim period are not necessarily indicative of the results of the Company's operations for any other interim period or for a full fiscal year.

Certain items contained in the 2007 financial statements have been reclassified to conform to the presentation for 2008. Such reclassifications had no effect on the net results of operations.

Recent Accounting Pronouncements

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

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

In March 2008, the FASB issued FAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, to require enhanced disclosures about derivative instruments and hedging activities. The new standard has revised financial reporting for derivative instruments and hedging activities by requiring more transparency about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under FAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. FAS No. 161 requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also requires entities to provide more information about their liquidity by requiring disclosure of derivative features that are credit risk-related. Further, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. FAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encourage. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

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

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

In February 2008, the FASB issued FSP No. FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*. This FSP concludes that a transferor and transferee should not separately account for a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. The FSP is effective for financial statements issued for fiscal years beginning on or after November 15, 2008, and interim periods within those fiscal years. The adoption of this FSP is not expected to have a material effect on the Company's results of operations or financial position.

In April 2008, the FASB issued FASB Staff Position No. 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP 142-3 ). FSP 142-3 amends the factors that should be considered in developing assumptions about renewal or extension used in estimating the useful life of a recognized intangible asset under FAS No. 142, *Goodwill and Other Intangible Assets*. This standard is intended to improve the consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141R and other GAAP. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The measurement provisions of this standard will apply only to intangible assets of the Company acquired after the effective date.

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

In October 2008, the FASB issued FSP No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset*. This FSP clarifies the application of FAS Statement No. 157, *Fair Value Measurements*, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP shall be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FAS Statement No. 154, *Accounting Changes and Error Corrections*). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application. The Company is currently evaluating the impact the adoption of the FSP will have on the Company's results of operations.

**NOTE 2 STOCK-BASED COMPENSATION**

During the nine months ended September, 2008, the Company recorded \$11,286 in compensation cost. As of September 30, 2008 there was approximately \$10,093 of unrecognized compensation cost related to the unvested share-based compensation awards granted. The cost is expected to be recognized in 2008. The Company had 4,487 unvested stock options outstanding as of September 30, 2008.



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FAS 123R requires that the cash flows from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for stock-based awards (excess tax benefits) be classified as financing cash flows. Prior to the adoption of FAS 123R, such excess tax benefits were presented as operating cash flows. Accordingly, there have been no excess tax benefits that have been classified as a financing cash inflow for the nine months ended September 30, 2008 in the Consolidated Statements of Cash Flows.

The Company had 5,824 non-vested stock options outstanding on September 30, 2008.

Stock option activity during the nine months ended September 30, 2008 and 2007 is as follows:

	2008	Weighted- average Exercise Price	2007	Weighted- average Exercise Price
Outstanding, January 1	88,211	\$ 28.04	77,287	\$ 26.23
Granted	1,337	36.25	10,357	37.73
Exercised	(992)	19.80	(565)	25.10
Forfeited	(1,591)	23.48		
Outstanding, September 30	86,965	\$ 28.34	87,079	\$ 27.60

**NOTE 3 EARNINGS PER SHARE**

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

There are no convertible securities that would affect the denominator in calculating basic and diluted earnings per share; therefore, net income as presented on the Consolidated Statement of Income (Unaudited) will be used as the numerator. The following tables set forth the composition of the weighted-average common shares (denominator) used in the basic and diluted earnings per share computation.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Weighted average common shares issued	1,712,574	1,703,114	1,707,720	1,660,903
Average treasury stock shares	(189,530)	(112,275)	(173,979)	(101,842)
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	1,523,044	1,590,839	1,533,741	1,559,061
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	2,329	19,468	12,659	21,354
	1,525,373	1,610,307	1,546,400	1,580,414



Weighted average common shares and common  
stock equivalents used to calculate diluted earnings  
per share

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Options to purchase 27,234 shares of common stock at prices ranging from \$36.25 to \$40.24 were outstanding during the nine months ended September 30, 2008 but were not included in the computation of diluted earnings per share as they were anti-dilutive due to the strike price being greater than the market price as of September 30, 2008. Options to purchase 21,554 shares of common stock at prices ranging from \$39.62 to \$42.25 were outstanding during the three and nine months ended September 30, 2007 but were not included in the computation of diluted earnings per share as they were anti-dilutive due to the strike price being greater than the market price as of September 30, 2007.

**NOTE 4 COMPREHENSIVE INCOME**

The components of comprehensive income consist exclusively of unrealized gains and losses on available for sale securities. For the nine months ended September 30, 2008, this activity is shown under the heading Comprehensive Income as presented in the Consolidated Statement of Changes in Stockholders' Equity (Unaudited).

