BAY NATIONAL CORP
Form 10QSB
May 15, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended March 31, 2006

Commission file number: 000-51765

Bay National Corporation
(Exact name of small business issuer as specified in its charter)

Maryland	52-2176710
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2328 West Joppa Road, Lutherville, MD 21093
Address of principal executive offices

(410) 494-2580
Issuer's telephone number

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

Yes X No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ____ No X

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

At May 12, 2006, the issuer had 1,930,894 shares of Common Stock outstanding.

Transitional Small Business Disclosure Format (Check One): Yes ____ No X

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

BAY NATIONAL CORPORATION

CONSOLIDATED BALANCE SHEETS
As of March 31, 2006 and December 31, 2005

	March 31, 2006 (Unaudited)	December 31, 2005
ASSETS		
Cash and due from banks	$ 2,196,148	$ 1,460,669
Federal funds sold and other overnight investments	7,384,745	6,032,952
Investment securities available for sale (AFS) - at fair value	1,935,242	1,540,386
Other equity securities	942,990	794,440
Loans held for sale	3,819,502	17,509,064
Loans, net of unearned fees	199,605,492	182,080,897
Total loans	203,424,994	199,589,961
Less: Allowance for credit losses	(3,000,000)	(3,000,000)
Loans, net	200,424,994	196,589,961
Premises and equipment, net	1,029,781	746,826
Accrued interest receivable and other assets	2,537,629	2,801,101
Total Assets	$ 216,451,529	$ 209,966,335
LIABILITIES		
Non-interest-bearing deposits	$ 27,504,239	$ 27,468,757
Interest-bearing deposits	162,126,069	155,104,329
Total deposits	189,630,308	182,573,086
Short-term borrowings	569,000	1,444,158
Subordinated debt	8,000,000	8,000,000
Accrued expenses and other liabilities	1,391,962	1,735,013
Total Liabilities	199,591,270	193,752,257
STOCKHOLDERS' EQUITY		
Common stock - $.01 par value, authorized: 9,000,000 shares authorized, 1,927,894 and 1,924,436 issued and outstanding as of March 31, 2006 and December 31, 2005, respectively	19,279	19,244
Additional paid in capital	17,495,272	17,451,201
Accumulated deficit	(654,292)	(1,256,367)
Total Stockholders' Equity	16,860,259	16,214,078
Total Liabilities and Stockholders' Equity	$ 216,451,529	$ 209,966,335

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
For the three-month periods ended March 31, 2006 and 2005
(Unaudited)

	Three Months Ending March 31 2006	Three Months Ending March 31 2005
INTEREST INCOME:		
Interest and fees on loans	$ 4,223,414	$ 2,463,260
Interest on federal funds sold and other overnight investments	62,389	66,478
Taxable interest and dividends on investment securities	21,442	11,606
Total interest income	4,307,245	2,541,344
INTEREST EXPENSE:		
Interest on deposits	1,434,862	790,469
Interest on short-term borrowings	17,720	8,116
Interest on note payable	-	16,996
Interest on subordinated debt	149,989	-
Total interest expense	1,602,571	815,581
Net interest income	2,704,674	1,725,763
Provision for credit losses	-	32,000
Net interest income after provision for credit losses	2,704,674	1,693,763
NON-INTEREST INCOME:		
Service charges on deposit accounts	40,739	49,239
Gain on sale of mortgage loans	83,256	41,604
Other income	16,285	11,386
Total non-interest income	140,280	102,229
NON-INTEREST EXPENSES:		
Salaries and employee benefits	1,230,142	748,595
Occupancy expenses	122,408	94,174
Furniture and equipment expenses	83,674	77,091
Legal and professional fees	35,583	40,000
Data processing and other outside services	162,164	208,825
Advertising and marketing related expenses	68,634	61,785
Other expenses	142,917	136,032
Total non-interest expenses	1,845,522	1,366,502
Income before income taxes	999,432	429,490
Income tax expense	397,357	-
NET INCOME	$ 602,075	$ 429,490
Per Share Data:		

Cash Dividends Paid	$	-	$	-
Net Income (basic)	$	.31	$	.22
Net Income (diluted)	$	.30	$	.22
Weighted Average shares outstanding (basic)		1,926,038		1,919,725
Effect of Dilution - Stock options and Warrants		84,804		66,573
Weighted Average shares outstanding (diluted)		2,010,842		1,986,298

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
For the three-months ended March 31, 2006 and 2005
(Unaudited)

