

MIDDLEFIELD BANC CORP

Form 10-K

March 30, 2007

**Table of Contents**

**United States SECURITIES AND EXCHANGE COMMISSION  
Washington , D.C. 20549  
FORM 10-K**

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of  
1934 for the fiscal year ended: December 31, 2006  
Commission File Number: 33-23094  
Middlefield Banc Corp.  
(Exact name of registrant as specified in its charter)**

Ohio

34-1585111

**(State or other jurisdiction of  
incorporation or organization)**

**IRS Employer  
(Identification No.)**

15985 East High Street, Middlefield, Ohio 44062-0035  
(440) 632-1666

**( Address, including zip code, and telephone number,  
including area code, of registrant s principal executive offices )  
Securities registered pursuant to section 12(b) of the Act : none**

**Securities registered pursuant to section 12(g) of the Act : common stock, without par value**

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

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

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate market value on June 30, 2006 of common stock held by non-affiliates of the registrant was approximately \$60.0 million. As of March 20, 2007, there were 1,525,324 shares of common stock issued and outstanding.

**Documents Incorporated by Reference**

Portions of the registrant s definitive proxy statements for the 2007 Annual Meeting of Shareholders are incorporated by reference in Part III of this report. Portions of the Annual Report to Shareholders for the year ended December 31, 2006 are incorporated by reference into Part I and Part II of this report.

## Table of Contents

		<b>Page</b>
<b>Part I</b>		
	<u>Item 1</u> <u>Business</u>	1
	<u>Item 1A</u> <u>Risk Factors</u>	16
	<u>Item 2</u> <u>Properties</u>	19
	<u>Item 3</u> <u>Legal Proceedings</u>	19
	<u>Item 4</u> <u>Submission of Matters to a Vote of Security Holders</u>	19
 <b><u>Part II</u></b>		
	<u>Item 5</u> <u>Market for Registrant's Common Equity and Related Stockholder Matters</u>	20
	<u>Item 6</u> <u>Selected Financial Data</u>	20
	<u>Item 7</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
	<u>Item 7A</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	20
	<u>Item 8</u> <u>Financial Statements and Supplementary Data</u>	20
	<u>Item 9</u> <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	20
	<u>Item 9a</u> <u>Controls and Procedures</u>	20
 <b><u>Part III</u></b>		
	<u>Item 10</u> <u>Directors and Executive Officers of the Registrant</u>	21
	<u>Item 11</u> <u>Executive Compensation</u>	21
	<u>Item 12</u> <u>Security Ownership of Certain Beneficial Owners and Management</u>	21
	<u>Item 13</u> <u>Certain Relationships and Related Transactions</u>	21
	<u>Item 14</u> <u>Principal Accountant Fees and Services</u>	21
 <b><u>Part IV</u></b>		
	<u>Item 15</u> <u>Exhibits, Financial Statement Schedules</u>	21
	<u>EX-13</u>	
	<u>EX-23</u>	
	<u>EX-31.1</u>	

EX-31.2

EX-32

**Table of Contents**

**Item 1 Business**

***Middlefield Banc Corp.*** Incorporated in 1988 under the Ohio General Corporation Law, Middlefield Banc Corp. ( Middlefield ) is a one-bank holding company registered under the Bank Holding Company Act of 1956. Its sole subsidiary is The Middlefield Banking Company (the Bank ), an Ohio-chartered commercial bank that began operations in 1901. The bank engages in a general commercial banking business in northeastern Ohio. Our principal executive offices are located at 15985 East High Street, Middlefield, Ohio 44062-0035, and our telephone number is (440) 632-1666.

Middlefield became the holding company for The Middlefield Banking Company in 1988. The principal source of Middlefield's income and funds is earnings of and dividends paid by The Middlefield Banking Company. Middlefield's business currently is limited to acting as holding company for the bank. Middlefield currently does not plan to engage in any non-banking activities, although it may do so as opportunities arise.

***The Middlefield Banking Company.*** The Middlefield Banking Company was chartered under Ohio law in 1901. The bank offers its customers a broad range of banking services, including checking, savings, and negotiable order of withdrawal (NOW) accounts; money market accounts; time certificates of deposit, commercial loans, real estate loans, and various types of consumer loans; safe deposit facilities, and travelers' checks. The bank offers online banking and bill payment services to individuals and online cash management services to business customers through its website at [www.middlefieldbank.com](http://www.middlefieldbank.com).

Engaged in a general commercial banking business in northeastern Ohio, the bank offers commercial banking services principally to small and medium-sized businesses, professionals and small business owners, and retail customers. The bank has developed and continues to monitor and update a marketing program to attract and retain consumer accounts, and to offer banking services and facilities compatible with the needs of its customers.

The bank's loan products include operational and working capital loans; loans to finance capital purchases; term business loans; residential construction loans; selected guaranteed or subsidized loan programs for small businesses; professional loans; residential mortgage and commercial mortgage loans, and consumer installment loans to purchase automobiles, boats, and for home improvement and other personal expenditures. Although the bank makes agricultural loans, it currently has no significant agricultural loans.

***Pending Transaction with Emerald Bank.*** Middlefield Banc Corp. has entered into an Agreement and Plan of Merger for the acquisition of Emerald Bank, an Ohio-chartered savings bank headquartered in the city of Dublin in Franklin County, Ohio. Established on June 1, 2004, at December 31, 2006 Emerald Bank had total assets of approximately \$41.2 million, total shareholders' equity of approximately \$5.2 million, and a net loss for the year ended December 31, 2006 of approximately \$676,000. Emerald Bank has one banking office.

Middlefield Banc Corp. organized an interim bank subsidiary under Ohio commercial bank law to carry out the merger with Emerald Bank. At the effective time of the merger, Emerald Bank will merge into the new interim subsidiary, which will be the surviving corporation and which will thereafter operate under the name Emerald Bank as a wholly owned commercial bank subsidiary of Middlefield Banc Corp. Subject to possible adjustment if Emerald Bank's stockholders' equity is not at least \$5.3 million at the end of the month immediately before the month in which the merger occurs (disregarding the effect costs associated with the merger transaction have had on Emerald Bank's shareholders' equity), the total purchase price for Emerald Bank is expected to be \$7,326,890. One half of the merger consideration is payable in cash and the other half in shares of Middlefield Banc Corp. common stock.

The merger is subject to bank regulatory approval and to approval of Emerald Bank stockholders. The meeting at which Emerald Bank stockholders will consider and vote upon the transaction is scheduled for March 29, 2007. Middlefield has received approval of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Ohio Division of Financial Institutions for the acquisition of Emerald Bank. Assuming Emerald Bank shareholder approval is also obtained, Middlefield expects that the transaction with Emerald Bank will be completed in April 2007. As a condition to obtaining Federal Reserve Board approval of the proposed acquisition of Emerald Bank, Middlefield expects to enter into an agreement with the Federal Reserve Board that will require Middlefield to take certain actions to improve Emerald Bank's earnings, prospects, and financial condition and strengthen Emerald's management. The terms of the agreement and the precise actions that will be required have not yet been determined, nor has the time period within which the required actions must be taken. Middlefield expects that

if Emerald Bank cannot be restored to well-managed and well-capitalized status within the required period Middlefield will cause Emerald Bank to be merged into The Middlefield Banking Company and operated as a division, rather than continuing to operate as a separate subsidiary.

**Market Area .** The Middlefield Banking Company s market area consists principally of Geauga, Portage, Trumbull, and Ashtabula Counties. Benefiting from the area s proximity both to Cleveland and Warren, population and income levels have maintained steady growth over the years.

**Competition .** The banking industry has been changing for many reasons, including continued consolidation within the banking industry, legislative and regulatory changes, and advances in technology. To deliver banking products and services more effectively and efficiently, banking institutions are opening in-store branches, installing more automated teller machines (ATMs) and investing in technology to permit telephone, personal computer, and internet banking. While all banks are experiencing the effects of the changing competitive and technological

**Table of Contents**

environment, the manner in which banks choose to compete is increasing the gap between large national and super-regional banks, on one hand, and community banks on the other. Large institutions are committed to becoming national or regional brand names, providing a broad selection of products at low cost and with advanced technology, while community banks provide most of the same products but with a commitment to personal service and with local ties to the customers and communities they serve. The Middlefield Banking Company seeks to take competitive advantage of its local orientation and community banking profile. It competes for loans principally through responsiveness to customers and its ability to communicate effectively with them and understand and address their needs. The bank competes for deposits principally by offering customers personal attention, a variety of banking services, attractive rates, and strategically located banking facilities. The bank seeks to provide high quality banking service to professionals and small and mid-sized businesses, as well as individuals, emphasizing quick and flexible responses to customer demands.

**Forward-looking Statements** . This document contains forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995) about Middlefield Banc Corp. and subsidiaries. Information incorporated in this document by reference, future filings by Middlefield Banc Corp. on Form 10-Q and Form 8-K, and future oral and written statements by Middlefield Banc Corp. and its management may also contain forward-looking statements. Forward-looking statements include statements about anticipated operating and financial performance, such as loan originations, operating efficiencies, loan sales, charge-offs and loan loss provisions, growth opportunities, interest rates, and deposit growth. Words such as may, could, should, would, believe, anticipate, estimate, expect, project, plan, and similar expressions are intended to identify these forward-looking statements.

Forward-looking statements are necessarily subject to many risks and uncertainties. A number of things could cause actual results to differ materially from those indicated by the forward-looking statements. These include the factors we discuss immediately below, those addressed under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations, other factors discussed elsewhere in this document or identified in our filings with the Securities and Exchange Commission, and those presented elsewhere by our management from time to time. Many of the risks and uncertainties are beyond our control. The following factors could cause our operating and financial performance to differ materially from the plans, objectives, assumptions, expectations, estimates, and intentions expressed in forward-looking statements:

- the strength of the United States economy in general and the strength of the local economies in which we conduct our operations; general economic conditions, either nationally or regionally, may be less favorable than we expect, resulting in a deterioration in the credit quality of our loan assets, among other things

- the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest-rate policies of the Federal Reserve Board

- inflation, interest rate, market, and monetary fluctuations

- the development and acceptance of new products and services of Middlefield Banc Corp. and subsidiaries and the perceived overall value of these products and services by users, including the features, pricing, and quality compared to competitors' products and services

- the willingness of users to substitute our products and services for those of competitors

- the impact of changes in financial services laws and regulations (including laws concerning taxes, banking, securities, and insurance)

- changes in consumer spending and saving habits

Forward-looking statements are based on our beliefs, plans, objectives, goals, assumptions, expectations, estimates, and intentions as of the date the statements are made. Investors should exercise caution because Middlefield Banc Corp. cannot give any assurance that its beliefs, plans, objectives, goals, assumptions, expectations, estimates, and intentions will be realized. Middlefield Banc Corp. disclaims any obligation to update or revise any forward-looking statements based on the occurrence of future events, the receipt of new information, or otherwise.