The following shows the components and activity of comprehensive income during the periods ended September 30, 2008 and 2007 (net of the income tax effect):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Unrealized holding gains (losses) arising during the period on securities held	(727,463)	656,243	(1,807,694)	(111,356)
Reclassification adjustment for gains included in net income	17,000		22,775	
Net change in unrealized gains (losses) during the period	(710,463)	656,243	(1,784,919)	(111,356)
Unrealized holding losses, beginning of period	(1,127,425)	(1,288,586)	(52,969)	(520,987)
Unrealized holding losses, end of period	(1,837,888)	(632,343)	(1,837,888)	(632,343)
Net income	704,448	860,944	2,224,473	2,512,550
Other comprehensive income (loss), net of tax:				
Unrealized holding gains (losses) arising during the period	(710,463)	656,243	(1,784,919)	(111,356)
Comprehensive income (losses)	(6,015)	1,517,187	439,554	2,401,194

**NOTE 5 FAIR VALUE MEASUREMENTS**

In September 2006, the FASB issued FASB No. 157, *Fair Value Measurements*, to provide consistency and comparability in determining fair value measurements and to provide for expanded disclosures about fair value measurements. The definition of fair value maintains the exchange price notion in earlier definitions of fair value but focuses on the exit price of the asset or liability. The exit price is the price that would be received to sell the asset or paid to transfer the liability adjusted for certain inherent risks and restrictions. Expanded disclosures are also required about the use of fair value to measure assets and liabilities.



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The following table presents the balance of certain assets reported at fair value as of September 30, 2008 and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

	Quoted Prices in Active Markets for Assets Identical (Level 1)	Significant Other Observable Inputs (Level 2)	Balance as of 30-Sep-08
Assets measured at fair value on a recurring basis:			
Securities available-for-sale	\$ 1,038,412	\$ 95,332,939	\$ 96,371,351

Assets measured at fair value on a non-recurring basis:

Collateral dependent impaired loans	\$	\$ 1,493,013	\$ 1,493,013
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As required by FASB No. 157, each financial asset and liability must be identified as having been valued according to specified level of input, 1, 2 or 3. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset, either directly or indirectly. Level 2 inputs include quoted prices for similar assets in active markets, and inputs other than quoted prices that are observable for the asset or liability. Level 3 inputs are unobservable inputs for the asset, and include situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy, within which the fair value measurement in its entirety falls, has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset.

The measurement of fair value should be consistent with one of the following valuation techniques: market approach, income approach, and/or cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities. As of September 30, 2008, all of the financial assets measured at fair value utilized the market approach.

**NOTE 6 ACQUISITIONS**

On November 15, 2006 Middlefield Banc Corp. entered into an Agreement and Plan of Merger for the acquisition of Emerald Bank, an Ohio-chartered savings bank headquartered in Dublin, Ohio. Middlefield Banc Corp. organized an interim bank subsidiary under Ohio commercial bank law to carry out the merger with Emerald Bank. The Agreement and Plan of Merger was amended on January 3, 2007 to make the new interim bank subsidiary, known as EB Interim Bank, a party to the agreement. At the effective time of the merger Emerald Bank merged into the new interim subsidiary, which was the surviving corporation and which has thereafter operated under the name Emerald Bank as a wholly owned commercial bank subsidiary of Middlefield Banc Corp. The purchase price for Emerald Bank totaled \$7,326,890 with one half of the merger consideration paid in cash and the other half in shares of Middlefield Banc Corp. common stock. The merger was approved by both bank regulators and Emerald Bank stockholders. The transaction was completed on April 19, 2007.



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The following Unaudited pro forma condensed combined financial information presents the results of operations of the Company had the merger taken place at January 1, 2007.

	Nine Months Ended	
	2008	2007
Interest Income	\$ 19,651,284	\$ 18,906,851
Interest Expense	10,670,499	10,230,811
Net Interest Income	8,980,785	8,676,040
Provision for loan losses	357,000	220,493
Net Interest Income after provision for loan losses	8,623,785	8,455,547
Non Interest Income	1,954,915	1,945,839
Non Interest Expense	7,824,227	7,531,965
Income before income taxes	2,754,473	2,869,421
Provision for income taxes	530,000	621,128
Net income	\$ 2,224,473	\$ 2,248,293

**EARNINGS PER SHARE**

Basic	\$ 1.45	\$ 1.44
Diluted	1.44	1.42

On June 12, 2008 Emerald Bank filed a Notice of Intent for a Bank to Acquire a Banking Office under the provisions of Section 1161.05 of the Ohio Revised Code. Emerald Bank, whose address is 6215 Perimeter Drive, Dublin, Franklin County, Ohio 43017, will purchase and assume certain assets and liabilities associated with the branch office of The Commercial Savings Bank, 118 South Sandusky Avenue, Upper Sandusky, Wyandot County, Ohio 43351 located at 17 N. State Street, Westerville, Franklin County, Ohio, 43081 (the Westerville Branch ). As of May 12, 2008, total deposits at the Westerville Branch were approximately \$6.4 million, and the combined purchase price for the real property and the furniture, fixtures, and equipment at net book value was approximately \$440,373. Upon consummation of the proposed transaction, Emerald Bank will operate the Westerville Branch as a branch office. Emerald Bank and The Commercial Savings Bank desire to complete the transaction by or as soon after November 10, 2008, as is possible, but in any case no later than December 1, 2008.

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

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

**CHANGES IN FINANCIAL CONDITION**

**General.** The Company's total assets increased by \$19.8 million or 4.6% from December 31, 2007 to September 30, 2008 to a balance of \$454.1 million. Loans receivable and investment securities increased \$10.7 million and \$10.4 million respectively. The increase in total assets reflects a corresponding increase in total liabilities of \$21.4 million or 5.4% and a decline in stockholders' equity of \$1.8 million or -4.5%. The increase in total liabilities was primarily the result of deposit growth of \$17.1 million. The decline in stockholders' equity was the result of increases in accumulated other comprehensive loss and treasury stock of \$1.8 million and \$1.4 million respectively

which was partially offset by increases in common stock and retained earnings of \$509,000 and \$1.1 million.

