

FEDERAL DEPOSIT INSURANCE CORPORATION  
WASHINGTON, DC 20429

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2009

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

FDIC Certificate Number: 19101

HARFORD BANK

(Name of registrant as specified in its charter)

Maryland

(State or other jurisdiction of organization)

52-0799113

(IRS Employer incorporation or

Identification No.)

8 West Bel Air Avenue, Aberdeen, Maryland 21001

(Address of principal executive offices)

(410) 272-5000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No  (Not Applicable)

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

Large accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Accelerated filer

Smaller reporting company

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date 974,195.7 shares of common stock as of October 16, 2009.

This Quarterly Report of Harford Bank (the “Bank”) on Form 10-Q may contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Readers of this report should be aware of the speculative nature of “forward-looking statements”. Statements that are not historical in nature, including those that include the words “anticipate”, “estimate”, “should”, “expect”, “believe”, “intend”, and similar expressions, are forward-looking statements and are based on current expectations, estimates and projections about, among other things, the industry and the markets in which the Bank operates, and they are not guarantees of future performance. Whether actual results will conform to expectations and predictions is subject to known and unknown risks and uncertainties, including risks and uncertainties discussed in this report; general economic, market, or business conditions; changes in interest rates, deposit flow, the cost of funds, and demand for loan products and financial services; changes in the Bank’s competitive position or competitive actions by other companies; changes in the quality or composition of loan and investment portfolios; the ability to manage growth; changes in laws or regulations or policies of federal and state regulators and agencies; and other circumstances beyond the Bank’s control. Consequently, all of the forward-looking statements made in this document are qualified by these cautionary statements, and there can be no assurance that the actual results anticipated will be realized, or if substantially realized, will have the expected consequences on the Bank’s business or operations. These and other risks are discussed in detail in the periodic reports that the Bank files with the Federal Deposit Insurance Corporation (“FDIC”) (see Item 1A of Part II of this report for further information). Except as required by applicable laws, the Bank does not intend to publish updates or revisions of forward-looking statements it makes to reflect new information, future events or otherwise.

## **PART I**

### **Item 1. Financial Statements**

The information required by this item can be found beginning on page F-1 immediately following the signatures to this report and is incorporated herein by reference.

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

The following discussion should be read and reviewed in conjunction with the interim financial statements and the notes thereto included elsewhere in this report, and with Management’s Discussion and Analysis of Financial Condition and Results of Operation, the audited financial statements and notes thereto, and the other statistical information contained in the Bank’s Annual Report on Form 10-K for the year ended December 31, 2008.

The Bank is a Maryland-chartered bank with its principal office in Aberdeen, Harford County, Maryland. Through its six branches located throughout Harford County, plus a branch in Cecil County, the Bank offers a full range of deposit services that are typically offered by most banks, savings and loan associations, and credit unions, including checking accounts, NOW accounts, savings accounts and other time deposits of various types, ranging from money market accounts to longer-term certificates of deposit. In addition, the Bank offers Individual Retirement Accounts. The Bank also offers a full range of short- to medium-term commercial and personal loans, including fixed-rate consumer mortgage loans, commercial mortgage loans, home equity loans, and real estate construction loans. Other banking services include safe deposit boxes, traveler’s checks, direct deposit of payroll and social security checks, Internet banking with bill pay service, ATM services and a Visa debit card.

## **APPLICATION OF CRITICAL ACCOUNTING POLICIES**

The Bank’s financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the industry in which the Bank operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the 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 needs to 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 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.

The most significant accounting policies followed by the Bank are presented in Note 1 to the financial statements appearing elsewhere in this report. These policies, along with the disclosures presented in the other financial statement notes and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. 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 loan losses as the accounting area that requires the most subjective or complex judgments, and as such should be most subject to revision as new information becomes available.

The allowance for loan losses represents management's estimate of loan losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the balance sheets. Note 1 to the financial statements describes the methodology used to determine the allowance for loan losses.

## **RESULTS OF OPERATIONS**

### **Summary**

For the three- and nine-month periods ended September 30, 2009, the Bank reported net income of \$551,375 and \$1,246,477, respectively, compared to \$426,698 and \$1,285,837 for the same periods in 2008. Basic net income per share for the three- and nine-month periods ended September 30, 2009 was \$.56 and \$1.28, respectively, compared to \$.43 and \$1.31, respectively, for the same periods of 2008.

Return on average assets was .67% for the nine months ended September 30, 2009, compared to .78% for the same period in 2008. Return on average stockholders' equity for the nine months ended September 30, 2009 was 6.88%, compared to 7.28% for the nine months ended September 30, 2008. Comparing the nine months ended September 30, 2009 with the same period in 2008, average assets increased 13.64% to \$248,963,012, average net loans increased 14.93% to \$207,407,452, average deposits increased 9.17% to \$192,865,788 and average stockholders' equity increased 2.53% to \$24,157,793.

### **Net Interest Income and Net Interest Margin**

The primary source of income for the Bank is net interest income, which is the difference between revenue on interest-earning assets, such as investment securities and loans, and interest incurred on interest-bearing liabilities, such as deposits and borrowings. The level of net interest income is determined primarily by the average balance of interest-earning assets and interest-bearing liabilities and the various rate spreads between such assets and liabilities. The table below entitled "Average Balances, Interest, and Yields" shows the Bank's average volume of interest-earning assets and interest-bearing liabilities for the three and nine-month periods ended September 30, 2009 and 2008 and related income/expense and yields. Changes in net interest income from period to period result from increases or decreases in the volumes of interest-earning assets and interest-bearing liabilities, and increases or decreases in the average rates earned and paid on such assets and liabilities. The volumes of interest-earning assets and interest-bearing liabilities are affected by management's ability to effectively and efficiently manage the earning-asset portfolio (which includes loans), and the availability of particular sources of funds, such as non-interest bearing deposits.

**Harford Bank**  
**Average Balances, Interest, and Yields**

	For the three months ended September 30, 2009			For the three months ended September 30, 2008			For the nine months ended September 30, 2009			For the nine months ended September 30, 2008		
	Average balance	Interest	Yield	Average balance	Interest	Yield	Average balance	Interest	Yield	Average balance	Interest	Yield
<b>Assets</b>												
Federal funds sold	\$ 7,750,762	\$ 4,735	0.24%	\$ 3,370,608	\$ 19,428	2.29%	\$ 5,596,772	\$ 11,145	0.27%	\$ 3,463,490	\$ 70,240	2.71%
FHLB interest bearing deposits	247,021	47	0.08%	335,991	1,929	2.28%	260,279	228	0.12%	965,959	21,669	3.00%
Investment CDs	3,133,304	6,551	0.83%	-	-	-	2,274,161	28,243	1.66%	-	-	-
Investment securities:												
U.S. government agency securities	9,967,642	99,197	3.95%	10,483,507	114,234	4.33%	9,274,507	287,534	4.15%	10,645,589	359,304	4.51%
State and municipal	1,572,635	14,187	3.58%	2,479,034	22,473	3.61%	1,872,688	53,755	3.84%	3,026,984	78,065	3.44%
Other	1,974,100	4,375	0.88%	1,450,733	11,722	3.21%	1,980,164	4,375	0.30%	1,197,991	45,575	5.08%
Total investment securities	13,514,377	117,759	3.46%	14,413,274	148,429	4.10%	13,127,359	345,664	3.52%	14,870,564	482,945	4.34%
Loans:												
Overdrafts	279,739			352,332			283,492			395,033		
Personal loans	21,352,761	344,831	6.41%	21,571,280	377,308	6.96%	21,504,515	1,079,763	6.71%	21,557,131	1,119,046	6.93%
Credit lines	7,901,811	64,192	3.22%	7,275,895	89,530	4.90%	7,814,658	185,043	3.17%	6,732,138	271,292	5.38%
Business loans	24,668,000	398,209	6.40%	21,163,132	345,180	6.49%	23,116,680	1,004,801	5.81%	21,218,223	1,076,257	6.78%
Real estate loans	157,600,487	2,660,433	6.70%	140,601,952	2,317,852	6.56%	156,765,724	7,834,134	6.68%	132,191,649	6,772,044	6.84%
Total loans	211,802,798	3,467,665	6.50%	190,964,591	3,129,870	6.52%	209,485,069	10,103,741	6.45%	182,094,174	9,238,639	6.78%
Allowance for loan losses	(2,201,728)			(1,729,576)			(2,077,617)			(1,632,955)		
Total loans, net of allowance	209,601,070	3,467,665	6.56%	189,235,015	3,129,870	6.58%	207,407,452	10,103,741	6.51%	180,461,219	9,238,639	6.84%
Total interest-earning assets	234,246,534	\$ 3,596,757	6.09%	207,354,888	\$ 3,299,656	6.33%	228,666,023	\$ 10,489,021	6.13%	199,761,232	\$ 9,813,493	6.56%
Noninterest-bearing cash	6,794,209			5,797,709			6,471,630			5,223,296		
Premises and equipment	7,825,477			8,002,559			7,864,573			8,089,517		
Restricted stock	100,000			100,000			100,000			100,000		
Other assets	5,933,679			5,725,897			5,860,786			5,904,618		
Total assets	\$ 254,899,899			\$ 226,981,053			\$ 248,963,012			\$ 219,078,663		
<b>Liabilities and Stockholders' Equity</b>												
Interest-bearing Deposits												
NOW deposits	\$ 22,584,383	\$ 7,740	0.14%	\$ 20,545,734	\$ 13,257	0.26%	\$ 21,023,631	\$ 24,906	0.16%	\$ 20,370,506	\$ 32,754	0.21%
Savings	21,386,967	16,140	0.30%	21,542,410	29,789	0.55%	21,567,413	75,224	0.47%	21,925,825	90,216	0.55%
Money market	23,347,072	53,931	0.92%	17,903,129	81,183	1.80%	22,738,375	174,381	1.03%	16,548,452	221,111	1.78%
Personal investment	15,025,180	34,497	0.91%	12,271,202	58,786	1.91%	14,156,598	108,054	1.02%	12,014,875	171,249	1.90%
Time deposits	85,889,859	621,422	2.87%	72,591,471	733,417	4.02%	82,301,149	1,946,977	3.16%	72,081,925	2,321,511	4.30%
Total interest-bearing deposits	168,233,461	733,730	1.73%	144,853,946	916,432	2.52%	161,787,166	2,329,542	1.93%	142,941,583	2,836,841	2.65%
Noninterest-bearing deposits	31,748,194	-	-	34,113,531	-	-	31,078,622	-	-	33,726,792	-	-
Total deposits	199,981,655	733,730	1.46%	178,967,477	916,432	2.04%	192,865,788	2,329,542	1.61%	176,668,375	2,836,841	2.14%
FHLB long term borrowing	29,388,199	253,390	3.42%	21,549,689	193,484	3.57%	29,638,932	756,737	3.41%	16,565,693	435,620	3.51%
Borrowed overnight funds	43	-	-	1,903,424	8,567	1.79%	1,293,788	5,630	0.58%	1,492,336	24,261	2.17%
Total borrowed funds	29,388,242	253,390	3.42%	23,453,113	202,051	3.43%	30,932,720	762,367	3.30%	18,058,029	459,881	3.40%
Total deposits and borrowed funds	229,369,897	\$ 987,120	1.71%	202,420,590	\$ 1,118,483	2.20%	223,798,508	\$ 3,091,909	1.85%	194,726,404	3,296,722	2.26%
Other liabilities	1,101,923	-		867,150			1,006,711			789,744		
Stockholders' equity	24,428,079	-		23,693,313			24,157,793			23,562,515		
Total liabilities and stockholders' equity	\$ 254,899,899			\$ 226,981,053			\$ 248,963,012			\$ 219,078,663		
Net interest spread			4.38%			4.13%			4.29%			4.30%
Net interest income		\$ 2,609,637			\$ 2,181,173			\$ 7,397,112			\$ 6,516,771	
Net margin on interest-earning assets			4.42%			4.18%			4.33%			4.36%