**Lending** *Loan Portfolio Composition and Activity* . The Middlefield Banking Company makes residential mortgage and commercial mortgage loans, home equity loans, secured and unsecured consumer installment loans, commercial and industrial loans, and real estate construction loans for owner-occupied and rental properties. The bank's loan policy aspires to a loan composition mix consisting of approximately 60% to 70% residential real estate

loans, 35% to 40% commercial loans, consumer loans of 5% to 15%, and credit card accounts of up to 5%.

Although Ohio bank law imposes no material restrictions on the kinds of loans The Middlefield Banking Company may make, real estate-based lending has historically been the bank's primary focus. For prudential reasons, the bank avoids lending on the security of real estate located in regions with which the bank is not familiar, and as a consequence almost all of the bank's real-estate secured loans are secured by real property in northeastern Ohio. Ohio bank law does restrict the amount of loans an Ohio-chartered bank such as The Middlefield Banking Company may make, however, providing generally that loans and extensions of credit to any one borrower may not exceed 15% of capital. An additional margin of 10% of capital is allowed for loans fully secured by readily marketable collateral. This 15% legal lending limit has not been a material restriction on The Middlefield Banking Company's lending. The Middlefield Banking Company can accommodate loan volumes exceeding the legal lending limit by selling loan participations to other banks. The Middlefield Banking Company's internal policy is to maintain its credit exposure to any one borrower at less than \$3.0 million, which is comfortably within the range of the bank's legal lending limit. As of December 31, 2006, the bank's 15%-of-capital limit on loans to a single borrower was approximately \$4.8 million.

The bank offers specialized loans for business and commercial customers, including equipment and inventory financing, real estate construction loans and Small Business Administration loans for qualified businesses. A substantial portion of the bank's commercial loans are designated as real estate loans for regulatory reporting purposes because they are secured by mortgages on real property. Loans of that type may be made for purpose of financing commercial activities, such as accounts receivable, equipment purchases and leasing, but they are secured by real estate to provide the bank with an extra measure of security. Although these loans might be secured in whole or in part by real estate, they are treated in the discussions to follow as commercial and industrial loans. The bank's consumer installment loans include secured and unsecured loans to individual borrowers for a variety of purposes, including personal, home improvements, revolving credit lines, autos, boats, and recreational vehicles.



**Table of Contents**

The following table shows the composition of the loan portfolio in dollar amounts and in percentages at December 31, 2006, 2005, and 2004, along with a reconciliation to loans receivable, net.

(Dollars in thousands)	Loan Portfolio Composition at December 31,									
	2006		2005		2004		2003		2002	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Type of loan:										
Commercial and industrial	\$ 68,496	27.49	\$ 65,162	27.84%	\$ 52,148	24.18%	\$ 42,063	21.81%	\$ 32,916	18.82%
Real estate construction	2,458	0.99	2,725	1.16	3,144	1.46	3,434	1.78	3,207	1.83
Mortgage:										
Residential	162,917	65.38	151,982	64.93	147,425	68.36	134,007	69.48	123,844	70.79
Commercial	9,949	3.99	8,208	3.51	7,027	3.26	7,866	4.08	9,521	5.44
Consumer installment	5,371	2.16	5,978	2.56	5,909	2.74	5,510	2.85	5,455	3.12
Total loans	249,191	100	234,055	100%	215,653	100%	192,880	100%	174,943	100%
Less:										
Allowance for loan losses	2,849		2,841		2,623		2,521		2,300	
Net loans	\$ 246,342		\$ 231,214		\$ 213,030		\$ 190,359		\$ 172,643	
Net loans as a percent of total assets	72.27%		74.29%		73.15%		72.55%		76.31%	

**Table of Contents**

The following table presents maturity information for the loan portfolio at December 31, 2006. The table does not include prepayments or scheduled principal repayments. All loans are shown as maturing based on contractual maturities.

Loan Portfolio Maturity at December 31, 2006						
(Dollars in thousands)	Commercial	Real	Mortgage		Consumer	Total
	and Industrial	Estate Construction	Residential	Commercial	Installment	
Amount due:						
In one year or less	\$ 20,312	\$ 933	\$ 58,677	\$ 904	\$ 1,552	\$ 82,378
After one year through five years	30,294	817	77,605	4,735	3,508	116,959
After five years	17,890	708	26,635	4,310	311	49,854
Total amount due	\$ 68,496	\$ 2,458	\$ 162,917	\$ 9,949	\$ 5,371	\$ 249,191

Loans due on demand and overdrafts are included in the amount due in one year or less. The Middlefield Banking Company has no loans without a stated schedule of repayment or a stated maturity.

The following table shows the dollar amount of all loans due after December 31, 2007 that have pre-determined interest rates and the dollar amount of all loans due after December 31, 2007 that have floating or adjustable rates

(Dollars in thousands)	Fixed Rate	Adjustable Rate	Total
Commercial and industrial	\$ 22,823	\$ 25,361	\$ 48,184
Real estate construction	722	803	1,525
Mortgage:			
Residential	26,812	77,428	104,240
Commercial	4,668	4,377	9,045
Consumer installment	3,787	32	3,819
	\$ 58,812	\$ 108,001	\$ 166,813

**Table of Contents**

***Residential Mortgage Loans*** . A significant portion of the bank's lending consists of origination of conventional loans secured by 1-4 family real estate located in Geauga, Portage, Trumbull, and Ashtabula Counties. These loans approximated \$163 million or 65.4% of the bank's total loan portfolio at December 31, 2006.

The bank makes loans of up to 80% of the value of the real estate and improvements securing a loan (the loan-to-value or LTV ratio) on 1-4 family real estate. The bank generally does not lend in excess of 80% of the appraised value or sales price (whichever is less) of the property unless additional collateral is obtained, thereby lowering the total LTV. The bank offers residential real estate loans with terms of up to 30 years.

Before 1996, nearly all residential mortgage loans originated by the bank were written on a balloon-note basis. During 1996, the bank began to originate fixed-rate mortgage loans for maturities up to 20 years. In late 1998, the bank began originating adjustable-rate mortgage loans and de-emphasized balloon-note mortgages. Approximately 74.3% of the portfolio of conventional mortgage loans secured by 1-4 family real estate at December 31, 2006 was adjustable rate. The bank's mortgage loans are ordinarily retained in the loan portfolio. The bank's residential mortgage loans have not been originated with loan documentation that would permit their sale to Fannie Mae and Freddie Mac.

The bank's home equity loan policy generally allows for a loan of up to 85% of a property's appraised value, less the principal balance of the outstanding first mortgage loan. The bank's home equity loans generally have terms of 10 years.

At December 31, 2006, residential mortgage loans of approximately \$1,060,000 were over 90 days delinquent or nonaccruing on that date, representing 0.65% of the residential mortgage loan portfolio.

***Commercial and Industrial Loans and Commercial Real Estate Loans*** . The bank's commercial loan services include

- accounts receivable, inventory and working capital loans
- renewable operating lines of credit
- loans to finance capital equipment
- term business loans
- short-term notes
- selected guaranteed or subsidized loan programs for small businesses
- loans to professionals
- commercial real estate loans

Commercial real estate loans include commercial properties occupied by the proprietor of the business conducted on the premises, and income-producing or farm properties. Although the bank makes agricultural loans, it currently does not have a significant amount of agricultural loans. The primary risks of commercial real estate loans is loss of income of the owner or occupier of the property and the inability of the market to sustain rent levels. Although commercial and commercial real estate loans generally bear somewhat more risk than single-family residential mortgage loans, commercial and commercial real estate loans tend to be higher yielding, tend to have shorter terms and commonly provide for interest-rate adjustments as prevailing rates change. Accordingly, commercial and commercial real estate loans enhance a lender's interest rate risk management and, in management's opinion, promote more rapid asset and income growth than a loan portfolio comprised strictly of residential real estate mortgage loans.

Although a risk of nonpayment exists for all loans, certain specific types of risks are associated with various kinds of loans. One of the primary risks associated with commercial loans is the possibility that the commercial borrower will not generate income sufficient to repay the loan. The bank's loan policy provides that commercial loan applications must be supported by documentation indicating that there will be cash flow sufficient for the borrower to service the proposed loan. Financial statements or tax returns for at least three years must be submitted, and annual

reviews are undertaken for loans of \$200,000 or more. The fair market value of collateral for collateralized commercial loans must exceed the bank's loan exposure. For this purpose fair market value is determined by independent appraisal or by the loan officer's estimate employing guidelines established by the loan policy. Term loans not secured by real estate generally have terms of five years or less, unless guaranteed by the U.S. Small Business Administration or other governmental agency, and terms loans secured by collateral having a useful life exceeding five years may have longer terms. The bank's loan policy allows for terms of up to 15 years for loans secured by commercial real estate, and one year for business lines of credit. The maximum loan-to-value ratio for commercial real estate loans is 75% of the appraised value or cost, whichever is less.

Real estate is commonly a material component of collateral for the bank's loans, including commercial loans. Although the expected source of repayment of these loans is generally the operations of the borrower's business or personal income, real estate collateral provides an additional measure of security. Risks associated with loans secured by real estate include fluctuating land values, changing local economic conditions, changes in tax policies, and a concentration of loans within a limited geographic area.

At December 31, 2006, commercial and commercial real estate loans totaled \$78.4 million, or 31.5% of the bank's total loan portfolio. At December 31, 2006, commercial and commercial real estate loans of approximately \$274,000 were over 90 days delinquent or non-accruing on that date, and represented 0.35% of the commercial and commercial real estate loan portfolios.

**Table of Contents**

***Real Estate Construction*** . The Middlefield Banking Company originates several different types of loans that it categorizes as construction loans, including residential construction loans to borrowers who will occupy the premises upon completion of construction, residential construction loans to builders, commercial construction loans, and real estate acquisition and development loans.

Because of the complex nature of construction lending, these loans are generally recognized as having a higher degree of risk than other forms of real estate lending. The bank's fixed-rate and adjustable-rate construction loans do not provide for the same interest rate terms on the construction loan and on the permanent mortgage loan that follows completion of the construction phase of the loan. It is the norm for the bank to make residential construction loans without an existing written commitment for permanent financing. The bank's loan policy provides that the bank may make construction loans with terms of up to one year, with a maximum loan-to-value ratio for residential construction of 80%.

At December 31, 2006, real estate construction loans totaled \$2.5 million, or 1.0% of the bank's total loan portfolio. There were no real estate construction loans with outstanding balances more than 90 days delinquent or nonaccruing.

***Consumer Installment Loans*** . The bank's consumer installment loans include secured and unsecured loans to individual borrowers for a variety of purposes, including personal, home improvement, revolving credit lines, autos, boats, and recreational vehicles. The bank does not currently do any indirect lending. Unsecured consumer loans carry significantly higher interest rates than secured loans. The bank maintains a higher loan loss allowance for consumer loans, while maintaining strict credit guidelines when considering consumer loan applications.