**Cash on hand and due from banks.** Cash on hand and due from banks represent cash equivalents. Cash equivalents declined a combined \$4.9 million or 27.3% to \$13.0 million at September 30, 2008 from \$17.8 million at December 31, 2007. Deposits from customers into savings and checking accounts, loan and security repayments and proceeds from borrowed funds typically increase these accounts. Decreases result from customer withdrawals, new loan originations, security purchases and repayments of borrowed funds. The decline for the first nine months can principally be attributed to a decrease in Federal Funds Sold which was used to fund the loan portfolio.

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**Investment securities.** Investment securities available for sale ended the September 30, 2008 quarter at \$96.4 million an increase of \$10.4 million or 12.1% from \$86.0 million at December 31, 2007. During this period the Company recorded purchases of available for sale securities of \$27.8 million, consisting of purchases of mortgage-backed securities. Offsetting the purchases of securities were repayments and maturities of securities of \$14.5 million during the nine months ended September 30, 2008. In addition, the securities portfolio decreased approximately \$2.7 million due to a decline in the market value. These fair value adjustments represent temporary fluctuations resulting from changes in market rates in relation to average yields in the available for sale portfolio. If securities are held to their respective maturity dates, no fair value gain or loss will be realized.

**Loans receivable.** The loans receivable category consists primarily of single family mortgage loans used to purchase or refinance personal residences located within the Company's market area and commercial real estate loans used to finance properties that are used in the borrowers businesses or to finance investor-owned rental properties, and to a lesser extent commercial and consumer loans. Net loans receivable increased \$10.4 million or 3.4% to \$316.5 million at September 30, 2008 from \$306.1 million at December 31, 2007. Included in this increase were growth in commercial real estate mortgage loans of \$9.7 million or 26.3% and real estate construction loans of \$818,000 or 12.2%, as well as an increase in commercial and industrial loans of \$219,000 during the nine months ended September 30, 2008.

The Company's lending philosophy is to focus on the commercial loans and to attempt to grow the portfolio. To attract and build the commercial loan portfolio, the Corporation has taken a proactive approach in contacting new and current clients to ensure that the Company is servicing its clients needs. These lending relationships generally offer more attractive returns than residential loans and also offer opportunities for attracting larger balance deposit relationships. However, the shift in loan portfolio mix from residential real estate to commercial oriented loans may increase credit risk.

**Non-performing loans.** Non-performing loans include non-accrual loans, renegotiated loans, loans 90 days or more past due, other real estate loans, and repossessed assets. A loan is classified, as non-accrual when, in the opinion of management, there are serious doubts about collectibility of interest and principal. At the time the accrual of interest is discontinued, future income is recognized only when cash is received. Renegotiated loans are those loans which terms have been renegotiated to provide a reduction or deferral of principal or interest as a result of the deterioration of the borrower. The ratio of non-performing loans to total loans stood at 2.1% at September 30, 2008. This was an increase from the 1.4% reported as of September 30, 2007. Loans classified as non-accrual at September 30, 2008, were \$3.4 million, which was up from the \$2.2 million reported at September 30, 2007. Loans past due 90 days and still accruing interest, as of September 30, 2008, were \$3.3 million which is \$1.1 million above the prior year figure. Additionally, the Company held \$1.1 million in other real estate owned most of which came from its Emerald Bank affiliate.

**Deposits.** The Company considers various sources when evaluating funding needs, including but not limited to deposits, which are a significant source of funds totaling \$380.0 million or 90.8% of the Company's total funding sources at September 30, 2008. Total deposits increased \$17.1 million or 4.7% to \$380.0 million at September 30, 2008 from \$362.9 million at December 31, 2007. The increase in deposits is primarily related to the growth of certificates of deposits that totaled \$215.0 million at September 30, 2008 an increase of \$12.5 million or 6.2% for the year. Interest-bearing demand and money market accounts increased \$7.8 and \$4.1 while savings and noninterest demand accounts declined by \$7.1 million and \$418,000 respectively, during the nine months ended September 30, 2008.

**Borrowed funds.** The Company utilizes short and long-term borrowings as another source of funding for asset growth and liquidity needs. These borrowings primarily include FHLB advances, junior subordinated debt and repurchase agreements. Borrowed funds increased \$4.5 million or 13.2% to \$38.4 million at September 30, 2008 from \$33.9 million at December 31, 2007. The majority of the increase came from FHLB borrowings which increased \$4.2 million or 17.4%. The increase in FHLB advances was the result of additional borrowings by both banks in order to take advantage of lower rates currently being offered by the FHLB.

**Stockholders equity.** Stockholders equity declined \$1.6 million or 4.5% to \$33.4 million at September 30, 2008 from \$35.0 million at December 31, 2007. The decrease in stockholders equity was the result of increases in common stock



and retained earnings of \$509,000 and \$1.1 million, respectively, offset by increases in accumulated other comprehensive loss and treasury stock of \$1.8 million and \$1.4 million respectively.