Interest and dividends on securities and loans are reported on fully taxable equivalent basis (a non-GAAP financial measure)

Interest revenue on a fully taxable equivalent basis for the three- and nine-month periods ended September 30, 2009 was \$3,596,757 and \$10,489,021, respectively, compared to \$3,299,656 and \$9,813,493, respectively, for the same periods in 2008, representing increases of \$297,101 or 9.00% and \$675,528 or 6.88%, respectively. Average net loan volume for the three- and nine-month periods ended September 30, 2009 increased 10.76% and 14.93%, respectively, when compared to September 30, 2008. The weighted average rate received on the Bank's loan portfolio on a fully taxable equivalent basis for the three- and nine-month periods ended September 30, 2009 decreased 2 basis points to 6.56% and 33 basis points to 6.51%, respectively, when compared to September 30, 2008. Interest revenue on a fully taxable equivalent basis for federal funds sold, investment certificate of deposits and interest-bearing deposits in the Federal Home Loan Bank (the "FHLB") of Atlanta decreased 46.94% or \$10,024 and 56.90% or \$52,293, respectively, for the three and nine months ended September 30, 2009 when compared to the same periods in 2008. Average volume for these instruments for the three- and nine-month periods ended September 30, 2009 increased 200% and 83.57%, respectively, when compared to September 30, 2008; however, the weighted average rate received on these investments on a fully taxable equivalent basis decreased 1.88% and 2.12%, respectively, for the same three- and nine-month periods in 2009 when compared to 2008. Interest revenue on investment securities on a tax equivalent basis for the three- and nine-month periods ended September 30, 2009 declined \$23,323 or 17.06% and \$96,080 or 21.97%, respectively, when compared to the same periods in 2008. The decrease is mainly attributable to a 10.97% and 18.47% decrease in the average balance of the investment portfolio for the three- and nine-month periods ended September 30, 2009 when compared to the same periods in 2008. The Bank is a member of the FHLB of Atlanta and is required to purchase capital stock of the FHLB of Atlanta as a condition to obtaining a line of credit. For the nine months ended September 30, 2009, the FHLB of Atlanta paid dividends in the amount of \$4,375 on its stock compared to a \$45,575 dividend paid during the first nine months of 2008.

During the three- and nine-month periods ended September 30, 2009, the average balance of interest-bearing deposits increased 16.14% and 13.18%, respectively, but the weighted average rate paid on these deposits decreased 79 basis points and 72 basis points, respectively, resulting in decreases in interest expense of \$182,702 and \$507,299, respectively, when compared to the same periods in 2008. The average balance of FHLB borrowed funds increased 25.31% and 71.30%, respectively, for the three- and nine-month periods ended September 30, 2009 when compared to the same periods of 2008.

The key performance measure for net interest income is the "net margin on interest-earning assets," or net interest income divided by average interest-earning assets. The Bank's net interest margin on a fully taxable equivalent basis increased 24 basis points to 4.42% for the three-month period ended September 30, 2009 when compared to the same period in 2008. The nine-month margin decreased 3 basis points to 4.33% from 4.36% at September 30, 2008. The net margin may be adversely affected by increases in competition, volatile interest rates, decreases in loan demand, and the Bank's cost of funds where it outpaces the return on the Bank's loans and investment securities, and other unpredictable changes in the marketplace.

### **Noninterest Revenue**

Noninterest revenue for the three- and nine-month periods ended September 30, 2009 was \$391,892 and \$1,131,218, respectively, compared to \$408,907 and \$1,293,371, respectively, for the same periods in 2008, representing decreases of \$17,015 or 4.16% and \$162,153 or 12.54%, respectively. Other commission and fees were \$80,975 and \$235,885 for the three and nine months ended September 30, 2009, respectively, compared to \$69,821 and \$327,119, respectively, for the same period in 2008. The nine-month decrease of \$91,234 was mainly attributable to a recovery during the first quarter of 2008 of prior year attorney fees as a result of the settlement of a loan previously in a nonaccrual status and an insurance refund.

For the three months ended September 30, 2009, service charges decreased \$28,515 when compared to the third quarter of 2008, as a result of a declining overdraft fees on personal and commercial accounts. For the nine months ended September 30, 2009, service charges decreased \$72,127 to \$784,668 when compared to September 30, 2008.

### **Noninterest Expenses**

Noninterest expenses for the three- and nine-month periods ended September 30, 2009 were \$1,929,912 and \$5,992,337, respectively, compared to \$1,807,304 and \$5,494,859, respectively, for the same periods in 2008, representing increases of \$122,608 or 6.78% and \$497,478 or 9.05%, respectively. The increased expenses for the 2009 nine month period are mainly attributable to increased FDIC and State assessment fees of \$326,222 and salary and benefit expense of \$265,879, offset by decreased occupancy and operating costs, when compared to the corresponding 2008 period.

### **Income Tax Expense**

Income tax expense for the three- and nine-month periods ended September 30, 2009 was \$298,804 and \$623,518 respectively, compared to \$215,623 and \$622,294, respectively, for the same periods in 2008, representing increases of \$83,181 and \$1,224,

respectively. The main contributor to the increase was an increase in pretax earnings for the periods. For the nine-month period ended September, 2009, the Bank's effective tax rate was 33.34%, compared to 32.61% for the same period in 2008.

## FINANCIAL CONDITION

### Assets

Total assets at September 30, 2009 increased \$15,359,672 (6.36%) to \$256,693,275 from \$241,333,603 at December 31, 2008.

The Bank invests excess cash balances in interest-bearing accounts at other banks and federal funds sold to correspondent banks. These liquid investments are maintained at a level management believes necessary to meet the immediate liquidity needs of the Bank. These balances increased \$7,121,261 to \$9,882,535 at September 30, 2009 from \$2,761,274 at December 31, 2008.

The balance of investment securities at September 30, 2009 was \$14,061,247, an increase of \$1,098,665 from investments at December 31, 2008.

### Loans

Loans, net of the allowance for loan losses, increased \$7,408,997 (3.67%) to \$209,023,221 at September 30, 2009 from \$201,614,224 at December 31, 2008. The loan portfolio represented 90.70% of average earning assets for the nine-month period ended September 30, 2009, compared to 90.34% for the same period in 2008.

The following table sets forth the composition of the Bank's loan portfolio.

	<u>September 30, 2009</u>		<u>December 31, 2008</u>	
	<u>Amount</u>	<u>Percent of total</u>	<u>Amount</u>	<u>Percent of total</u>
Real Estate Loans				
Construction & land development	\$ 13,788,478	6.52%	\$ 10,625,260	5.22%
Secured by farmland	2,519,031	1.19%	2,655,122	1.30%
Residential	57,926,996	27.40%	60,798,762	29.86%
Commercial	99,079,980	46.86%	88,463,748	43.45%
Commercial Loans	16,253,092	7.69%	18,634,961	9.15%
Lease Financing	462,551	.22%	511,568	.25%
Consumer Loans	21,406,465	10.12%	21,922,856	10.77%
Total Loans	211,436,593	100.00%	173,360,832	100.00%
Net deferred (fees) and costs	(178,902)		(145,949)	
Allowance for loan losses	(2,234,470)		(1,852,104)	
Net Loans	<u>\$209,023,221</u>		<u>\$201,614,224</u>	

### Off-Balance Sheet Arrangements

In the normal course of business, to meet the financing needs of its customers, the Bank is a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit, lines of credit, and standby letters of credit. The Bank's exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Bank generally requires collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Bank evaluates each customer's creditworthiness on a case-by-case basis.