According to the bank's loan policy, consumer loans secured by collateral other than real estate generally may have terms of up to five years, and unsecured consumer loans may have terms up to two and one-half years. Real estate security generally is required for consumer loans having terms exceeding five years.

At December 31, 2006, the bank had approximately \$5.4 million in its consumer installment loan portfolio, representing 2.16% of total loans. Consumer installment loans of approximately \$55,000 were over 90 days delinquent or nonaccruing on that date, representing 1.02% of the installment loan portfolio.

***Loan Solicitation and Processing*** . Loan originations are developed from a number of sources, including continuing business with depositors, other borrowers and real estate builders, solicitations by bank personnel and walk-in customers.

When a loan request is made, the bank reviews the application, credit bureau reports, property appraisals or evaluations, financial information, verifications of income, and other documentation concerning the creditworthiness of the borrower, as applicable to each loan type. The bank's underwriting guidelines are set by senior management and approved by the board. The loan policy specifies each individual officer's loan approval authority, including residential mortgage loans up to \$400,000 for the President, Executive Vice President and the Senior Lender, and secured commercial loans up to \$300,000 for the Executive Vice President and the Senior Commercial Lender. Loans exceeding an individual officer's approval authority are submitted to a committee consisting of loan officers, which has authority to approve loans up to \$300,000. The full board acts as a loan committee for loans exceeding that amount.

***Income from Lending Activities*** . The bank earns interest and fee income from its lending activities. Net of origination costs, loan origination fees are amortized over the life of a loan. The bank also receives loan fees related to existing loans, including late charges. Income from loan origination and commitment fees and discounts varies with the volume and type of loans and commitments made and with competitive and economic conditions. Note 1 to the Consolidated Financial Statements included herein contains a discussion of the manner in which loan fees and income are recognized for financial reporting purposes.

***Nonperforming Loans*** . Late charges on residential mortgages and consumer loans are assessed if a payment is not received by the due date plus a grace period. When an advanced stage of delinquency appears on a single-family

loan and if repayment cannot be expected within a reasonable time or a repayment agreement is not entered into, a required notice of foreclosure or repossession proceedings may be prepared by the bank's attorney and delivered to the borrower so that foreclosure proceedings may be initiated promptly, if necessary. The bank also collects late charges on commercial loans.

When the bank acquires real estate through foreclosure, voluntary deed, or similar means, it is classified as other real estate owned until it is sold. When property is acquired in this manner, it is recorded at the lower of cost (the unpaid principal balance at the date of acquisition) or fair value. Any subsequent write-down is charged to expense. All costs incurred from the date of acquisition to maintain the property are expensed. Other real estate owned is appraised during the foreclosure process, before acquisition. Losses are recognized for the amount by which the book value of the related mortgage loan exceeds the estimated net realizable value of the property.

The bank undertakes regular review of the loan portfolio to assess its risks, particularly the risks associated with the commercial loan portfolio. This includes annual review of every commercial loan representing credit exposure of \$150,000 or more. An independent firm performs semi-annual loan reviews for the bank.

**Table of Contents**

**Classified Assets** . FDIC regulations governing classification of assets require nonmember commercial banks including The Middlefield Banking Company to classify their own assets and to establish appropriate general and specific allowances for losses, subject to FDIC review. The regulations are designed to encourage management to evaluate assets on a case-by-case basis, discouraging automatic classifications. Under this classification system, problem assets of insured institutions are classified as substandard, doubtful, or loss. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses inherent in those classified substandard, with the added characteristic that the weaknesses make collection of principal in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets that do not expose the bank to risk sufficient to warrant classification in one of the above categories, but that possess some weakness, are required to be designated special mention by management.

When an insured institution classifies assets as either substandard or doubtful, it may establish allowances for loan losses in an amount deemed prudent by management. When an insured institution classifies assets as loss, it is required either to establish an allowance for losses equal to 100% of that portion of the assets so classified or to charge off that amount. An FDIC-insured institution's determination about classification of its assets and the amount of its allowances is subject to review by the FDIC, which may order the establishment of additional loss allowances. Management also employs an independent third party to semi-annually review and validate the internal loan review process and loan classifications. As of December 31, 2006, 2005, and 2004 classified assets were as follows:

	Classified Assets at December 31,									
	2006		2005		2004		2003		2002	
(Dollars in thousands)	Amount	Percent of total loans	Amount	Percent of total loans	Amount	Percent of total loans	Amount	Percent of total loans	Amount	Percent of total loans
Classified loans:										
Special mention	\$ 7,394	2.97%	\$ 6,567	2.81%	\$ 4,094	1.90%	\$ 2,876	1.49%	4,713	2.69%
Substandard	1,515	0.61%	2,020	0.86%	3,097	1.44%	1,920	1.00%	1,285	0.74%
Doubtful					163	0.08%	199	0.10%	280	0.16%
Loss										
Total amount due	\$ \$8,909	3.58%	\$ \$8,587	3.67%	\$ \$7,354	3.42%	\$ \$4,995	3.41%	\$ \$6,278	3.59%

**Investments** . Investment securities provide a return on residual funds after lending activities. Investments may be in federal funds sold, corporate securities, U.S. Government and agency obligations, state and local government obligations and government-guaranteed, mortgage-backed securities. The bank generally does not invest in securities that are rated less than investment grade by a nationally recognized statistical rating organization. Ohio bank law prescribes the kinds of investments an Ohio-chartered bank may make. Permitted investments include local, state, and federal government securities, mortgage-backed securities, and securities of federal government agencies. An Ohio-chartered bank also may invest up to 10% of its assets in corporate debt and equity securities, or a higher percentage in certain circumstances. Similar to the legal lending limit on loans to any one borrower, Ohio bank law

also limits to 15% of capital the amount an Ohio-chartered bank may invest in the securities of any one issuer, other than local, state, and federal government and federal government agency issuers and mortgage-backed securities issuers. These Ohio bank law provisions have not been a material constraint upon the bank's investment activities.

All securities-related activity is reported to the bank's board of directors. General changes in investment strategy are required to be reviewed and approved by the board. Senior management can purchase and sell securities in accordance with the bank's stated investment policy.



**Table of Contents**

Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the bank has the ability at the time of purchase to hold a security until maturity or on a long-term basis, the security is classified as held-to-maturity and is reflected on the balance sheet at historical cost. Securities to be held for indefinite periods and not intended to be held to maturity or on a long-term basis are classified as available-for-sale. Available-for-sale securities are reflected on the balance sheet at their market value.

**Investment Portfolio Amortized Cost and  
Estimated Value at December 31,**

	2006				2005				2004			
	Amortized cost	Gross gains	Gross losses	Estimated market value	Amortized cost	Gross gains	Gross losses	Estimated market value	Amortized cost	Gross gains	Gross losses	Estimated market value
<b>Available for Sale:</b>												
U.S. Government agency securities	\$ 7,253	\$ 2	\$ (110)	\$ 7,145	\$ 7,261	\$ 10	\$ (112)	\$ 7,159	\$ 5,273	\$ 71	\$ (18)	\$ 5,326
Obligations of states and political subdivisions:												
Taxable	749		(22)	727	748		(23)	725	748		(11)	737
Tax-exempt	38,182	140	(354)	37,968	28,231	98	(331)	27,998	21,239	303	(66)	21,477
Corporate securities												
Mortgage-backed securities	16,959		(490)	16,469	22,229	16	(640)	21,605	29,625	81	(403)	29,302
Equity securities	694	48	(3)	739	444	1	(45)	400	399			399
<b>Total</b>	<b>\$ 63,837</b>	<b>\$ 190</b>	<b>\$ (979)</b>	<b>\$ 63,048</b>	<b>\$ 58,913</b>	<b>\$ 125</b>	<b>\$ (1,151)</b>	<b>\$ 57,887</b>	<b>\$ 57,284</b>	<b>\$ 455</b>	<b>\$ (498)</b>	<b>\$ 57,241</b>
<b>Held to Maturity:</b>												
Obligations of states and political subdivisions:												
Taxable												
Tax-exempt	126	8		134	221	12		233	221	22		
<b>Total</b>	<b>\$ 126</b>	<b>\$ 8</b>	<b>\$</b>	<b>\$ 134</b>	<b>\$ 221</b>	<b>\$ 12</b>	<b>\$</b>	<b>\$ 233</b>	<b>\$ 221</b>	<b>\$ 22</b>	<b>\$</b>	<b>\$ 244</b>

**Total Investment  
Securities**

\$ 63,963 \$ 198 \$ (979) \$ 63,182 \$ 59,134 \$ 137 \$ (1,151) \$ 58,120 \$ 57,505 \$ 477 \$ (498) \$ 57,485

8

---

**Table of Contents**

The following table sets forth the amortized cost and estimated market value of the bank's investment portfolio at the dates indicated.

	31-Dec-06										
	One year or less		More than one to five years		More than five to ten years		More than ten years		Total investment securities and mortgage-backed securities		Market value
	Amortized cost	Average yield	Amortized cost	Average yield	Amortized cost	Average yield	Amortized cost	Average yield	Amortized cost	Average yield	
U.S. Government agency securities	\$ 652	5.88	\$ 3,607	4.75	\$ 2,994	4.70	\$		\$ 7,253	4.83	\$ 7,145
Obligations of states and political subdivisions:											
Taxable			749	3.83					749	3.83	727
Tax-exempt	4,333	3.78	7,296	3.91	6,829	4.18	19,723	4.39	38,181	4.19	37,968
Mortgage-backed securities			153	5.00	1,037	5.02	15,770	4.64	16,960	4.67	16,469
Equity Securities	694								694		739
<b>Total</b>	<b>\$ 5,679</b>	<b>3.56%</b>	<b>\$ 11,805</b>	<b>4.18%</b>	<b>\$ 10,860</b>	<b>4.40%</b>	<b>\$ 35,493</b>	<b>4.50%</b>	<b>\$ 63,837</b>	<b>4.34%</b>	<b>\$ 63,048</b>

**Table of Contents**

The contractual maturity of investment securities at December 31, 2006 is shown below. Expected maturities of investment securities could differ from contractual maturities because the borrower, or issuer, could have the right to call or prepay obligations with or without call or prepayment penalties.

As of December 31, 2006, the bank also held 15,073 shares of \$100 par value Federal Home Loan Bank of Cincinnati stock, which is a restricted security. FHLB stock represents an equity interest in the FHLB, but it does not have a readily determinable market value. The stock can be sold at its par value only, and only to the FHLB or to another member institution. Member institutions are required to maintain a minimum stock investment in the FHLB, based on total assets, total mortgages, and total mortgage-backed securities. The bank's minimum investment in FHLB stock at December 31, 2006 was approximately \$1,507,300.