The increase of accumulated other comprehensive loss was the result of a reduction in the mark to market value of the Company's securities available for sale portfolio. The decrease in treasury stock was the result of the purchase of 37,785 shares of the Company's common stock at an average price of \$35.75 since December 31, 2007. The increase in common stock was due to stock purchased through the dividend reinvestment plan and stock based compensation expense recognized in earnings of \$498,193 and \$11,286 respectively. The increase in retained earnings was the result of \$2.2 million in net income for the nine months which was partially offset by \$1.2 million in cash dividends.

#### **RESULTS OF OPERATIONS**

**General.** Net income for the third quarter of 2008 totaled \$704,448, or 18.2 percent less than the \$860,944 reported for the same period in 2007. Diluted earnings per share for the third quarter of 2008 were \$0.46, a 13.2% decrease from 2007's third quarter diluted earnings per share of \$0.53. These third quarter results include the operations of Emerald Bank of Dublin, Ohio, which became a subsidiary of the Company on April 19, 2007.

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Results from the nine months of 2008 reflect a net income of \$2,224,473 an 11.5% decrease compared to \$2,512,550 for the first three quarters of 2007. Diluted earnings per share for the nine months of 2008 were \$1.44, or 9.4% less than diluted earnings per share of \$1.59 for the first nine months of 2007. These figures include Emerald Bank's operations from April 19, 2007 through September 30, 2007.

**Net interest income.** Net interest income, the primary source of revenue for the Company, is determined by the Company's interest rate spread, which is defined as the difference between income on earning assets and the cost of funds supporting those assets, and the relative amounts of interest earning assets and interest bearing liabilities. Management periodically adjusts the mix of assets and liabilities, as well as the rates earned or paid on those assets and liabilities in order to manage and improve net interest income. The level of interest rates and changes in the amount and composition of interest earning assets and liabilities affect the Company's net interest income. Historically from an interest rate risk perspective, it has been management's perception that differing interest rate environments can cause sensitivity to the Company's net interest income, these being extended low long-term interest rates or rapidly rising short-term interest rates.

Net interest income totaled \$3.2 million for the third quarter of 2008, an increase of 8.4% from the \$2.9 million reported for the comparable period of 2007. The net interest margin of 3.20% for the third quarter of 2008 showed improvement over the 3.15% reported for the same quarter of 2007. The increase in the net interest margin is primarily attributable to higher loan volume along with a 21 basis point increase in the investment portfolio yield during a substantial decline in the interest rate environment.

Net interest income increased \$585,000, or 7.0%, for the nine months ended September 30, 2008 compared to the same period in the prior year. This increase in net interest income can be attributed to an increase in interest income of \$1.5 million, partially offset by an increase in interest expense of \$866,000. The net interest margin was 3.08% for the first three quarters 2008, down from the 3.29% reported for the same period of 2007. The declining margin for the first nine months of the year is primarily attributable to the changing interest rate environment in which the market experienced a 325 basis point decline in the prime rate.

**Interest income.** Interest income declined \$23,000, or .3%, for the three months ended September 30, 2008, compared to the same period in the prior year. This decrease can be attributed to a 39 basis point drop in the yield on interest-earning assets for the quarter. The largest factor in this decline was the 57 basis point loan yield reduction due to the falling prime rate for the period. This decline was partly offset by a 21 basis point increase in the investment portfolio. Interest income increased \$1.5 million, or 8.0%, for the nine months ended September 30, 2008, compared to the same period in the prior year. This increase can be attributed to increases in interest earned on loans receivable and investment securities of \$824,000 and \$998,000 respectively.

Interest earned on loans declined 179,000, or 3.2%, for the three months ended September 30, 2008, compared to the same period in the prior year. This decline was the result of both an increase in income due to a higher average balance in the loan portfolio which was more than offset by a reduction of interest income due to the lower rate environment.

For the nine months ended September 30, 2008, interest earned on loans receivable increased \$824,000, or 5.3%, , compared to the same period in the prior year. This increase was attributable to an increase in the average balance of loans outstanding of \$33.9 million, or 12.0%, to \$316.0 million for the nine months ended September 30, 2008 compared to \$282.2 million for the same period in the prior year. Loan interest income was reduced by a decline in the yield on the loans to 6.86% for the nine months ended September 30, 2008 from 7.32% for the same period in the prior year.

Interest earned on securities increased \$281,000, or 35.5%, for the three months ended September 30, 2008, compared to the same period in the prior year. This increase was primarily the result of an increase in the average balance of the securities portfolio of \$16.6 million, or 21.4%, to \$94.5 million at September 30, 2008 from \$77.9 million for the same period in the prior year. Interest earned on securities was enhanced by an increase in the yield on the investments to 5.48 for the three months ended September 30, 2008 from 5.27% for the same period in the prior year.

Interest earned on securities increased \$1.0 million, or 46.9%, for the nine months ended September 30, 2008, compared to the same period in the prior year. This increase was primarily the result of an increase in the average balance of the securities portfolio of \$23.4 million, or 32.6%, to \$95.4 million at September 30, 2008 from

\$72.0 million for the same period in the prior year. Interest earned on securities was enhanced by an increase in the yield on the investments to 5.40% for the nine months ended September 30, 2008 from 5.26% for the same period in the prior year.