	Common Stock	Additional Paid in Capital	Accumulated Deficit	Total Stockholders' Equity
Balances at December 31, 2005	$ 19,244	$17,451,201	$ (1,256,367)	$ 16,214,078
Issuance of Common Stock	35	26,177	-	26,212
Stock based compensation expense	-	17,894	-	17,894
Net Income	-	-	602,075	602,075
Balances at March 31, 2006	$ 19,279	$17,495,272	$ (654,292)	$ 16,860,259

	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	25	18,804	-	18,829
Net Income	-	-	429,490	429,490
Balances at March 31, 2005	$ 19,202	$17,419,088	$ (3,571,207)	$ 13,867,083

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
For the three-months ended March 31, 2006 and 2005
(Unaudited)

	2006	2005
Cash Flows From Operating Activities		
Net income	$ 602,075	$ 429,490
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	50,540	41,113
Accretion of investment discounts	(16,871)	(9,009)
Provision for credit losses	-	32,000
Stock-based compensation expense	17,894	-
Gain on sale of loans held for sale	(83,256)	(41,604)
Origination of loans held for sale	(31,876,629)	(29,932,146)
Proceeds from sale of loans	45,649,447	31,860,097
Net decrease (increase) in accrued interest receivable and other assets	263,472	(188,976)
Net decrease in accrued expenses and other liabilities	(343,051)	(26,292)
Net cash provided by operating activities	14,263,621	2,164,673
Cash Flows From Investing Activities		
Purchases of investment securities - AFS	(1,927,985)	(1,539,568)
Maturities of investment securities - AFS	1,550,000	1,550,000
Purchase of Federal Reserve Bank stock	(70,850)	-
Purchase of Federal Home Loan Bank of Atlanta stock	(77,700)	(98,700)
Loan disbursements in excess of principal payments	(17,524,595)	(781,359)
Capital expenditures	(333,495)	(74,940)
Net cash used in investing activities	(18,384,625)	(944,567)
Cash Flows From Financing Activities		
Net increase in deposits	7,057,222	424,913
Net decrease in short-term borrowings	(875,158)	(120,000)
Net proceeds from stock issuance	26,212	18,829
Net cash provided by financing activities	6,208,276	323,742
Net increase in cash and cash equivalents	2,087,272	1,543,848
Cash and cash equivalents at beginning of period	7,493,621	18,111,952
Cash and cash equivalents at end of period	$ 9,580,893	$ 19,655,800
Cash paid for:		
Interest	$ 1,465,563	$ 801,949
Income taxes	$ 431,357	$ -

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For The Three Months Ended March 31, 2006 and 2005
(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, 2005 have been derived from audited financial statements. These consolidated financial statements should be read in conjunction with the financial statements and accompanying notes included in Bay National Corporation's 2005 Annual Report on Form 10-KSB. There have been no significant changes to the Company's Accounting Policies as disclosed in the 2005 Annual Report. The results shown in this interim report are not necessarily indicative of results to be expected for the full year 2006 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 March 31, 2006, that the Bank meets all capital adequacy requirements to which it is subject.

As of March 31, 2006, 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 were not recognized until the fourth quarter of 2005 when it was deemed more likely than not that the benefits of such deferred income taxes would be realized; accordingly, no deferred income taxes or income tax benefits were recorded by the Company for the three months ended March 31, 2005.

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

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (“SFAS”) No. 123(R), *Share-based Payment,* and has included the stock-based employee compensation cost in its income statements for the three month period ended March 31, 2006. Prior periods have not been restated. Amounts recognized in the financial statements with respect to stock-based compensation are as follows:

	Three Months Ending March 31	
	2006	2005
Amounts charged against income, before tax benefit	$ 17,894	$ -
Amount of related income tax benefit recognized in income	$ 883	$ -

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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 period ended March 31, 2005:

	Three Months Ending March 31, 2005
Net income, as reported	$ 429,490
Less pro forma stock-based compensation expense determined under the fair value method	(17,011)
Pro forma net income	$ 412,479
Net income per share:	
Basic - as reported	$ .22
Diluted - as reported	$ .22
Basic - pro forma	$ .21
Diluted - pro forma	$ .21

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants during the year ended December 31:

	2002
Dividend yield	-
Expected volatility	20.00%
Risk-free interest rate	4.17%
Expected lives (in years)	8

The Company's 2001 Stock Option Plan ("Option Plan") provides for the granting of incentive and non-qualifying stock options to the Company's directors and to selected employees on a periodic basis at the discretion of the Board of Directors. The Option Plan authorizes the issuance of up to 200,000 shares of common stock, has a term of ten years, and is administered by the Compensation Committee of the Board of Directors. The Compensation Committee consists of at least three non-employee directors appointed by the Board of Directors. In general, the options have an exercise price, which may not be less than 100% of the fair market value on the date of the grant, must be exercised within eight years and vest over a period of six years.