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. Letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. Further information about these arrangements is provided in Note 5 to the financial statements included elsewhere in this report.

Management does not believe that any of the foregoing arrangements have or are reasonably likely to have a current or future effect on the Bank's financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

### **Credit Risk Management**

The Bank's loan portfolio is subject to varying degrees of credit risk. Credit risk is alleviated through portfolio diversification, limiting exposure to any single industry or customer, collateral protection and strong underwriting criteria. The following discussion provides information and statistics on the overall quality of the Bank's loan portfolio. Note 1 to the financial statements describes the accounting policies related to nonperforming loans and charge-offs and describes the methodologies used to develop the allowance for loan losses. Management believes the policies governing nonperforming loans and charge-offs are consistent with industry and regulatory standards. The amount of the allowance for loan losses and the resulting provision are reviewed and approved quarterly by the Board of Directors.

The allowance is increased by provisions for loan losses charged to expense and recoveries of loans previously charged-off. Provisions for loan losses are made to bring the allowance for loan losses within the range of balances that are considered appropriate based upon the allowance methodology and to reflect losses within the loan portfolio as of the balance sheet date. The Bank's process for determining the appropriate level of the allowance for possible loan losses is designed to account for credit deterioration as it occurs. The provision for possible loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, and net charge-offs or recoveries, among other factors. The provision for possible loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for possible loan losses related to newly identified rated loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The provision for loan losses for the three- and nine-month periods ended September 30, 2009 was \$133,599 and \$478,597, respectively, compared to \$79,998 and \$239,994, respectively, for the same periods in 2008, representing increases of \$53,601 or 67% and \$238,603 or 99.42%, respectively. These increases strengthened the "Allowance for Loan Losses to Total Loans" ratio to 1.06% from .91% at December 31, 2008.

The adequacy of the allowance for loan losses is determined based upon management's estimate of the inherent risks associated with lending activities, estimated fair value of collateral, past experience and present indicators such as loan delinquency trends, nonaccrual loans and current market conditions. Management believes that the allowance is adequate as of September 30, 2009; however, future changes in the composition of the loan portfolio and financial condition of borrowers may result in additions to the allowance. Examination of the portfolio and allowance by regulatory agencies and consultants engaged by the Bank may result in the need for additional provisions based upon information available at the time of examination.

The following table sets forth activity in the Bank's allowance for loan losses for the periods indicated:

<b>Allowance for Loan Losses</b>	<b>9 months ended</b>	<b>Year ended</b>	<b>9 months ended</b>
	<b>9/30/09</b>	<b>12/31/08</b>	<b>9/30/08</b>
Balance at beginning of year	<b>\$1,852,104</b>	\$1,521,691	\$1,521,691
Loan losses:			
Real Estate:			
Residential	<b>65,000</b>	-	-
Commercial	-	-	-
Consumer	<b>41,148</b>	52,488	44,818
Total loan losses	<b>106,148</b>	52,488	44,818
Recoveries on loans previously charged off			
Commercial	<b>3,000</b>	32,000	31,333
Consumer	<b>6,917</b>	30,909	29,805
Total loan recoveries	<b>9,917</b>	62,909	61,138
Net loan losses (recoveries)	<b>96,231</b>	(10,421)	(16,320)
Provision for loan losses charged to expense	<b>478,597</b>	319,992	239,994
Balance at end of period	<b>\$2,234,470</b>	\$1,852,104	\$1,778,005
Allowance for loan losses to loans outstanding at end of period	<b>1.06%</b>	.91%	.91%
Net loan losses to average loans	<b>.05%</b>	N/A	.00%

#### **Risk Elements of Loan Portfolio**

The following table provides information on the Bank's nonaccrual loans, troubled debt restructured loans, and loans that are 90 days or more past due as to principal and interest payments with interest still accruing at September 30, 2009 and December 31, 2008:

	<u>9/30/09</u>	<u>12/31/08</u>
<u>Nonaccrual loans</u>		
Commercial, financial and agricultural	\$ -	\$ -
Real Estate	<b>455,448</b>	936,764
Consumer	<b>42,599</b>	3,160
	<b>498,047</b>	939,924
<u>Past due 90 days</u>		
Commercial, financial and agricultural	-	-
Real Estate	<b>1,110,409</b>	-
Consumer	<b>55,700</b>	-
	<b>1,166,109</b>	-
<u>Troubled debt restructured loans</u>		
Commercial, financial and agricultural	-	-
Real Estate	<b>7,423,534</b>	3,187,083
Consumer	-	-
	<b>7,423,534</b>	3,187,083
Total nonperforming loans	<b>\$9,087,690</b>	\$4,127,007
Interest not accrued on nonaccrual loans	<b>\$ 19,719</b>	\$ 27,022

A troubled debt restructuring is a restructuring of debt in which the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. A concession can be as simple as reducing the interest rate on the debt, extending the due date on the loan, or modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. The Bank is accruing interest on the restructured loans listed in the table shown above.

## Deposits

Total deposits at September 30, 2009 were \$201,833,694, an increase of 9.75% over total deposits at December 31, 2008. Interest bearing deposits have increased 11.46% or \$17,502,846 since the beginning of the year. Consumers often seek the safety of insured deposit accounts when the markets for stocks and other securities experience a significant and prolonged downturn, such as that experienced with the current economic recession. The Bank primarily utilizes core deposits to fund its earning assets. During the nine-month period ended September 30, 2009, average deposits provided funding for approximately 84.34% of average earning assets. The Bank currently has \$3,841,503 in reciprocal certificates of deposit through the CDARS network.

Certificates of deposit greater than \$100,000 totaled \$41,643,556 at September 30, 2009, compared to \$31,998,651 at December 31, 2008.

## Long-term borrowings

The Bank may borrow up to 25% of its reported total assets from the FHLB of Atlanta through any combination of notes or line of credit advances. The line of credit interest rate is a variable rate set daily by the FHLB of Atlanta. The notes payable and the line of credit are secured by a floating lien on all of the Bank's residential first mortgage loans, home equity loans and commercial real estate loans.

The following table summarizes the FHLB advances:

Note date	First Callable date Quarterly thereafter	Maturity date	Interest rate	9/30/2009	12/31/2008	Interest frequency
01/23/04	-	01/24/11	3.45%	\$ 1,285,714	\$ 2,142,857	Monthly
10/31/07	10/30/09	10/31/17	3.76%	6,000,000	6,000,000	Quarterly
12/31/07	12/29/08	12/29/17	2.99%	5,000,000	5,000,000	Quarterly
06/20/08	06/20/12	06/20/18	3.93%	7,000,000	7,000,000	Quarterly
09/19/08	09/19/11	09/19/18	2.91%	10,000,000	10,000,000	Quarterly
				<u>\$ 29,285,714</u>	<u>\$ 30,142,857</u>	

Further information about these advances is provided in Note 9 to the financial statements included elsewhere in this report.

## Capital

Total stockholders' equity was \$24,268,802 at September 30, 2009, which was 2.43% or \$576,164 more than at December 31, 2008. During the nine months ended September 30, 2009, the Bank funded a portion of stockholders' dividend reinvestments under its dividend reinvestment plan through the purchase of 5,408 outstanding shares of the Bank's common stock in the open market, which resulted in a reduction to capital and surplus in the amount of \$177,162. During the nine months ended September 30, 2009, the Bank also repurchased 5,525.3 outstanding shares of the Bank's common stock under the stock repurchase plan which resulted in a reduction to capital and surplus in the amount of \$177,963. Capital also decreased as a result of cash dividends declared of \$546,794. These entries were offset by dividends reinvested in newly issued shares of stock, stock compensation expense and stock options exercised in the amount of \$231,606, and earnings in the amount of \$1,246,477.

The Bank continues to maintain capital at levels in excess of the minimum risk based capital requirements adopted by the federal banking agencies and was considered to be "well capitalized" as of September 30, 2009. One measure of capital adequacy is the risk-based capital ratio, or the ratio of total capital to risk adjusted assets. Total capital is composed of both core capital (Tier 1) and supplemental capital (Tier 2). Total assets are adjusted for off-balance sheet items, such as letters of credit, and the different degrees of risk among various assets. Regulators require a minimum risk-based capital ratio of 8%, with 10% being the regulatory minimum for well-capitalized banks. At September 30, 2009, the Bank's risk-based capital ratio was 12.7%.

Another measure of capital adequacy is the leverage capital ratio, which is calculated by dividing average total assets for the most recent quarter into Tier 1 capital. The regulatory minimum for this ratio is 4%, with 5% being the regulatory minimum for well-capitalized banks. The Bank's leverage capital ratio as of September 30, 2009 was 9.5%.

Management is not aware of any trends, favorable or unfavorable, that are likely to have a material effect on our financial condition or on our earnings.

## Liquidity

Liquidity describes the ability of the Bank to meet financial obligations that arise during the normal course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of customers and to fund current and planned expenditures. Liquidity is derived through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in short-term funds markets. The Bank has arrangements with correspondent banks whereby it has \$5,000,000 available in federal funds lines of credit. The Bank is also a member of the FHLB of Atlanta, which provides another source of liquidity. As of September 30, 2009, the Bank had available credit of \$34,000,000 remaining for future FHLB advances.

