

BAY NATIONAL CORP  
Form 10QSB  
November 14, 2005

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 September 30, 2005.

Commission file number: 333-87781

**Bay National Corporation**

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

Maryland  
(State or other jurisdiction of  
incorporation or organization)

52-2176710  
(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

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

At November 11, 2005, the issuer had 1,924,436 shares of Common Stock outstanding.

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

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



**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****BAY NATIONAL CORPORATION****CONSOLIDATED BALANCE SHEETS**

As of September 30, 2005 and December 31, 2004

|  | September<br>30,<br>2005<br>(Unaudited) | December<br>31,<br>2004 |
|--|---|-------------------------|
| <b>ASSETS</b>  |   |                         |
| Cash and due from banks  | \$ 1,663,245                            | \$ 1,403,424            |
| Federal funds sold and other overnight investments   | 11,847,688                              | 16,708,528              |
| Investment securities available for sale (AFS) - at fair value   | 1,541,231                               | 1,544,496               |
| Other equity securities  | 906,940                                 | 556,090                 |
| Loans held for sale  | 19,096,277                              | 9,613,162               |
| Loans, net of unearned fees  | 167,657,004                             | 141,413,437             |
| Total loans  | 186,753,281                             | 151,026,599             |
| Less: Allowance for credit losses  | (2,350,000)                             | (1,810,000)             |
| Loans, net   | 184,403,281                             | 149,216,599             |
| Premises and equipment, net  | 759,786                                 | 593,583                 |
| Accrued interest receivable and other assets   | 1,310,985                               | 740,754                 |
| <b>Total Assets</b>  | <b>\$ 202,433,156</b>                   | <b>\$ 170,763,474</b>   |
| <b>LIABILITIES</b>   |   |                         |
| Non-interest-bearing deposits  | \$ 24,910,101                           | \$ 20,638,596           |
| Interest-bearing deposits  | 155,442,869                             | 133,288,446             |
| Total deposits   | 180,352,970                             | 153,927,042             |
| Short-term borrowings  | 3,710,000                               | 1,381,000               |
| Note payable   | 2,100,000                               | 1,250,000               |
| Accrued expenses and other liabilities   | 1,182,181                               | 786,668                 |
| <b>Total Liabilities</b>   | <b>187,345,151</b>                      | <b>157,344,710</b>      |
| <b>STOCKHOLDERS' EQUITY</b>  |   |                         |
| Common stock - \$.01 par value, authorized:<br>9,000,000 shares authorized, 1,924,436 and 1,917,710<br>issued<br>and outstanding as of September 30, 2005 and December<br>31, 2004, respectively | 19,244                                  | 19,177                  |

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|  |                |                |
|--|----------------|----------------|
| Additional paid in capital                 | 17,451,201     | 17,400,284     |
| Accumulated deficit                        | (2,382,440)    | (4,000,697)    |
| Total Stockholders' Equity                 | 15,088,005     | 13,418,764     |
| Total Liabilities and Stockholders' Equity | \$ 202,433,156 | \$ 170,763,474 |

See accompanying notes to consolidated financial statements.

**BAY NATIONAL CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS**

For the three and nine-month periods ended September 30, 2005 and 2004  
(Unaudited)