The following is a summary of changes in shares under options for the three-month periods ended March 31, 2006 and 2005:

	Number of Shares	Weighted Average Exercise Price
Balance, December 31, 2004	147,492	$ 7.67
Granted	-	-
Cancelled	-	-
Exercised	(2,484)	7.67
Balance, March 31, 2005	145,008	7.67
Balance, December 31, 2005	140,766	7.67
Granted	-	-
Cancelled	(1,242)	7.58
Exercised	(3,458)	7.58
Balance, March 31, 2006	136,066	7.68
Weighted average fair value of options granted during 2002	$ 3.05	

The following table summarizes information about options outstanding at March 31, 2006:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	Number	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
$7.58	119,251	3	$7.58	99,949	$7.58
$8.37	16,815	4	$8.37	4,204	$8.37
	136,066		$7.68	104,153	$7.61

The aggregate intrinsic value of options outstanding and exercisable as of March 31, 2006 was $1,560,677 and $1,201,926, respectively based upon a closing price of $19.15 per share.

Item 2. Management's Discussion and Analysis

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 March 31, 2006 and December 31, 2005 and for the three-month periods ended March 31, 2006 and 2005.

Overview

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.

Asset growth continued for the three-month period ended March 31, 2006, while operating results continued to improve significantly over prior year results. Key measurements for the three-month period ended March 31, 2006 include the following:

- Total assets at March 31, 2006 increased to $216.5 million from $210 million as of December 31, 2005.
- Net loans outstanding increased from $196.6 million as of December 31, 2005 to $200.4 million as of March 31, 2006.
- There were approximately $1.2 million of nonperforming loans at March 31, 2006. The Company continues to maintain appropriate reserves for loan losses.
- Deposits at March 31, 2006 increased to $189.6 million from $182.6 million as of December 31, 2005.
- During March 2006, the Company began using brokered certificates of deposit through the Promontory Financial Network. This network provides the Company with the ability to offer its customers access to FDIC-insured deposit products in aggregate amounts exceeding current insurance limits. When the Company places funds through CDARS on behalf of a customer, it receives matching deposits through the network. These deposits are considered “Brokered Deposit” for bank regulatory purposes. As of March 31, 2006, the Company had approximately $1.2 million of CDARS deposits outstanding.
- Net income before income taxes was $999,432 for the three-month period ended March 31, 2006. This represents an increase of $569,942 or 132.7% over net income before income taxes for the three-month period ended March 31, 2005.
- The Company realized net income of $602,075 for the three-month period ended March 31, 2006. This represents an increase of 40.2% over net income of $429,490 for the three-month period ended March 31, 2005.
- Net interest income, the Company’s main source of income, was $2.7 million during the three-month period ended March 31, 2006 compared to $1.7 million for the same period in 2005. This represents an increase of 56.7%.

· There were no charge-offs for the three-month periods ended March 31, 2006 and 2005, respectively.

· Non-interest income increased by $38,051, or 37.2%, for the three-month period ended March 31, 2006 as compared to the same period in 2005.

· Non-interest expenses increased by $479,020, or 35.1%, for the three-month period ended March 31, 2006 as compared to the three-month period ended March 31, 2005.

· The market price of common shares increased 32.1%, to a closing price of $19.15 at March 31, 2006 from the closing price of $14.50 on March 31, 2005.

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

Results of Operations

General

The Company recorded net income of $602,075 for the three-month period ended March 31, 2006. This compares to net income of $429,490 for the same period in 2005. This is an improvement of $172,585, or 40.2%, for the three-month period. This significant improvement occurred even though the Company recorded $397,357 of income tax expense for the quarter ended March 31, 2006 and no income tax expense for the same period in 2005. The year-over-year improvement in results is due to the continued year-over-year growth of the loan portfolio, resulting in increased interest and fees on loans, improvement in net interest margins and prudent management of operating expenses.

The Bank's mortgage origination operations, located in Lutherville and Salisbury, Maryland, originate conventional first and second lien residential mortgage loans. The 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 March 31, 2006 and 2005, gains on the sale of mortgage loans totaled $83,256 and $41,604, respectively.