During the second quarter of 2009, the Bank became eligible to borrow from the Federal Reserve Bank Discount Window. The credit line will be secured by the Bank's consumer loan portfolio. Based on available collateral, the Bank could borrow an additional \$11,000,000 from the Federal Reserve Bank Discount Window as of September 30, 2009.

## New Accounting Standards

As discussed in Note 1 - to the financial statements included elsewhere in this report on [July 1, 2009](#), the Accounting Standards Codification became FASB's officially recognized source of authoritative U.S. generally accepted accounting principles applicable to all public and non-public non-governmental entities, superseding existing FASB, AICPA, EITF and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

*FASB ASC Topic 320, "Investments - Debt and Equity Securities."* New authoritative accounting guidance under ASC Topic 320, "Investments - Debt and Equity Securities," (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity's management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. The Bank adopted the provisions of the new authoritative accounting guidance under ASC Topic 320 during the first quarter of 2009. Adoption of the new guidance did not significantly impact the Bank's financial statements.

*FASB ASC Topic 715, "Compensation - Retirement Benefits."* New authoritative accounting guidance under ASC Topic 715, "Compensation - Retirement Benefits," provides guidance related to an employer's disclosures about plan assets of defined benefit pension or other post-retirement benefit plans. Under ASC Topic 715, disclosures should provide users of financial statements with an understanding of how investment allocation decisions are made, the factors that are pertinent to an understanding of investment policies and strategies, the major categories of plan assets, the inputs and valuation techniques used to measure the fair value of plan assets, the effect of fair value measurements using significant unobservable inputs on changes in plan assets for the period and significant concentrations of risk within plan assets. The disclosures required by ASC Topic 715 will be included in the Bank's financial statements beginning with the financial statements for the year-ended [December 31, 2009](#).

*FASB ASC Topic 820, "Fair Value Measurements and Disclosures."* New authoritative accounting guidance under ASC Topic 820, "Fair Value Measurements and Disclosures," affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. ASC Topic 820 requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence. The new accounting guidance amended prior guidance to expand certain disclosure requirements. The Bank adopted the new authoritative accounting guidance under ASC Topic 820 during the first quarter of 2009. Adoption of the new guidance did not significantly impact the Bank's financial statements.

Further new authoritative accounting guidance (Accounting Standards Update No. 2009-5) under ASC Topic 820 provides guidance for measuring the fair value of a liability in circumstances in which a quoted price in an active market for the identical liability is not available. In such instances, a reporting entity is required to measure fair value utilizing a valuation technique that uses (i) the quoted price of the identical liability when traded as an asset, (ii) quoted prices for similar liabilities or similar liabilities when traded as assets, or (iii) another valuation technique that is consistent with the existing principles of ASC Topic 820, such as an income

approach or market approach. The new authoritative accounting guidance also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. The forgoing new authoritative accounting guidance under ASC Topic 820 will be effective for the Bank's financial statements beginning [October 1, 2009](#) and is not expected to have a significant impact on the Bank's financial statements.

*FASB ASC Topic 825 "Financial Instruments."* New authoritative accounting guidance under ASC Topic 825, "Financial Instruments," requires an entity to provide disclosures about the fair value of financial instruments in interim financial information and amends prior guidance to require those disclosures in summarized financial information at interim reporting periods. The new interim disclosures required under Topic 825 are included in Note 16 - Fair Value Measurements.

*FASB ASC Topic 855, "Subsequent Events."* New authoritative accounting guidance under ASC Topic 855, "Subsequent Events," establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. ASC Topic 855 defines (i) the period after the balance sheet date during which a reporting entity's management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (iii) the disclosures an entity should make about events or transactions that occurred after the balance sheet date. The new authoritative accounting guidance under ASC Topic 855 became effective for the Bank's financial statements for periods ending after [June 15, 2009](#) and did not have a significant impact on the Bank's financial statements.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Bank's principal market risk is the fluctuation of interest rates and the impact such fluctuation would have on the Bank's lending, investing and deposit activities. Management has adopted procedures to evaluate and mitigate this risk. This risk and management's procedures are discussed in detail in Item 7 of Part II of the Bank's Annual Report on Form 10-K for the year ended December 31, 2008 under the caption "Market Risk Management". Management believes that there have been no material changes in the Bank's market risks or the procedures used to evaluate and mitigate these risks since December 31, 2008. The simulation models that the Bank uses to quantify the effect a hypothetical immediate plus or minus 300 basis point change in rates produced the following results on net interest income and return on assets projected 12 months from September 30, 2009 as well as the fair value of capital at September 30, 2009.

	+300 Basis Points	+200 Basis Points	+100 Basis Points	-100 Basis Points	-200 Basis Points	-300 Basis Points	Recommended Policy Guidelines
% Change in Net Interest Income	7.14%	7.91%	4.56%	(2.79)%	(3.09)%	(2.88)%	
ROA YTD	1.19%	1.22%	1.11%	.90%	.90%	.90 %	+ .50%
% Change in Fair Value of Capital	.34%	3.34%	6.51%	15.75%	22.00%	28.20%	>(2.50)%

### Item 4. Controls and Procedures.

The Bank maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Bank's reports filed under the Securities Exchange Act of 1934 with the FDIC, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to the Bank's management, including the President/Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of September 30, 2009 was carried out under the supervision and with the participation of the Bank's management, including the CEO and CFO. Based on that evaluation, the Bank's management,

including the CEO and CFO, has concluded that the Bank's disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the quarter ended September 30, 2009, there was no change in the Bank's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Bank's internal control over financial reporting.

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

The Bank is party to various legal actions normally associated with a financial institution. In management's opinion, the effect of these actions will not be material to the financial condition of the Bank.

### Item 1A. Risk Factors.

The risks and uncertainties to which the Bank's financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Bank's Annual Report on Form 10-K for the year ended December 31, 2008. Management believes that no material changes in these risk factors have occurred since December 31, 2008.

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

#### *Unregistered Sales of Stock*

Section 3(a)(2) of the Securities Act of 1933, as amended (the "Securities Act"), exempts from the definition of "security" any securities issued by a bank, and the FDIC, as the Bank's primary federal regulator, does not require the registration of the Bank's securities prior to offer or sale. From time to time, the Bank sells shares of its common stock pursuant to its dividend reinvestment plan ("DRIP") and upon exercise of options granted under its Director Stock Purchase Plan, Incentive Stock Option Plan, Employee Stock Purchase Plan, 2004 Director Non-Qualified Stock Option Plan (the "2004 Plan"), 2008 Employee Stock Purchase Plan (the "2008 Employee Plan") and the 2008 Key Employee Stock Option Plan (the 2008 "Key Employee Plan"). The DRIP and all equity compensation plans other than the 2004 Director Plan, 2008 Employee Plan and the 2008 Key Employee Plan were adopted before the Bank converted from a national banking association into a state chartered bank, and the Office of the Comptroller of the Currency required that the shares issuable under such plans be registered under the Securities Act prior to their offer and sale. During the third quarter of 2009, a total of 1,911 shares of common stock were issued pursuant to the DRIP at an average price of \$30.00 per share, and a total of 10 shares of common stock were issued pursuant to the exercise of stock options at an average exercise price of \$27.41 per share.

#### *Issuer Repurchases*

In August of 2006, the Bank's Board of Directors adopted a stock repurchase plan pursuant to which the Bank is authorized to purchase up to 60,000 shares of the Bank's common stock over a 36-month period (subject to annual renewal approval by the FDIC). The Bank filed a Current Report on Form 8-K to announce the regulatory approval on October 17, 2006. The following table provides information about shares of common stock of the Bank purchased by or on behalf of the Bank and its affiliates (as defined by Exchange Act Rule 10b-18) during the three-month period ended September 30, 2009 under this plan:

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
July 2009	-	-	-	-
August 2009	1,519	30.00	-	-
September 2009	2,000	29.00	-	-
Total	<b>3,519</b>	<b>\$29.43</b>	-	<b>Expired</b>

### Item 3. Defaults Upon Senior Securities

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None.

**Item 6. Exhibits**

The exhibits filed or furnished herewith are listed in the Exhibit Index attached hereto, which index is incorporated herein by reference.

**SIGNATURES**

Pursuant to the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HARFORD BANK

Date: November 12, 2009

/s/Charles H. Jacobs, Jr.  
President/CEO

Date: November 12, 2009

/s/Charlotte A. Mock  
Executive Vice President/CFO

## **EXHIBIT INDEX**

<u>Exhibit No.</u>	<u>Description</u>
Exhibit 31.1	Certifications of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
Exhibit 31.2	Certifications of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
Exhibit 32.1	Certification of the Periodic Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).

**CERTIFICATIONS OF THE CHIEF EXECUTIVE OFFICER**  
**Pursuant to Securities Exchange Act Rules 13a-1 and 15d-14**  
**As adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Charles H. Jacobs, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Harford Bank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statement made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared; and
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 12, 2009

/s/Charles H. Jacobs, Jr.  
President/CEO

**CERTIFICATIONS OF THE CHIEF FINANCIAL OFFICER**  
**Pursuant to Securities Exchange Act Rules 13a-1 and 15d-14**  
**As adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Charlotte A. Mock, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Harford Bank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statement made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared; and
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 12, 2009

/s/Charlotte A. Mock  
Executive Vice President/CFO

**CERTIFICATION OF THE PERIODIC REPORT**  
**Pursuant to 18 U.S.C. Section 1350**  
**As adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Pursuant to, and for purposes only of, 18 U.S.C. § 1350, each of the undersigned hereby certifies that (i) the Quarterly Report of Harford Bank on Form 10-Q for the quarter ended September 30, 2009, filed with the Federal Deposit Insurance Corporation (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (ii) information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Harford Bank.