|   | Three Months Ending<br>September 30 |             | Nine Months Ending<br>September 30 |             |
|---|-------------------------------------|-------------|------------------------------------|-------------|
|   | 2005                                | 2004        | 2005                               | 2004        |
| <b>INTEREST INCOME:</b>   |                                     |             |                                    |             |
| Interest and fees on loans  | \$3,532,663                         | \$1,947,348 | \$8,772,889                        | \$5,186,493 |
| Interest on federal funds sold and other<br>overnight investments | 48,617                              | 46,725      | 160,401                            | 99,224      |
| Taxable interest and dividends on<br>investment<br>securities     | 16,555                              | 7,035       | 53,923                             | 26,820      |
| Total interest income   | 3,597,835                           | 2,001,108   | 8,987,213                          | 5,312,537   |
| <b>INTEREST EXPENSE:</b>  |                                     |             |                                    |             |
| Interest on deposits  | 1,110,071                           | 649,532     | 2,774,317                          | 1,725,216   |
| Interest on short-term borrowings                                 | 45,309                              | 6,178       | 90,859                             | 12,618      |
| Interest on note payable  | 26,278                              | -           | 61,801                             | -           |
| Total interest expense  | 1,181,658                           | 655,710     | 2,926,977                          | 1,737,834   |
| Net interest income   | 2,416,177                           | 1,345,398   | 6,060,236                          | 3,574,703   |
| Provision for credit losses                                       | 297,000                             | 136,500     | 532,500                            | 350,221     |
| Net interest income after provision for<br>credit losses          | 2,119,177                           | 1,208,898   | 5,527,736                          | 3,224,482   |
| <b>NON-INTEREST INCOME:</b>                                       |                                     |             |                                    |             |
| Service charges on deposit accounts                               | 58,267                              | 66,447      | 152,209                            | 178,025     |
| Gain on sale of mortgage loans                                    | 160,592                             | 50,576      | 352,745                            | 181,697     |
| Other income  | 12,158                              | 15,579      | 35,095                             | 41,703      |
| Total non-interest income   | 231,017                             | 132,602     | 540,049                            | 401,425     |
| <b>NON-INTEREST EXPENSES:</b>                                     |                                     |             |                                    |             |
| Salaries and employee benefits                                    | 1,002,607                           | 621,937     | 2,630,500                          | 1,805,823   |
| Occupancy expenses  | 102,119                             | 80,930      | 297,002                            | 223,945     |
| Furniture and equipment expenses                                  | 69,782                              | 62,912      | 221,664                            | 185,482     |
| Legal and professional fees                                       | 30,000                              | 49,087      | 102,712                            | 122,335     |
| Data processing and other outside<br>services                     | 165,953                             | 133,391     | 517,788                            | 416,051     |
| Advertising and marketing related<br>expenses                     | 102,340                             | 55,687      | 254,975                            | 140,661     |
| Other expenses  | 126,748                             | 93,184      | 424,887                            | 252,855     |
| Total non-interest expenses                                       | 1,599,549                           | 1,097,128   | 4,449,528                          | 3,147,152   |
| Income before income taxes  | 750,645                             | 244,372     | 1,618,257                          | 478,755     |

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|  |            |            |              |            |
|--|------------|------------|--------------|------------|
| Income tax expense                                 | -          | -          | -            | -          |
| NET INCOME   | \$ 750,645 | \$ 244,372 | \$ 1,618,257 | \$ 478,755 |
| Per Share Data:                                    |            |            |              |            |
| Cash Dividends Paid                                | \$ -       | \$ -       | \$ -         | \$ -       |
| Net Income (basic)                                 | \$ .39     | \$ .13     | \$ .84       | \$ .26     |
| Net Income (diluted)                               | \$ .37     | \$ .13     | \$ .81       | \$ .25     |
| Weighted Average shares outstanding<br>(basic)     | 1,924,436  | 1,872,058  | 1,921,954    | 1,865,849  |
| Effect of Dilution - Stock options and<br>Warrants | 80,192     | 60,799     | 75,231       | 60,416     |
| Weighted Average shares outstanding<br>(diluted)   | 2,004,628  | 1,932,857  | 1,997,185    | 1,926,265  |

See accompanying notes to consolidated financial statements.

