Middlefield Banc Corp.

Annual Report 2002

It's a Brand New Day…

MBC
MIDDLEFIELD BANC CORP.


Personal Finances
Business Finances
Corporate Finances
Global Finances
…a Brand New Century of Dedication to Your Future

mbc

Middlefield Banc Corp.

Thomas G. Caldwell

President and Chief Executive Officer

To Our Shareholders and Friends

It is a distinct pleasure to report that, in 2002, Middlefield Banc Corp. achieved strong financial results and made continued progress in its strategic plan for continued long-term growth and reward for our shareholders.

For the year, net income was $2,500,949. This represents an increase of 10.1% from our record level of earnings in 2001. On a per share basis, this equates to $2.16, up from the prior year level of $1.96. Our corresponding returns on average assets and on average equity were 1.17% and 12.08%, respectively. These ratios are indicative of the high capital level that we choose to maintain, as well as the current economic environment within which we operate.

Exclusive of gains on the sale of securities, our non-interest income increased 4.3% for the year. Our level of non-interest expenses grew 9.8%. The increase in non-interest expenses is, in part, attributable to a full year of operation of our Chardon office, as well as an overall increase reflective of our continued growth patterns.

Asset levels ended the year at a record high of $226,245,533. This 14.3% increase in 2002 follows the 12.1% growth that we achieved in 2001. Loan and deposit levels both grew substantially during 2002. We believe that our 14% increase in loans and 12% increase in deposits are reflective of our effort to be responsive to the communities that we are fortunate to serve.

Several of the efforts that we have made within the last few years are presenting positive results to our organization. The Chardon office, after just fifteen months of operation, has achieved its three-year growth target. We are also pleased with the continued growth and acceptance of both our EasyLine and EasyLink products. During the last year, 70,000 calls were placed to EasyLine, our voice-response banking. This flexibility permits our customers to fill their basic banking needs at any time of day or night. EasyLink, our Internet banking service, has also shown steady growth within the last year. At **www.middlefieldbank.com**, you may conduct many banking transactions from anywhere in the world at your convenience. We would encourage you to visit this site and learn of the advantages this service has for you.

Within the last few years, we have also made an effort to diversify the risk in our loan portfolio. Although we remain very dedicated to our residential mortgage customers, we recognized the need of small business people within our communities. Indicative of our outreach in this area is the fact that the commercial side of our loan portfolio grew 33.9% during 2002. To support these efforts, we are pleased to have placed calling officers in Middlefield, Chardon and Mantua.

We continue to work to grow your company. Our office in Orwell is under roof and is expected to open near the middle of the second quarter of 2003. Our staff in that office will be a mixture of existing and new personnel. In this manner, we are very fortunate. We have been able to continue to develop internal candidates for promotion, while also growing an organization that seasoned bankers are happy to join.

Interest rates have continued at forty-one year record low levels. This has continued to put considerable pressure on our net interest margin. Our economy remains uncertain and, as we write this, a possible war looms in the Middle East. Also, as you are aware from various news sources, the year 2002 saw many examples of poor corporate stewardship. All of these challenges continue to impact our work on your behalf on a daily basis.

As a public company, we are now required to generate substantial additional reporting to the Securities and Exchange Commission. While it has always been our motive to run your corporation on this highest of ethical levels, we do recognize the desire for these additional assurances. In an effort to solidify our desire to continue to have a well-run, well-respected company, we made the decision in early 2002 to outsource our internal audit function. We now have three separate external firms providing us with independent audits services, internal audit services, and independent loan review.

Our efforts have also continued to provide a proper return to you, our shareholders. During 2002, we were pleased to pay a five percent stock dividend. Following in the line of recent stock dividends, this means that a shareholder owning one hundred shares in 1994 would now own 1270 shares. Additionally, the cash dividend paid during 2002 increased 10.9% from the 2001 level.

Also contained within this Annual Report you will find one of our most exciting undertakings of 2003. We are proud to introduce you to our new logo for The Middlefield Banking Company and for Middlefield Banc Corp. This stylish new design reflects the fluid, forward-looking focus of your company. As we have expanded geographically and through product offerings, our ability for more outside the box thinking has become pronounced. This logo mirrors that dynamic nature.

Many challenges lie ahead in this year and beyond. Our course remains straight and our conviction strong. We thank you for your support and welcome the continued opportunity to serve you.

Sincerely,

Thomas Caldwell

Thomas G. Caldwell
President and Chief Executive Officer

Donald D. Hunter

Donald D. Hunter
Chairman, Board of Directors

mbc

Donald D. Hunter

Thomas G. Caldwell

Donald E. Villers

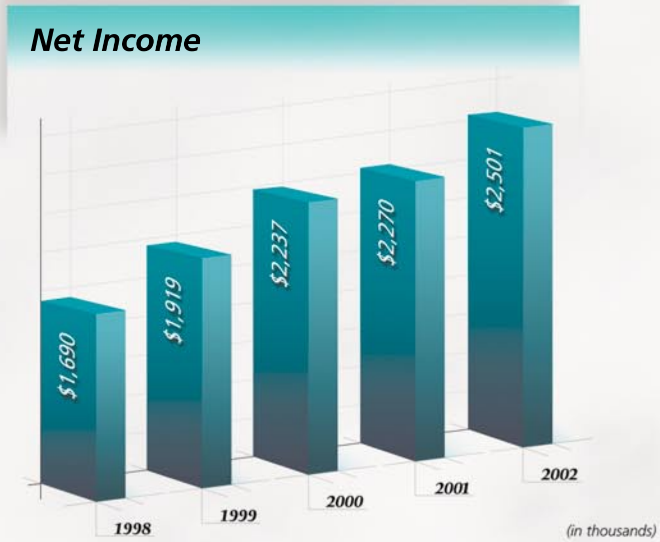
Thomas C. Halstead

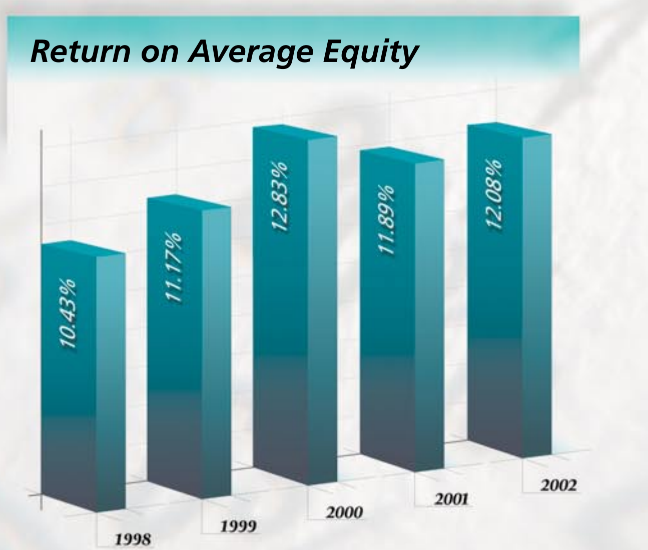
George F. Hasman

Frances H. Frank | *Richard T. Coyne* | *Martin S. Paul* | *James R. Heslop, II* | *James J. McCaskey* | *Carolyn J. Turk*

Board of Directors

As we embark on a second century of dedication to the future, the principles of our foundation are more important than ever. Our future is shaped by sound business practices, involved leadership, and accountability to our shareholders and customers.



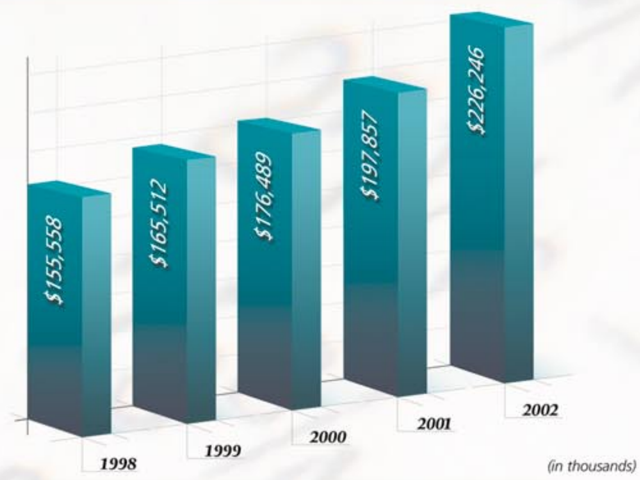


Consolidated Audited Financial Statements

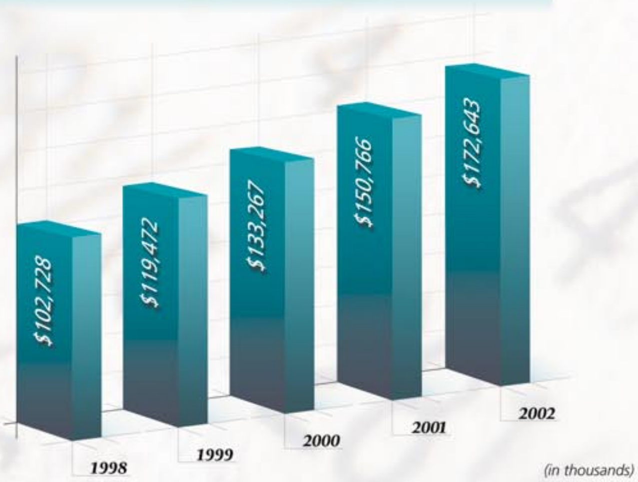
December 31, 2002

Return on Average Assets

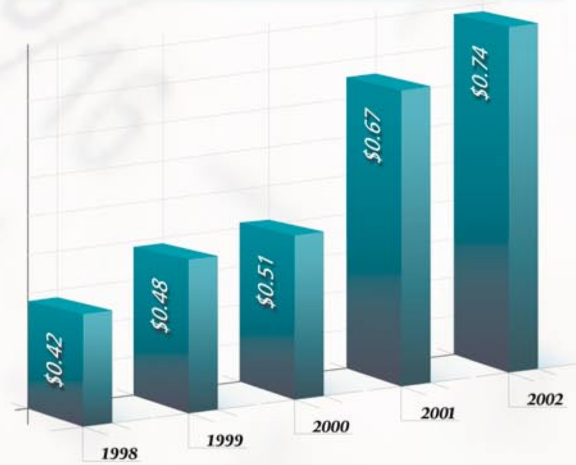
Total Assets



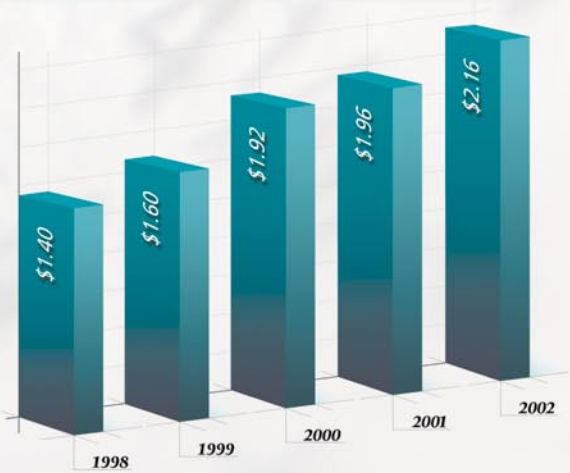
Net Loans Outstanding



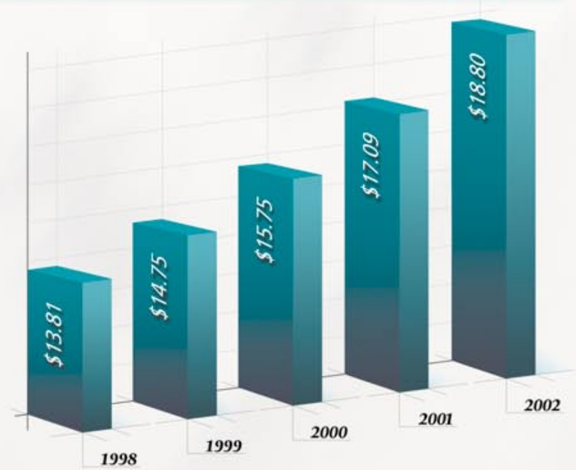
Dividends Per Share



Earnings Per Share



Book Value Per Share



Consolidated Balance Sheet

	December 31, 2002	December 31, 2001
ASSETS		
Cash and due from banks	$ 1,775,324	$ 3,443,435
Federal funds sold	350,000	2,450,000
Cash and cash equivalents	2,125,324	5,893,435
Interest-bearing deposits in other institutions	571,969	1,240,207
Investment securities available for sale	35,917,057	21,179,786
Investment securities held to maturity (estimated market value of $6,405,918 and $10,471,978)	6,242,095	10,229,068
Loans	174,943,131	152,828,355
Less allowance for loan losses	2,300,485	2,062,252
Net loans	172,642,646	150,766,103
Premises and equipment	6,480,730	6,244,797
Accrued interest and other assets	2,265,712	2,304,568
TOTAL ASSETS	$ 226,245,533	$ 197,857,964
LIABILITIES		
Deposits:		
Noninterest-bearing demand	$ 26,610,912	$ 24,952,407
Interest-bearing demand	7,216,385	6,523,152
Money market	10,660,657	7,940,807
Savings	49,277,572	41,518,906
Time	93,618,968	86,447,456
Total deposits	187,384,494	167,382,728
Short-term borrowings	785,778	660,678
Other borrowings	15,690,053	9,301,334
Accrued interest and other liabilities	638,800	726,417
TOTAL LIABILITIES	204,499,125	178,071,157
STOCKHOLDERS' EQUITY		
Common stock, no par value; 5,000,000 shares authorized, 1,209,123 and 1,148,676 shares issued	7,883,155	6,287,011
Retained earnings	15,051,110	14,842,519
Accumulated other comprehensive income	475,428	133,717
Treasury stock, at cost (52,578 and 45,722 shares)	(1,663,285)	(1,476,440)
TOTAL STOCKHOLDERS' EQUITY	21,746,408	19,786,807
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 226,245,533	$ 197,857,964

See accompanying notes to consolidated financial statements.