Date: November 12, 2009

/s/Charles H. Jacobs, Jr.  
President/CEO

Date: November 12, 2009

/s/Charlotte A. Mock  
Executive Vice President/CFO

HARFORD BANK FINANCIAL STATEMENTS

SEPTEMBER 30, 2008

## BALANCE SHEETS

	September 30, 2009	December 31, 2008
<b>ASSETS</b>	(Unaudited)	
Cash and due from banks	\$ 7,390,893	\$ 8,614,427
Federal funds sold and Federal Home Loan Bank deposit	<u>4,890,535</u>	<u>761,274</u>
Cash and cash equivalents	12,281,428	9,375,701
Interest-bearing deposits in other banks	4,992,000	2,000,000
Investment securities held to maturity (fair value of \$14,292,090- 9/30/09 and \$13,302,356 - 12/31/08)	14,061,247	12,962,582
Federal Home Loan Bank stock, at cost	1,974,100	1,856,600
Loans, net	209,023,221	201,614,224
Bank premises and equipment	7,777,754	7,887,069
Accrued interest receivable	929,649	843,809
Deferred income taxes	366,939	366,939
Bank owned life insurance	4,030,696	3,920,031
Foreclosed real estate	567,048	-
Other assets	<u>689,193</u>	<u>506,648</u>
	<u>\$ 256,693,275</u>	<u>\$ 241,333,603</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits:		
Noninterest-bearing	\$ 31,571,552	\$ 31,151,164
Interest-bearing	<u>170,262,142</u>	<u>152,759,296</u>
Total deposits	201,833,694	183,910,460
Federal funds purchased	-	2,600,000
Federal Home Loan Bank advances	29,285,714	30,142,857
Accrued interest payable	332,264	401,791
Income taxes payable	64,854	145,407
Dividend payable	165,612	97,894
Other liabilities	<u>742,335</u>	<u>342,556</u>
	<u>232,424,473</u>	<u>217,640,965</u>
Stockholders' equity		
Common stock, par value \$10 per share; authorized 5,000,000 shares: issued and outstanding 974,188.5 shares at 9/30/09 and 978,794.8 shares at 12/31/08	9,741,885	9,787,948
Surplus	11,053,761	11,131,217
Undivided profits	<u>3,473,156</u>	<u>2,773,473</u>
	<u>24,268,802</u>	<u>23,692,638</u>
	<u>\$ 256,693,275</u>	<u>\$ 241,333,603</u>

## STATEMENTS OF INCOME (Unaudited)

September 30,	For the three months ended		For the nine months ended	
	2009	2008	2009	2008
<b>Interest revenue</b>				
Loans, including fees	\$ 3,387,494	\$ 3,081,156	\$ 9,941,357	\$ 9,104,716
U. S. government agency securities	93,795	107,145	271,834	341,830
State and municipal securities	12,162	18,985	44,688	65,903
Federal funds sold and Federal Home Loan Bank deposit	4,780	21,089	11,361	90,729
Interest bearing deposits in other banks	6,551	-	28,243	-
Other	4,137	10,824	4,137	43,157
Total interest revenue	<u>3,508,919</u>	<u>3,239,199</u>	<u>10,301,620</u>	<u>9,646,335</u>
<b>Interest expense</b>				
Deposits	733,731	916,432	2,329,542	2,836,841
Borrowed funds	253,390	202,051	762,367	459,881
Total interest expense	<u>987,121</u>	<u>1,118,483</u>	<u>3,091,909</u>	<u>3,296,722</u>
Net interest income	2,521,798	2,120,716	7,209,711	6,349,613
<b>Provision for loan losses</b>	<u>133,599</u>	<u>79,998</u>	<u>478,597</u>	<u>239,994</u>
Net interest income after provision for loan losses	<u>2,388,199</u>	<u>2,040,718</u>	<u>6,731,114</u>	<u>6,109,619</u>
<b>Noninterest revenue</b>				
Service charges on deposit accounts	273,524	302,039	784,668	856,793
Earnings on bank owned life insurance	37,393	37,047	110,665	109,457
Other fees and commissions	80,975	69,821	235,885	327,119
Total noninterest revenue	<u>391,892</u>	<u>408,907</u>	<u>1,131,218</u>	<u>1,293,371</u>
<b>Noninterest expenses</b>				
Salaries and benefits	1,023,460	932,654	3,024,113	2,758,234
Occupancy	154,081	154,771	452,162	441,848
Furniture and equipment	120,564	140,104	378,790	448,796
Data processing expense	164,582	117,186	437,118	351,386
Professional fees	19,959	20,316	75,521	94,794
Director and committee fees	42,842	47,547	137,580	145,516
Stationery and supplies	26,392	32,302	120,317	127,242
FDIC and State Assessments	81,337	34,798	380,950	54,728
Advertising	23,504	42,523	94,497	120,473
Net losses (gains) and write-downs of repossessed assets	236	7,833	89,639	124,322
Other operating	272,955	277,270	801,650	827,520
Total noninterest expenses	<u>1,929,912</u>	<u>1,807,304</u>	<u>5,992,337</u>	<u>5,494,859</u>
Income before income taxes	850,179	642,321	1,869,995	1,908,131
Income taxes	298,804	215,623	623,518	622,294
<b>Net income</b>	<u>\$ 551,375</u>	<u>\$ 426,698</u>	<u>\$ 1,246,477</u>	<u>\$ 1,285,837</u>
Basic earnings per share	\$ 0.56	\$ 0.43	\$ 1.28	\$ 1.31
Diluted earnings per share	\$ 0.56	\$ 0.43	\$ 1.27	\$ 1.30

**STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
**Nine months ended September 30, 2009 and 2008**  
**(Unaudited)**

	Common Stock		Surplus	Undivided profits
	Shares	Par value		
<b>Balance, December 31, 2007</b>	<b>956,575.7</b>	<b>\$ 9,565,757</b>	<b>\$ 10,617,918</b>	<b>\$ 2,956,152</b>
Net income	-	-	-	1,285,837
Cash dividends, \$.81 per share	-	-	-	(785,959)
Common stock issued				
Options exercised	4,687.0	46,870	83,371	-
Dividend reinvestment plan	8,671.0	86,710	284,571	-
Stock compensation expense	-	-	27,981	-
Stock acquired and cancelled	(19,575.9)	(195,759)	(628,014)	-
<b>Balance, September 30, 2008</b>	<b><u>950,357.8</u></b>	<b><u>\$ 9,503,578</u></b>	<b><u>\$ 10,385,827</u></b>	<b><u>\$ 3,456,030</u></b>
<b>Balance, December 31, 2008</b>	<b>978,794.8</b>	<b>\$ 9,787,948</b>	<b>\$ 11,131,217</b>	<b>\$ 2,773,473</b>
Net income	-	-	-	1,246,477
Cash dividends, \$.56 per share	-	-	-	(546,794)
Common stock issued				
Options exercised	919.0	9,190	20,244	-
Dividend reinvestment plan	5,408.0	54,080	123,082	-
Stock compensation expense	-	-	25,010	-
Stock acquired and cancelled	(10,933.3)	(109,333)	(245,792)	-
<b>Balance, September 30, 2009</b>	<b><u>974,188.5</u></b>	<b><u>\$ 9,741,885</u></b>	<b><u>\$ 11,053,761</u></b>	<b><u>\$ 3,473,156</u></b>

**STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

For the nine months ended September 30,  
2009 2008

**Cash flows from operating activities**

Interest received	\$ 10,246,758	\$ 9,647,419
Fees and commissions received	1,134,718	1,292,051
Interest paid	(3,161,436)	(3,352,208)
Cash paid to suppliers and employees	(5,366,086)	(4,713,953)
Income taxes paid	(704,071)	(659,661)
	<b>2,149,883</b>	<b>2,213,648</b>

**Cash flows from investing activities**

Proceeds from maturities of investment securities	6,900,000	6,916,600
Purchase of investment securities	(7,997,500)	(5,608,194)
Certificates of deposit (net)	(2,992,000)	-
Purchases and redemption of FHLB stock	(117,500)	(498,200)
Loans originated, net of principal repayments	(8,725,737)	(22,964,741)
Purchases of premises, equipment, and software	(295,669)	(151,951)
Proceeds from sale of foreclosed real estate	145,765	594,677
	<b>(13,082,641)</b>	<b>(21,711,809)</b>

**Cash flows from financing activities**

Net increase in time deposits	8,107,560	3,259,560
Net increase(decrease) in other deposits	9,815,674	2,907,515
Net increase (decrease) in borrowed funds	(3,457,143)	16,142,857
Dividends paid	(479,076)	(788,002)
Dividends reinvested	177,162	371,281
Stock options exercised, including tax benefit	29,434	130,241
Stock acquired and cancelled	(355,126)	(823,773)
	<b>13,838,485</b>	<b>21,199,679</b>

**Net increase in cash and cash equivalents**

	2,905,727	1,701,518
Cash and cash equivalents at beginning of period	9,375,701	11,352,764
<b>Cash and cash equivalents at end of period</b>	<b>\$ 12,281,428</b>	<b>\$ 13,054,282</b>