**Sources of Funds** *Deposit Accounts* . Deposit accounts are a major source of funds for the bank. The bank offers a number of deposit products to attract both commercial and regular consumer checking and savings customers, including regular and money market savings accounts, NOW accounts, and a variety of fixed-maturity, fixed-rate certificates with maturities ranging from seven days to 60 months. These accounts earn interest at rates established by management based on competitive market factors and management's desire to increase certain types or maturities of deposit liabilities. The bank also provides travelers' checks, official checks, money orders, ATM services, and IRA accounts.

The following table shows the amount of time deposits of \$100,000 or more as of December 31, 2006, including certificates of deposit, by time remaining until maturity.

Time Remaining to Maturity	Maturity of Time Deposits of \$100,000 or more at December 31, 2006	
	Amount	Percent of Total
Within three months	\$ 4,991,253	13.73%
Beyond three but within six months	6,024,266	16.58
Beyond six but within twelve months	7,345,317	20.21
Beyond one year	17,983,463	49.48
Total	\$ 36,344,299	100.00%

*Borrowings* . Deposits and repayment of loan principal are the bank's primary sources of funds for lending activities and other general business purposes. However, when the supply of lendable funds or funds available for general business purposes cannot satisfy the demand for loans or general business purposes, the bank can obtain funds from the FHLB of Cincinnati. Interest and principal are payable monthly, and the line of credit is secured by a blanket pledge collateral agreement. At December 31, 2006, the bank had \$27.9 million of FHLB borrowings outstanding. Middlefield also has access to credit through the Federal Reserve Bank of Cleveland and other funding sources.

The outstanding balances and related information about short-term borrowings, which includes securities sold under agreements to repurchase are summarized as follows:

	2006	2005	2004
Balance at year-end	\$1,609,738	\$6,710,914	1,871,763
Average balance outstanding	3,281,340	1,844,018	298,500
Maximum month-end balance	8,245,406	6,710,914	2,057,054
Weighted-average rate at year-end	4.35%	4.38%	3.80%
Weighted-average rate during the year	5.10	5.63	0.73

**Personnel .**

As of December 31, 2006 Middlefield and the bank had 80 full-time equivalent employees. None of the employees is represented by a collective bargaining group. Management considers its relations with employees to be excellent.

**Table of Contents****Supervision and Regulation**

The following discussion of bank supervision and regulation is qualified in its entirety by reference to the statutory and regulatory provisions discussed. Changes in applicable law or in the policies of various regulatory authorities could affect materially the business and prospects of Middlefield and the bank.

Middlefield is a bank holding company within the meaning of the Bank Holding Company Act of 1956. As such, Middlefield is subject to regulation, supervision, and examination by the Board of Governors of the Federal Reserve System, acting primarily through the Federal Reserve Bank of Cleveland. Middlefield is required to file annual reports and other information with the Federal Reserve. The Middlefield Banking Company is an Ohio-chartered commercial bank. As a state-chartered, nonmember bank, the bank is primarily regulated by the FDIC and by the Ohio Division of Financial Institutions.

Middlefield and the bank are subject to federal banking laws, and the bank is subject also to Ohio bank law. These federal and state laws are intended to protect depositors, not stockholders. Federal and state laws applicable to holding companies and their financial institution subsidiaries regulate the range of permissible business activities, investments, reserves against deposits, capital levels, lending activities and practices, the nature and amount of collateral for loans, establishment of branches, mergers, dividends, and a variety of other important matters. The bank is subject to detailed, complex, and sometimes overlapping federal and state statutes and regulations affecting routine banking operations. These statutes and regulations include but are not limited to state usury and consumer credit laws, the Truth-in-Lending Act and Regulation Z, the Equal Credit Opportunity Act and Regulation B, the Fair Credit Reporting Act, the Truth in Savings Act, and the Community Reinvestment Act. The bank must comply with Federal Reserve Board regulations requiring depository institutions to maintain reserves against their transaction accounts (principally NOW and regular checking accounts). Because required reserves are commonly maintained in the form of vault cash or in a noninterest-bearing account (or pass-through account) at a Federal Reserve Bank, the effect of the reserve requirement is to reduce an institution's earning assets.

The Federal Deposit Insurance Corporation Improvement Act of 1991 expanded significantly the authority of federal agencies to regulate the activities of federally chartered and state-chartered financial institutions and their holding companies. The Federal Reserve Board and the FDIC have extensive authority to prevent and to remedy unsafe and unsound practices and violations of applicable laws and regulations by institutions and holding companies. The agencies may assess civil money penalties, issue cease-and-desist or removal orders, seek injunctions, and publicly disclose those actions. In addition, the Ohio Division of Financial Institutions possesses enforcement powers to address violations of Ohio banking law by Ohio-chartered banks.

**Regulation of Bank Holding Companies** *Bank and Bank Holding Company Acquisitions*. The Bank Holding Company Act requires every bank holding company to obtain approval of the Federal Reserve before directly or indirectly acquiring ownership or control of any voting shares of another bank or bank holding company, if after the acquisition the acquiring company would own or control more than 5% of the shares of the other bank or bank holding company (unless the acquiring company already owns or controls a majority of the shares),

acquiring all or substantially all of the assets of another bank, or

merging or consolidating with another bank holding company.

The Federal Reserve will not approve an acquisition, merger, or consolidation that would have a substantially anticompetitive result, unless the anticompetitive effects of the proposed transaction are clearly outweighed by a greater public interest in satisfying the convenience and needs of the community to be served. The Federal Reserve also considers capital adequacy and other financial and managerial factors in its review of acquisitions and mergers.

Additionally, the Bank Holding Company Act, the Change in Bank Control Act and the Federal Reserve Board's Regulation Y require advance approval of the Federal Reserve to acquire control of a bank holding company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of a class of voting securities of the bank holding company. If the holding company has securities registered under Section 12 of the Securities Exchange Act of 1934, as Middlefield does, or if no other person owns a greater percentage of the class of voting

securities, control is rebuttably presumed to exist if a person acquires 10% or more, but less than 25%, of any class of voting securities. Approval of the Ohio Division of Financial Institutions is also necessary to acquire control of an Ohio-chartered bank.

*Nonbanking Activities* . With some exceptions, the Bank Holding Company Act has for many years also prohibited a bank holding company from acquiring or retaining direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve non-bank activities that, by statute or by Federal Reserve Board regulation or order, are held to be closely related to the business of banking or of managing or controlling banks. In making its determination that a particular activity is closely related to the business of banking, the Federal Reserve considers whether the performance of the activities by a bank holding company can be expected to produce benefits to the public such as greater convenience, increased competition, or gains in efficiency in resources that will outweigh the risks of possible adverse effects such as decreased or unfair competition, conflicts of interest, or unsound banking practices. Some of the activities determined by Federal Reserve Board regulation to be closely related to the business of banking are: making or servicing loans or leases; engaging in insurance and discount brokerage activities;

**Table of Contents**

owning thrift institutions; performing data processing services; acting as a fiduciary or investment or financial advisor; and making investments in corporations or projects designed primarily to promote community welfare.

*Financial Holding Companies* . On November 12, 1999 the Gramm-Leach-Bliley Act became law, repealing much of the 1933 Glass-Steagall Act's separation of the commercial and investment banking industries. The Gramm-Leach-Bliley Act expands the range of nonbanking activities a bank holding company may engage in, while preserving existing authority for bank holding companies to engage in activities that are closely related to banking. The new legislation creates a new category of holding company called a financial holding company. Financial holding companies may engage in any activity that is

financial in nature or incidental to that financial activity, or

complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Activities that are financial in nature include

acting as principal, agent, or broker for insurance,

underwriting, dealing in, or making a market in securities, and

providing financial and investment advice.

The Federal Reserve Board and the Secretary of the Treasury have authority to decide that other activities are also financial in nature or incidental to financial activity, taking into account changes in technology, changes in the banking marketplace, competition for banking services, and so on. Middlefield is engaged solely in activities that were permissible for a bank holding company before enactment of the Gramm-Leach-Bliley Act. Although Middlefield has become a financial holding company, Middlefield has no immediate plans to use the expanded authority to engage in activities other than those in which it is currently engaged. Federal Reserve Board rules require that all of the depository institution subsidiaries of a financial holding company be and remain well capitalized and well managed. If all depository institution subsidiaries of a financial holding company do not remain well capitalized and well managed, the financial holding company must enter into an agreement acceptable to the Federal Reserve Board, undertaking to comply with all capital and management requirements within 180 days. In the meantime the financial holding company may not use its expanded authority to engage in nonbanking activities without Federal Reserve Board approval and the Federal Reserve may impose other limitations on the holding company's or affiliates' activities. If a financial holding company fails to restore the well-capitalized and well-managed status of a depository institution subsidiary, the Federal Reserve may order divestiture of the subsidiary. As a condition to obtaining Federal Reserve Board approval of the proposed acquisition of Emerald Bank, Middlefield expects to enter into an agreement with the Federal Reserve Board that will require Middlefield to take certain actions to improve Emerald Bank's earnings, prospects, and financial condition and strengthen Emerald's management. The terms of the agreement and the precise actions that will be required have not yet been determined, nor has the time period within which the required actions must be taken. Middlefield expects that if Emerald Bank cannot be restored to well-managed and well-capitalized status within the required period Middlefield will cause Emerald Bank to be merged into The Middlefield Banking Company and operated as a division, rather than continuing to operate as a separate subsidiary.

*Holding Company Capital and Source of Strength* . The Federal Reserve considers the adequacy of a bank holding company's capital on essentially the same risk-adjusted basis as capital adequacy is determined by the FDIC at the bank subsidiary level. In general, bank holding companies are required to maintain a minimum ratio of total capital to risk-weighted assets of 8% and Tier 1 capital consisting principally of stockholders' equity of at least 4%. Bank holding companies are also subject to a leverage ratio requirement. The minimum required leverage ratio for the very highest rated companies is 3%, but as a practical matter the minimum required leverage ratio for most bank holding companies is 4% or higher. It is also Federal Reserve Board policy that bank holding companies serve as a source of strength for their subsidiary banking institutions.

Under Bank Holding Company Act section 5(e), the Federal Reserve Board may require a bank holding company to terminate any activity or relinquish control of a nonbank subsidiary if the Federal Reserve Board determines that



the activity or control constitutes a serious risk to the financial safety, soundness or stability of a subsidiary bank. And with the Federal Deposit Insurance Corporation Improvement Act of 1991's addition of the prompt corrective action provisions to the Federal Deposit Insurance Act, section 38(f)(2)(I) of the Federal Deposit Insurance Act now provides that a federal bank regulatory authority may require a bank holding company to divest itself of an undercapitalized bank subsidiary if the agency determines that divestiture will improve the bank's financial condition and prospects.

**Federal Deposit Insurance** . The FDIC insures deposits of banks, savings banks, and savings associations, and it safeguards the safety and soundness of the banking industry. Two separate insurance funds are maintained and administered by the FDIC. In general, bank deposits are insured through the Bank Insurance Fund. Deposits in savings associations are insured through the Savings Association Insurance Fund.