Consolidated Statement of Income

	Year Ended December 31,		
	2002	2001	2000
INTEREST INCOME			
Interest and fees on loans	$12,340,920	$11,807,799	$ 10,853,292
Interest-bearing deposits in other institutions	48,293	61,718	97,037
Federal funds sold	64,994	138,415	99,320
Investment securities:			
Taxable	1,241,399	1,235,922	1,195,504
Tax-exempt	424,357	462,715	525,017
Total interest income	14,119,963	13,706,569	12,770,170
INTEREST EXPENSE			
Deposits	5,478,030	6,198,365	5,311,657
Short-term borrowings	7,175	15,411	64,031
Other borrowings	662,881	534,146	534,196
Total interest expense	6,148,086	6,747,922	5,909,884
NET INTEREST INCOME	7,971,877	6,958,647	6,860,286
Provision for loan losses	300,000	170,000	275,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	7,671,877	6,788,647	6,585,286
NONINTEREST INCOME			
Service charges on deposit accounts	955,121	930,431	823,888
Investment securities gains	-	97,807	-
Other income	188,096	165,955	158,775
Total noninterest income	1,143,217	1,194,193	982,663
NONINTEREST EXPENSE			
Salaries and employee benefits	2,523,433	2,316,342	2,240,522
Occupancy expense	357,500	291,706	320,539
Equipment expense	324,659	292,168	283,174
Data processing costs	427,164	361,839	315,011
Professional fees	246,285	247,222	212,298
Ohio state franchise tax	250,050	225,081	208,457
Other expense	1,077,248	1,007,016	828,616
Total noninterest expense	5,206,339	4,741,374	4,408,617
Income before income taxes	3,608,755	3,241,466	3,159,332
Income taxes	1,107,806	970,859	922,661
NET INCOME	$ 2,500,949	$ 2,270,607	$ 2,236,671
EARNINGS PER SHARE			
Basic	$ 2.16	$ 1.96	$ 1.92
Diluted	2.16	1.95	1.92

See accompanying notes to consolidated financial statements.

Consolidated Statement of Changes in Stockholders' Equity

	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity	Comprehensive Income
Balance, December 31, 1999	1,148,676	$ 6,287,011	$ 11,702,564	$ (90,631)	$ (209,889)	$ 17,689,055	
Net income			2,236,671			2,236,671	$ 2,236,671
Other comprehensive income:							
Unrealized gain on available for sale securities net of taxes of $ 92,440				179,442		179,442	179,442
Comprehensive income							$ 2,416,113
Cash dividends ($.51 per share)			(595,255)			(595,255)	
Purchase of treasury stock					(1,311,050)	(1,311,050)	
Sale of treasury stock					44,499	44,499	
Balance, December 31, 2000	1,148,676	6,287,011	13,343,980	88,811	(1,476,440)	18,243,362	
Net income			2,270,607			2,270,607	$ 2,270,607
Other comprehensive income:							
Unrealized gain on available for sale securities net of taxes of $23,133				44,906		44,906	44,906
Comprehensive income							$ 2,315,513
Cash dividends ($.67 per share)			(772,068)			(772,068)	
Balance, December 31, 2001	1,148,676	6,287,011	14,842,519	133,717	(1,476,440)	19,786,807	
Net income			2,500,949			2,500,949	$ 2,500,949
Other comprehensive income:							
Unrealized gain on available for sale securities net of taxes of $176,033				341,711		341,711	341,711
Comprehensive income							$ 2,842,660
Exercise of stock options	988	23,509				23,509	
Sale of treasury stock		795			17,225	18,020	
Purchase of treasury stock					(204,070)	(204,070)	
Five percent stock dividend (including cash paid for fractional shares)	54,997	1,429,662	(1,434,607)			(4,945)	
Dividend reinvestment plan	4,462	142,178				142,178	
Cash dividends ($.74 per share)			(857,751)			(857,751)	
Balance, December 31, 2002	1,209,123	$ 7,883,155	$ 15,051,110	$ 475,428	$ (1,663,285)	$ 21,746,408	

	2002	2001	2000
Components of comprehensive income:			
Change in net unrealized gain (loss) on investments available for sale	$ 341,711	$ 109,459	$ 179,442
Realized gains included in net income, net of taxes of $33,254	-	(64,553)	-
Total	$ 341,711	$ 44,906	$ 179,442

See accompanying notes to consolidated financial statements.

Consolidated Statement of Cash Flows

	Year Ended December 31,		
	2002	**2001**	**2000**
OPERATING ACTIVITIES			
Net income	$ 2,500,949	$ 2,270,607	$ 2,236,671
Adjustments to reconcile net income to			
net cash provided by operating activities:			
Provision for loan losses	300,000	170,000	275,000
Depreciation and amortization	354,550	300,531	352,613
Amortization of premium and			
discount on investment securities	159,047	69,237	75,563
Amortization of net deferred loan costs (fees)	(76,684)	(31,666)	35,489
Investment securities gains	-	(97,807)	-
Deferred income taxes	(72,302)	54,403	(87,521)
Decrease (increase) in accrued interest receivable	34,337	140,147	(59,663)
Increase (decrease) in accrued interest payable	(121,258)	38,927	84,301
Other, net	124,129	(211,763)	39,943
Net cash provided by operating activities	3,202,768	2,702,616	2,952,396
INVESTING ACTIVITIES			
Decrease (increase) in interest-bearing deposits			
in other institutions, net	668,238	(255,766)	2,361,081
Investment securities available for sale:			
Proceeds from repayments and maturities	10,006,949	5,144,986	766,880
Purchases	(24,359,041)	(16,392,621)	(2,561,359)
Proceeds from sales	-	2,092,980	-
Investment securities held to maturity:			
Proceeds from repayments and maturities	3,960,491	7,853,057	3,997,990
Purchases	-	(200,000)	-
Increase in loans, net	(22,099,859)	(17,637,544)	(14,105,641)
Purchase of regulatory stock	(189,700)	(143,100)	(136,100)
Purchase of premises and equipment	(590,483)	(1,112,856)	(150,361)
Net cash used for investing activities	(32,603,405)	(20,650,864)	(9,827,510)
FINANCING ACTIVITIES			
Net increase in deposits	20,001,766	20,216,682	12,071,587
Increase (decrease) in short-term borrowings, net	125,100	117,456	(1,964,448)
Proceeds from other borrowings	7,000,000	-	2,000,000
Repayment of other borrowings	(611,281)	(560,262)	(1,740,900)
Purchase of treasury stock	(204,070)	-	(1,311,050)
Sale of treasury stock	18,020	-	44,499
Exercise of stock options	23,509	-	-
Proceeds from dividend reinvestment plan	142,178	-	-
Cash dividends	(862,696)	(772,068)	(595,255)
Net cash provided by financing activities	25,632,526	19,001,808	8,504,433
Increase (decrease) in cash and cash equivalents	(3,768,111)	1,053,560	1,629,319
CASH AND CASH EQUIVALENTS			
AT BEGINNING OF YEAR	5,893,435	4,839,875	3,210,556
CASH AND CASH EQUIVALENTS			
AT END OF YEAR	$ 2,125,324	$ 5,893,435	$ 4,839,875
SUPPLEMENTAL INFORMATION			
Cash paid during the year for:			
Interest on deposits and borrowings	$ 6,269,344	$ 6,708,995	$ 5,825,583
Income taxes	1,054,000	980,000	1,097,000

See accompanying notes to consolidated financial statements.

Notes To Consolidated Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A summary of the significant accounting and reporting policies applied in the presentation of the accompanying financial statements follows:

Nature of Operations and Basis of Presentation

Middlefield Banc Corp. (the "Company") is an Ohio corporation organized to become the holding company of The Middlefield Banking Company (the "Bank"). The Bank is a state-chartered bank located in Ohio. The Company and its subsidiary derive substantially all of their income from banking and bank-related services which include interest earnings on residential real estate, commercial mortgage, commercial, and consumer financings as well as interest earnings on investment securities and deposit services to its customers through five locations. The Company is supervised by the Board of Governors of the Federal Reserve System, while the Bank is subject to regulation and supervision by the Federal Deposit Insurance Corporation and the Ohio Division of Financial Institutions.

The consolidated financial statements of the Company include its wholly-owned subsidiary, the Bank. Significant intercompany items have been eliminated in preparing the consolidated financial statements.

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the balance sheet date and revenues and expenses for the period. Actual results could differ significantly from those estimates.

Investment Securities

Investment securities are classified at the time of purchase, based on management's intention and ability, as securities held to maturity or securities available for sale. Debt securities acquired with the intent and ability to hold to maturity are stated at cost adjusted for amortization of premium and accretion of discount which are computed using a level yield method and recognized as adjustments of interest income. Certain other debt securities have been classified as available for sale to serve principally as a source of liquidity. Unrealized holding gains and losses for available for sale securities are reported as a separate component of stockholders' equity, net of tax, until realized. Realized security gains and losses are computed using the specific identification method. Interest and dividends on investment securities are recognized as income when earned.

Common stock of the Federal Home Loan Bank ("FHLB") represents ownership in an institution that is wholly-owned by other financial institutions. This equity security is accounted for at cost and classified with other assets.

Loans

Loans are reported at their principal amount net of the allowance for loan losses. Interest income is recognized as income when earned on the accrual method. The accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions, the borrower's financial condition is such that collection of interest is doubtful. Interest received on nonaccrual loans is recorded as income against principal according to management's judgment as to the collectibility of such principal.

Loan origination fees and certain direct loan origination costs are being deferred and the net amount amortized as an adjustment of the related loan's yield. Management is amortizing these amounts over the contractual life of the related loans.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses

The allowance for loan losses represents the amount which management estimates is adequate to provide for probable loan losses inherent in its loan portfolio. The allowance method is used in providing for loan losses. Accordingly, all loan losses are charged to the allowance, and all recoveries are credited to it. The allowance for loan losses is established through a provision for loan losses which is charged to operations. The provision is based on management's periodic evaluation of the adequacy of the allowance for loan losses which encompasses the overall risk characteristics of the various portfolio segments, past experience with losses, the impact of economic conditions on borrowers, and other relevant factors. The estimates used in determining the adequacy of the allowance for loan losses, including the amounts and timing of future cash flows expected on impaired loans, are particularly susceptible to significant change in the near term.

A loan is considered impaired when it is probable the borrower will not repay the loan according to the original contractual terms of the loan agreement. Management has determined that first mortgage loans on one-to-four family properties and all consumer loans represent large groups of smaller-balance homogeneous loans that are to be collectively evaluated. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. A loan is not impaired during a period of delay in payment if the Company expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay. All loans identified as impaired are evaluated independently by management. The Company estimates credit losses on impaired loans based on the present value of expected cash flows or the fair value of the underlying collateral if the loan repayment is expected to come from the sale or operation of such collateral. Impaired loans, or portions thereof, are charged off when it is determined a realized loss has occurred. Until such time, an allowance for loan losses is maintained for estimated losses. Cash receipts on impaired loans are applied first to accrued interest receivable unless otherwise required by the loan terms, except when an impaired loan is also a nonaccrual loan in which case the portion of the payment related to interest is recognized as income.

Premises and Equipment

Premises and equipment are stated at cost net of accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets, which range from three to twenty years for furniture, fixtures, and equipment and three to forty years for buildings and leasehold improvements. Expenditures for maintenance and repairs are charged against income as incurred. Costs of major additions and improvements are capitalized.

Income Taxes

The Company and the Bank file a consolidated federal income tax return. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Earnings Per Share

The Company provides dual presentation of basic and diluted earnings per share. Basic earnings per share are calculated utilizing net income as reported in the numerator and average shares outstanding in the denominator. The computation of diluted earnings per share differs in that the dilutive effects of any stock options, warrants, and convertible securities are adjusted in the denominator.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock Options

The Company maintains a stock option plan for key officers, employees, and non-employee directors. Had compensation expense for the stock option plans been recognized in accordance with the fair value accounting provisions of FAS No. 123, "*Accounting for Stock-based Compensation*," net income applicable to common stock, basic and diluted net income per common share for the year ended December 31, would have been as follows:

	2002	2001	2000
Net income as reported:			
Pro forma net income	$ 2,500,949	$ 2,270,607	$ 2,236,671
Less pro forma expense related to option	52,434	37,644	41,301
	$ 2,448,515	$ 2,232,963	$ 2,195,370
Basic net income per common share:			
As reported	$ 2.16	$ 1.96	$ 1.92
Pro forma	2.12	1.92	1.88
Diluted net income per common share:			
As reported	$ 2.16	$ 1.95	$ 1.92
Pro forma	2.11	1.92	1.88

For purposes of computing pro forma results, the Company estimated the fair values of stock options using the Black-Scholes option pricing model. The model requires the use of subjective assumptions which can materially affect fair value estimates. Therefore, the pro forma results are estimates of results of operations as if compensation expense had been recognized for the stock option plans. The fair value of each stock option granted was estimated using the following weighted-average assumptions:

Grant Year	Expected Dividend Yield	Risk-free Interest Rate	Expected Volatility	Remaining Expected Life (in years)
2000	2.50%	5.29%	5.00%	9.95
2002	2.72%	4.19%	27.04%	9.94

Stockholders' Equity

The Board of Directors approved a five percent stock dividend to stockholders of record as of June 1, 2002, payable June 14, 2002. As a result of the dividend, 54,997 additional shares of the Company's common stock were issued, common stock was increased by $1,429,662 and retained earnings decreased by $1,434,607.

Fractional shares paid were paid in cash. All average shares outstanding and all per share amounts included in the financial statements are based on the increased number of shares after giving retroactive effects to the stock dividend.