**Interest expense.** Interest expense declined \$267,000, or 7.3%, for the three months ended September 30, 2008, compared to the same period in the prior year. The decrease in interest expense can be attributed to a combination of two factors:

1. A volume increase in the balance of interest-bearing liabilities of \$32.5 million resulting in \$377,000 of additional interest cost.
2. The interest rate on interest-bearing liabilities declining by 86 basis points from 4.28% for the third quarter of 2007 to 3.62% for the same period in 2008.

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Interest expense increased \$866,000, or 8.8%, for the nine months ended September 30, 2008, compared to the same period in the prior year. The increase in interest expense can be attributed to a combination of two factors:

1. A volume increase in the balance of interest-bearing liabilities of \$57.8 million resulting in \$1.8 million of additional interest cost.
2. The interest rate on interest-bearing liabilities declining by 36 basis points from 4.21% for the first three quarters of 2007 to 3.85% for the same period in 2008.

Interest incurred on deposits, the largest component of the Company's interest-bearing liabilities, decreased \$228,000, or 7.2%, for the three months ended September 30, 2008, compared to the same period in the prior year. This reduced cost was primarily attributable to the average balance of interest-bearing deposits which increased by \$32.8 million, or 10.1%, to \$334.4 million for the three months ended September 30, 2008, compared to \$301.5 million for the same period in the prior year. Interest expense was positively affected by a reduction in the cost of interest-bearing deposits to 3.50% from 4.18% for the quarters ended September 30, 2008 and 2007, respectively. The Company diligently monitors the interest rates on its products as well as the rates being offered by its competition and utilize rate surveys to keep its total interest expense costs down.

For the nine months ended September 30, 2008 interest incurred on deposits increased \$1.0 million, or 12.2%, compared to the same period in the prior year. This increase was primarily attributable to an increase in the average balance of interest-bearing deposits of \$60.5 million, or 22.1%, to \$333.8 million for the nine months ended September 30, 2008, compared to \$273.4 million for the same period in the prior year. Interest expense was positively affected by a reduction in the cost of interest-bearing deposits to 3.74% from 4.09% for the nine months September 30, 2008 and 2007, respectively.

Interest incurred on borrowed funds, declined by \$40,000 or 8.2%, for the three months ended September 30, 2008, compared to the same period in the prior year. This decline was due to both a decrease in the average balance of borrowing and a reduction in the rate paid. The rate of the borrowings declined to 4.5% from 4.90% for the quarters ended September 30, 2008 and 2007, respectively. Adding to the reduction in the cost of these funds was a decline in the average balance of borrowed funds of \$584,000, or 1.5%, to \$38.1 million for the three months ended September 30, 2008, compared to \$38.7 million for the same period in the prior year. This decline is reflected in the quarterly rate volume report presented below which compares the decrease to the costs associated with the interest-bearing liabilities.

For the nine months ended September 30, 2008, interest incurred on borrowed funds decreased by \$155,000, or 10.7%, compared to the same period in the prior year. As with the third quarter results this decline was due to both a decrease in the average balance of borrowing and a reduction in the rate paid. The average balance of borrowed funds declined by \$2.7 million, or 7.0%, to \$35.7 million for the nine months ended September 30, 2008, compared to \$38.4 million for the nine months ended September 30, 2007.

**Provision for loan losses.** The provision is maintained at a level to absorb management's estimate of probable inherent credit losses within the Company's loan portfolio. At September 30, 2008, the allowance for loan losses as a percentage of total loans was 1.13%, which represented an 11.9% increase over the 1.01% reported at September 30, 2007. The ratio of non-performing loans to total loans stood at 2.11% at September 30, 2008. This was an increase from the 1.24% reported as of September 30, 2007. Loans classified as non-accrual at September 30, 2008, were \$3.4 million, which was \$1.3 million increase over the total reported at September 30, 2007. Loans past due 90 days and still accruing interest, as of September 30, 2008, were \$3.3 million, or \$1.6 million more than the prior year figure. The majority of the increase in this category was in residential secured real estate loans.

**Non-interest income.** Non-interest income increased \$26,400 for the third quarter of 2008 over the comparable 2007 period. This increase of 4.0% was primarily the result of a gain realized on investment securities. Service charges on deposit accounts decreased \$1,200, with other non-interest income being \$3,500 lower. Earnings on bank-owned life insurance were \$5,400 higher during the third quarter of 2008 than the same period of 2007.

For the nine months ended September 30, 2008, non-interest income increased by \$31,000 or 1.6% to \$2.0 million. This increase was the result of investment security gains taken in the first three quarters of 2008 of \$35,000.

**Non-interest expense.** Non-interest expense for the third quarter of 2008 was 12.9%, or \$312,600, higher than the third quarter of 2007. Increases in salary and employee benefits of \$101,400 were largely attributable to increased

staffing, including the opening of the Cortland banking office, normal wage adjustments, and an additional payroll in the third quarter of 2008 that did not exist in 2007. Other expense items contributing to the overall increase were costs associated with compliance with Section 404 of the Sarbanes-Oxley Act, primarily centered in audit and legal functions, higher fees associated with the increased level of ATM/Debit card usage, amortization of the core deposit intangible associated with acquisitions made by the company, and higher postage. Significantly increasing were FDIC premiums, with further increases anticipated as that agency works to meet statutory minimums. For the nine months ended September 30, 2008 non-interest expense increased \$813,000 or 11.6% from the same period in the prior year.