As an FDIC member institution, deposits in the bank are insured to a maximum of \$100,000 per depositor. The banks are required to pay semiannual deposit insurance premium assessments to the FDIC. In general terms, each institution is assessed insurance premiums according to how much risk to the insurance fund the institution represents. Well-capitalized institutions with few supervisory concerns are assessed lower

**Table of Contents**

premiums than other institutions. The premium range is currently from \$0.00 for the highest-rated institutions to \$0.27 per \$100 of domestic deposits.

The FDIC may terminate the deposit insurance of any insured depository institution if the FDIC determines that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order, or any condition imposed in writing by, or written agreement with, the FDIC. The FDIC also may suspend deposit insurance temporarily during the hearing process for a permanent termination of insurance if the institution has no tangible capital.

**Interstate Banking and Branching** . In 1994 the Riegle-Neal Interstate Banking and Branching Efficiency Act eased restrictions on interstate banking. The Riegle-Neal Act allows the Federal Reserve to approve an application by an adequately capitalized and adequately managed bank holding company to acquire a bank located in a state other than the acquiring company's home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve may not approve acquisition of a bank that has not been in existence for the minimum time period (up to five years) specified by the statutory law of the acquired, or target, bank's state. The Riegle-Neal Act also prohibits the Federal Reserve from approving an application if the applicant (and its depository institution affiliates) controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. The Riegle-Neal Act does not affect the authority of states to limit the percentage of total insured deposits in the state that may be held or controlled by a bank or bank holding company if the limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% statewide concentration limit contained in the Riegle-Neal Act.

Branching between states may be accomplished by merging commonly controlled banks located in different states into one legal entity. Branching may also be accomplished by establishing *de novo* branches or acquiring branches in another state. Under section 24(j) of the Federal Deposit Insurance Act, a branch of a bank operating out-of-state in a host state is subject to the law of the host state regarding community reinvestment, fair lending, consumer protection, and establishment of branches. The Riegle-Neal Act authorizes the FDIC to approve interstate branching *de novo* by state-chartered banks solely in states that specifically allow it. Ohio bank law allows *de novo* branching in Ohio by an out-of-state bank. The FDIC has adopted regulations under the Riegle-Neal Act to prohibit an out-of-state bank from using the new interstate branching authority primarily for the purpose of deposit production. These regulations include guidelines to ensure that interstate branches operated by an out-of-state bank in a host state are reasonably helping to satisfy the credit needs of the communities served by the out-of-state bank.

**Capital Risk-Based Capital Requirements** . The Federal Reserve Board and the FDIC employ similar risk-based capital guidelines in their examination and regulation of bank holding companies and financial institutions. If capital falls below the minimum levels established by the guidelines, the bank holding company or bank may be denied approval to acquire or establish additional banks or non-bank businesses or to open new facilities. Failure to satisfy capital guidelines could subject a banking institution to a variety of enforcement actions by federal bank regulatory authorities, including the termination of deposit insurance by the FDIC and a prohibition on the acceptance of brokered deposits.

In the calculation of risk-based capital, assets and off-balance sheet items are assigned to broad risk categories, each with an assigned weighting (0%, 20%, 50% and 100%). Most loans are assigned to the 100% risk category, except for first mortgage loans fully secured by residential property, which carry a 50% rating. Most investment securities are assigned to the 20% category, except for municipal or state revenue bonds, which have a 50% risk-weight, and direct obligations of or obligations guaranteed by the United States Treasury or United States Government agencies, which have a 0% risk-weight. Off-balance sheet items are also taken into account in the calculation of risk-based capital, with each class of off-balance sheet item being converted to a balance sheet equivalent according to established conversion factors. From these computations, the total of risk-weighted assets is derived. Risk-based capital ratios therefore state capital as a percentage of total risk-weighted assets and off-balance sheet items. The ratios established by guideline are minimums only.

Current risk-based capital guidelines require bank holding companies and banks to maintain a minimum risk-based total capital ratio equal to 8% and a Tier 1 capital ratio of 4%. Intangibles other than readily marketable mortgage

servicing rights are generally deducted from capital. Tier 1 capital includes stockholders' equity, qualifying perpetual preferred stock (within limits and subject to conditions, particularly if the preferred stock is cumulative preferred stock), and minority interests in equity accounts of consolidated subsidiaries, less intangibles, identified losses, investments in securities subsidiaries, and certain other assets. Tier 2 capital includes

the allowance for loan losses, up to a maximum of 1.25% of risk-weighted assets,

any qualifying perpetual preferred stock exceeding the amount includable in Tier 1 capital,

mandatory convertible securities, and

subordinated debt and intermediate term preferred stock, up to 50% of Tier 1 capital.

The FDIC also employs a market risk component in its calculation of capital requirements for nonmember banks. The market risk component could require additional capital for general or specific market risk of trading portfolios of debt and equity securities and other investments or assets. The FDIC's evaluation of an institution's capital adequacy takes account of a variety of other factors as well, including

**Table of Contents**

interest rate risks to which the institution is subject, the level and quality of an institution's earnings, loan and investment portfolio characteristics and risks, risks arising from the conduct of nontraditional activities, and a variety of other factors.

Accordingly, the FDIC's final supervisory judgment concerning an institution's capital adequacy could differ significantly from the conclusions that might be derived from the absolute level of an institution's risk-based capital ratios. Therefore, institutions generally are expected to maintain risk-based capital ratios that exceed the minimum ratios discussed above. This is particularly true for institutions contemplating significant expansion plans and institutions that are subject to high or inordinate levels of risk. Moreover, although the FDIC does not impose explicit capital requirements on holding companies of institutions regulated by the FDIC, the FDIC can take account of the degree of leverage and risks at the holding company level. If the FDIC determines that the holding company (or another affiliate of the institution regulated by the FDIC) has an excessive degree of leverage or is subject to inordinate risks, the FDIC may require the subsidiary institution(s) to maintain additional capital or the FDIC may impose limitations on the subsidiary institution's ability to support its weaker affiliates or holding company.

The banking agencies have also established a minimum leverage ratio of 3%, which represents Tier 1 capital as a percentage of total assets, less intangibles. However, for bank holding companies and financial institutions seeking to expand and for all but the most highly rated banks and bank holding companies, the banking agencies expect an additional cushion of at least 100 to 200 basis points. At December 31, 2005, the bank was in compliance with all regulatory capital requirements.

**Prompt Corrective Action.** To resolve the problems of undercapitalized institutions and to prevent a recurrence of the banking crisis of the 1980s and early 1990s, the Federal Deposit Insurance Corporation Improvement Act of 1991 established a system known as prompt corrective action. Under the prompt corrective action provisions and implementing regulations, every institution is classified into one of five categories, depending on its total risk-based capital ratio, its Tier 1 risk-based capital ratio, its leverage ratio, and subjective factors. The categories are well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. financial institution's operations can be significantly affected by its capital classification. For example, an institution that is not well capitalized generally is prohibited from accepting brokered deposits and offering interest rates on deposits higher than the prevailing rate in its market, and the holding company of any undercapitalized institution must guarantee, in part, aspects of the institution's capital plan. Financial institution regulatory agencies generally are required to appoint a receiver or conservator shortly after an institution enters the category of weakest capitalization. The Federal Deposit Insurance Corporation Improvement Act of 1991 also authorizes the regulatory agencies to reclassify an institution from one category into a lower category if the institution is in an unsafe or unsound condition or engaging in an unsafe or unsound practice. Undercapitalized institutions are required to take specified actions to increase their capital or otherwise decrease the risks to the federal deposit insurance funds.

The following table illustrates the capital and prompt corrective action guidelines applicable to Middlefield, as well as its total risk-based capital ratio, Tier 1 capital ratio and leverage ratio as of December 31, 2006.

	At December 31, 2006	Minimum Necessary to be Well Capitalized	Minimum Necessary to be Adequately Capitalized
Total Risk-Based Capital Ratio	18.05%	10.00%	8.00%
Tier 1 Risk-Based Capital Ratio	16.82%	6.00%	4.00%
Leverage Ratio	11.82%	5.00%	4.00%

**Limits on Dividends and Other Payments.** Middlefield's ability to obtain funds for the payment of dividends and for other cash requirements depends on the amount of dividends that may be paid to it by the bank. Under Ohio bank law, an Ohio-chartered bank may not pay a cash dividend if the amount of the dividend exceeds undivided profits, which is defined in Ohio bank law to mean the cumulative undistributed amount of the bank's net income. But with the approval of two thirds of the outstanding shares and approval of the superintendent of the Division of Financial

Institutions, an Ohio-chartered bank may pay cash dividends from surplus. Lastly, approval of the superintendent is also required if the total of all dividends and distributions declared on the bank's shares in any year exceeds the total of the bank's net income for the year plus retained net income for the two preceding years.

State-chartered banks' ability to pay dividends may be affected by capital maintenance requirements of their primary federal bank regulatory agency as well. Moreover, regulatory authorities may prohibit banks and bank holding companies from paying dividends if payment of dividends would constitute an unsafe and unsound banking practice.

A 1985 policy statement of the Federal Reserve Board declares that a bank holding company should not pay cash dividends on common stock unless the organization's net income for the past year is sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

**Recent Legislation** . On July 30, 2002 the Sarbanes-Oxley Act of 2002 became law. The goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies, and to

**Table of Contents**

protect investors by improving the accuracy and reliability of corporate disclosures made under the securities laws. The proposed changes are intended to allow shareholders to monitor the performance of companies and directors more easily and efficiently.

The Sarbanes-Oxley Act generally applies to all companies that file or are required to file periodic reports with the SEC under the Securities Exchange Act of 1934. The Act includes very specific additional disclosure requirements and new corporate governance rules, requires the SEC, securities exchanges, and Nasdaq to adopt extensive additional disclosure, corporate governance, and other related rules. The final scope of all of these new requirements is not yet clear. Some of the changes are effective already, but others will become effective in the future.

The Sarbanes-Oxley Act has an impact on a wide variety of corporate governance and disclosure issues, including the composition of audit committees, certification of financial statements by the chief executive officer and the chief financial officer, forfeiture of bonuses and profits made by directors and senior officers in the 12-month period covered by restated financial statements, a prohibition on insider trading during pension plan black-out periods, disclosure of off-balance sheet transactions, a prohibition on personal loans to directors and officers (excluding Federally insured financial institutions), expedited filing requirements for stock transaction reports by officers and directors, the formation of a public accounting oversight board, auditor independence, and various increased criminal penalties for violations of securities laws.