Cash Flow Information

The Company has defined cash and cash equivalents as those amounts included in the consolidated balance sheet captions Cash and due from banks and Federal funds sold.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recent Accounting Pronouncements

In August 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("FAS") No. 143, *Accounting for Asset Retirement Obligations*, which requires that the fair value of a liability be recognized when incurred for the retirement of a long-lived asset and the value of the asset be increased by that amount. The statement also requires that the liability be maintained at its present value in subsequent periods and outlines certain disclosures for such obligations. The adoption of this statement, which is effective January 1, 2003, is not expected to have a material effect on the Company's financial statements.

In October 2001, the FASB issued FAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. FAS No. 144 supercedes FAS No. 121 and applies to all long-lived assets (including discontinued operations) and consequently amends APB Opinion No. 30, *Reporting Results of Operations – Reporting the Effects of Disposal of a Segment of a Business*. FAS No. 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less costs to sell. FAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and, generally, its provisions are to be applied prospectively. The adoption of this statement did not have a material effect on the Company's financial statements.

In April 2002, the FASB issued FAS No. 145, *Recission of FASB Statement No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. FAS No. 145 rescinds FAS No. 4, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. As a result, the criteria in APB Opinion No. 30 will now be used to classify those gains and losses. This statement also amends FAS No. 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. This statement also makes technical corrections to existing pronouncements, which are not substantive but in some cases may change accounting practice. The provisions of this statement related to the rescission of FAS No. 4 shall be applied in fiscal years beginning after May 15, 2002. Any gain or loss on extinguishments of debt that was classified as an extraordinary item in prior periods presented that does not meet the criteria in APB Opinion No. 30 for classification as an extraordinary item shall be reclassified. Early adoption of the provisions of this statement related to FAS No. 13 shall be effective for transactions occurring after May 15, 2002. All other provisions of this statement shall be effective for financial statements issued on or after May 15, 2002. Early application of this statement is encouraged. The adoption of the effective portions of this statement did not have an impact on the Company's financial position or results of operations. The adoption of the remaining portions of this statement is not expected to have an impact on the Company's financial position or results of operations.

In July 2002, the FASB issued FAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. This statement replaces EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*. The new statement will be effective for exit or disposal activities initiated after December 31, 2002, the adoption of which is not expected to have a material effect on the Company's financial statements.

On October 1, 2002, the FASB issued FAS No. 147, *Acquisitions of Certain Financial Institutions*, effective for all business combinations initiated after October 1, 2002. This statement addresses the financial accounting and reporting for the acquisition of all or part of a financial institution, except for a transaction between two or more mutual enterprises. This statement removes acquisitions of financial institutions, other than transactions between two or more mutual enterprises, from the scope of FAS No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, and FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a*

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recent Accounting Pronouncements (Continued)

Business Combination Accounted for by the Purchase Method. The acquisition of all or part of a financial institution that meets the definition of a business combination shall be accounted for by the purchase method in accordance with FAS No. 141, *Business Combinations*, and FAS No. 142, *Goodwill and Other Intangible Assets*. This statement also provides guidance on the accounting for the impairment or disposal of acquired long-term customer-relationship intangible assets (such as depositor and borrower-relationship intangible assets and credit cardholder intangible assets), including those acquired in transactions between two or more mutual enterprises. The adoption of this statement is not expected to have a material effect on the Company's financial statements.

On December 31, 2002, the FASB issued FAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, which amends FAS No. 123, *Accounting for Stock-Based Compensation*. FAS No. 148 amends the disclosure requirements of FAS No. 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. Under the provisions of FAS No. 123, companies that adopted the preferable, fair value based method were required to apply that method prospectively for new stock option awards. This contributed to a "ramp-up" effect on stock-based compensation expense in the first few years following adoption, which caused concern for companies and investors because of the lack of consistency in reported results. To address that concern, FAS No. 148 provides two additional methods of transition that reflect an entity's full complement of stock-based compensation expense immediately upon adoption, thereby eliminating the ramp-up effect. FAS No. 148 also improves the clarity and prominence of disclosures about the pro forma effects of using the fair value based method of accounting for stock-based compensation for all companies—regardless of the accounting method used—by requiring that the data be presented more prominently and in a more user-friendly format in the footnotes to the financial statements. In addition, the statement improves the timeliness of those disclosures by requiring that this information be included in interim as well as annual financial statements. The transition guidance and annual disclosure provisions of FAS No. 148 are effective for fiscal years ending after December 15, 2002, with earlier application permitted in certain circumstances. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002.

In November, 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. This interpretation clarifies that a guarantor is required to disclose (a) the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee; (b) the maximum potential amount of future payments under the guarantee; (c) the carrying amount of the liability, if any, for the guarantor's obligations under the guarantee; and (d) the nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amounts paid under the guarantee. This interpretation also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, including its ongoing obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur. The objective of the initial measurement of that liability is the fair value of the guarantee at its inception. The initial recognition and initial measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements in this interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002.

Reclassification of Comparative Amounts

Certain items previously reported have been reclassified to conform with the current year's format. Such reclassifications did not affect net income or stockholders' equity.

2. EARNINGS PER SHARE

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

	2002	*2001*	*2000*
Weighted-average common shares outstanding	1,205,155	1,206,110	1,206,110
Average treasury stock shares	(47,786)	(45,722)	(42,704)
Weighted-average common shares and common stock equivalents used to calculate basic earnings per share	1,157,369	1,160,388	1,163,406
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	1,899	1,203	-
Weighted-average common shares and common stock equivalents used to calculate diluted earnings per share	1,159,268	1,161,591	1,163,406

Options to purchase 9,975 shares of common stock at prices from $29.52 to $30.24 per share were outstanding during 2002 and 2001 but were not included in the computation of diluted EPS because to do so would have been anti-dilutive.

3. INVESTMENT SECURITIES AVAILABLE FOR SALE

The amortized cost and estimated market values of securities available for sale are as follows:

	2002			
	Amortized Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Estimated Market Value*
U.S. Government agency securities	$ 3,737,068	$ 162,442	$ -	$ 3,899,510
Obligations of states and political subdivisions:				
Taxable	1,160,507	21,107	-	1,181,614
Tax-exempt	10,113,698	290,242	(27,762)	10,376,178
Corporate securities	349,747	23,659	-	373,406
Mortgage-backed securities	19,835,691	263,981	(13,323)	20,086,349
Total	$35,196,711	$ 761,431	$ (41,085)	$35,917,057

3. INVESTMENT SECURITIES AVAILABLE FOR SALE (Continued)

	2001			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
U.S. Government agency securities	$ 2,152,877	$ 60,470	$ -	$ 2,213,347
Obligations of states and political subdivisions:				
Taxable	1,411,166	16,700	(2,957)	1,424,909
Tax-exempt	5,822,240	107,864	(15,099)	5,915,005
Corporate securities	550,472	25,809	-	576,281
Mortgage-backed securities	11,040,429	69,408	(59,593)	11,050,244
Total	$20,977,184	$ 280,251	$ (77,649)	$21,179,786

The amortized cost and estimated market value of debt securities at December 31, 2002, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Market Value
Due in one year or less	$ 2,449,962	$ 2,473,942
Due after one year through five years	8,550,471	8,910,167
Due after five years through ten years	3,004,457	3,139,208
Due after ten years	21,191,821	21,393,740
Total	$ 35,196,711	$ 35,917,057

Investment securities with an approximate carrying value of $11,397,600 and $9,381,000 at December 31, 2002 and 2001, respectively, were pledged to secure deposits and other purposes as required by law.

The gross proceeds received and the gross gains realized on the sale of investment securities available for sale for the year ended December 31, 2001 were $2,092,980 and $97,807, respectively. The Company had no sales in 2002 or 2000.

4. INVESTMENT SECURITIES HELD TO MATURITY

The amortized cost and estimated market values of investment securities held to maturity are as follows:

	2002			
	Amortized Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Estimated Market Value*
Obligations of states and political subdivisions:				
Taxable	$ 1,370,215	$ 50,360	$ -	$ 1,420,575
Tax-exempt	3,368,276	95,092	-	3,463,368
Corporate securities	1,503,604	18,371	-	1,521,975
Total	$ 6,242,095	$ 163,823	$ -	$ 6,405,918

	2001			
	Amortized Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Estimated Market Value*
Obligations of states and political subdivisions:				
Taxable	$ 2,255,342	$ 57,931	$ -	$ 2,313,273
Tax-exempt	5,561,426	120,456	-	5,681,882
Corporate securities	2,213,060	59,896	-	2,272,956
Mortgage-backed securities	199,240	4,627	-	203,867
Total	$10,229,068	$ 242,910	$ -	$10,471,978

The amortized cost and estimated market value of debt securities at December 31, 2002, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	*Estimated Market Value*
Due in one year or less	$ 4,370,736	$ 4,434,763
Due after one year through five years	1,724,637	1,802,246
Due after five years through ten years	46,722	51,811
Due after ten years	100,000	117,098
Total	$ 6,242,095	$ 6,405,918

Investment securities held to maturity with carrying values of approximately $1,535,726 and $3,205,000 and estimated market values of approximately $1,590,910 and $3,424,000 at December 31, 2002 and 2001, respectively, were pledged to secure public deposits and other purposes required by law.

5. LOANS

Major classifications of loans are summarized as follows:

	2002	2001
Commercial and industrial	$ 32,915,776	$ 28,313,488
Real estate - construction	3,207,434	3,199,738
Real estate - mortgage:		
Residential	123,843,881	113,048,775
Commercial	9,520,812	3,387,969
Consumer installment	5,455,228	4,878,385
	174,943,131	152,828,355
Less allowance for loan losses	2,300,485	2,062,252
Net loans	$ 172,642,646	$ 150,766,103

The Company's primary business activity is with customers located within its local trade area, eastern Geauga County, and contiguous counties to the north, east, and south. Commercial, residential, consumer, and agricultural loans are granted. Although the Company has a diversified loan portfolio at December 31, 2002 and 2001, loans outstanding to individuals and businesses are dependent upon the local economic conditions in its immediate trade area.

6. ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses for the years ended December 31, are as follows:

	2002	2001	2000
Balance, January 1	$ 2,062,252	$ 2,037,322	$ 1,756,137
Add:			
Provisions charged to operations	300,000	170,000	275,000
Recoveries	57,388	120,814	61,002
Less loans charged off	119,155	265,884	54,817
Balance, December 31	$ 2,300,485	$ 2,062,252	$ 2,037,322

7. PREMISES AND EQUIPMENT

Major classifications of premises and equipment are summarized as follows:

	2002	2001
Land and land improvements	$ 1,094,647	$ 1,094,546
Building and leasehold improvements	6,068,568	6,018,245
Furniture, fixtures, and equipment	2,452,273	2,349,709
Construction in progress	447,595	10,100
	10,063,083	9,472,600
Less accumulated depreciation and amortization	3,582,353	3,227,803
Total	$ 6,480,730	$ 6,244,797

Depreciation and amortization charged to operations was $354,550 in 2002, $300,531 in 2001, and $337,158 in 2000.

8. OTHER ASSETS

The components of other assets are as follows:

	2002	2001
FHLB stock	$ 1,245,700	$ 1,056,000
Accrued interest on investment securities	294,077	329,312
Accrued interest on loans	424,650	423,752
Deferred tax asset, net	87,117	190,848
Other	214,168	304,656
Total	$ 2,265,712	$ 2,304,568

9. DEPOSITS

Time deposits at December 31, 2002 mature $49,951,941 in 2003, $33,385,345 during 2004 through 2005, and $10,281,682 beyond 2005.

Time deposits include certificates of deposit in denominations of $100,000 or more. Such deposits aggregated $17,677,677 and $15,866,131 at December 31, 2002 and 2001, respectively.

Maturities on time deposits of $100,000 or more at December 31, 2002, are as follows:

Within three months	$ 3,697,008
Beyond three but within six months	3,434,299
Beyond six but within twelve months	1,983,994
Beyond one year	8,562,366
Total	$ 17,677,667

10. SHORT-TERM BORROWINGS

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

	2002	2001
Balance at year-end	$ 785,778	$ 660,678
Average balance outstanding	977,343	637,106
Maximum month-end balance	1,176,829	833,008
Weighted-average rate at year-end	0.33%	0.79%
Weighted-average rate during the year	0.73%	2.42%

Average balances outstanding during the year represent daily average balances, and average interest rates represent interest expense divided by the related average balance.

The Company maintains a $4,000,000 line of credit at an adjustable rate, currently 4.00 percent, from Lorain National Bank. At December 31, 2002 and 2001, there were no outstanding balances on this line.

11. OTHER BORROWINGS

Other borrowings consist of fixed rate advances from the FHLB as follows:

Maturity	Interest Rate	2002	2001
August 8, 2003	2.03 %	$ 1,440,000	$ -
August 9, 2004	2.70 %	525,000	-
August 9, 2005	3.34 %	525,000	-
August 9, 2006	3.87 %	510,000	-
July 1, 2007	6.40 %	880,803	1,301,334
September 4, 2008	5.36 %	4,000,000	4,000,000
October 2, 2008	4.53 %	2,000,000	2,000,000
July 28, 2010	6.45 %	2,000,000	2,000,000
February 1, 2012	4.17 %	1,863,265	-
June 4, 2012	4.04 %	965,887	-
June 4, 2017	4.34 %	980,098	-
Total		$ 15,690,053	$ 9,301,334

Advances from FHLB maturing July 1, 2007, February 1, 2012, June 4, 2012, and June 4, 2017 require monthly principal and interest payments and an annual 20 percent paydown of outstanding principal. Monthly principal and interest payments are adjusted after each 20 percent paydown. Under terms of a blanket agreement, collateral for the FHLB borrowings are secured by certain qualifying assets of the Bank which consist principally of first mortgage loans. Under this credit arrangement, the Bank has a remaining borrowing capacity of approximately $91.4 million at December 31, 2002.