**STATEMENTS OF CASH FLOWS (continued)**  
**(Unaudited)**

For the nine months ended September 30,  
2009 2008

**Reconciliation of net income to net cash provided  
by operating activities**

Net income	\$ 1,246,477	\$ 1,285,837
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	371,240	389,841
Provision for loan losses	478,597	239,994
Amortization of premiums and accretion of discounts, net	(1,165)	(12,111)
Gain on call of security	-	(1,320)
Loss (gain) on disposition of equipment and software	6,589	-
Loss (gain) on disposition of foreclosed real estate	93,187	111,323
Stock compensation expense	25,010	27,981
Decrease (increase) in:		
Accrued interest receivable	(85,840)	(59,434)
Prepaid income tax	-	(34,224)
Cash surrender value of BOLI	(110,665)	(109,457)
Other assets	(155,389)	(27,032)
Increase (decrease) in:		
Accrued interest payable	(69,527)	(55,486)
Income taxes payable	(80,553)	(3,143)
Deferred loan fees and costs	32,143	72,629
Other liabilities	399,779	388,250
	<u>\$ 2,149,883</u>	<u>\$ 2,213,648</u>
Transfer of loans to foreclosed real estate	<u>\$ 567,048</u>	<u>\$ -</u>

## **1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The accompanying unaudited financial statements of Harford Bank (the “Bank”) have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for audited year-end financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the period ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009 or any other future interim period. The financial statements contained herein should be read in conjunction with the financial statements and related notes contained in the Bank’s Annual Report on Form 10-K for the year ended December 31, 2008.

### **Accounting Standards Codification**

The Financial Accounting Standards Board’s (FASB) Accounting Standards Codification (ASC) became effective on [July 1, 2009](#). At that date, the ASC became FASB’s officially recognized source of authoritative U.S. generally accepted accounting principles (GAAP) applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

### **Use of estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. These estimates and assumptions may affect the reported amounts of revenue and expenses during the period. Actual results could differ from these estimates.

### **Nature of operations**

Harford Bank provides a full range of banking services to customers located in Harford and Cecil Counties and surrounding areas of northeastern Maryland.

### **Cash and cash equivalents**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold. Generally, federal funds are purchased and sold for one-day periods.

### **Interest-bearing deposits in other banks**

Interest-bearing deposits mature within one year and are carried at cost.

### **Investment securities**

Management has classified all securities as held to maturity. Management has the intent and ability to hold all securities to maturity. These securities are recorded at amortized cost which is cost adjusted for amortization of premiums and accretion of discounts to maturity. Premiums and discounts are recognized in interest revenue using the interest method over the term of the securities.

### **Federal Home Loan Bank stock**

As a member of the Federal Home Loan Bank, the Bank is required to purchase stock based on its total assets. Additional stock is purchased and redeemed based on the outstanding Federal Home Loan Bank advances to the Bank. The stock is carried at cost.

### **Loans and allowance for loan losses**

Loans are stated at face value, adjusted for the allowance for loan losses, and deferred origination fees and costs.

Interest on loans is accrued based on the principal amounts outstanding. Origination fees and costs are recognized as an

## **1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

adjustment to the related loan yield using an approximate interest method. The accrual of interest is discontinued when any portion of the principal or interest is ninety days past due and collateral is insufficient to discharge the debt in full. Past due status is based on the contractual terms of the loan.

Loans are considered impaired when, based on current information, management considers it unlikely that the collection of principal and interest payments will be made according to contractual terms. Generally, loans are not reviewed for impairment until the accrual of interest has been discontinued. If collection of principal is evaluated as doubtful, all payments are applied to principal.

Management considers a loan to be a troubled debt restructured loan when the terms have been renegotiated to a below market condition to provide a reduction or deferral of principal or interest as a result of the deteriorating financial position of the borrower.

The allowance for loan losses represents an amount, which, in management's judgment, will be adequate to absorb probable losses on existing loans and other extensions of credit that may become uncollectible. Management's judgment in determining the adequacy of the allowance is based on evaluations of the collectibility of loans. These evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, current economic conditions that may affect the borrowers' ability to pay, overall portfolio quality, and review of specific problem areas. If the current economy or real estate market were to further deteriorate, the estimate for uncollectible accounts would need to be increased. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are considered impaired or adversely risk rated. The general component covers nonclassified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

### **Bank premises and equipment**

Land is carried at cost. Buildings, furniture, equipment, and leasehold improvements are recorded at cost, less accumulated depreciation and amortization computed principally on the straight-line method over the estimated useful lives of the assets.

### **Foreclosed real estate**

Real estate acquired through foreclosure is recorded at the lower of cost or fair market value on the date acquired. Losses incurred at the time of acquisition of the property are charged to the allowance for loan losses. Subsequent reductions in the estimated value of the property are included in other operating expenses.

### **Income taxes**

The provision for income taxes includes taxes payable for the current year and deferred income taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

### **Per share data**

Basic earnings per share are determined by dividing net income by the weighted average number of shares of common stock outstanding after giving retroactive effect to stock dividends. Diluted earnings per share are determined by including the average dilutive shares of common stock equivalents outstanding during the periods calculated using the treasury stock method.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The weighted average number of shares outstanding and dilutive common equivalent number of shares are as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2009	2008	2009	2008
Weighted average number of shares	976,835	981,601	977,201	982,972
Dilutive average number of shares	395	3,624	787	4,790

### Stock-Based Compensation

The Bank accounts for employee and director stock options under the fair value method of accounting using a Black-Scholes valuation model to measure stock based compensation expense at the date of grant. The Bank accounts for stock based compensation in accordance with FASB ASC Topic 718, "Stock Compensation" under the modified prospective method. This standard requires public companies to recognize compensation expense related to stock based compensation awards in their income statements over the period during which an individual is required to provide service in exchange for such award. For the nine months ended September 30, 2009 and 2008, the Bank recorded stock based compensation expense of \$25,010 and \$27,981, respectively.

## 2. CASH AND CASH EQUIVALENTS

The Bank normally carries balances with other banks that exceed the federally insured limit. These banks are currently participating in the FDIC's Transaction Account Guarantee Program. Under this program, through December 31, 2009, all noninterest-bearing transaction accounts are fully guaranteed by the FDIC for the entire amount in the account. The average balance carried in unsecured federal funds sold to the same banks, was **\$5,596,772** for the nine months ended September 30, 2009 and \$4,318,910 for the year ended December 31, 2008.

Banks are required to carry noninterest-bearing cash reserves at specified percentages of deposit balances. The Bank's normal amount of cash on hand and on deposit with other banks is sufficient to satisfy the reserve requirements.

## 3. INVESTMENT SECURITIES

Investment securities at September 30, 2009 and December 31, 2008 are summarized as follows:

SEPTEMBER 30, 2009	AMORTIZED COST	UNREALIZED GAINS	UNREALIZED LOSSES	FAIR VALUE
<i>Held to maturity</i>				
U.S. Government agency	\$ 12,489,160	\$208,040	\$4,960	\$12,692,240
State and municipal	<u>1,572,087</u>	<u>27,763</u>	<u>-</u>	<u>1,599,850</u>
<b>Total</b>	<b><u>\$14,061,247</u></b>	<b><u>\$235,803</u></b>	<b><u>\$4,960</u></b>	<b><u>\$14,292,090</u></b>
<hr/>				
DECEMBER 31, 2008	AMORTIZED COST	UNREALIZED GAINS	UNREALIZED LOSSES	FAIR VALUE
<i>Held to maturity</i>				
U.S. Government agency	\$ 10,488,542	\$318,549	\$5,791	\$10,801,300
State and municipal	2,474,040	27,016	-	2,501,056
<b>Total</b>	<b>\$12,962,582</b>	<b>\$345,565</b>	<b>\$5,791</b>	<b>\$13,302,356</b>

### 3. INVESTMENT SECURITIES (continued)

Securities in an unrealized loss position at September 30, 2009 are as follows:

	Less than 12 months		12 months or longer		Total	
	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value
U.S. Gov. Agency	<u>\$4,960</u>	<u>\$4,496,210</u>	\$ -	\$ -	<u>\$4,960</u>	<u>\$4,496,210</u>
Total temporarily impaired securities	<u>\$4,960</u>	<u>\$4,496,210</u>	\$ -	\$ -	<u>\$4,960</u>	<u>\$4,496,210</u>

The securities that are experiencing a market loss as of September 30, 2009 are considered to be temporarily impaired. Management has the intent and ability to hold these securities until maturity. In most cases, temporary impairment is caused by market interest rate fluctuations.

Contractual maturities and the amount of pledged securities are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	SEPTEMBER 30, 2009		DECEMBER 31, 2008	
	AMORTIZED COST	FAIR VALUE	AMORTIZED COST	FAIR VALUE
Maturing				
Within one year	\$ 1,754,666	\$ 1,775,660	\$ 3,532,852	\$ 3,602,705
Over one to five years	12,306,581	12,516,430	9,429,730	9,699,651
Total	<u>\$14,061,247</u>	<u>\$14,292,090</u>	<u>\$12,962,582</u>	<u>\$13,302,356</u>
Pledged securities	\$5,489,160	\$5,695,580	\$10,488,542	\$10,801,300

Securities are pledged to secure deposits of federal and local governments.