**Transactions with Affiliates** . Although the bank is not a member bank of the Federal Reserve System, it is required by the Federal Deposit Insurance Act to comply with section 23A and section 23B of the Federal Reserve Act pertaining to transactions with affiliates as if it were a member bank. These statutes are intended to protect banks from abuse in financial transactions with affiliates, preventing federally insured deposits from being diverted to support the activities of unregulated entities engaged in nonbanking businesses. An affiliate of a bank includes any company or entity that controls or is under common control with the bank. Generally, section 23A and section 23B of the Federal Reserve Act

limit the extent to which a bank or its subsidiaries may lend to or engage in various other kinds of transactions with any one affiliate to an amount equal to 10% of the institution's capital and surplus, limiting the aggregate of covered transactions with all affiliates to 20% of capital and surplus,

impose restrictions on investments by a subsidiary bank in the stock or securities of its holding company,

impose restrictions on the use of a holding company's stock as collateral for loans by the subsidiary bank, and

require that affiliate transactions be on terms substantially the same, or at least as favorable to the institution or subsidiary, as those provided to a non-affiliate.

The bank's authority to extend credit to insiders—meaning executive officers, directors and greater than 10% stockholders—or to entities those persons control, is subject to section 22(g) and section 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve Board. Among other things, these laws require insider loans to be made on terms substantially similar to those offered to unaffiliated individuals, place limits on the amount of loans a bank may make to insiders based in part on the bank's capital position, and require that specified approval procedures be followed. Loans to an individual insider may not exceed the legal limit on loans to any one borrower, which in general terms is 15% of capital but can be higher in some circumstances. And the aggregate of all loans to all insiders may not exceed the bank's unimpaired capital and surplus. Insider loans exceeding the greater of 5% of capital or \$25,000 must be approved in advance by a majority of the board, with any interested director not participating in the voting. Lastly, loans to executive officers are subject to special limitations. Executive officers may borrow in unlimited amounts to finance their children's education or to finance the purchase or improvement of their residence, and they may borrow no more than \$100,000 for most other purposes. Loans to executive officers exceeding \$100,000 may be allowed if the loan is fully secured by government securities or a segregated deposit account. A violation of these restrictions could result in the assessment of substantial civil monetary penalties, the imposition of a cease-and-desist order or other regulatory sanctions.

**Community Reinvestment Act** . Under the Community Reinvestment Act of 1977 and implementing regulations of the banking agencies, a financial institution has a continuing and affirmative obligation consistent with safe and sound operation to address the credit needs of its entire community, including low- and moderate-income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions, nor does it limit an institution's discretion to develop the types of products and services it believes are best suited to its particular community. The CRA requires that bank regulatory agencies conduct regular CRA examinations and provide written evaluations of institutions' CRA performance. The CRA also requires that an institution's CRA performance rating be made public. CRA performance evaluations are based on a four-tiered rating system: Outstanding, Satisfactory, Needs to Improve and Substantial Noncompliance.

Although CRA examinations occur on a regular basis, CRA performance evaluations have been used principally in the evaluation of regulatory applications submitted by an institution. CRA performance evaluations are considered in evaluating applications for such things as mergers, acquisitions, and applications to open branches. Over the 25 years that the CRA has existed, and particularly in the last decade, institutions have faced increasingly difficult regulatory obstacles and public interest group objections in connection with their regulatory applications, including institutions that have received the highest possible CRA ratings.

A bank holding company cannot elect to be a financial holding company with the expanded securities, insurance and other powers that designation entails unless all of the depository institutions owned by the holding company have a CRA rating of satisfactory or better. The

**Table of Contents**

Gramm-Leach-Bliley Act also provides that a financial institution with total assets of \$250 million or greater will be subject to CRA examinations no more frequently than every 2 years. Following a CRA examination as of September 19, 2005, the bank received a rating of Outstanding. Lastly, the Gramm-Leach-Bliley Act requires public disclosure of private CRA agreements entered into between banking organizations and other parties, and annual reporting by banking organizations of actions taken under the private CRA agreements. This last provision of the Gramm-Leach-Bliley Act addresses the increasingly common practice whereby a bank or holding company undertaking acquisition of another bank or holding company enters into an agreement with parties who might otherwise file with bank regulators a CRA protest of the acquisition. The details of these agreements have not been universally disclosed by acquiring institutions in the past.

**Federal Home Loan Banks** . The Federal Home Loan Banks serve as credit sources for their members. As a member of the FHLB of Cincinnati, The Middlefield Banking Company is required to maintain an investment in the capital stock of the FHLB of Cincinnati in an amount calculated by reference to its and the amount of loans, or advances, from the FHLB. The bank is in compliance with this requirement, with an investment in FHLB stock of \$1,507,300 at December 31, 2006.

Each FHLB is required to establish standards of community investment or service that its members must maintain for continued access to long-term advances from the FHLB. The standards take into account a member's performance under the Community Reinvestment Act and its record of lending to first-time home buyers.

**State Banking Regulation** . As an Ohio-chartered bank, the bank is subject to regular examination by the Ohio Division of Financial Institutions. State banking regulation affects the internal organization of the bank as well as its savings, lending, investment, and other activities. State banking regulation may contain limitations on an institution's activities that are in addition to limitations imposed under federal banking law. The Ohio Division of Financial Institutions may initiate supervisory measures or formal enforcement actions, and if the grounds provided by law exist it may take possession and control of an Ohio-chartered bank.

**Monetary Policy** . The earnings of financial institutions are affected by the policies of regulatory authorities, including monetary policy of the Federal Reserve Board. An important function of the Federal Reserve System is regulation of aggregate national credit and money supply. The Federal Reserve Board accomplishes these goals with measures such as open market transactions in securities, establishment of the discount rate on bank borrowings, and changes in reserve requirements against bank deposits. These methods are used in varying combinations to influence overall growth and distribution of financial institutions' loans, investments and deposits, and they also affect interest rates charged on loans or paid on deposits. Monetary policy is influenced by many factors, including inflation, unemployment, short-term and long-term changes in the international trade balance, and fiscal policies of the United States government. Federal Reserve Board monetary policy has had a significant effect on the operating results of financial institutions in the past, and it can be expected to influence operating results in the future.

**Item 1.A Risk Factors**

*Our market is very competitive* . We face competition both in making loans and in attracting deposits. Competition is based on interest rates and other credit and service charges, the quality of services rendered, the convenience of banking facilities, the range and type of products offered and, in the case of loans to larger commercial borrowers, lending limits, among other factors. Competition for loans comes principally from commercial banks, savings banks, savings and loan associations, credit unions, mortgage banking companies, insurance companies, and other financial service companies. Our most direct competition for deposits has historically come from commercial banks, savings banks, and savings and loan associations. We face additional competition for deposits from non-depository institutions such as mutual funds, securities and brokerage firms, and insurance companies.

Competition among financial institutions and other financial service organizations is increasing with the continuing consolidation of the financial services industry. Additionally, legislative and regulatory changes could affect competition. Congress' elimination in 1994 of many restrictions on interstate branching could increase competition from large banks headquartered outside of northeastern Ohio. Congress' repeal in late 1999 of much of the Glass-Steagall Act (which had separated the commercial and investment banking industries) and elimination of the barriers between the banking and insurance industries might make competition even more intense. Because of our smaller size, we may have less opportunity to take advantage of the flexibility offered by that new legislation.



*The bank does not have the financial and other resources that larger competitors have; this could affect its ability to compete for large commercial loan originations and its ability to offer products and services competitors provide to customers .* The northeastern Ohio market in which The Middlefield Banking Company operates has a high concentration of financial institutions. Many of the financial institutions operating in our market are branches of significantly larger institutions headquartered in Cleveland or in other major metropolitan areas, with significantly greater financial resources and higher lending limits. More geographically diversified than The Middlefield Banking Company, they are therefore less vulnerable to adverse changes in our local economy. And many of these institutions offer services that we do not or cannot provide. For example, the larger competitors' greater resources offer advantages such as the ability to price services at lower, more attractive levels, and the ability to provide larger credit facilities than The Middlefield Banking Company can provide. Likewise, some of the competitors are not subject to the same kind and amount of regulatory restrictions and supervision to which The Middlefield Banking Company is subject. Because The Middlefield Banking Company is smaller than many commercial lenders in its market, it is on occasion prevented from making commercial loans in amounts competitors can offer. The Middlefield Banking Company accommodates loan volumes in excess of its lending limits from time to time through the sale of loan participations to other banks.

**Table of Contents**

*The business of banking is changing rapidly with changes in technology, which poses financial and technological challenges to small and mid-sized institutions .* With frequent introductions of new technology-driven products and services, the banking industry is undergoing rapid technological changes. In addition to enhancing customer service, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Financial institutions' success is increasingly dependent upon use of technology to provide products and services that satisfy customer demands and to create additional operating efficiencies. Many of The Middlefield Banking Company's competitors have substantially greater resources to invest in technological improvements, which could enable them to perform various banking functions at lower costs than The Middlefield Banking Company, or to provide products and services that The Middlefield Banking Company is not able to provide economically. We cannot assure you that we will be able to develop and implement new technology-driven products or services or that we will be successful in marketing these products or services to customers.

Because of the demand for technology-driven products, banks rely increasingly on unaffiliated vendors to provide data processing services and other core banking functions. The use of technology-related products, services, delivery channels, and processes exposes banks to various risks, particularly transaction, strategic, reputation, and compliance risk. We cannot assure you that we will be able to successfully manage the risks associated with our dependence on technology.

*The banking industry is heavily regulated; the compliance burden to the industry is considerable; the principal beneficiary of federal and state regulation is the public at large and depositors, not stockholders .* Middlefield Banc Corp. and The Middlefield Banking Company are and will remain subject to extensive state and federal government supervision and regulation. Affecting many aspects of the banking business, including permissible activities, lending, investments, payment of dividends, the geographic locations in which our services can be offered, and numerous other matters, state and federal supervision and regulation are intended principally to protect depositors, the public, and the deposit insurance funds administered by the FDIC. Protection of stockholders is not a goal of banking regulation.

Applicable statutes, regulations, agency and court interpretations, and agency enforcement policies have undergone significant changes, some retroactively applied, and could change significantly again. Changes in applicable laws and regulatory policies could adversely affect the banking industry generally or Middlefield and The Middlefield Banking Company in particular. The burdens of federal and state banking regulation could place banks in general at a competitive disadvantage compared to less regulated competitors. We give you no assurance that we will be able to adapt successfully to industry changes caused by governmental actions.

Federal and state banking agencies require banks and bank holding companies to maintain capital. Failure to maintain adequate capital or to comply with applicable laws, regulations, and supervisory agreements could subject a bank or bank holding company to federal or state enforcement actions, including termination of deposit insurance, imposition of fines and civil penalties, and, in the most severe cases, appointment of a conservator or receiver for a depository institution.

*Success in the banking industry requires disciplined management of lending risks .* There are many risks in the business of lending, including risks associated with the duration over which loans may be repaid, risks resulting from changes in economic conditions, risks inherent in dealing with individual borrowers, and risks resulting from changes in the value of loan collateral. We maintain an allowance for loan losses based on historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality, among other things. Our judgment about the adequacy of the loan loss allowance is based on assumptions that we believe are reasonable but that might nevertheless prove to be incorrect. We can give you no assurance that the allowance will be sufficient to absorb future charge-offs. Additions to the loan loss allowance could occur, which would decrease net income and capital.