12. OTHER LIABILITIES

The components of other liabilities are as follows:

	2002	2001
Accrued interest on deposits	$ 485,946	$ 607,204
Other	152,854	119,213
Total	$ 638,800	$ 726,417

13. INCOME TAXES

The provision for federal income taxes consists of:

	2002	2001	2000
Current payable	$ 1,180,108	$ 916,456	$ 1,010,182
Deferred	(72,302)	54,403	(87,521)
Total provision	$ 1,107,806	$ 970,859	$ 922,661

The tax effects of deductible and taxable temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

	2002	2001
Deferred tax assets:		
Allowance for loan losses	$ 713,232	$ 632,233
Supplemental retirement plan	19,348	-
Gross deferred tax assets	732,580	632,233
Deferred tax liabilities:		
Deferred origination fees, net	173,186	164,450
Premises and equipment	122,908	119,082
Net unrealized gain on securities	244,918	68,885
Other	104,451	88,968
Gross deferred tax liabilities	645,463	441,385
Net deferred tax assets	$ 87,117	$ 190,848

No valuation allowance was established at December 31, 2002 and 2001 in view of the Company's ability to carryback to taxes paid in previous years and certain tax strategies, coupled with the anticipated future taxable income as evidenced by the Company's earnings potential.

13. INCOME TAXES (Continued)

The reconciliation between the federal statutory rate and the Company's effective consolidated income tax rate is as follows:

	2002		2001		2000	
	Amount	% of Pre-tax Income	Amount	% of Pre-tax Income	Amount	% of Pre-tax Income
Provision at statutory rate	$ 1,226,976	34.0%	$ 1,102,098	34.0%	$ 1,074,173	34.0%
Tax-free income	(147,425)	(4.1)	(157,362)	(4.9)	(178,520)	(5.7)
Nondeductible interest expense	21,590	0.6	26,068	0.8	19,966	0.6
Other	6,665	0.2	55	0.1	7,042	0.3
Actual tax expense and effective rate	$ 1,107,806	30.7%	$ 970,859	30.0%	$ 922,661	29.2%

14. EMPLOYEE BENEFITS

Retirement Plan

The Bank maintains a section 401(k) employee savings and investment plan for all full-time employees and officers of the Bank with more than one year of service. The Bank's contribution to the plan is based on 50 percent matching of voluntary contributions up to 6 percent of compensation. An eligible employee can contribute up to 15 percent of salary. Employee contributions are vested at all times, and the Bank contributions are fully vested after six years beginning at the second year in 20 percent increments. Contributions for 2002, 2001, and 2000 to this plan amounted to $53,268, $49,130, and $44,411, respectively.

Supplemental Retirement Plan

Effective December 1, 2001, the Bank adopted a Directors Retirement Plan to provide post-retirement payments over a ten-year period to members of the Board of Directors who have completed five or more years of service. The Plan requires payment of 25 percent of the final average annual board fees paid to a director in the three years preceding the director's retirement. The expense of the plan for the years ended December 31, 2002 and 2001 amounted to $52,800 and $4,107, respectively.

Stock Option Plan

The Company maintains a stock option plan ("the Plan") for granting incentive stock options and non-qualified stock options for key officers and employees and non-employee directors of the Company. A total of 119,779 shares of authorized and unissued or issued common stock are reserved for issuance under the Plan, which expires ten years from the date of stockholder ratification. The per share exercise price of an option granted will not be less than the fair value of a share of common stock on the date the option is granted. No option shall become exercisable earlier than one year from the date the Plan was approved by the stockholders.

14. EMPLOYEE BENEFITS (Continued)

Stock Option Plan (Continued)

The following table presents share data related to the outstanding options:

	2002	Weighted-average Exercise Price	2001	Weighted-average Exercise Price
Outstanding, January 1	21,985	$ 26.11	21,985	$ 26.11
Granted	9,450	28.50	-	-
Exercised	(989)	22.86	-	-
Forfeited	-	-	-	-
Outstanding, December 31	30,446	$ 26.97	21,985	$ 26.11
Exercisable at year-end	20,996	26.28	21,985	26.11

The following table summarizes the characteristics of stock options at December 31, 2002:

		Outstanding			Exercisable	
Grant Date	Exercise Price	Shares	Contractual Average Life	Average Exercise Price	Shares	Average Exercise Price
June 14, 1999	$ 30.24	7,350	6.45	$ 30.24	7,350	$ 30.24
November 23, 1999	29.52	2,625	6.90	29.52	2,625	29.52
December 11, 2000	22.86	11,021	7.95	22.86	11,021	22.86
December 9, 2002	28.50	9,450	9.94	28.50	-	-
		30,446		26.97	20,996	26.28

15. COMMITMENTS

In the normal course of business, there are various outstanding commitments and certain contingent liabilities which are not reflected in the accompanying consolidated financial statements. These commitments and contingent liabilities represent financial instruments with off-balance sheet risk. The contract or notional amounts of those instruments reflect the extent of involvement in particular types of financial instruments which were comprised of the following:

	2002	2001
Commitments to extend credit	$ 12,863,165	$ 17,265,756
Standby letters of credit	86,692	72,692
Total	$ 12,949,857	$ 17,338,448

15. COMMITMENTS (Continued)

The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The same credit policies are used in making commitments and conditional obligations as for on-balance sheet instruments. Generally, collateral is not required to support financial instruments with credit risk. The terms are typically for a one-year period with an annual renewal option subject to prior approval by management.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the loan agreement. These commitments are comprised primarily of available commercial and personal lines of credit. Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party.

The exposure to loss under these commitments is limited by subjecting them to credit approval and monitoring procedures. Substantially all commitments to extend credit are contingent upon customers maintaining specific credit standards at the time of the loan funding. Management assesses the credit risk associated with certain commitments to extend credit in determining the level of the allowance for loan losses. Since many of the commitments are expected to expire without being drawn upon, the contractual amounts do not necessarily represent future funding requirements.

16. REGULATORY RESTRICTIONS

Loans

Federal law prevents the Company from borrowing from the Bank unless the loans are secured by specific obligations. Further, such secured loans are limited in amount of ten percent of the Bank's common stock and capital surplus.

Dividends

The Bank is subject to a dividend restriction which generally limits the amount of dividends that can be paid by an Ohio state-chartered bank. Under the Ohio Banking Code, cash dividends may not exceed net profits as defined for that year combined with retained net profits for the two preceding years less any required transfers to surplus. Under this formula, the amount available for payment of dividends in 2003 is $3,101,000 plus 2003 profits retained up to the date of the dividend declaration.

17. REGULATORY CAPITAL

Federal regulations require the Company and the Bank to maintain minimum amounts of capital. Specifically, each is required to maintain certain minimum dollar amounts and ratios of Total and Tier I capital to risk-weighted assets and of Tier I capital to average total assets.

In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") established five capital categories ranging from "well capitalized" to "critically undercapitalized." Should any institution fail to meet the requirements to be considered "adequately capitalized," it would become subject to a series of increasingly restrictive regulatory actions.

17. REGULATORY CAPITAL (Continued)

As of December 31, 2002 and 2001, the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be classified as a well capitalized financial institution, Total risk-based, Tier 1 risk-based, and Tier 1 Leverage capital ratios must be at least ten percent, six percent, and five percent, respectively.

The Company's actual capital ratios are presented in the following table which shows the Company met all regulatory capital requirements. The capital position of the Bank does not differ significantly from the Company's.

	2002		***2001***	
	Amount	***Ratio***	***Amount***	***Ratio***
Total Capital (to Risk-weighted Assets)				
Actual	$ 22,997,205	16.72%	$ 21,147,628	17.82%
For Capital Adequacy Purposes	11,001,899	8.00	9,493,703	8.00
To Be Well Capitalized	13,752,374	10.00	11,867,129	10.00
Tier I Capital (to Risk-weighted Assets)				
Actual	$ 21,270,980	15.47%	$ 19,657,090	16.56%
For Capital Adequacy Purposes	5,500,950	4.00	4,746,851	4.00
To Be Well Capitalized	8,251,424	6.00	7,120,277	6.00
Tier I Capital (to Average Assets)				
Actual	$ 21,270,980	9.42%	$ 19,657,090	9.94%
For Capital Adequacy Purposes	9,033,386	4.00	7,906,376	4.00
To Be Well Capitalized	11,291,733	5.00	9,882,970	5.00

18. FAIR VALUE DISCLOSURE OF FINANCIAL INSTRUMENTS

The estimated fair values of the Company's financial instruments at December 31, are as follows:

	2002		2001	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
Cash and due from banks	$ 1,775,324	$ 1,775,324	$ 3,443,435	$ 3,443,435
Federal funds sold	350,000	350,000	2,450,000	2,450,000
Interest-bearing deposits in other institutions	571,969	571,969	1,240,207	1,240,207
Investment securities:				
Available for sale	35,917,057	35,917,057	21,179,786	21,179,786
Held to maturity	6,242,095	6,405,918	10,229,068	10,471,978
Net loans	172,642,646	182,439,113	150,766,103	157,569,103
Regulatory stock	1,245,700	1,245,700	1,056,000	1,056,000
Accrued interest receivable	718,727	718,727	753,064	753,064
Total	$219,463,518	$ 229,423,808	$191,117,663	$198,163,573
Financial liabilities:				
Deposits	$187,384,494	$ 191,025,787	$167,382,728	$170,258,728
Short-term borrowings	785,778	785,778	660,678	660,678
Other borrowings	15,690,053	16,390,391	9,301,334	9,679,000
Accrued interest payable	485,946	485,946	607,204	607,204
Total	$204,346,271	$208,687,902	$177,951,944	$181,205,610

Financial instruments are defined as cash, evidence of ownership interest in an entity, or a contract which creates an obligation or right to receive or deliver cash or another financial instrument from/to a second entity on potentially favorable or unfavorable terms.

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing parties other than in a forced liquidation sale. If a quoted market price is available for a financial instrument, the estimated fair value would be calculated based upon the market price per trading unit of the instrument.

If no readily available market exists, the fair value estimates for financial instruments should be based upon management's judgment regarding current economic conditions, interest rate risk, expected cash flows, future estimated losses, and other factors as determined through various option pricing formulas or simulation modeling. As many of these assumptions result from judgments made by management based upon estimates which are inherently uncertain, the resulting estimated fair values may not be indicative of the amount realizable in the sale of a particular financial instrument. In addition, changes in assumptions on which the estimated fair values are based may have a significant impact on the resulting estimated fair values.

As certain assets such as deferred tax assets and premises and equipment are not considered financial instruments, the estimated fair value of financial instruments would not represent the full value of the Company.

The Company employed simulation modeling in determining the estimated fair value of financial instruments for which quoted market prices were not available based upon the following assumptions:

18. FAIR VALUE DISCLOSURE OF FINANCIAL INSTRUMENTS (Continued)

Cash and Due from Banks, Interest-bearing Deposits in Other Institutions, Federal Funds Sold, Regulatory Stock, Accrued Interest Receivable, Accrued Interest Payable, and Short-term Borrowings.

The fair value is equal to the current carrying value.

Investment Securities

The fair value of investment securities available for sale and held to maturity is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities.

Loans, Deposits, and Other Borrowings

The fair value of loans, certificates of deposit, and other borrowings is estimated by discounting the future cash flows using a simulation model which estimates future cash flows and constructs discount rates that consider reinvestment opportunities, operating expenses, noninterest income, credit quality, and prepayment risk. Demand, savings, and money market deposit accounts are valued at the amount payable on demand as of year-end.

Commitments to Extend Credit

These financial instruments are generally not subject to sale, and estimated fair values are not readily available. The carrying value, represented by the net deferred fee arising from the unrecognized commitment or letter of credit, and the fair value, determined by discounting the remaining contractual fee over the term of the commitment using fees currently charged to enter into similar agreements with similar credit risk, are not considered material for disclosure. The contractual amounts of unfunded commitments and letters of credit are presented in Note 15.

19. PARENT COMPANY

Following are condensed financial statements for the Company.