Gains on the sale of mortgage loans has increased from 2005 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. Management believes that this type of residential lending is less sensitive to the fluctuation of interest rates than conventional mortgage loans.

During the second quarter of 2004, the Company began purchasing 100% participations 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.

As of March 31, 2006, the Company held $1.1 million of these loans which were classified as held for sale. The Company earned $137,159 of interest on this program for the three-month period ended March 31, 2006. This compares to $104,558 for the same period in 2005. The activity in this program declined significantly during the first quarter of 2006 as the originating mortgage company has utilized other available funding sources. As a result, management expects income from this program to decline over the remainder of the year. Total interest income for this program was $751,803 for the year ended December 31, 2005.

Management expects continued strength in operating results over the remainder of 2006; 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 Lutherville mortgage lending operation, the impact of declining volume in the mortgage participations purchasing program 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 subordinated debt 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 $2.7 million during the three-month period ended March 31, 2006 as compared to $1.7 million for the same period in 2005. This represents an increase of 56.7% for the three-months ended March 31, 2006 as compared to the same period in 2005.

Interest income from loans and investments for the three-month period ended March 31, 2006 was $4.3 million, compared to $2.5 million for the three-month period ended March 31, 2005. The 69.5% increase for the three-month period over the same period in 2005 was directly related to the 25.4% increase in average interest-earning assets for the three-months ended March 31, 2006 as compared to the same period in 2005. The increase in interest income was also aided by a significant increase in average yields due to eight .25% increases in the target federal funds rate since March 31, 2005. The yields on interest earning assets increased from 6.05% for the three-months ended March 31, 2005 to 8.28% for the three-months ended March 31, 2006.

The percentage of average interest-earning assets represented by loans was 94.1% and 89.6% for the three-month periods ended March 31, 2006 and 2005, respectively. The increase was related to management’s decision to increase net interest income by maintaining a higher concentration of loans which typically earn higher yields than investment securities. For the three-month period ended March 31, 2006, the average yield on the loan portfolio increased to 8.63% from 6.54% for the three-month period ended March 31, 2005. This increase is primarily due to the Federal Reserve increasing its target for the federal funds rate from 2.75% as of March 31, 2005 to 4.75% as of March 31, 2006. As can be seen by the yields discussed above, these increases had a significant effect on the Company’s operating results. Management believes that any future increases in the target federal funds rate will similarly improve yields on earning assets in future periods.

The average yield on the investment portfolio and other earning assets, such as federal funds sold, was 2.74% for the three-month period ended March 31, 2006 as compared to 1.79% for the same period in 2005. This improvement in the average yield was a direct result of the Federal Reserve actions discussed above, as well as an increase in the Company’s holdings of Federal Reserve and Federal Home Loan bank stocks, which pay dividend yields greater than those earned by the Company’s cash and cash equivalents. The percentage of average interest-earning assets represented by investments was 5.9% and 10.4% for the three-month periods ended March 31, 2006 and 2005, respectively.

Interest expense from deposits and borrowings for the three-month period ended March 31, 2006 was $1,602,571, compared to $815,581 for the comparable period in 2005. This 96.5% increase is the result of a 29.0% increase in average interest-bearing liabilities for the three-month period ended March 31, 2006 as compared to the same period in 2005 as well as an increase in average rates paid. Average rates paid on these liabilities increased from 2.47% for the three-month period ended March 31, 2005 to 3.82% for the three-month period ended March 31, 2006. The increase in rates paid is directly attributable to the Federal Reserve actions discussed above as well as the issuance of $8 million of subordinated debt in December 2005. This subordinated debt bears interest at 7.2% plus the amortization of debt issuance costs, which brings the effective cost to 7.60%.

As a result of the factors discussed above, net interest margins increased to 5.20% for the three-month period ended March 31, 2006. This is a 26.5% improvement over net interest margin of 4.11% for the same period in 2005. Although market rates of interest have increased significantly since March 31, 2005, 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 daily average balances. The amortization of loan fees is included in computing interest income; however, such fees are not material.