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**Provision for income taxes.** The Company recognized \$530,000 in income tax expense, which reflected an effective tax rate of 17.35% for the nine months, ended September 30, 2008, as compared to \$621,000 with an effective tax rate of 19.24% for the respective 2007 period.

**CRITICAL ACCOUNTING ESTIMATES**

The Company's critical accounting estimates involving the more significant judgments and assumptions used in the preparation of the consolidated financial statements as of September 30, 2008, have remained unchanged from December 31, 2007.

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

**Analysis of Changes in Net Interest Income.** The following tables analyze the changes in interest income and interest expense, between the three and nine month periods ended September 30, 2008 and 2007, in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Company's interest income and interest expense are attributable to changes in rate (change in rate multiplied by prior period volume), changes in volume (changes in volume multiplied by prior period rate) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances. Changes in interest income on securities reflects the changes in interest income on a fully tax equivalent basis.

	For the Three Months Ended September 30, 2008		2007			
	Average Balance (Dollars in thousands)	Interest (1)	(4) Average Yield/Cost	Average Balance (Dollars in thousands)	Interest (1)	(4) Average Yield/Cost
<b>Interest-earning assets:</b>						
Loans receivable	318,761	\$ 5,425	6.75%	303,872	\$ 5,604	7.32%
Investments securities	94,532	1,073	5.48%	77,861	792	5.27%
Interest-bearing deposits with other banks	5,897	52	3.48%	15,187	177	4.62%
<b>Total interest-earning assets</b>	<b>419,191</b>	<b>6,550</b>	<b>6.42%</b>	<b>396,920</b>	<b>6,573</b>	<b>6.81%</b>
Noninterest-earning assets	29,782			20,392		
<b>Total assets</b>	<b>448,973</b>			<b>\$ 417,312</b>		
<b>Interest-bearing liabilities:</b>						
Interest bearing demand deposits	25,962	78	1.19%	\$ 17,025	91	2.12%
Money market deposits	25,789	197	3.02%	26,090	257	3.91%

Savings deposits	70,001	318	1.80%	77,539	573	2.93%
Certificates of deposit	212,605	2,357	4.40%	180,867	2,255	4.95%
Borrowings	38,111	450	4.68%	38,695	490	5.02%
<b>Total interest-bearing liabilities</b>	<b>372,468</b>	<b>3,399</b>	<b>3.62%</b>	<b>340,216</b>	<b>3,666</b>	<b>4.28%</b>
<b>Noninterest-bearing liabilities</b>						
Other liabilities	44,376			42,867		
Stockholders equity	32,129			34,228		
<b>Total liabilities and stockholders equity</b>	<b>\$ 448,973</b>			<b>\$ 417,311</b>		
<b>Net interest income</b>		<b>\$ 3,152</b>			<b>\$ 2,907</b>	
<b>Interest rate spread (2)</b>			<b>2.80%</b>			<b>2.54%</b>
<b>Net yield on interest-earning assets (3)</b>			<b>3.20%</b>			<b>3.15%</b>
<b>Ratio of average interest-earning assets to average interest-bearing liabilities</b>			<b>112.54%</b>			<b>116.67%</b>

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

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

(3) Net yield on interest-earning assets represents net interest income as a percentage of average

**interest-earning  
assets.**

- (4) Average yields  
are computed  
using  
annualized  
interest income  
and expense for  
the periods.**



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	2008 versus 2007		
	Increase (decrease) due to		
	Volume	Rate	Total
	(Dollars in thousands)		
<b>Interest-earning assets:</b>			
Loans receivable	275	-453	-179
Investments securities	221	60	281
Interest-bearing deposits with other banks	-108	-17	-125
<b>Total interest-earning assets</b>	<b>388</b>	<b>-410</b>	<b>-23</b>
<b>Interest-bearing liabilities:</b>			
Interest bearing demand deposits	48	-61	-13
Money market deposits	-3	-57	-60
Savings deposits	-56	-200	-255
Certificates of deposit	396	-293	102
Borrowings	-7	-33	-40
<b>Total interest-bearing liabilities</b>	<b>377</b>	<b>-645</b>	<b>-267</b>
<b>Net interest income</b>	<b>\$ 10</b>	<b>\$ 235</b>	<b>\$ 245</b>

	For the Nine Months Ended September 30,					
	2008			2007		
	Average	(4)	Average	Average	(4)	Average
	Balance	Interest	Yield/Cost	Balance	Interest	Yield/Cost
	(Dollars in thousands)			(Dollars in thousands)		
<b>Interest-earning assets:</b>						
Loans receivable	316,032	\$ 16,274	6.86%	282,169	\$ 15,450	7.32%
Investments securities	95,419	3,165	5.40%	71,969	2,155	5.26%
Interest-bearing deposits with other banks	6,803	213	4.17%	14,730	596	5.41%
<b>Total interest-earning assets</b>	<b>418,255</b>	<b>19,651</b>	<b>6.48%</b>	<b>368,868</b>	<b>18,201</b>	<b>6.84%</b>
<b>Noninterest-earning assets</b>	<b>28,141</b>			<b>18,285</b>		
<b>Total assets</b>	<b>\$ 446,396</b>			<b>\$ 387,153</b>		
<b>Interest-bearing liabilities:</b>						
Interest bearing demand deposits	23,310	220	1.26%	\$ 14,201	265	2.49%
Money market deposits	24,418	588	3.21%	25,557	801	4.19%
Savings deposits	71,834	1,100	2.04%	66,403	1,187	2.39%