CONDENSED BALANCE SHEET

	December 31, 2002	December 31, 2001
ASSETS		
Cash and due from banks	$ 292,947	$ 167,074
Interest-bearing deposits in other institutions	283,969	377,207
Investment in subsidiary bank	21,169,492	19,242,526
TOTAL ASSETS	$ 21,746,408	$ 19,786,807
STOCKHOLDERS' EQUITY	$ 21,746,408	$ 19,786,807

19. PARENT COMPANY (Continued)

CONDENSED STATEMENT OF INCOME

	Year Ended December 31, 2002	2001	2000
INCOME			
Dividends from subsidiary bank	$ 1,020,895	$ 854,703	$ 1,335,994
Interest income	6,963	4,709	25,600
Total income	1,027,858	859,412	1,361,594
EXPENSES	166,800	152,626	120,243
Income before income tax benefit	861,058	706,786	1,241,351
Income tax benefit	(54,636)	(48,063)	(34,178)
Income before equity in undistributed net income of subsidiary	915,695	754,849	1,275,529
Equity in undistributed net income of subsidiary	1,585,254	1,515,758	961,142
NET INCOME	$ 2,500,949	$ 2,270,607	$ 2,236,671

CONDENSED STATEMENT OF CASH FLOWS

	Year Ended December 31, 2002	2001	2000
OPERATING ACTIVITIES			
Net income	$ 2,500,949	$ 2,270,607	$ 2,236,671
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net income of subsidiary	(1,585,254)	(1,515,758)	(961,142)
Other	-	32,210	(32,176)
Net cash provided by operating activities	915,695	787,059	1,243,353
INVESTING ACTIVITIES			
Decrease (increase) in interest-bearing deposits in other institutions	93,237	(350,766)	1,002,177
Net cash provided by (used for) investing activities	93,237	(350,766)	1,002,177
FINANCING ACTIVITIES			
Purchase of treasury stock	(204,070)	-	(1,311,050)
Sale of treasury stock	18,020	-	44,499
Exercise of stock options	23,509	-	-
Proceeds from dividend reinvestment plan	142,178	-	-
Cash dividends	(862,696)	(772,068)	(595,255)
Net cash used for financing activities	(883,059)	(772,068)	(1,861,806)
Increase (decrease) in cash	125,873	(335,775)	383,724
CASH AT BEGINNING OF YEAR	167,074	502,849	119,125
CASH AT END OF YEAR	$ 292,947	$ 167,074	$ 502,849

20. SELECTED QUARTERLY FINANCIAL DATA (unaudited)

	Three Months Ended			
	March 31, 2002	*June 30, 2002*	*September 30, 2002*	*December 31, 2002*
Total interest income	$ 3,426,323	$ 3,499,140	$ 3,585,611	$ 3,557,998
Total interest expense	1,536,068	1,512,260	1,590,727	1,509,031
Net interest income	1,890,255	1,986,880	1,994,884	2,048,967
Provision for loan losses	75,000	75,000	75,000	75,000
Net interest income after provision for loan losses	1,815,255	1,911,880	1,919,884	1,973,967
Total noninterest income	261,077	283,715	285,499	363,817
Total noninterest expense	1,259,422	1,345,672	1,268,026	1,333,219
Income before income taxes	816,910	849,923	937,357	1,004,565
Income taxes	268,000	278,000	298,000	263,806
Net income	$ 548,910	$ 571,923	$ 639,357	$ 740,759
Per share data:				
Net income				
Basic	$ 0.47	$ 0.49	$ 0.55	$ 0.64
Diluted	0.47	0.49	0.55	0.64
Average shares outstanding				
Basic	1,158,377	1,158,665	1,156,181	1,156,476
Diluted	1,159,491	1,159,196	1,159,277	1,158,868

	Three Months Ended			
	March 31, 2001	*June 30, 2001*	*September 30, 2001*	*December 31, 2001*
Total interest income	$ 3,299,426	$ 3,462,634	$ 3,508,111	$ 3,534,205
Total interest expense	1,655,626	1,725,151	1,730,710	1,636,435
Net interest income	1,643,800	1,737,483	1,777,401	1,897,770
Provision for loan losses	39,000	41,000	45,000	45,000
Net interest income after provision for loan losses	1,604,800	1,696,483	1,732,401	1,852,770
Total noninterest income	258,665	267,775	365,793	204,153
Total noninterest expense	1,090,308	1,237,226	1,149,978	1,263,862
Income before income taxes	773,157	727,032	948,216	793,061
Income taxes	235,900	235,600	288,326	211,033
Net income	$ 537,257	$ 491,432	$ 659,890	$ 582,028
Per share data:				
Net income				
Basic	$ 0.46	$ 0.42	$ 0.57	$ 0.50
Diluted	0.46	0.42	0.57	0.50
Average shares outstanding				
Basic	1,158,102	1,157,911	1,160,388	1,158,102
Diluted	1,159,519	1,159,738	1,160,934	1,158,565

SNODGRASS
Certified Public Accountants and Consultants

REPORT OF INDEPENDENT AUDITORS

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, 2002 and 2001, 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, 2002. 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 auditing standards generally accepted in the United States of America. 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, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ending December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

S.R. Snodgrass, A.C.

Wexford, PA
January 17, 2003

S.R. Snodgrass, A.C.
1000 Stonewood Drive, Suite 200 Wexford, PA 15090-8399 Phone: 724-934-0344 Facsimile: 724-934-0345

Selected Financial Data

The summary financial information to follow is not a substitute for Middlefield's historical financial information and other detailed financial information we provide elsewhere in this document. You should read the summary financial information together with the historical financial information and other detailed financial information we provide elsewhere in this document. We derived the financial data from Middlefield's audited financial statements for the fiscal years ended December 31, 1998 through 2002.

(In thousands, except share and per share amounts and ratios)	***As of or For the Years Ended December 31,*** 2002	2001	2000	1999	1998
Income Statement Data:					
Interest income	$ 14,120	$ 13,707	$ 12,770	$ 11,449	$ 10,901
Interest expense	6,148	6,748	5,910	5,048	5,085
Net interest income	7,972	6,959	6,860	6,401	5,817
Provision for loan losses	300	170	275	296	270
Net interest income after provision for loan losses	7,672	6,789	6,585	6,105	5,546
Noninterest income, including securities gains (losses)	1,143	1,194	983	804	599
Noninterest expense	5,206	4,741	4,409	4,254	3,825
Income before income taxes	3,609	3,242	3,159	2,655	2,320
Income taxes	1,108	971	922	735	630
Net income	$ 2,501	$ 2,271	$ 2,237	$ 1,920	$ 1,690
Balance Sheet Data:					
Investment securities	$ 42,159	$ 31,409	$ 29,811	$ 31,818	$ 36,656
Loans, net	$ 172,643	$ 150,766	$ 133,267	$ 119,472	$ 102,728
Total deposits	$ 187,384	$ 167,383	$ 147,166	$ 135,094	$ 128,828
FHLB Cincinnati advances	$ 15,690	$ 9,301	$ 9,862	$ 9,602	$ 9,576
Total stockholders' equity	$ 21,746	$ 19,791	$ 18,243	$ 17,689	$ 16,657
Total assets	$ 226,246	$ 197,858	$ 176,489	$ 165,512	$ 155,558
Per Common Share Data: (1)					
Basic net income	$ 2.16	$ 1.96	$ 1.92	$ 1.60	$ 1.40
Diluted net income	$ 2.16	$ 1.95	$ 1.92	$ 1.60	$ N/A
Book value	$ 18.80	$ 17.09	$ 15.75	$ 14.75	$ 13.81
Weighted Average Number of Shares:					
Basic	1,157,369	1,160,388	1,163,406	1,200,247	1,203,673
Diluted	1,159,268	1,161,591	1,163,406	1,200,247	N/A
Selected Ratios:					
Return on average total stockholders' equity	12.08%	11.89%	12.83%	11.17%	10.43%
Return on average total assets	1.17%	1.22%	1.31%	1.21%	1.15%
Dividend payout ratio	34.49%	33.94%	26.61%	29.82%	29.53%
Efficiency ratio (2)	57.12%	58.16%	56.21%	59.05%	59.62%
Asset Quality Ratios:					
Allowance for loan losses to ending total loans	1.31%	1.35%	1.51%	1.45%	1.48%
Net loan charge-offs to average loans	0.04%	0.10%	—%	0.07%	0.07%
Capital Ratios:					
Average stockholders' equity to average assets	9.70%	10.24%	10.20%	10.83%	11.04%
Leverage ratio (3)	9.42%	9.94%	10.32%	10.93%	11.35%
Total risk-based capital ratio (3)	16.72%	17.82%	17.75%	18.39%	18.37%

(1) Per share amounts are adjusted for a 5% stock dividend paid in 2002, a 10% stock dividend paid in 1998, and a 2-for-1 stock split in 2000.
(2) Efficiency ratio is noninterest expense divided by the sum of net interest income plus noninterest income minus nonrecurring items.
(3) Computed in accordance with Federal Reserve Board and FDIC guidelines.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The consolidated review and analysis of Middlefield Banc Corp. ("Middlefield") is intended to assist the reader in evaluating the performance of Middlefield for the years ended December 31, 2002 and 2001. This information should be read in conjunction with the consolidated financial statements and accompanying notes to the financial statements.

Middlefield is an Ohio corporation organized to become the holding company of The Middlefield Banking Company ("Bank"). The Bank is a state-chartered bank located in Middlefield, Ohio. Middlefield and its subsidiary bank derive substantially all of their income from banking and bank-related services, including interest earnings on residential real estate, commercial mortgage, commercial, and consumer financings as well as interest earnings on investment securities and deposit services to its customers through five locations.

Forward Looking Statement

The Private Securities Litigation Reform Act of 1995 contains safe harbor provisions regarding forward-looking statements. Forward-looking statements can be identified by terminology such as "believes," "expects," "anticipates," "estimates," "intends," "should," "will," "plans," "potential" and similar words. Forward-looking statements are also statements that are not statements of historical fact. Forward-looking statements necessarily involve risks and uncertainties. They are merely predictive or statements of probabilities, involving known and unknown risks, uncertainties and other factors. If one or more of these risks of uncertainties occurs or if the underlying assumptions prove incorrect, actual results in 2003 and beyond could differ materially from those expressed in or implied by the forward-looking statements.

Forward-looking statements are based upon a variety of estimates and assumptions. The estimates and assumptions involve judgments about a number of things, including future economic, competitive, and financial market conditions and future business decisions. These matters are inherently subject to significant business, economic, and competitive uncertainties, all of which are difficult to predict and many of which are beyond Middlefield's control. Although Middlefield believes its estimates and assumptions are reasonable, actual results could vary materially from those shown. Inclusion of forward-looking information does not constitute a representation by Middlefield or any other person that the indicated results will be achieved. Investors are cautioned not to place undue reliance on forward-looking information.

Results of Operations

Middlefield recorded net income of $2.5 million in 2002, which represents an increase of $230,000, or 10.1%, over 2001. Net income for 2001 of $2.3 million represented an increase of $34,000, or 1.5%, over 2000. Diluted earnings per share have increased each of the past three years to $2.16 per share for 2002, $1.95 per share for 2001, and $1.92 per share for 2000.

Net Interest Income — *2002 Compared to 2001*. Net interest income for 2002 increased to $8.0 million, compared to $7.0 million for 2001. Interest income for 2002 was $14.1 million as compared to $13.7 million for 2001. This increase of $413,000 or 3.0% was influenced primarily by an increase in interest earned on loans receivable of $533,000, while offset by decreases in interest earned on federal

Results of Operations (Continued)

funds sold, investment securities, and interest-bearing deposits in other institutions of $73,000, $33,000, and $14,000 respectively. Although the rate environment forced a decrease to interest rate yields, interest income was driven by increases in average balances of interest-earning assets. The average balance of loans receivable and investment securities increased $20.3 million to $163.8 million and $5.3 million to $35.2 million, respectively, during 2002. The tax-equivalent yield on interest earning assets decreased to 6.99% for 2002 from 7.79% for 2001, and primarily resulted from a 102 basis point and 69 basis point decrease in investment securities and loans receivable, respectively. During 2002, $14.0 million in called, matured, and repayed investment securities were reinvested at substantially lower rates. The inflow of deposits coupled with the rapid repayment of mortgage-backed securities has resulted in reinvestment options at substantially lower rates than the previous year. The lower interest rate environment resulted during 2001, when interest rates were driven downward by an aggressive rate reduction policy by the Federal Reserve Board.

Interest expense decreased $600,000 or 8.9% for 2002 to $6,148,000 from $6,748,000 for 2001. Interest expense incurred on deposits decreased $720,000 for 2002 as compared to 2001 and was primarily attributable to the current interest rate environment that resulted in a lowering of the cost of funds to 3.68% for 2002 as compared to 4.71% for 2001. Offsetting the declining rates was an increase in the average balance of interest-bearing liabilities of $23.9 million to $167.2 million for 2002. In particular, the average balance of savings and certificates of deposits increased $10.6 million and $6.7 million, respectively. Core deposit growth also was driven by a general shift in customer preference away from the equity markets and into insured bank deposits. Although the Bank reduced its costs on all deposit products during 2002, certificates of deposits were the primary target as such costs decreased by 113 basis points. Interest expense on borrowings increased to $670,000 for 2002 as compared to $550,000 for 2001 and resulted primarily from an additional $7.0 million in borrowings with the Federal Home Loan Bank that Middlefield did not have at December 31, 2001.

2001 Compared to 2000. Net interest income for 2001 increased slightly to $7.0 million, compared to $6.9 million for 2000. Interest income of $13.7 million in 2001 represents an increase of $0.9 million, or 7.3%, over 2000, and 2001 was influenced primarily by an increase in interest earned on loans receivable of $1.0 million. Correspondingly, interest expense of $6.7 million in 2001 increased by $0.8 million, or 14.2%, and resulted almost entirely from an increase in interest expense on deposits. The average balance of interest-earning assets increased $16.4 million for 2001 and was comprised of increases in loans receivable, specifically real estate mortgages, of $14.9 million, or 11.6%, to $143.6 million, and interest-bearing deposits with other banks of $1.8 million, or 47.3%, to $5.6 million. Due to the declining rate environment in 2001, the tax-equivalent yield on interest-earning assets declined to 7.79% from 8.02% for 2000. While the yield on loans receivable and interest-bearing deposits with other banks was reduced by 21 and 190 basis points, respectively, the investment securities yield remained unchanged as management engaged in restructuring the investment securities portfolio to include higher yielding mortgage-backed securities with longer maturity periods. Partially offsetting increases in interest income in 2001 was an increase in the average balances of time deposits of $13.3 million, or 19.1%, to $83.2 million and savings deposits of $3.4 million, or 10.6%, to $35.4 million. The average cost of funds on interest-bearing liabilities increased to 4.71% in 2001 from 4.58% in 2000, primarily resulting from an increase of 14 basis points for the more competitively priced certificates of deposit products.

Average Balances, Interest Rates and Yields. The following table sets forth certain information relating to our average balance sheet, and it reflects the average yield on assets and average cost of liabilities for the periods indicated and the average yields earned and rates paid. Such yields are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods presented. Average balances are derived from daily average balances.