	Three Months Ended March 31, 2006				
		Average Balance		Interest and fees	Yield/ Rate
ASSETS					
Loans and loans held for sale	$	198,417,445	$	4,223,414	8.63%
Investment securities		2,514,546		21,442	3.46
Federal funds sold and other overnight investments		9,896,110		62,389	2.56
Total earning assets		210,828,101		4,307,245	8.28%
Less: Allowance for credit losses		(3,000,000)			
Cash and due from banks		2,018,514			
Premises and equipment, net		996,564			
Accrued interest receivable and other assets		2,577,895			
Total assets	$	213,421,074			
LIABILITIES AND STOCKHOLDERS' EQUITY					
Interest-bearing demand deposits	$	53,327,622		393,507	2.99%
Regular savings deposits		10,331,445		16,599	.65
Time deposits		96,558,104		1,024,756	4.30
Short-term borrowings		1,875,344		17,720	3.83
Subordinated debt		8,000,000		149,989	7.60
Total interest-bearing liabilities		170,092,515		1,602,571	3.82%
Net interest income and spread			$	2,704,674	4.47%
Non-interest-bearing demand deposits		25,333,352			
Accrued expenses and other liabilities		1,475,407			
Stockholders' equity		16,519,800			
Total liabilities and stockholders' equity	$	213,421,074			
Interest income/earning assets		8.28%			
Interest expense/earning assets		3.08			
Net interest margin		5.20%			
Return on Average Assets (Annualized)		1.14%			
Return on Average Equity (Annualized)		14.78%			
Average Equity to Average Assets		7.74%			

Three Months Ended March 31, 2005		Average Balance		Interest and fees	Yield/ Rate
ASSETS					
Loans and loans held for sale	$	150,681,459	$	2,463,260	6.54%
Investment securities		2,104,452		11,606	2.21
Federal funds sold and other overnight investments		15,320,999		66,478	1.74
Total earning assets		168,106,910		2,541,344	6.05%
Less: Allowance for credit losses		(1,821,378)			
Cash and due from banks		1,173,244			
Premises and equipment, net		608,415			
Accrued interest receivable and other assets		667,893			
Total assets	$	168,735,084			
LIABILITIES AND STOCKHOLDERS' EQUITY					
Interest-bearing demand deposits	$	55,952,233		202,465	1.45%
Regular savings deposits		5,335,595		8,538	.64
Time deposits		67,856,868		579,466	3.42
Short-term borrowings		1,460,756		8,116	2.22
Note payable		1,250,000		16,996	5.44
Total interest-bearing liabilities		131,855,452		815,581	2.47%
Net interest income and spread			$	1,725,763	3.58%
Non-interest-bearing demand deposits		22,758,094			
Accrued expenses and other liabilities		614,716			
Stockholders' equity		13,506,822			
Total liabilities and stockholders' equity	$	168,735,084			

Interest income/earning assets	6.05%
Interest expense/earning assets	1.94
Net interest margin	4.11%
Return on Average Assets (Annualized)	1.02%
Return on Average Equity (Annualized)	12.72%
Average Equity to Average Assets	8.00%

Provision for Credit Losses

There was no provision for credit losses for the three-month period ended March 31, 2006, as compared to a $32,000 provision for the three-month period ended March 31, 2005. The provision for credit losses is normally reflective of the growth in loan balances outstanding in all segments of the portfolio as well as changes in the relative level of risk in the portfolio. The provision for the three-month period ended March 31, 2006 was lower than the same period in the prior year due to the fact that the relative risk mix of the portfolio declined for the three-month period ended March 31, 2006 as the Company successfully eliminated some riskier loans from the portfolio. 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 March 31, 2006, the Company realized non-interest income of $140,280 as compared to $102,229 for the three-month period ended March 31, 2005. Gains on the sale of mortgage loans of $83,256 comprised 59.3% of the total for the three-month period ended March 31, 2006. This compares to gains on the sale of mortgage loans of $41,604, or 40.7% of total non-interest income, for the three-month period ended March 31, 2005.

The level of gains on the sale of mortgage loans increased in the three-month period ended March 31, 2006 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. While these additional capabilities have increased the level of gains on the sale of mortgage loans, while also providing interest income on construction loans, it should be noted that additional increases in interest rates, or a slow down in the housing market, could impact the Company's ability to generate non-interest income associated with mortgage loan production.

Service charges on deposit accounts totaled $40,739 for the three-month period ended March 31, 2006, as compared to $49,239 for the three-month period ended March 31, 2005. This 17.3% decrease is directly attributable 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 period ended March 31, 2006 totaled $1,845,522. This compares to non-interest expense for the comparable periods in 2005 of $1,366,502. The increases of $479,020, or 35.1%, resulted from an increase in salaries and benefits of $481,547, or 64.3% for the same period. 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 $28,234 for the three months ended March 31, 2006, as compared to the same period in 2005. The 30.0% increase for the period, as compared to the same period in 2005, was due in part to scheduled rent increa