Certificates of deposit	214,270	7,474	4.65%	167,217	6,108	4.88%
Borrowings	35,677	1,289	4.81%	38,352	1,444	5.03%
<b>Total interest-bearing liabilities</b>	<b>369,509</b>	<b>10,670</b>	<b>3.85%</b>	<b>311,730</b>	<b>9,805</b>	<b>4.21%</b>
<b>Noninterest-bearing liabilities</b>						
Other liabilities	43,114			42,445		
Stockholders equity	33,773			32,979		
<b>Total liabilities and stockholders equity</b>	<b>446,396</b>			<b>\$ 387,154</b>		
<b>Net interest income</b>		<b>\$ 8,981</b>			<b>\$ 8,396</b>	
<b>Interest rate spread (2)</b>			<b>2.64%</b>			<b>2.64%</b>
<b>Net yield on interest-earning assets (3)</b>			<b>3.08%</b>			<b>3.29%</b>
<b>Ratio of average interest-earning assets to average interest-bearing liabilities</b>			<b>113.19%</b>			<b>118.33%</b>

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

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

(3) Net yield on interest-earning assets represents net interest income as a percentage of average interest-earning

assets.

- (4) Average yields are computed using annualized interest income and expense for the periods.**

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	<b>2008 versus 2007</b>		
	<b>Increase (decrease) due to</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>		
<b>Interest-earning assets:</b>			
<b>Loans receivable</b>	<b>1,854</b>	<b>-1,031</b>	<b>824</b>
<b>Investments securities</b>	<b>922</b>	<b>87</b>	<b>1,010</b>
<b>Interest-bearing deposits with other banks</b>	<b>-321</b>	<b>-62</b>	<b>-383</b>
<b>Total interest-earning assets</b>	<b>2,456</b>	<b>-1,005</b>	<b>1,450</b>
<b>Interest-bearing liabilities:</b>			
<b>Interest bearing demand deposits</b>	<b>170</b>	<b>-215</b>	<b>-45</b>
<b>Money market deposits</b>	<b>-36</b>	<b>-177</b>	<b>-213</b>
<b>Savings deposits</b>	<b>97</b>	<b>-184</b>	<b>-87</b>
<b>Certificates of deposit</b>	<b>1,719</b>	<b>-353</b>	<b>1,366</b>
<b>Borrowings</b>	<b>-101</b>	<b>-54</b>	<b>-155</b>
<b>Total interest-bearing liabilities</b>	<b>1,849</b>	<b>-984</b>	<b>865</b>
<b>Net interest income</b>	<b>\$ 606</b>	<b>\$ (22)</b>	<b>\$ 585</b>

**LIQUIDITY**

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

For the nine months ended September 30, 2008, the adjustments to reconcile net income to net cash from operating activities consisted mainly of depreciation and amortization of premises and equipment, the provision for loan losses, net amortization of securities and net changes in other assets and liabilities. Cash and cash equivalents increased as a result of the purchasing of government agency securities. For a more detailed illustration of sources and uses of cash, refer to the condensed consolidated statements of cash flows.

**INFLATION**

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

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

effect of changes in interest rates on the Company's performance.

**REGULATORY MATTERS**

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

**Table of Contents****REGULATORY CAPITAL REQUIREMENTS**

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

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

The following table illustrates the Company's risk-weighted capital ratios at September 30, 2008:

	Middlefield Banc Corp.		The Middlefield Banking Co.		Emerald Bank	
	September 30, 2008		September 30, 2008		September 30, 2008	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>Total Capital (to Risk-weighted Assets)</b>						
Actual For Capital Adequacy Purposes	\$ 42,881,146	13.98%	\$ 33,069,404	12.60%	\$ 7,913,660	17.97%
To Be Well Capitalized	24,532,435	8.00	21,000,160	8.00	3,522,319	8.00
	30,665,544	10.00	26,250,200	10.00	4,402,899	10.00
<b>Tier I Capital (to Risk-weighted Assets)</b>						
Actual For Capital Adequacy Purposes	\$ 39,096,390	12.75%	\$ 30,109,199	11.47%	\$ 7,362,022	16.72%
To Be Well Capitalized	12,266,218	4.00	10,500,080	4.00	1,761,159	4.00
	18,399,327	6.00	15,750,120	5.00	2,641,739	6.00
<b>Tier I Capital (to Average Assets)</b>						
Actual For Capital Adequacy Purposes	\$ 39,096,390	8.83%	\$ 30,109,199	7.78%	\$ 7,362,022	14.06%
To Be Well Capitalized	17,707,847	4.00	15,473,487	4.00	2,094,131	4.00
	22,134,809	5.00	19,341,858	5.00	2,617,664	5.00