	Year ended December 31,								
	2002			2001			2000		
(Dollars in thousands)	**Average balance**	**Interest [1]**	**Average yield/cost [4]**	**Average balance**	**Interest [1]**	**Average yield/cost [4]**	**Average balance**	**Interest [1]**	**Average yield/cost [4]**
Interest-earning assets:									
Loans receivable	$ 163,828	$ 12,341	7.53%	$ 143,560	$ 11,808	8.23%	$ 128,661	$ 10,852	8.43%
Investment securities	35,169	1,615	5.21%	29,887	1,625	6.24%	30,162	1,658	6.39%
Interest-earning deposits with other banks	6,116	164	2.68%	5,647	274	4.85%	3,833	259	6.76%
Total interest-earning assets	205,113	14,120	6.99%	179,094	13,707	7.79%	162,656	12,769	8.02%
Non-interest-earning assets	8,368			7,455			8,231		
Total assets	$ 213,481			$ 186,549			$ 170,887		
Interest-bearing liabilities:									
Interest-bearing demand deposits	$ 7,905	109	1.38%	$ 6,296	153	2.43%	$ 6,268	174	2.78%
Money market deposits	9,090	199	2.19%	8,123	244	3.00%	10,310	308	2.99%
Savings deposits	46,045	948	2.06%	35,432	954	2.69%	32,036	855	2.67%
Certificates of deposit	89,857	4,222	4.70%	83,177	4,847	5.83%	69,866	3,975	5.69%
Borrowings	14,258	670	4.70%	10,211	550	5.39%	10,641	598	5.62%
Total interest-bearing liabilities	167,155	6,148	3.68%	143,239	6,748	4.71%	129,121	5,910	4.58%
Non interest-bearing liabilities:									
Other liabilities	25,621			24,216			24,336		
Stockholders' equity	20,705			19,094			17,430		
Total liabilities and stockholders' equity	$ 213,481			$ 186,549			$ 170,887		
Net interest income		$ 7,972			$ 6,959			$ 6,859	
Interest rate spread [2]			3.31%			3.08%			3.44%
Net yield on interest-earning assets [3]			3.99%			3.89%			4.22%
Ratio of average interest-earning assets to average interest-bearing liabilities			122.71%			125.03%			125.97%

[1] Interest income and expense are for the period that banking operations were in effect.
[2] Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.
[3] Net yield on interest-earning assets represents net interest income as a percentage of average interest-earning assets.
[4] Average yield/cost is presented on a taxable equivalent basis using 34%.

Rate/Volume Analysis. The following table sets forth certain information regarding the changes in our interest income and interest expense for the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (1) changes in volume (changes in average volume multiplied by prior year rate), and (2) changes in rates (changes in rate multiplied by prior year average volume). Increases and decreases due to both rate and volume have been allocated proportionally to the change due to volume and the change due to rate.

	Changes in net interest income for the year ended December 31,					
	2002 vs. 2001 Increase (decrease) due to			2001 vs. 2000 Increase (decrease) due to		
(Dollars in thousands)	**Volume**	**Rate**	**Total**	**Volume**	**Rate**	**Total**
Interest income:						
Loans receivable	$ 1,320	$ (787)	$ 533	$ 1,217	$ (262)	$ 955
Investment securities	(138)	128	(10)	(9)	(24)	(33)
Other interest-earning assets	25	(135)	(110)	37	(22)	15
Total interest income	1,207	(794)	413	1,245	(308)	937
Interest expense:						
Interest-bearing demand	64	(108)	(44)	1	(22)	(21)
Money market	35	(80)	(45)	(66)	2	(64)
Savings	(28)	22	(6)	8	99	102
Certificates of deposit	443	(1,068)	(625)	774	98	872
Other interest-bearing liabilities	177	(57)	120	(24)	(24)	(48)
Total interest expense	690	(1,290)	(600)	766	63	838
Change in net interest income	$ 517	$ 496	$ 1,013	$ 469	$ (370)	$ 99

Loan Loss Provision — *2002 Compared to 2001*. The provision for loan losses was $300,000 in 2002 as compared to $170,000 in 2001. The loan loss provision is based upon management's assessment of a variety of factors, including types and amounts of nonperforming loans, historical loss experience, collectibility of collateral values and guaranties, pending legal action for collection of loans and related guaranties, and current economic conditions. The loan loss provision reflects management's judgment of the current period cost-of-credit risk inherent in the loan portfolio. Although management believes the loan loss provision has been sufficient to maintain an adequate allowance for loan losses, actual loan losses could exceed the amounts that have been charged to operations. The change in the loan loss provision in 2002 was principally a result of an increase in nonperforming loans during the year coupled with an increase in classified assets from 2001 to 2002.

2001 Compared to 2000. The provision for loan losses was $170,000 in 2001 as compared to $275,000 in 2000. The change in the loan loss provision in 2001 was principally a result of a reduction in the amount of classified assets from 2000 to 2001.

Noninterest Income — *2002 Compared to 2001*. Total noninterest income decreased slightly in 2002 to $1.1 million from $1.2 million for 2001. The decrease is accounted for principally by the recognition of investment security gains of $98,000 in 2001 that was not repeated in 2002. Offsetting this decline was an increase in fee income from deposit accounts, as well as increases in ATM surcharges and debit card fees. Such fees have progressively increased as the number of accounts and volume of related transactions have increased.

Results of Operations (Continued)

2001 Compared to 2000. Total noninterest income was $1.2 million in 2001, an increase of 21.5% over 2000. The increase is accounted for principally by fee income from deposit accounts, which grew commensurate with deposit growth, coupled with the recognition of investment security gains of $98,000.

Transaction deposit accounts grew at a steady pace in 2002, 2001, and 2000. In general, management prices deposits at rates competitive with rates offered by the other banks in Middlefield's market, which rates tend to be somewhat lower than rates offered by thrift institutions and credit unions. Middlefield generally has not imposed service charges and fees to the same extent as other local institutions. Although a wider range of service charges and fees and higher service charges and fees would yield more income for each dollar of deposits, imposing service charges and fees on a basis equivalent to those imposed by many other area banks might adversely affect deposit growth. To promote deposit growth and provide cross-selling opportunities, Middlefield has not adopted the most aggressive fee structure. Deposit growth is generated by developing strong customer relationships and cross-selling deposit relationships to loan customers. Management intends to continue promoting demand deposit products, particularly noninterest-bearing deposit products, in order to obtain additional interest-free lendable funds.

Noninterest Expense — *2002 Compared to 2001*. Noninterest expense increased 9.8% to $5.2 million for 2002 as compared to $4.7 million for 2001. Compensation and employee benefits increased $207,000, or 8.9%, primarily as a result of normal merit raises and a 17.0% increase in health insurance expenses for 2002. Occupancy and equipment expenses increased 16.8% or $98,000 as a result of added capital expenditures in prior years, in particular the Chardon branch which became operational in 2001. As a result of increased transaction activity from operating a larger organization, data processing expenses increased $65,000 or 18.1% during 2002 as compared to 2001. In addition, all other expenses increased $94,000 or 6.4% as a result of an increase in operational expenses for such items as telephone and postage usage that resulted from expanding into a larger organization, as well as a full years worth of expenses relating to the Directors Retirement Plan. Offsetting these increases was a reduction in marketing costs that occurred in 2001 marking the 100th anniversary of the Bank. Middlefield has also purchased land for expansion of a new branch in early 2003, and anticipates incurring additional capital and operational expenditures in the next twelve months.

2001 Compared to 2000. Noninterest expense increased 7.6% to $4.7 million for 2001 as compared to $4.4 million for 2000. Compensation and employee benefits increased $76,000, or 3.4%, primarily as a result of normal merit raises. Data processing expenses increased $47,000, or 14.9%, as a result of increased transaction activity with the opening of the Chardon branch. Professional fees increased $35,000, or 16.5%, and resulted from outside assistance in complying with the increased levels of regulatory compliance of a publicly reporting company. Other expenses increased $178,000 due to the marketing of the 100th anniversary of the Bank, costs incurred with the addition of internet banking, as well as increases in other expenses such as telephones, supplies, etc., that relate to increases in volume that correspond with the sustained growth of the Bank.

Provision for Income Taxes. The provision for income taxes fluctuated in 2002, 2001, and 2000 in direct correlation to the changing level of pre-taxable income during these periods.

Financial Condition

Assets and Liabilities. Middlefield's total assets increased $28.4 million, or 14.4%, to $226.2 million at December 31, 2002 from $197.9 million at December 31, 2001. This increase primarily resulted from a $21.9 million, or 14.5%, increase in net loans receivable to $172.6 million at December 31, 2002 that was funded by a $20.0 million net increase in customer deposits and a series of borrowings with the Federal Home Loan Bank of approximately $7.0 million. The increase in net loans receivable resulted from the economic health of Middlefield's market area, the current interest rate environment, and the strategic,

Financial Condition (Continued)

service-oriented marketing approach taken by management to meet the lending needs of the area. The majority of Middlefield's lending activity consists of mortgage loans secured by one-to-four family residential property. Such loans grew $10.8 million, or 9.6%, to $123.8 million at December 31, 2002, representing 70.8% of the loan portfolio. Management attributes the increases in residential real estate properties to continued customer referrals and Middlefield's overall relationship with its customers. Also affected by the local economic conditions were commercial and commercial real estate loans, which increased in total by $10.7 million to $42.4 million.

Investment securities available for sale increased to $35.9 million at December 31, 2002 from $21.2 million at December 31, 2001. Meanwhile, investment securities held to maturity decreased to $6.2 million at December 31, 2002 from $10.2 million at December 31, 2001. The net increase in 2002 is primarily due to investment purchases of $24.4 million primarily in mortgage-backed securities, which was partially offset by investment calls and maturities of $14.0 million. Purchases of mortgage-backed securities, which have all been classified as available for sale, typically have maturities ranging from 15 to 30 years with yields between 4.5% and 6.0%. Approximately half of the entire investment securities portfolio is now comprised of mortgage-backed securities as compared to 36.0% at December 31, 2001. Management was able to fund this growth with an influx of deposits coupled with the utilization of excess cash and cash equivalents of $3.8 million and the reinvestment of called and matured securities during the year. Furthermore, available for sale securities now comprise 84.9% of the investment securities portfolio as compared to 67.4% at December 31, 2001.

Total deposits increased $20.0 million, or 11.9%, to $187.4 million at December 31, 2002 from $167.4 million at December 31, 2001. Growth was primarily concentrated in savings and time deposits, which increased $7.8 and $7.2 million, respectively, and resulted from continual marketing efforts by management, as well as management's competitive pricing of such products. As noted previously, deposit growth also was driven by a general shift in customer preference away from the equity markets and into insured bank deposits. Time deposits at December 31, 2002 continue to account for approximately half of the total deposit portfolio and remain a dominant resource for funds.

Other borrowings increased $6.4 million or 68.7% to $15.7 million at December 31, 2002 from $9.3 million at December 31, 2001. As noted previously, this primarily consisted of a series of Federal Home Loan Bank borrowings with staggered maturities to be repaid over a fifteen-year period. As noted previously, the proceeds from these borrowings were used to supplement the funding of loan demand.

Total stockholders' equity increased to $21.7 million at December 31, 2002 due to net income of $2.5 million that was offset partially by dividend payments of $858,000 and an increase in accumulated other comprehensive income of $342,000. Accumulated other comprehensive income increased as a result of changes in the net unrealized gain on investment securities available for sale due to fluctuations in interest rates. Because of interest rate volatility, accumulated other comprehensive income could materially fluctuate for each interim period and year-end period depending on economic and interest rate conditions. Middlefield declared a 5.0% stock dividend during the period that resulted in a transfer between retained earnings and common stock of approximately $1.4 million. In September 2002, Middlefield's dividend reinvestment plan was initiated to promote long-term ownership by investors with the proceeds from such purchases being used for general corporate purposes. Approximately $142,000 was used for reinvestment purposes in 2002. Middlefield will continue to repurchase shares of its common stock for both stock option and restricted stock purposes. In addition, future dividend policies will be determined by the Board of Directors in light of the earnings and financial condition of Middlefield, including applicable governmental regulations and policies.

Financial Condition (Continued)

Allowance for Loan Losses. The allowance for loan losses represents the amount management estimates is adequate to provide for probable losses inherent in the loan portfolio as of the balance sheet date. Accordingly, all loan losses are charged to the allowance, and all recoveries are credited to it. At December 31, 2002, Middlefield's allowance for loan losses increased to $2.3 million from $2.1 million at December 31, 2001, and now represents 1.31% of the gross loan portfolio as compared to 1.35% for the previous period. The allowance for loan losses is established through a provision for loan losses, which is charged to operations. The provision is based on management's periodic evaluation of the adequacy of the allowance for loan losses, taking into account the overall risk characteristics of the various portfolio segments, the bank's loan loss experience, the impact of economic conditions on borrowers, and other relevant factors. The estimates used to determine the adequacy of the allowance for loan losses, including the amounts and timing of future cash flows expected on impaired loans, are particularly susceptible to significant change in the near term. The total allowance for loan losses is a combination of a specific allowance for identified problem loans, a formula allowance, and an unallocated allowance.

The specific allowance incorporates the results of measuring impaired loans as provided in Statement of Financial Accounting Standards ("FAS") No. 114, *Accounting by Creditors for Impairment of a Loan*, and FAS No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*. These accounting standards prescribe the measurement methods, income recognition and disclosures for impaired loans.

The formula allowance is calculated by applying loss factors to outstanding loans by type, excluding loans for which a specific allowance has been determined. Loss factors are based on management's determination of the amounts necessary for concentrations and changes in mix and volume of the loan portfolio, and consideration of historical loss experience.

The unallocated allowance is determined based upon management's evaluation of existing economic and business conditions affecting the key lending areas of the bank and other conditions, such as new loan products, credit quality trends, collateral values, specific industry conditions within portfolio segments that existed as of the balance sheet date, and the impact of those conditions on the collectibility of the loan portfolio. Management reviews these conditions quarterly. The unallocated allowance is subject to a higher degree of uncertainty because it considers risk factors that may not be reflected in the historical loss factors.