**BAY NATIONAL CORPORATION****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

For the nine-months ended September 30, 2005 and 2004  
(Unaudited)

|                                   | Common<br>Stock | Additional<br>Paid in<br>Capital | Accumulated<br>Deficit | Total<br>Stockholders'<br>Equity |
|-----------------------------------|-----------------|----------------------------------|------------------------|----------------------------------|
| Balances at December 31,<br>2004  | \$ 19,177       | \$ 17,400,284                    | \$ (4,000,697)         | \$ 13,418,764                    |
| Issuance of Common Stock          | 67              | 50,917                           | -                      | 50,984                           |
| Net Income                        | -               | -                                | 1,618,257              | 1,618,257                        |
| Balances at September 30,<br>2005 | \$ 19,244       | \$ 17,451,201                    | \$ (2,382,440)         | \$ 15,088,005                    |
|                                   |                 |                                  |                        |                                  |
|                                   | Common<br>Stock | Additional<br>Paid in<br>Capital | Accumulated<br>Deficit | Total<br>Stockholders'<br>Equity |
| Balances at December 31,<br>2003  | \$ 18,627       | \$ 16,850,834                    | \$ (4,802,961)         | \$ 12,066,500                    |
| Issuance of Common Stock          | 413             | 412,087                          | -                      | 412,500                          |
| Net Income                        | -               | -                                | 478,755                | 478,755                          |
| Balances at September 30,<br>2004 | \$ 19,040       | \$ 17,262,921                    | \$ (4,324,206)         | \$ 12,957,755                    |

See accompanying notes to consolidated financial statements.

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

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



See accompanying notes to consolidated financial statements.

**BAY NATIONAL CORPORATION**

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

**1. GENERAL**

*Organization*

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

*Basis of Presentation*

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

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

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

*Reclassifications*

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

**2. REGULATORY MATTERS**

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



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

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

### **3. INCOME TAXES**

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

### **4. EARNINGS PER SHARE**

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

### **5. STOCK-BASED COMPENSATION**

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

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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 and nine-month periods ended September 30:

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

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

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

### General

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

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

### Overview

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

- Total assets at September 30, 2005 increased to \$202.4 million as compared to \$170.8 million as of December 31, 2004.
- Net loans outstanding increased from \$149.2 million as of December 31, 2004 to \$184.4 million as of September 30, 2005.
- There were no nonperforming loans at September 30, 2005. Appropriate reserves for loan losses continue to be maintained.
- Deposits at September 30, 2005 were \$180.4 million, an increase from \$153.9 million as of December 31, 2004.
- The Company realized net income of \$750,645 and \$1,618,257 for the three-month and nine-month periods ended September 30, 2005, respectively. This represents increases of 207.2% and 238.0% over net income of \$244,372 and \$478,755 for the three-month and nine month periods ended September 30, 2004, respectively.
- Net interest income, the Company's main source of income, was \$2.4 million and \$6.1 million during the three-month and nine-month periods ended September 30, 2005 compared to \$1.3 million and \$3.6 million for the same periods in 2004. This represents an increase of 79.6% and 69.5% for the three-months and nine-months ended September 30, 2005, respectively, as compared to the same periods in 2004.
- There were recoveries on prior charge-offs of \$7,500 for the nine-month period ended September 30, 2005. Loan charge-offs were \$6,221 for the nine-month period ended September 30, 2004.

- Non-interest income increased by \$98,415, or 74.2%, and by \$138,624, or 34.5%, for the three-month and nine-month periods September 30, 2005, respectively, as compared to the same periods in 2004.
- Non-interest expenses increased by \$502,421 and \$1,302,376, or 45.8% and 41.4%, for the three-month and nine-month periods ended September 30, 2005, respectively, as compared to the same periods ended September 30, 2004.
- The market price of common shares ended the quarter at \$19.00, up 43.4% from the closing price of \$13.25 on December 31, 2004.