**Item 3. Quantitative and Qualitative Disclosures about Market Risk****ASSET AND LIABILITY MANAGEMENT**

The primary objective of the Company's asset and liability management function is to maximize the Company's net interest income while simultaneously maintaining an acceptable level of interest rate risk given the Company's operating environment, capital and liquidity requirements, performance objectives and overall business focus. The

principal determinant of the exposure of the Company's earnings to interest rate risk is the timing difference between the repricing and maturity of interest-earning assets and the repricing or maturity of its interest-bearing liabilities. The Company's asset and liability management policies are designed to decrease interest rate sensitivity primarily by shortening the maturities of interest-earning assets while at the same time extending the maturities of interest-bearing liabilities. The Board of Directors of the Company continues to believe in strong asset/liability management in order to insulate the Company from material and prolonged increases in interest rates. As a result of this policy, the Company emphasizes a larger, more diversified portfolio of residential mortgage loans in the form of mortgage-backed securities. Mortgage-backed securities generally increase the quality of the Company's assets by virtue of the insurance or guarantees that back them, are more liquid than individual mortgage loans and may be used to collateralize borrowings or other obligations of the Company.

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

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

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

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

The following table presents the simulated impact of a 200 basis point upward and a 200 basis point downward shift of market interest rates on net interest income and the change in portfolio equity. This analysis was done assuming that the interest-earning asset and interest-bearing liability levels at September 30, 2008 remained constant. The impact of the market rate movements was developed by simulating the effects of rates changing gradually over a one-year period from the September 30, 2008 levels for net interest income. The impact of market rate movements was developed by simulating the effects of an immediate and permanent change in rates at September 30, 2008 for portfolio equity:

	<b>Increase 200 BP</b>	<b>Decrease 200 BP</b>
<b>Net interest income increase (decrease)</b>	<b>(0.5)%</b>	<b>(0.9)%</b>
<b>Portfolio equity increase (decrease)</b>	<b>(11.2)%</b>	<b>(2.6)%</b>

**ITEM 4. Controls and Procedures Disclosure**

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

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



significant deficiencies and material weaknesses.

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

**Changes in Internal Control over Financial Reporting**

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

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

None

Item 1a. There are no material changes to the risk factors set forth in Part I, Item 1A, Risk Factors, of the Company's Annual Report on Form 10-K for the year ended December 31, 2007. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company's business.

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

On May 12, 2008, the Company announced the adoption of a stock repurchase program that authorizes the repurchase of up to 4.99% or approximately 76,936 shares of its outstanding common stock in the open market or in privately negotiated transactions. This program expires in May 2009.

**Item 3. Defaults by the Company on its senior securities**

None

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

None

**Item 5. Other information**

None

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## Item 6. Exhibits

<b>exhibit number</b>	<b>description</b>	<b>location</b>
2	Agreement and Plan of Merger among Middlefield Banc Corp., EB Interim Bank, and Emerald Bank, dated as of November 15, 2007, as amended by Amendment No. 1	Incorporated by reference to the prospectus/proxy statement, Appendix A, contained in Part I of Form S-4 Registration Statement Amendment No. 1 filed on February 9, 2008. Disclosure schedules referred to in the Agreement and Plan of Merger are omitted in reliance on Item 601(b)(2) of Regulation S-K. Upon request of the SEC, Middlefield Banc Corp. will furnish supplemental to the SEC a copy of the disclosure schedules
3.1	Second Amended and Restated Articles of Incorporation of Middlefield Banc Corp., as amended	Incorporated by reference to Exhibit 3.1 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2005, filed on March 29, 2007
3.2	Regulations of Middlefield Banc Corp.	Incorporated by reference to Exhibit 3.2 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001
4	Specimen stock certificate	Incorporated by reference to Exhibit 3.2 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001
4.1	Amended and Restated Trust Agreement, dated as of December 21, 2007, between Middlefield Banc Corp., as Depositor, Wilmington Trust Company, as Property Trustee, Wilmington Trust Company, as Delaware Trustee, and Administrative Trustees	Incorporated by reference to Exhibit 4.1 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 27, 2007
4.2	Junior Subordinated Indenture, dated as of December 21, 2007, between Middlefield Banc Corp. and Wilmington Trust Company	Incorporated by reference to Exhibit 4.2 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 27, 2007
4.3	Guarantee Agreement, dated as of December 21, 2007, between Middlefield Banc Corp. and Wilmington Trust Company	Incorporated by reference to Exhibit 4.3 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 27, 2007
99	Report of independent registered public accounting firm.	filed herewith
31	Rule 13a-14(a) certification of Chief Executive Officer	filed herewith
31.1		filed herewith

Rule 13a-14(a) certification of Chief Financial  
Officer

32 Rule 13a-14(b) certification filed herewith

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***SIGNATURES***

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

MIDDLEFIELD BANC CORP.

Date: November 13, 2008

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

Date: November 13, 2008

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

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***EXHIBIT INDEX***

<b>exhibit number</b>	<b>description</b>	<b>location</b>
99	Report of independent registered public accounting firm.	filed herewith
31	Rule 13a-14(a) certification of Chief Executive Officer	filed herewith
31.1	Rule 13a-14(a) certification of Chief Financial Officer	filed herewith
32	Rule 13a-14(b) certification	filed herewith