Although management believes that it uses the best information available to make such determinations and that the allowance for loan losses was adequate at December 31, 2002, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy and employment could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions, and reductions in income. Additionally, as an integral part of the examination process bank regulatory agencies periodically review a bank's loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

Financial Condition (Continued)

The following table sets forth information concerning the Middlefield's allowance for loan losses at the dates and for the periods presented.

(Dollars in thousands)	***Loan Loss Experience for the Year Ended December 31,*** ***2002***	***2001***	***2000***
Loan loss allowance, beginning of period	$ 2,062	$ 2,037	$ 1,756
Loans charged off:			
Commercial and industrial	(67)	(74)	(3)
Real estate construction	0	0	0
Mortgage:			
Residential	0	(21)	0
Commercial	0	(92)	0
Consumer installment	(52)	(71)	(52)
Total loans charged off	(119)	(258)	(55)
Recoveries of loans previously charged off:			
Commercial and industrial	24	4	2
Real estate construction	0	0	0
Mortgage:			
Residential	0	0	0
Commercial	0	87	0
Consumer installment	33	22	59
Total recoveries	57	113	61
Net loans recovered (charged off)	(62)	(145)	6
Provision charged to operations	300	170	275
Loan loss allowance, end of period	$ 2,300	$ 2,062	$ 2,037
Loans outstanding:			
Average	$ 163,828	$ 143,560	$ 128,661
End of period, net	$ 174,943	$ 152,828	$ 135,304
Ratio of allowance for loan losses to loans outstanding at end of period	1.31 %	1.35 %	1.51 %
Net recoveries (charge offs) to average loans	(0.04)%	(0.10)%	0.00 %

Financial Condition (Continued)

The following table illustrates the allocation of Middlefield's allowance for probable loan losses for each category of loan for each reported period. The allocation of the allowance to each category is not necessarily indicative of future loss in a particular category and does not restrict our use of the allowance to absorb losses in other loan categories.

	Allocation of the Allowance for Loan Losses at December 31,					
	2002		2001		2000	
(Dollars in thousands)	*Amount*	*Percent of loans in each category to total loans*	*Amount*	*Percent of loans in each category to total loans*	*Amount*	*Percent of loans in each category to total loans*
Type of loan:						
Commercial and industrial	$ 611	18.82%	$ 722	18.53%	$ 723	15.9%
Real estate construction	38	1.83%	37	2.09%	26	1.9%
Mortgage:						
Residential	888	70.79%	781	73.97%	684	74.95%
Commercial	230	5.44%	161	2.22%	281	3.55%
Consumer installment	124	3.12%	111	3.19%	107	3.7%
Unallocated	409	—	250	—	216	—
Total	$ 2,300	100.00%	$ 2,062	100.00%	$ 2,037	100%

Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions, the borrower's financial condition is such that collection of interest is doubtful. Payments received on nonaccrual loans is recorded as income or applied against principal according to management's judgment as to the collectibility of principal.

A loan is considered impaired when it is probable the borrower will not repay the loan according to the original contractual terms of the loan agreement. Management has determined that first mortgage loans on one-to-four family properties and all consumer loans represent large groups of smaller-balance homogeneous loans that are to be collectively evaluated. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. A loan is not impaired during a period of delay in payment if the bank expects to collect all amounts due, including interest accrued at the contractual interest rate for the period of delay. All loans identified as impaired are evaluated independently by management. The bank estimates credit losses on impaired loans based on the present value of expected cash flows, or the fair value of the underlying collateral if loan repayment is expected to come from the sale or operation of the collateral. Impaired loans, or portions thereof, are charged off when it is determined a realized loss has occurred. Until that time, an allowance for loan losses is maintained for estimated losses. Unless otherwise required by the loan terms, cash receipts on impaired loans are applied first to accrued interest receivable, except when an impaired loan is also a nonaccrual loan, in which case the portion of the payment related to interest is recognized as income.

Nonperforming loans as a percentage of total net loans at December 31, 2002 increased to 0.31% from 0.19% for 2001. The bank had nonaccrual loans of $357,000 and $48,000 at December 31, 2002 and 2001, respectively. There were no loans on nonacrrual status at December 31, 2000. Interest income recognized on nonaccrual loans during all of the periods was insignificant. Management does not believe the nonaccrual loans or any amounts classified as nonperforming will have a significant effect on operations or liquidity in 2003. Furthermore, management is not aware of any trends or uncertainties related to any loans classified as doubtful or substandard that might have a material effect on earnings, liquidity, or capital resources. Management is not aware of any information pertaining to material credits that would cause it to doubt the ability of borrowers to comply with repayment terms.

Financial Condition (Continued)

The following table summarizes nonperforming assets by category.

(Dollars in thousands)	Nonperforming Assets at December 31, 2002	2001	2000
Commercial and industrial:			
Nonaccrual	$ 0	$ 48	$ 0
Past due 90 days or more	30	9	0
Real estate construction:			
Nonaccrual	0	0	0
Past due 90 days or more	0	0	0
Mortgage — Residential:			
Nonaccrual	357	0	0
Past due 90 days or more	144	216	0
Mortgage — Commercial:			
Nonaccrual	0	0	0
Past due 90 days or more	0	0	0
Consumer installment:			
Nonaccrual	0	0	0
Past due 90 days or more	7	20	5
Total nonperforming loans	538	293	5
Other real estate owned	0	0	0
Total nonperforming assets	$ 538	$ 293	$ 5
Loans outstanding, net	$ 172,643	$ 150,766	$ 133,267
Nonperforming loans to total net loans	0.31%	0.19%	0%
Nonperforming loans to total assets	0.24%	0.15%	0%
Allowance for loan losses to total loans	1.31%	1.35%	1.51%
Allowance for loan losses to nonperforming loans	427.51%	703.75%	40,740.00%

(1) Represents accruing loans delinquent greater than 90 days that are considered by management to be well secured and that are in the process of collection.

Liquidity. Liquidity management for Middlefield is measured and monitored on both a short- and long-term basis, allowing management to better understand and react to emerging balance sheet trends. After assessing actual and projected cash flow needs, management seeks to obtain funding at the most economical cost to Middlefield. Both short- and long-term liquidity needs are addressed by maturities and sales of investments securities, loan repayments and maturities, and liquidating money market investments such as federal funds sold. The use of these resources, in conjunction with access to credit, provide the core ingredients for satisfying depositor, borrower, and creditor needs.

Financial Condition (Continued)

Middlefield's liquid assets consist of cash and cash equivalents, which include investments in very short-term investments (i.e. federal funds sold), and investment securities classified as available for sale. The level of these assets is dependent on Middlefield's operating, investing, and financing activities during any given period. At December 31, 2002, cash and cash equivalents totaled $2.1 million or 0.9% of total assets while investment securities classified as available for sale totaled $35.9 million or 15.9% of total assets. Management believes that the liquidity needs of Middlefield are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, FHLB advances, and the portion of the investment and loan portfolios that mature within one year. These sources of funds will enable Middlefield to meet cash obligations and off-balance sheet commitments as they come due.

Operating activities provided net cash of $3.2 million, $2.7 million, and $3.0 million for 2002, 2001, and 2000, respectively, generated principally from net income of $2.5 million, $2.3 million, and $2.2 million in each of these respective periods.

Investing activities consist primarily of loan originations and repayments and investment purchases and maturities. These cash usages primarily consisted of loan originations of $22.1 million, as well as investment purchases of $24.4 million. Partially offsetting the usage of investment activities is $14.0 million of proceeds from investment security maturities and repayments. For the same period ended 2001, investing activities used $20.7 million in funds, principally for the net origination of loans and the purchase of investment securities of $17.6 million and $16.6 million, respectively. Such usage of cash was offset by proceeds from repayments and maturities and sales of investment securities of $13.0 million and $2.1 million, respectively. For the same period ended 2000, investing activities used $9.8 million in funds, principally from the net origination of loans of $14.1 million and the purchases of investment securities of $2.6 million. In 2000, these cash usages were offset somewhat by an increase in investment securities repayments and maturities of $4.8 million coupled with a decline in interest-bearing deposits in other institutions from maturities of certificates of deposits of $2.4 million.

Financing activities consist of the solicitation and repayment of customer deposits, borrowings and repayments, treasury stock activity, and the payment of dividends. During 2002, net cash provided by financing activities totaled $25.6 million, principally derived from an increase in deposit accounts in general, and savings and time deposits specifically. Also contributing to this influx of cash was proceeds from other borrowings of $7.0 million. During 2001, net cash provided by financing activities totaled $19.0 million, principally derived from an increase in deposit accounts in general, and time deposits specifically. During the same period ended 2000, net cash provided by financing activities was $8.5 million, and consisted of an increase in deposit accounts of $12.1 million that was offset by the net acquisition of treasury stock of $1.3 million and the repayment of other borrowings of $1.7 million.

Liquidity may be adversely affected by unexpected deposit outflows, excessive interest rates paid by competitors, and similar matters. Management monitors projected liquidity needs and determines the level desirable, based in part on Middlefield's commitment to make loans, as well as management's assessment of Middlefield's ability to generate funds. Middlefield anticipates that it will have sufficient liquidity to satisfy estimated short-term and long-term funding needs.

Capital Resources. Middlefield's primary source of capital has been retained earnings. Historically, Middlefield has generated net retained income to support normal growth and expansion. Management has developed a capital planning policy to not only ensure compliance with regulations, but also to ensure capital adequacy for future expansion.

Middlefield is subject to federal regulations imposing minimum capital requirements. Management monitors both Middlefield's and the Bank's Total risk-based, Tier I risk-based and Tier I leverage capital ratios to assess compliance with regulatory guidelines. At December 31, 2002, both Middlefield and the Bank exceeded the minimum risk-based and leverage capital ratio requirements. Middlefield's Total risk-based, Tier I risk-based and Tier I leverage ratios were 16.72%, 15.47%, and 9.42%, and the Bank's were 16.30%, 15.05%, and 9.16%, respectively, at December 31, 2002.

New Accounting Pronouncements

In August 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("FAS") No. 143, *Accounting for Asset Retirement Obligations*, which requires that the fair value of a liability be recognized when incurred for the retirement of a long-lived asset and the value of the asset be increased by that amount. The statement also requires that the liability be maintained at its present value in subsequent periods and outlines certain disclosures for such obligations. The adoption of this statement, which is effective January 1, 2003, is not expected to have a material effect on the Company's financial statements.

In October 2001, the FASB issued FAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. FAS No. 144 supercedes FAS No. 121 and applies to all long-lived assets (including discontinued operations) and consequently amends APB Opinion No. 30, *Reporting Results of Operations – Reporting the Effects of Disposal of a Segment of a Business*. FAS No. 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less costs to sell. FAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and, generally, its provisions are to be applied prospectively. The adoption of this statement did not have a material effect on the Company's financial statements.

In April 2002, the FASB issued FAS No. 145, *Recission of FASB Statement No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. FAS No. 145* rescinds FAS No. 4, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. As a result, the criteria in APB Opinion No. 30 will now be used to classify those gains and losses. This statement also amends FAS No. 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. This statement also makes technical corrections to existing pronouncements, which are not substantive but in some cases may change accounting practice. The provisions of this statement related to the rescission of FAS No. 4 shall be applied in fiscal years beginning after May 15, 2002. Any gain or loss on extinguishments of debt that was classified as an extraordinary item in prior periods presented that does not meet the criteria in APB Opinion No. 30 for classification as an extraordinary item shall be reclassified. Early adoption of the provisions of this statement related to FAS No. 13 shall be effective for transactions occurring after May 15, 2002. All other provisions of this statement shall be effective for financial statements issued on or after May 15, 2002. Early application of this statement is encouraged. The adoption of the effective portions of this statement did not have an impact on the Company's financial position or results of operations. The adoption of the remaining portions of this statement is not expected to have an impact on the Company's financial position or results of operations.

In July 2002, the FASB issued FAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. This statement replaces EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*. The new statement will be effective for exit or disposal activities initiated after December 31, 2002, the adoption of which is not expected to have a material effect on the Company's financial statements.

On October 1, 2002, the FASB issued FAS No. 147, *Acquisitions of Certain Financial Institutions*, effective for all business combinations initiated after October 1, 2002. This statement addresses the financial accounting and reporting for the acquisition of all or part of a financial institution, except for a transaction between two or more mutual enterprises. This statement removes acquisitions of financial institutions, other than transactions between two or more mutual enterprises, from the scope of FAS No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions,* and FASB Interpretation No. 9*, Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*. The acquisition of all or part of a financial institution that meets the definition of a business combination shall be accounted for by the purchase

New Accounting Pronouncements (Continued)

method in accordance with FAS No. 141, *Business Combinations*, and FAS No. 142, *Goodwill and Other Intangible Assets*. This statement also provides guidance on the accounting for the impairment or disposal of acquired long-term customer-relationship intangible assets (such as depositor and borrower-relationship intangible assets and credit cardholder intangible assets), including those acquired in transactions between two or more mutual enterprises. The adoption of this statement is not expected to have a material effect on the Company's financial statements.

On December 31, 2002, the FASB issued FAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, which amends FAS No. 123, *Accounting for Stock-Based Compensation*. FAS No. 148 amends the disclosure requirements of FAS No. 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. Under the provisions of FAS No. 123, companies that adopted the preferable, fair value based method were required to apply that method prospectively for new stock option awards. This contributed to a "ramp-up" effect on stock-based compensation expense in the first few years following adoption, which caused concern for companies and investors because of the lack of consistency in reported results. To address that concern, FAS No. 148 provides two additional methods of transition that reflect an entity's full complement of stock-based compensation expense immediately upon adoption, thereby eliminating the ramp-up effect. FAS No. 148 also improves the clarity and prominence of disclosures about the pro forma effects of using the fair value based method of accounting for stock-based compensation for all companies—regardless of the accounting method used—by requiring that the data be presented more prominently and in a more user-friendly format in the footnotes to the financial statements. In addition, the statement improves the timeliness of those disclosures by requiring that this information be included in interim as well as annual financial statements. The transition guidance and annual disclosure provisions of FAS No. 148 are effective for fiscal years ending after December 15, 2002, with earlier application permitted in certain circumstances. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002.