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

## **Results of Operations**

### *Overview*

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

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

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

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

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

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

#### *Net Interest Income*

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

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

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

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



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

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

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

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

**Nine Months Ended September 30, 2005**

|  | <b>Average<br/>Balance</b> | <b>Interest<br/>and fees</b> | <b>Yield/<br/>Rate</b> |
|--|----------------------------|------------------------------|------------------------|
| <b>ASSETS</b>                                      |                            |                              |                        |
| Loans and loans held for sale                      | \$ 162,883,257             | \$ 8,772,889                 | 7.18%                  |
| Investment securities                              | 2,325,834                  | 53,923                       | 3.09                   |
| Federal funds sold and other overnight investments | 11,643,564                 | 160,401                      | 1.84                   |
| Total earning assets                               | 176,852,655                | 8,987,213                    | 6.78%                  |
| Less: Allowance for credit losses                  | (1,959,675)                |                              |                        |
| Cash and due from banks                            | 1,316,501                  |                              |                        |
| Premises and equipment, net                        | 683,184                    |                              |                        |
| Accrued interest receivable and other assets       | 793,880                    |                              |                        |
| Total assets                                       | \$ 177,686,545             |                              |                        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>        |                            |                              |                        |
| Interest-bearing demand deposits                   | \$ 55,137,766              | 695,691                      | 1.68%                  |
| Regular savings deposits                           | 5,460,498                  | 26,457                       | .65                    |
| Time deposits                                      | 74,127,589                 | 2,052,169                    | 3.69                   |
| Short-term borrowings                              | 3,960,879                  | 90,859                       | 3.06                   |
| Note payable                                       | 1,337,363                  | 61,801                       | 6.16                   |
| Total interest-bearing liabilities                 | 140,024,095                | 2,926,977                    | 2.79%                  |
| Net interest income and spread                     |                            | \$ 6,060,236                 | 3.99%                  |
| Non-interest-bearing demand deposits               | 22,888,519                 |                              |                        |
| Accrued expenses and other liabilities             | 767,178                    |                              |                        |
| Stockholders' equity                               | 14,006,753                 |                              |                        |
| Total liabilities and stockholders' equity         | \$ 177,686,545             |                              |                        |
| Interest income/earning assets                     |                            | 6.78%                        |                        |
| Interest expense/earning assets                    |                            | 2.21                         |                        |
| Net interest margin                                |                            | 4.57%                        |                        |
| Return on Average Assets (Annualized)              |                            | 1.21%                        |                        |
| Return on Average Equity (Annualized)              |                            | 15.40%                       |                        |
| Average Equity to Average Assets                   |                            | 7.88%                        |                        |



**Nine Months Ended September 30, 2004**

|  | <b>Average<br/>Balance</b> | <b>Interest<br/>and fees</b> | <b>Yield/<br/>Rate</b> |
|--|----------------------------|------------------------------|------------------------|
| <b>ASSETS</b>                                      |                            |                              |                        |
| Loans and loans held for sale                      | \$ 120,097,860             | \$5,186,493                  | 5.76%                  |
| Investment securities                              | 2,022,488                  | 26,820                       | 1.77                   |
| Federal funds sold and other overnight investments | 15,729,612                 | 99,224                       | .84                    |
| Total earning assets                               | 137,849,960                | 5,312,537                    | 5.14%                  |
| Less: Allowance for credit losses                  | (1,406,395)                |                              |                        |
| Cash and due from banks                            | 859,704                    |                              |                        |
| Premises and equipment, net                        | 650,349                    |                              |                        |
| Accrued interest receivable and other assets       | 556,700                    |                              |                        |
| Total assets                                       | \$ 138,510,318             |                              |                        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>        |                            |                              |                        |
| Interest-bearing demand deposits                   | \$ 44,806,717              | 359,507                      | 1.07%                  |
| Regular savings deposits                           | 4,015,492                  | 19,556                       | .65                    |
| Time deposits                                      | 59,201,495                 | 1,346,153                    | 3.03                   |
| Short-term borrowings                              | 1,456,369                  | 12,618                       | 1.16                   |
| Total interest-bearing liabilities                 | 109,480,073                | 1,737,834                    | 2.12%                  |
| Net interest income and spread                     |                            | \$3,574,703                  | 3.02%                  |
| Non-interest-bearing demand deposits               | 16,306,404                 |                              |                        |
| Accrued expenses and other liabilities             | 463,110                    |                              |                        |
| Stockholders' equity                               | 12,260,731                 |                              |                        |
| Total liabilities and stockholders' equity         | \$ 138,510,318             |                              |                        |
| Interest income/earning assets                     | 5.14%                      |                              |                        |
| Interest expense/earning assets                    | 1.68                       |                              |                        |
| Net interest margin                                | 3.46%                      |                              |                        |
| Return on Average Assets (Annualized)              | .46%                       |                              |                        |
| Return on Average Equity (Annualized)              | 5.21%                      |                              |                        |
| Average Equity to Average Assets                   | 8.85%                      |                              |                        |