*Changing interest rates have a direct and immediate impact on financial institutions .* The risk of nonpayment of loans or credit risk is not the only lending risk. Lenders are subject also to interest rate risk. Fluctuating rates of interest prevailing in the market affect a bank's net interest income, which is the difference between interest earned from loans and investments, on one hand, and interest paid on deposits and borrowings, on the other. In the early 1990s, many banking organizations experienced historically high interest rate spreads, meaning the difference between the interest rates earned on loans and investments and the interest rates paid on deposits and borrowings.

Since then, however, interest rate spreads have generally narrowed due to changing market conditions and competitive pricing pressures. It has become increasingly difficult for depository institutions to maintain deposit growth at the same rate as loan growth. Under these circumstances, to maintain deposit growth an institution might have to offer more attractive deposit terms, further narrowing the institution's interest rate spread. Middlefield cannot assure you that interest rate spreads will not narrow even more or that higher interest rate spreads will return.

Banks manage interest rate risk exposure by closely monitoring assets and liabilities, altering from time to time the mix and maturity of loans, investments, and funding sources. Changes in interest rates could result in an increase in higher-cost deposit products within a bank's existing portfolio, as well as a flow of funds away from bank accounts into direct investments (such as U.S. Government and corporate securities, and other investment instruments such as mutual funds) if the bank does not pay competitive interest rates. The percentage of household financial assets held in the form of deposits is shrinking. Banking customers are investing a growing portion of their financial assets in stocks, bonds, mutual funds, and retirement accounts. Changes in interest rates also affect the volume of loans originated, as well as the value of loans and other interest-earning assets, including investment securities.

*An economic downturn in our market area would adversely affect our loan portfolio and our growth prospects .* Our lending market area is concentrated in northeastern Ohio, particularly Geauga, Portage, Trumbull and Ashtabula Counties. A high percentage of our loan portfolio is secured by real estate collateral, primarily residential mortgage loans. Commercial and industrial loans to small and medium-sized businesses also represent a significant percentage of our loan portfolio. The asset quality of our loan portfolio is largely dependent upon the area's economy and real estate markets. A downturn in the economy in our primary lending area would adversely affect our operations and limit our future growth potential.

**Table of Contents**

*Middlefield common stock is very thinly traded, and it is therefore susceptible to wide price swings . Middlefield s common stock is not traded or authorized for quotation on any exchanges or on Nasdaq. However, bid prices for Middlefield common stock appear from time to time in the pink sheets under the symbol MBCN. The pink sheets is a quotation service for over-the-counter securities that is maintained by Pink Sheets LLC, a private company. Thinly traded, illiquid stocks are more susceptible to significant and sudden price changes than stocks that are widely followed by the investment community and actively traded on an exchange or Nasdaq. The liquidity of the common stock depends upon the presence in the marketplace of willing buyers and sellers. We cannot assure you that you will be able to find a buyer for your shares. Two regional broker/dealers facilitate trades of Middlefield common stock, matching interested buyers and sellers.*

We currently do not intend to seek listing of the common stock on a securities exchange and we do not intend to seek authorization for trading of the shares on Nasdaq. Even if we successfully list the common stock on a securities exchange or obtain Nasdaq trading authorization, we nevertheless could not assure you that an organized public market for the securities will develop or that there will be any private demand for the common stock. We could also fail subsequently to satisfy the standards for continued exchange listing or Nasdaq trading, such as standards having to do with the minimum number of public shareholders or the aggregate market value of publicly held shares.

A stock that is not listed on a securities exchange or authorized for Nasdaq trading might not be accepted as collateral for loans. If accepted as collateral, the stock s value could nevertheless be substantially discounted. Consequently, investors should regard the common stock as a long-term investment and should be prepared to bear the economic risk of an investment in the common stock for an indefinite period. Investors who need or desire to dispose of all or a part of their investments in the common stock might not be able to do so except by private, direct negotiations with third parties.

*Government regulation could restrict our ability to pay cash dividends . Dividends from the bank are the only significant source of cash for Middlefield. Statutory and regulatory limits could prevent the bank from paying dividends or transferring funds to Middlefield. As of December 31, 2005 the bank could have declared dividends of approximately \$4.1 million to Middlefield without having to obtain advance regulatory approval. We cannot assure you that the bank s profitability will continue to allow it to pay dividends to Middlefield, and we therefore cannot assure you that Middlefield will be able to continue paying regular, quarterly cash dividends.*

*We could incur liabilities under federal and state environmental laws if we foreclose on commercial properties . A high percentage of the bank s loans are secured by real estate. Although the vast majority of these loans are residential mortgage loans with little associated environmental risk, some are commercial loans secured by property on which manufacturing and other commercial enterprises are carried on. The bank currently does not own any property acquired by foreclosure. However, the bank has in the past and could again acquire property by foreclosing on loans in default. Under federal and state environmental laws, the bank could face liability for some or all of the costs of removing hazardous substances, contaminants, or pollutants from properties acquired in this fashion. Although other persons might be primarily responsible for these costs, they might not be financially solvent or they might be unable to bear the full cost of clean up. Regardless of whether it forecloses on property, it is also possible that a lender exercising unusual influence over a borrower s commercial activities could be required to bear a portion of the clean-up costs under federal or state environmental laws.*

*Middlefield does not have acquisition experience . Many financial institutions and holding companies achieve growth through mergers and acquisitions. Although Middlefield has never undertaken acquisition of another institution, from time to time Middlefield explores potential acquisitions. Management holds informal discussions about possible acquisitions of other institutions with some frequency, as it believes management of many institutions do. In the vast majority of cases, however, those discussions never progress beyond the most preliminary or exploratory stages. Sometimes preliminary discussions do progress beyond that point, but for one reason or another they nevertheless do not progress to the point of negotiating terms of an acquisition. Discussions of this sort have become routine among financial institutions both large and small. Investors may generally assume that these discussions have occurred and will occur again, but Middlefield cautions investors not to assume that discussions will actually lead to an acquisition by Middlefield, although that could occur.*

There are risks associated with assessing the values, strengths, weaknesses, and profitability of acquisition candidates, including adverse short-term effects of acquisitions on operating results, diversion of management's attention, dependence on retaining key personnel, and risks associated with unanticipated problems. An acquisition's success depends in part on the acquirer's ability to integrate the operations of the acquired institution or assets and capitalize on synergies for cost savings. Without experience integrating acquired companies, Middlefield therefore would face greater risk that acquisition costs will exceed projections and that the benefits will be less than projected or harder to attain.

**Table of Contents****Item 2 Properties**

The bank's offices are:

<b>Location</b>	<b>County</b>	<b>Owned/Leased</b>	<b>Other Information</b>
<b>Main Office:</b> 15985 East High Street Middlefield, Ohio 44062-1666	Geauga	Owned	
<b>Branches :</b> West Branch 15545 West High Street Middlefield, Ohio	Geauga	Owned	
Garrettsville Branch 8058 State Street Garrettsville, Ohio	Portage	Owned	
Mantua Branch 10519 South Main Street Mantua, Ohio	Portage	Leased	three-year lease renewed in November 2004, with option to renew for six additional consecutive three-year terms
Chardon Branch 348 Center Street Chardon, Ohio	Geauga	Owned	opened in September, 2001
Orwell Branch 30 South Maple Avenue Orwell, Ohio	Ashtabula	Owned	opened in April, 2003
Newbury Branch 11110 Kinsman Road Newbury, Ohio	Geauga	Leased	ten-year lease dated December 2006, with option to renew for four additional consecutive five-year terms
Cortland Loan Production 130 Windsor Drive Cortland, Ohio	Trumbull	Leased	one-year lease dated November 2006, with option to renew

At December 31, 2006 the net book value of the bank's investment in premises and equipment totaled \$6.7 million.

The bank's electronic data processing functions are performed under contract with an electronic data processing services firm that performs services for financial institutions throughout the Midwest.

**Item 3 Legal Proceedings**

From time to time Middlefield and the bank are involved in various legal proceedings that are incidental to its business. In the opinion of management, no current legal proceedings are material to the financial condition of Middlefield or the bank, either individually or in the aggregate.

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

No matters were submitted to a vote of Middlefield Banc Corp.'s security holders during the fourth quarter of 2006.

**Table of Contents**

**Part II**

**Item 5 Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Information relating to the market for Middlefield's common equity and related shareholder matters appears under Market for Middlefield's Common Equity and Related Stockholder Matters in Middlefield's 2006 Annual Report to Shareholders on page ?? and is incorporated herein by reference. Information relating to dividend restrictions for Registrant's common stock appears under Supervision and Regulation.

**Item 6 Selected Financial Data**

The above-captioned information appears under Selected Financial Data in Middlefield's 2006 Annual Report to Shareholders and is incorporated herein by reference.

**Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations**

The above-captioned information appears under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations in Middlefield's 2006 Annual Report to Shareholders and is incorporated herein by reference.

**Item 7A Quantitative and Qualitative Disclosures About Market Risk**

The above-captioned information appears under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations under the section *Interest Rate Sensitivity Simulation Analysis* in Middlefield's 2006 Annual Report to Shareholders and is incorporated herein by reference.

**Item 8 Financial Statements and Supplementary Data**

The Consolidated Financial Statements of Middlefield Banc Corp. and its subsidiary, together with the report thereon by S.R. Snodgrass, A.C. appears in the Middlefield's 2006 Annual Report to Shareholders and are incorporated herein by reference.

**Item 9 Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None

**Item 9a Controls and Procedures**

Middlefield's management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. As of December 31, 2006, an evaluation was performed under the supervision and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of Middlefield's disclosure controls and procedures. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that Middlefield's disclosure controls and procedures as of December 31, 2006 were effective in ensuring that material information required to be disclosed in this Annual Report on Form 10-K was recorded, processed, summarized, and reported on a timely basis. Additionally, there were no changes in Middlefield's internal control over financial reporting that occurred during the quarter ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, Middlefield's internal control over financial reporting.

Management's responsibilities related to establishing and maintaining effective disclosure controls and procedures include maintaining effective internal controls over financial reporting that are designed to produce reliable financial statements in accordance with accounting principles generally accepted in the United States of America.

There have been no significant changes in Middlefield's internal controls or in other factors that could significantly affect internal controls subsequent to December 31, 2006.