### 4. LOANS

Major classifications of loans are as follows:

LOAN CLASSIFICATIONS	SEPTEMBER 30, 2009	DECEMBER 31, 2008
Real Estate		
Construction and land development	\$ 13,788,478	\$ 10,625,260
Secured by farmland	2,519,031	2,655,122
Residential	57,926,996	60,798,762
Commercial	99,079,980	88,463,748
Commercial	16,253,092	15,386,874
Lease financing	462,551	511,568
Consumer	<u>21,406,465</u>	<u>21,922,856</u>
Total	<u>211,436,593</u>	<u>203,612,277</u>
Net deferred (fees) and costs	(178,902)	(145,949)
Allowance for loan losses	<u>(2,234,470)</u>	<u>(1,852,104)</u>
	<u>\$209,023,221</u>	<u>\$201,614,224</u>

#### 4. LOANS (continued)

The maturity and rate repricing distribution of the loan portfolio follows:

	SEPTEMBER 30, 2009	DECEMBER 31, 2008
Maturing within one year	\$ 45,491,485	\$ 49,787,677
Maturing over one to five years	92,765,812	86,387,113
Maturing over five years	<u>73,179,296</u>	<u>67,437,487</u>
	<u>\$211,436,593</u>	<u>\$203,612,277</u>
Variable rate loans included above	\$ 46,525,172	\$ 36,767,365

The following table summarizes nonaccrual loans, troubled debt restructured loans, and loans that are 90 days or more past due as to principal and interest payments and still accruing interest at September 30, 2009 and December 31, 2008.

	9/30/09	12/31/08
<u>Nonaccrual loans</u>		
Commercial, financial and agricultural	\$ -	\$ -
Real Estate	455,448	936,764
Consumer	<u>42,599</u>	<u>3,160</u>
	<u>498,047</u>	<u>939,924</u>
 <u>Past due 90 days</u>		
Commercial, financial and agricultural	-	-
Real Estate	1,110,409	-
Consumer	<u>55,700</u>	<u>-</u>
	<u>1,166,109</u>	<u>-</u>
 <u>Troubled debt restructured loans</u>		
Commercial, financial and agricultural	-	-
Real Estate	7,423,534	3,187,083
Consumer	<u>-</u>	<u>-</u>
	<u>7,423,534</u>	<u>3,187,083</u>
Total nonperforming loans	<u>\$9,087,690</u>	<u>\$4,127,007</u>
Interest not accrued on nonaccrual loans	<u>\$ 19,719</u>	<u>\$ 27,022</u>

A troubled debt restructuring is a restructuring of debt in which the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. A concession can be as simple as reducing the interest rate on the debt, extending the due date on the loan, or modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. The Bank is accruing interest on the restructured loans listed in the table shown above.

Transactions in the allowance for loan losses were as follows:

	FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009	FOR THE YEAR ENDED DECEMBER 31, 2008
Balance, beginning of period	\$1,852,104	\$1,521,691
Provision charged to operations	478,597	319,992
Recoveries	9,917	62,909
Loans charged off	<u>(106,148)</u>	<u>(52,488)</u>
Balance, end of period	<u>\$2,234,470</u>	<u>\$1,852,104</u>

The Bank makes loans to customers located primarily in Harford County and surrounding areas. Substantial portions of the Bank's loans are secured by residential and commercial real estate. The performance of the loan portfolio will be influenced by the regional real estate market and economy.

## 5. CREDIT COMMITMENTS

Outstanding loan commitments, unused lines and letters of credit were as follows:

	SEPTEMBER 30, 2009	DECEMBER 31, 2008
Commitments to extend credit		
Loan origination commitments	\$ 7,273,600	\$ 9,405,000
Unused home equity lines of credit	7,044,751	6,885,110
Unused overdraft lines of credit	2,556,469	2,630,652
Unused commercial and construction lines of credit	<u>19,870,013</u>	<u>17,353,934</u>
Total	<u>\$36,744,834</u>	<u>\$36,274,696</u>
Letters of credit	\$ 1,818,806	\$ 1,740,635

Loan commitments and lines of credit are agreements to lend to a customer as long as there is no violation of any condition to the contract. Loan commitments generally have variable interest rates, fixed expiration dates, and may require payment of a fee. Lines of credit generally have variable interest rates. Such lines do not represent future cash requirements because it is unlikely that all customers will draw upon their lines in full at one time. Letters of credit are commitments issued to guarantee the performance of a customer to a third party.

The Bank's exposure to credit loss in the event of nonperformance by the customer is the contractual amount of the commitment. Loan commitments, lines of credit, and letters of credit are made on the same terms, including collateral, as outstanding loans. Management is not aware of any accounting loss to be incurred by funding these commitments.

## 6. RELATED PARTY TRANSACTIONS

The officers and directors of the Bank enter into loan transactions with the Bank in the ordinary course of business. These loans are made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with unrelated borrowers.

The following table shows the activity in related party loans:

	NINE MONTHS ENDED SEPTEMBER 30, 2009	YEAR ENDED DECEMBER 31, 2008
Beginning balance	\$5,781,634	\$4,036,557
Advances	2,811,917	5,715,647
Payments	<u>(428,234)</u>	<u>(3,970,570)</u>
Ending balance	<u>\$8,165,317</u>	<u>\$5,781,634</u>

In addition to the outstanding balances listed above, the officers and directors of the Bank have **\$1,241,145** in unused loans committed but not funded as of September 30, 2009.

Deposits from the officers and directors of the Bank were **\$5,709,386** at September 30, 2009 and \$5,127,944 at December 31, 2008.

## 7. BANK PREMISES AND EQUIPMENT

A summary of bank premises and equipment and the related depreciation follows:

	USEFUL LIVES	SEPTEMBER 30, 2009	DECEMBER 31, 2008
Land		\$ 3,191,486	\$ 3,191,486
Building and improvements	15-60 years	4,546,116	4,462,540
Leasehold improvements	10-19 years	502,742	502,743
Furniture, fixtures and equipment	3-10 years	2,921,740	2,882,380
		<u>11,162,084</u>	11,039,149
Accumulated depreciation		<u>3,884,330</u>	3,152,080
Net bank premises and equipment		<u>\$7,777,754</u>	\$ 7,887,069
Depreciation expense		\$ 312,363	\$ 458,276

Computer software included in other assets and the related amortization are as follows:

	USEFUL LIVES	SEPTEMBER 30, 2009	DECEMBER 31, 2008
Cost	3 years	\$418,677	\$413,966
Accumulated amortization		<u>299,486</u>	<u>321,931</u>
Net computer software		<u>\$119,191</u>	<u>\$92,035</u>
Amortization expense		\$ 58,877	\$ 60,478

## 8. LEASE COMMITMENTS

The Bank leases various banking facilities under non-cancelable operating leases expiring on various dates through 2021. As of September 30, 2009 future minimum payments, by year and in the aggregate, of non-cancelable operating leases are as follows:

(1)	YEAR	AMOUNT
	2009	\$ 29,277
	2010	112,027
	2011	112,825
	2012	115,223
	2013	115,223
	Thereafter	918,057
		<u>\$1,402,632</u>

Rent expense for the nine months ending September 30, 2009 and 2008 was \$87,132 and \$84,115, respectively.

## 9. BORROWINGS AND AVAILABLE LINES OF CREDIT

Federal Home Loan Bank(FHLB) advances are summarized as follows:

Note date	First Callable date thereafter	Maturity date	Interest rate	9/30/2009	12/31/2008	Interest frequency
01/23/04	-	01/24/11	3.45%	\$ 1,285,714	\$ 2,142,857	Monthly
10/31/07	10/30/09	10/31/17	3.76%	6,000,000	6,000,000	Quarterly
12/31,07	12/29/08	12/29/17	2.99%	5,000,000	5,000,000	Quarterly
06/20/08	06/20/12	06/20/18	3.93%	7,000,000	7,000,000	Quarterly
09/19/08	09/19/11	09/19/18	2.91%	10,000,000	10,000,000	Quarterly
				<u>\$ 29,285,714</u>	<u>\$ 30,142,857</u>	

FHLB advances as of September 30, 2009 will require principal repayments as follows:

Year	Principal reduction
2009	\$ -
2010	857,141
2011	428,573
2012	-
After five years	<u>28,000,000</u>
	<u>\$ 29,285,714</u>

The Bank may borrow up to 25% of its reported total assets from the FHLB through any combination of notes or line of credit advances. The line of credit interest rate is a variable rate set daily by the lender. The notes payable and the line of credit are secured by a floating lien on all of the Bank's residential first mortgage loans, home equity loans and commercial real estate loans. The Bank was required to purchase shares of capital stock in the FHLB as a condition to obtaining the line of credit. Based on collateral available, the Bank could borrow an additional \$34,000,000 from the FHLB as of September 30, 2009.

During the second quarter of 2009 the Bank became eligible to borrow from the Federal Reserve Bank (FRB) Discount Window. This credit line will be secured by the Bank's consumer loan portfolio. Based on collateral available the Bank could borrow an additional \$11,000,000 from the FRB Discount Window as of September 30, 2009.

In addition to the line of credit available from FHLB and the Federal Reserve, the Bank has unsecured credit lines with correspondent banks for \$2,000,000 and an additional secured line of \$1,000,000.

## 10. RETIREMENT PLAN

The Bank has a profit sharing plan qualifying under section 401(k) of the Internal Revenue Code. The plan covers all full-time employees with one year of service and who have reached 21 years of age. The Board of Directors determines the Bank's contribution annually.

The Bank has a Supplemental Executive Retirement Plans (SERPs) for executive officers providing for retirement income benefits. The Bank accrues the present value of these benefits over the remaining number of years to the executives' retirement dates. As of September 30, 2009, the Bank has recorded a liability of **\$273,185**.