*Provision for Credit Losses*

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

*Non-Interest Income*

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

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

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

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

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

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

#### *Non-Interest Expense*

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

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

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

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

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

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

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

### *Income Taxes*

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

### **Financial Condition**

#### *Composition of the Balance Sheet*

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

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

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

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



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

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

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

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

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

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

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

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

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

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

#### *Allowance for Credit Losses and Credit Risk Management*

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

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

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

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

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

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

### *Liquidity*

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

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

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

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

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

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

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

#### *Interest Rate Sensitivity*

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

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

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

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

The Company has 71.47% of its interest-earning assets and 45.11% of its interest-bearing liabilities in variable rate balances. Interest-earning assets exceed interest-bearing liabilities by \$39,796,271. The majority of this gap is concentrated in items maturing or repricing within 5 years. This gap is generally reflective of the Company's emphasis on originating variable rate loans and the demand in the market for higher yielding fixed rate deposits. This analysis

indicates that the Company generally will benefit from increasing market rates of interest. However, since all interest rates and yields do not adjust at the same pace, the gap is only a general indicator of interest rate sensitivity. The analysis of the Company's interest-earning assets and interest-bearing liabilities presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration the fact that changes in interest rates do not affect all assets and liabilities equally. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

Management constantly monitors and manages the structure of the Company's balance sheet, seeks to control interest rate exposure, and evaluate pricing strategies. Strategies to better match maturities of interest-earning assets and interest-bearing liabilities include structuring loans with rate floors and ceilings on variable-rate notes and providing for repricing opportunities on fixed rate notes. Management believes that a lending strategy focusing on variable-rate loans and short-term fixed rate loans will best facilitate the goal of minimizing interest rate risk. However, management will opportunistically enter into longer term fixed-rate loans and/or investments when, in management's judgment, rates adequately compensate the Company for the interest rate risk. The Company's current investment concentration in federal funds sold and other overnight

investments provides the most flexibility and control over rate sensitivity since it generally can be restructured more quickly than the loan portfolio. On the liability side, deposit products can be restructured so as to offer incentives to attain the maturity distribution desired although competitive factors sometimes make control over deposit maturity difficult.

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

*Off-Balance Sheet Arrangements*

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

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

|                        | <b>September<br/>30,<br/>2005</b> | <b>December<br/>31,<br/>2004</b> |
|------------------------|-----------------------------------|----------------------------------|
| Loan commitments       | \$ 22,514,982                     | \$ 9,867,893                     |
| Unused lines of credit | 43,250,442                        | 40,423,986                       |
| Letters of credit      | 3,685,563                         | 1,578,379                        |

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

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

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

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

*Capital Resources*

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

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

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

**Reconciliation of Non-GAAP Measures**

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

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

**Application of Critical Accounting Policies**

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





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

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

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

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

### Item 3. Controls and Procedures

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

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

#### *Information Regarding Forward-Looking Statements*

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

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

**PART II - OTHER INFORMATION**

Item 1. Legal Proceedings.

None

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

(a) None

(b) None

(c) None

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

None

Item 5. Other Information.

None

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Item 6. Exhibits.

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

**SIGNATURES**

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

Bay National Corporation

Date: November 11, 2005

By: /s/ Hugh W. Mohler  
Hugh W. Mohler, President  
(Principal Executive Officer)

Date: November 11, 2005

By: /s/ Mark A. Semanie  
Mark A. Semanie, Treasurer  
(Principal Accounting and Financial  
Officer)