**Item 9b Other Information**

None

**Table of Contents**

**Part III**

**Item 10 Directors and Executive Officers of the Registrant**

Incorporated by reference to the definitive proxy statement for the 2007 annual meeting of shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

**Item 11 Executive Compensation**

Incorporated by reference to the definitive proxy statement for the 2007 annual meeting of shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

**Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

Incorporated by reference to the definitive proxy statement for the 2007 annual meeting of shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

**Item 13 Certain Relationships and Related Transactions**

Incorporated by reference to the definitive proxy statement for the 2007 annual meeting of shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

**Item 14 Principal Accountant Fees and Services**

Incorporated by reference to the definitive proxy statement for the 2007 annual meeting of shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2006.

**Part IV**

**Item 15 Exhibits, Financial Statement Schedules**

(a)(1) Financial Statements

**Page No.**

**Index to Consolidated Financial Statements :**

Consolidated Financial Statements as of December 31, 2006 and 2005 and for each of the three years in the period ended December 31, 2006:

Report of Independent Registered Public Accounting firm

Consolidated Balance Sheets

Consolidated Statements of Income

Consolidated Statements of Changes in Stockholders' Equity

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

(a)(2) Financial Statement Schedules

Financial Statement Schedules have been omitted because they are not applicable or the required information is shown elsewhere in the document in the Financial Statements or Notes thereto, or in Management's Discussion and Analysis of Financial Condition and Results of Operations.

(a)(3) Exhibits

See the list of exhibits below

(b) Exhibits Required by Item 601 of Regulation S-K



**Table of Contents**

<b>exhibit number</b>	<b>description</b>	<b>location</b>
2	Agreement and Plan of Merger among Middlefield Banc Corp., EB Interim Bank, and Emerald Bank, dated as of November 15, 2006, as amended by Amendment No. 1	Incorporated by reference to the prospectus/proxy statement, Appendix A, contained in Part I of Form S-4 Registration Statement Amendment No. 1 filed on February 9, 2007. Disclosure schedules referred to in the Agreement and Plan of Merger are omitted in reliance on Item 601(b)(2) of Regulation S-K. Upon request of the SEC, Middlefield Banc Corp. will furnish supplementally to the SEC a copy of the disclosure schedules
3.1	Second Amended and Restated Articles of Incorporation of Middlefield Banc Corp., as amended	Incorporated by reference to Exhibit 3.1 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2005, filed on March 29, 2006
3.2	Regulations of Middlefield Ban Corp.	Incorporated by reference to Exhibit 3.2 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001
4	Specimen stock certificate	Incorporated by reference to Exhibit 3.2 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001
4.1	Amended and Restated Trust Agreement, dated as of December 21, 2006, between Middlefield Banc Corp., as Depositor, Wilmington Trust Company, as Property Trustee, Wilmington Trust Company, as Delaware Trustee, and Administrative Trustees	Incorporated by reference to Exhibit 4.1 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 27, 2006
4.2	Junior Subordinated Indenture, dated as of December 21, 2006, between Middlefield Banc Corp. and Wilmington Trust Company	Incorporated by reference to Exhibit 4.2 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 27, 2006
4.3	Guarantee Agreement, dated as of December 21, 2006, between Middlefield Banc Corp. and Wilmington Trust Company	Incorporated by reference to Exhibit 4.3 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 27, 2006
10.1 *	1999 Stock Option Plan of Middlefield Banc Corp.	Incorporated by reference to Exhibit 10.1 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001
10.2 *	Severance Agreement dated July 11, 2006 between Middlefield Banc Corp. and Thomas G.	Incorporated by reference to Exhibit 10.2 of Middlefield Banc Corp. s Form 8-K Current

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-K

Caldwell

Report filed on July 12, 2006

10.3 \*

Severance Agreement dated July 11, 2006  
between Middlefield Banc Corp. and James R.  
Heslop II

Incorporated by reference to Exhibit 10.3 of  
Middlefield Banc Corp. s Form 8-K Current  
Report filed on July 12, 2006

22

---

**Table of Contents**

<b>exhibit number</b>	<b>description</b>	<b>location</b>
10.4 *	Severance Agreement dated July 11, 2006 between Middlefield Banc Corp. and Jay P. Giles	Incorporated by reference to Exhibit 10.4 of Middlefield Banc Corp. s Form 8-K Current Report filed on July 12, 2006
10.4.1 *	Severance Agreement dated July 11, 2006 between Middlefield Banc Corp. and Teresa M. Hetrick	Incorporated by reference to Exhibit 10.4.1 of Middlefield Banc Corp. s Form 8-K Current Report filed on July 12, 2006
10.4.2 *	Severance Agreement dated July 11, 2006 between Middlefield Banc Corp. and Jack L. Lester	Incorporated by reference to Exhibit 10.4.2 of Middlefield Banc Corp. s Form 8-K Current Report filed on July 12, 2006
10.4.3 *	Severance Agreement dated July 11, 2006 between Middlefield Banc Corp. and Donald L. Stacy	Incorporated by reference to Exhibit 10.4.3 of Middlefield Banc Corp. s Form 8-K Current Report filed on July 12, 2006
10.4.4 *	Severance Agreement dated July 11, 2006 between Middlefield Banc Corp. and Alfred F. Thompson Jr.	Incorporated by reference to Exhibit 10.4.4 of Middlefield Banc Corp. s Form 8-K Current Report filed on July 12, 2006
10.5 *	Federal Home Loan Bank of Cincinnati Agreement for Advances and Security Agreement dated September 14, 2000	Incorporated by reference to Exhibit 10.4 of Middlefield Banc Corp. s registration statement on Form 10 filed on April 17, 2001
10.6 *	Director Retirement Agreement with Richard T. Coyne	Incorporated by reference to Exhibit 10.6 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.7 *	Director Retirement Agreement with Frances H. Frank	Incorporated by reference to Exhibit 10.7 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.8 *	Director Retirement Agreement with Thomas C. Halstead	Incorporated by reference to Exhibit 10.8 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.9 *	Director Retirement Agreement with George F. Hasman	Incorporated by reference to Exhibit 10.9 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.10 *	Director Retirement Agreement with Donald D. Hunter	Incorporated by reference to Exhibit 10.10 of Middlefield Banc Corp. s Annual Report on

Form 10-K for the Year Ended December 31,  
2001, filed on March 28, 2002

10.11 \* Director Retirement Agreement with Martin S.  
Paul

Incorporated by reference to Exhibit 10.11 of  
Middlefield Banc Corp. s Annual Report on  
Form 10-K for the Year Ended December 31,  
2001, filed on March 28, 2002

**Table of Contents**

<b>exhibit number</b>	<b>description</b>	<b>location</b>
10.12 *	Director Retirement Agreement with Donald E. Villers	Incorporated by reference to Exhibit 10.12 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2001, filed on March 28, 2002
10.13 *	Executive Survivor Income Agreement (aka DBO agreement [death benefit only]) with Donald L. Stacy	Incorporated by reference to Exhibit 10.14 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.14 *	DBO Agreement with Jay P. Giles	Incorporated by reference to Exhibit 10.15 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.15 *	DBO Agreement with Alfred F. Thompson Jr.	Incorporated by reference to Exhibit 10.16 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.16 *	DBO Agreement with Nancy C. Snow	Incorporated by reference to Exhibit 10.17 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.17 *	DBO Agreement with Theresa M. Hetrick	Incorporated by reference to Exhibit 10.18 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.18 *	DBO Agreement with Jack L. Lester	Incorporated by reference to Exhibit 10.19 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.19 *	DBO Agreement with James R. Heslop II	Incorporated by reference to Exhibit 10.20 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.20 *	DBO Agreement with Thomas G. Caldwell	Incorporated by reference to Exhibit 10.21 of Middlefield Banc Corp. s Annual Report on Form 10-K for the Year Ended December 31, 2003, filed on March 30, 2004
10.21 *		

Edgar Filing: MIDDLEFIELD BANC CORP - Form 10-K

Form of Indemnification Agreement with  
directors of Middlefield Banc Corp. and  
executive officers of Middlefield Banc Corp.  
and The Middlefield Banking Company

24

Incorporated by reference to Exhibit 99.1 of  
Middlefield Banc Corp. s registration statement  
on Form 10, Amendment No. 1, filed on June  
14, 2001

---

**Table of Contents**

<b>exhibit number</b>	<b>description</b>	<b>location</b>
10.22 *	Annual Incentive Plan Summary	Incorporated by reference to the summary description of the annual incentive plan included as Exhibit 10.22 of Middlefield Banc Corp. s Form 8-K Current Report filed on December 16, 2005
10.23 *	Executive Deferred Compensation Agreement with Thomas G. Caldwell	Incorporated by reference to Exhibit 10.23 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 4, 2007
10.24 *	Executive Deferred Compensation Agreement with James R. Heslop II	Incorporated by reference to Exhibit 10.24 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 4, 2007
10.25 *	Executive Deferred Compensation Agreement with Donald L. Stacy	Incorporated by reference to Exhibit 10.25 of Middlefield Banc Corp. s Form 8-K Current Report filed on January 4, 2007
13	Portions of the Annual Report for the year ended December 31, 2006 incorporated by reference into this Form 10-K	filed herewith
23	Consent of S.R. Snodgrass, A.C., independent auditors of Middlefield Banc Corp.	filed herewith
31.1	Rule 13a-14(a) certification of Chief Executive Officer	filed herewith
31.2	Rule 13a-14(a) certification of Chief Financial Officer	filed herewith
32	Rule 13a-14(b) certification	filed herewith
*	management contract or compensatory plan or arrangement	

**Table of Contents**

**Signatures**

Pursuant to the requirements of Section 13 or 15(d) of 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.

**Middlefield Banc Corp.**

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

March 21, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/ Thomas G. Caldwell March 21, 2007

Thomas G. Caldwell  
President, Chief Executive Officer, and  
Director

/s/ Donald L. Stacy March 21, 2007

Donald L. Stacy, Treasurer and Chief Financial  
Officer  
(Principal accounting and financial officer)

/s/ Richard T. Coyne March 21, 2007

Richard T. Coyne, Director

/s/ Frances H. Frank March 21, 2007

Frances H. Frank, Director

/s/ Thomas C. Halstead March 21, 2007

Thomas C. Halstead, Director

/s/ James R. Heslop, II March 21, 2007

James R. Heslop, II, Executive Vice President,  
Chief Operating Officer, and Director

/s/ Donald D. Hunter March 21, 2007

Donald D. Hunter, Chairman of the Board and  
Director

/s/ James McCaskey March 21, 2007



James McCaskey, Director

/s/ Carolyn Turk

March 21, 2007

Carolyn Turk, Director

/s/ Donald E. Villers

March 21, 2007

Donald E. Villers, Director

**Table of Contents**

**REPORT OF REGISTERED INDEPENDENT PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders  
Middlefield Banc Corp.

We have audited the accompanying consolidated balance sheet of Middlefield Banc Corp. and subsidiary as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Middlefield Banc Corp. and subsidiary as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ending December 31, 2006, in conformity with U.S. generally accepted accounting principles.

/s/ S. R. Snodgrass, A.C.

S. R. Snodgrass, A.C.  
Wexford, PA  
February 28, 2007