## 11. INTEREST-BEARING DEPOSITS

Major classifications of interest-bearing deposits are as follows:

	SEPTEMBER 30, 2009	DECEMBER 31, 2008
Money market and NOW	\$ 62,819,231	\$ 53,410,248
Savings	21,341,010	21,354,707
Certificates of deposit	<u>86,101,901</u>	<u>77,994,341</u>
	<u>\$170,262,142</u>	<u>\$152,759,296</u>

Maturities of certificates of deposit are as follows:

	SEPTEMBER 30, 2009	DECEMBER 31, 2008
Maturing within twelve months	\$62,781,761	\$58,689,460
Maturing over one to three years	16,282,131	11,465,611
Maturing over three to five years	7,038,009	7,839,270
	<u>\$86,101,901</u>	<u>\$77,994,341</u>
Certificates greater than \$100,000 included above	<u>\$41,643,556</u>	<u>\$31,998,651</u>

Interest expense on interest-bearing deposits for the nine months ended September 30 is as follows:

	2009	2008
Money market and NOW	\$307,340	\$425,115
Savings	75,224	90,216
Certificates of deposit	<u>1,946,978</u>	<u>2,321,510</u>
	<u>\$2,329,542</u>	<u>\$2,836,841</u>

## 12. INCOME TAXES

The components of income tax expense for the nine months ended September 30 are as follows:

	CURRENT	2009	2008
Federal		\$509,732	\$514,532
State		<u>113,786</u>	<u>107,762</u>
		<u>\$623,518</u>	<u>\$622,294</u>

The differences between the federal income tax rate of 34% and the effective tax rate for the Bank for the nine months ended September 30 are reconciled as follows:

	2009	2008
Statutory federal income tax rate	34.00%	34.00%
Increase (decrease) resulting from state income taxes, net, of federal income tax benefit	4.02	3.73
Tax-exempt income, stock option expense	(5.18)	(5.62)
Non deductible expenses.	.50	.50
	<u>33.34%</u>	<u>32.61%</u>

### 13. STOCK OPTIONS

The Bank has adopted a non-qualified stock option plan for directors and an incentive stock option plan for officers and key employees. In each case, the exercise price of an option is equal to the fair market value of a share of common stock on the date of grant. The Bank has also adopted a qualified employee stock purchase plan that allows the Bank to grant options to employees to acquire shares of common stock equal to 85% of the Fair Market Value of such share on the date of grant through payroll deductions or direct payment over a twenty-seven month period from the date of the grants.

The total number of shares originally granted for stock options for all plans was **213,729** restated for stock dividends as of September 30, 2009. A total of 111,718 shares remain available for grant.

Information with respect to outstanding stock options for the nine months ended September 30 is as follows:

	<u>2009</u>	WEIGHTED AVERAGE	<u>2008</u>	WEIGHTED AVERAGE
	NUMBER OF SHARES	EXERCISE PRICE	NUMBER OF SHARES	EXERCISE PRICE
Outstanding, beginning of year	39,607	\$36.12	36,021	\$33.20
Options granted	9,547	30.98	10,125	40.62
Options exercised	(923)	32.04	(5,565)	26.18
Options forfeited	<u>(1,460)</u>	34.33	<u>(974)</u>	31.67
Outstanding, September 30,	<u>46,771</u>	\$35.21	<u>39,607</u>	\$36.12

A summary of information about stock options outstanding is as follows at September 30, 2009:

	Weighted average exercise price	Total shares	Average remaining life (years)	Vested shares
	\$30.33	697	.58	697
	27.45	846	1.92	846
	26.17	1,075	2.75	1,075
	28.76	1,335	3.83	1,335
	32.20	5,808	4.58	5,808
	34.70	5,848	5.58	5,848
	36.52	7,218	6.42	7,218
	40.49	4,652	7.42	3,183
	42.23	7,550	8.67	3,399
	32.25	7,049	9.50	3,300
	35.90	2,262	.92	2,262
	27.41	<u>2,431</u>	1.75	<u>2,431</u>
	\$35.21	<u>46,771</u>		<u>37,402</u>
Intrinsic value on September 30, 2009		\$8,540		\$8,540

At September 30, 2009 and 2008, options to purchase **37,402** and 31,861 shares of the Bank's common stock, respectively, were vested and exercisable at weighted average prices of **\$34.52** and \$35.10, respectively.

The intrinsic value of stock options exercised during the nine months ended September 30, 2009 and 2008 was \$1,657 and \$84,687, respectively.

## 14. CAPITAL STANDARDS

The Federal Reserve Board and the Federal Deposit Insurance Corporation have adopted risk-based capital standards for banking organizations. These standards require ratios of capital to assets for minimum capital adequacy and to be classified as well capitalized under prompt corrective action provisions. As of September 30, 2009 and December 31, 2008 the capital ratios and minimum capital requirements are as follows:

	Actual AMOUNT	RATIO	Minimum Capital Adequacy AMOUNT	RATIO	To be well capitalized AMOUNT	RATIO
<b>September 30, 2009</b>						
<b>Total capital</b> (To risk-weighted assets)	<b>\$26,503</b>	<b>12.7%</b>	<b>\$16,722</b>	<b>8.0%</b>	<b>\$20,903</b>	<b>10.0%</b>
<b>Tier 1 capital</b> (To risk-weighted assets)	<b>24,269</b>	<b>11.6%</b>	<b>8,361</b>	<b>4.0%</b>	<b>12,542</b>	<b>6.0%</b>
<b>Tier 1 capital</b> (To average assets)	<b>24,269</b>	<b>9.5%</b>	<b>10,196</b>	<b>4.0%</b>	<b>12,745</b>	<b>5.0%</b>
<b>December 31, 2008</b>						
Total Capital (To risk-weighted assets)	\$25,544	12.2%	\$16,758	8.0%	\$20,948	10.0%
Tier 1 capital (To risk-weighted assets)	23,692	11.3%	8,379	4.0%	12,569	6.0%
Tier 1 capital (To average assets)	23,692	10.0%	9,514	4.0%	11,894	5.0%

Tier 1 capital consists of common stock, surplus, and undivided profits. Total capital includes a limited amount of the allowance for loan losses. In calculating risk-weighted assets, specified risk percentages are applied to each category of asset and off-balance sheet items.

Failure to meet the capital requirements could affect the Bank's ability to pay dividends and accept deposits and may significantly affect the operations of the Bank.

In its most recent regulatory report the Bank was categorized as well capitalized under the prompt corrective action regulations. Management knows of no events or conditions that should change this classification.

## 15. FAIR VALUE OF FINANCIAL INSTRUMENTS

On January 1, 2008 the Bank adopted FASB ASC Topic 820, "*Fair Value Measurements and Disclosures*". The adoption of this standard had no effect on the Bank's December 31, 2007 balance sheets or the statement of income for the year ended December 31, 2008.

FASB ASC Topic 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value. FASB ASC Topic 820 also establishes a hierarchy for determining fair value measurement. The hierarchy includes three levels and is based upon the valuation techniques used to measure assets and liabilities.

The fair value hierarchy is as follows:

- Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a Bank's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

During the period ended September 30, 2009 the Bank did not measure any financial assets or liabilities on a recurring or nonrecurring basis other than foreclosed real estate. Nonrecurring fair value adjustments to foreclosed real estate

## 15. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

owned reflect values that are based on the real estate's observable market price or current appraised value of the collateral. Since the market for foreclosed real estate is not active, nonrecurring fair value adjustments based on the current offered price or appraised value of the collateral are classified as Level 2. The carrying value of foreclosed real estate at September 30, 2009 was \$567,048.

The estimated fair value of the Bank's financial instruments equals the carrying value of the instruments except as follows. The fair values of a significant portion of these financial instruments are estimates derived using present value techniques and may not be indicative of the net realizable or liquidation values. Also, the calculation of estimated fair values is based on market conditions at a specific point in time and may not reflect current or future fair values.

	<u>September 30, 2009</u>		<u>December 31, 2008</u>	
	<u>Carrying amount</u>	<u>Fair value</u>	<u>Carrying amount</u>	<u>Fair value</u>
Financial assets				
Investment securities	\$ 14,061,247	\$ 14,292,090	\$ 12,962,582	\$ 13,302,356
Investment Certificates of Deposit	4,992,000	4,994,565	2,000,000	2,000,000
Loans, net	209,023,221	211,665,827	201,614,224	201,840,597
Financial liabilities				
Interest-bearing deposits	\$ 170,262,142	\$ 171,082,692	\$ 152,759,296	\$ 153,330,412
FHLB advances	29,285,714	29,498,583	30,142,857	29,384,341

The fair values of U.S. government agency securities are determined using market quotations. For state and municipal securities, the fair values are estimated using a matrix that considers yield to maturity, credit quality, and marketability.

The fair value of fixed-rate loans is estimated to be the present value of scheduled payments discounted using interest rates currently in effect for loans of the same class and term. The fair value of variable-rate loans, including loans with a demand feature, is estimated to equal the carrying amount. The valuation of loans is adjusted for possible loan losses.

The fair value of interest-bearing checking, savings, and money market deposit accounts is equal to the carrying amount. The fair value of fixed-maturity time deposits is estimated based on interest rates currently offered for deposits of similar remaining maturities.

It is not practicable to estimate the fair value of outstanding loan commitments, unused lines of credit, and letters of credit.

## 16. Legal Proceedings

The Bank is party to various legal actions normally associated with a financial institution. In management's opinion, the effect of these actions will not be material to the financial condition of the Bank.