In November, 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. This interpretation clarifies that a guarantor is required to disclose (a) the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee; (b) the maximum potential amount of future payments under the guarantee; (c) the carrying amount of the liability, if any, for the guarantor's obligations under the guarantee; and (d) the nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amounts paid under the guarantee. This interpretation also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, including its ongoing obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur. The objective of the initial measurement of that liability is the fair value of the guarantee at its inception. The initial recognition and initial measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements in this interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002.

Impact of Inflation and Changing Prices

Middlefield's consolidated financial statements and related data herein have been prepared in accordance with accounting principles generally accepted in the United States of America, which require measurement of financial condition and results of operations in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

Impact of Inflation and Changing Prices (Continued)

Because the primary assets and liabilities of Middlefield and the Bank are monetary in nature, changes in the general level of prices for goods and services have a relatively minor impact on total expenses. Increases in operating expenses such as salaries and maintenance are in part attributable to inflation. However, interest rates have a far more significant effect than inflation on the performance of financial institutions, including the Bank.

Quantitative and Qualitative Disclosures About Market Risk

Like other financial institutions, the Bank is subject to interest rate risk. The Bank's interest-earning assets could mature or reprice more rapidly than or on a different basis from its interest-bearing liabilities (primarily borrowings and deposits with short- and medium-term maturities) in a period of declining interest rates. Although having assets that mature or reprice more frequently on average than liabilities will be beneficial in times of rising interest rates, that asset/liability structure will result in lower net interest income in periods of declining interest rates.

Interest rate sensitivity, or interest rate risk, relates to the effect of changing interest rates on net interest income. Interest-earning assets with interest rates tied to the prime rate for example, or that mature in relatively short periods of time, are considered interest-rate sensitive. Interest-bearing liabilities with interest rates that can be repriced in a discretionary manner, or that mature in relatively short periods of time, are also considered interest-rate sensitive. The differences between interest-sensitive assets and interest-sensitive liabilities over various time horizons are commonly referred to as sensitivity gaps. As interest rates change, a sensitivity gap will have either a favorable effect or an adverse effect on net interest income. A negative gap — with liabilities repricing more rapidly than assets — generally should have a favorable effect when interest rates are falling, and an adverse effect when rates are rising. A positive gap — with assets repricing more rapidly than liabilities — generally should have the opposite effect: an adverse effect when rates are falling and a favorable effect when rates are rising.

Middlefield and the Bank have no financial instruments entered into for trading purposes. Interest rates change daily on federal funds purchased and sold. Federal funds are therefore the most sensitive to the market and have the most stable fair values. Loans and deposits tied to indices such as the prime rate or federal discount rate are also market sensitive, with stable fair values. The least sensitive instruments include long-term, fixed-rate loans and securities and fixed-rate savings deposits, which have the least stable fair value. Management of maturity distributions of assets and liabilities between these extremes is as important as the balances maintained. Management of maturity distributions involves matching interest rate maturities as well as principal maturities, and it influences net interest income significantly. In periods of rapidly changing interest rates, a negative or positive gap can cause major fluctuations in net interest income and earnings. Managing asset and liability sensitivities to enhance growth regardless of changes in market conditions is one of the objectives of the Bank's asset/liability management strategy.

Evaluating the Bank's exposure to changes in interest rates is the responsibility of the Asset/Liability Committee, a committee of Bank directors and officers. The Asset/Liability Committee assesses both the adequacy of the management process used to control interest rate risk and the quantitative level of exposure, ensuring that appropriate policies, procedures, management information systems, and internal controls are in place to maintain interest rate risk at appropriate levels. Evaluating the quantitative level of interest rate risk exposure requires assessment of existing and potential effects of changes in interest rates on the bank's financial condition, including capital adequacy, earnings, liquidity, and asset quality.

The Bank uses a static gap analysis to evaluate the risk associated with changes in interest rates. The table below illustrates the maturities or repricing of the Bank's assets and liabilities at December 31, 2002, based upon the contractual maturity or contractual repricing dates of loans and the contractual maturities of time deposits. Prepayment assumptions have not been applied to fixed-rate mortgage loans. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less. Allocation of deposits other than time deposits to the various maturity and repricing periods is based upon management's best estimate, taking into account, among other things, the proposed policy statement issued by federal bank regulators on August 4, 1995.

	Maturing or Repricing Periods				
(Dollars in thousands)	***Within 3 Months***	***4 - 12 Months***	***1 - 5 Years***	***Over 5 Years***	***Total***
Interest-earning assets:					
Interest-bearing deposits in other institutions	$ 607	$ 27	$ 288	$ 0	$ 922
Investment securities	3,696	17,795	13,907	6,041	41,439
Commercial and industrial loans (1)	9,408	9,657	10,368	3,483	32,916
Real estate construction loans (1)	507	1,598	173	929	3,207
Real estate mortgage loans (1)	26,154	28,551	67,316	11,344	133,365
Consumer installment loans (1)	829	1,464	2,334	828	5,455
Total interest-earning assets	$ 41,201	$ 59,092	$ 94,386	$ 22,625	$ 217,304
Interest-bearing liabilities:					
Interest-bearing demand	$ 577	$ 1,804	$ 4,835	$ 0	$ 7,216
Money market	1,835	5,343	3,483	0	10,661
Savings	3,267	12,791	33,219	0	49,277
Time	16,987	33,456	43,176	0	93,619
Short-term borrowings	786	0	0	0	786
Other borrowings	137	7,853	3,757	3,943	15,690
Total interest-bearing liabilities	$ 23,589	$ 61,247	$ 88,470	$ 3,943	$ 177,249
Interest sensitivity gap	$ 17,612	$ (2,155)	$ 5,916	$ 18,682	$ 40,055
Cumulative interest sensitivity gap	$ 17,612	$ 15,457	$ 21,373	$ 40,055	
Cumulative interest sensitivity gap as a percent of total assets	7.78%	6.83%	9.45%	17.7%	

(1) For purposes of the gap analysis, loans are not reduced by the allowance for loan losses and nonperforming loans.

The Bank's policy is that the one-year cumulative interest rate sensitivity gap should generally be within a range of negative 20% to positive 20%. As the table above shows, the one-year gap was within this range as of December 31, 2002, with a positive one-year gap of 6.83%. The cumulative gap at December 31, 2002 is due principally to fixed-rate securities and loans in the "over one year to five years" category to maximize yield on assets.

One way to minimize interest rate risk is to maintain a balanced or matched interest-rate sensitivity position. However, profits are not always maximized by matched funding. To increase net interest income, the Bank selectively mismatches asset and liability repricing to take advantage of short-term interest rate movements. The magnitude of the mismatch depends on a careful assessment of the risks presented by forecasted interest rate movements. The risk inherent in such a mismatch, or gap, is that interest rates might not move as anticipated.

Interest rate risk exposure is reviewed in quarterly meetings of the Asset/Liability Committee. At each meeting, guidelines are established for the following quarter and longer-term exposure. Risk is mitigated by matching maturities or repricing more closely. The Bank does not use derivative financial instruments to manage interest rate risk.

Limitations are inherent in any method of measuring interest rate risk. Actual results can differ significantly from simulated results if, for example, market conditions and management strategies vary from the assumptions used in the analysis. The static "gap" analysis is based on assumptions concerning such matters as when assets and liabilities will reprice in a changing interest rate environment. Because these assumptions are no more than estimates, certain assets and liabilities indicated as maturing or repricing within a stated period might actually mature or reprice at different times and at different volumes from those estimated. The actual prepayments and withdrawals experienced by the Bank after a change in interest rates could deviate significantly from those assumed in calculating the data shown in the table. Adjustable-rate loans, for example, commonly have provisions that limit changes in interest rates each time the interest rate changes and on a cumulative basis over the life of the loan. Also, the renewal or repricing of some assets and liabilities can be discretionary and subject to competitive and other pressures. The ability of many borrowers to service their debt could diminish after an interest rate increase. Therefore, the gap table above does not and cannot necessarily indicate the actual future impact of general interest movements on net interest income.

Middlefield's use of a simulation model to better measure the impact of interest rate changes on net interest income is incorporated into the risk management process to effectively identify, measure, and monitor Middlefield's risk exposure. Interest rate simulations using a variety of assumptions are employed by Middlefield to evaluate its interest rate risk exposure. A shock analysis at December 31, 2002 indicated that a 200 basis point movement in interest rates in either direction would have had a minor impact on Middlefield's anticipated net interest income and the market value of assets and liabilities over the next 12 months, well within Middlefield's ability to manage effectively.

Market for Middlefield's Common Equity and Related Stockholder Matters

Middlefield had approximately 650 stockholders of record as of March 1, 2003. There is no established market for Middlefield common stock. The stock is traded very infrequently. Bid prices are quoted from time to time on the National Quotation Bureau's "pink sheets" under the symbol "MBCN." The following table shows the high and low bid prices of and cash dividends paid on Middlefield common stock in 2002 and 2001, adjusted for stock splits and stock dividends. This information does not reflect retail mark-up, mark-down or commissions, and does not necessarily represent actual transactions.

	High bid	***Low bid***	***Cash dividends per share***
2002:			
First Quarter	$ 24.83	$ 22.86	$ 0.171
Second Quarter	$ 27.00	$ 23.58	$ 0.180
Third Quarter	$ 34.00	$ 26.15	$ 0.190
Fourth Quarter	$ 34.00	$ 26.30	$ 0.200
2001:			
First Quarter	$ 28.50	$ 24.00	$ 0.133
Second Quarter	$ 28.50	$ 27.50	$ 0.133
Third Quarter	$ 27.50	$ 23.25	$ 0.133
Fourth Quarter	$ 25.50	$ 24.00	$ 0.267

Because Middlefield is dependent on its bank subsidiary for earnings and funds necessary to pay dividends, the ability of Middlefield to pay dividends to its stockholders is subject to bank regulatory restrictions.

A Decade of Progress

	1993	1994	1995
Interest Income	$ 8,628,915	$ 9,512,712	$ 10,336,464
Interest Expense	4,024,735	4,200,784	4,855,690
Net Interest Income	4,604,180	5,311,928	5,480,774
Provision For Loan Losses	180,000	198,000	240,000
Net Interest Income After Provision For Loan Losses	4,424,180	5,113,928	5,240,774
Noninterest Income, Including Security Gains/(Losses)	351,236	327,607	355,149
Noninterest Expense	2,803,010	3,076,058	3,221,651
Income Before Income Taxes	1,972,406	2,365,477	2,374,272
Income Taxes	522,000	651,000	681,660
Net Income	$ 1,450,406	$ 1,714,477	$ 1,692,612
Total Assets	$ 125,229,507	$130,589,544	$ 134,570,716
Deposits	114,808,975	112,082,402	121,247,047
Equity Capital	10,019,887	11,449,463	12,800,762
Loans Outstanding, Net	62,759,415	80,431,585	86,250,549
Allowance For Loan Losses	681,118	811,212	1,067,956
Net Charge-Offs (Recoveries)	21,598	67,906	(16,744)
Full Time Employees (Average Equivalents)	48	50	53
Number Of Offices	Three	Three	Three
Earnings Per Share	$ 1.21	$ 1.43	$ 1.41
Dividends Per Share	0.22	0.24	0.28
Book Value Per Share	8.31	9.50	10.62
Dividend Pay-out Ratio	18.01%	16.62%	19.64%
Cash Dividends Paid	$ 261,159	$ 284,901	$ 332,385
Return On Average Assets	1.28%	1.34%	1.30%
Return On Average Equity	14.51%	14.99%	14.05%

Notes:
(1) The above per share amounts have been restated to reflect the five for one stock split effected in 1995, the 10% stock dividends paid in 1997 and 1998, and the two for one stock split effected in 2000. (2) Applicable income taxes for 1993 are net of cumulative effect of accounting changes for income taxes of $37,995.

	1996	1997	1998	1999	2000	2001	2002
	$ 10,375,117	$ 10,599,777	$ 10,901,445	$ 11,448,619	$ 12,770,170	$ 13,706,569	$ 14,119,963
	4,985,064	5,083,713	5,084,615	5,048,276	5,909,884	6,747,922	6,148,086
	5,390,053	5,516,064	5,816,830	6,400,343	6,860,286	6,958,647	7,971,877
	351,000	200,000	270,000	296,000	275,000	170,000	300,000
	5,039,053	5,316,064	5,546,830	6,104,343	6,585,286	6,788,647	7,671,877
	586,328	546,103	598,771	804,358	982,663	1,194,193	1,143,217
	3,245,926	3,493,280	3,824,819	4,254,374	4,408,617	4,741,374	5,206,339
	2,379,455	2,368,887	2,320,782	2,654,327	3,159,332	3,241,466	3,608,755
	657,000	624,243	630,337	735,318	992,661	970,859	1,107,806
	$ 1,722,455	$ 1,744,644	$ 1,690,445	$ 1,919,009	$ 2,236,671	$ 2,270,607	$ 2,500,949
	$ 133,867,396	$ 142,276,167	$ 155,557,609	$ 165,512,453	$176,488,813	$197,857,964	$226,245,533
	119,254,240	121,482,038	128,827,889	135,094,459	147,166,046	167,382,728	187,384,494
	14,135,561	15,465,255	16,656,797	17,689,055	18,243,362	19,786,807	21,746,408
	83,946,960	88,320,047	102,728,454	119,471,741	133,266,893	150,766,103	172,642,646
	1,138,919	1,334,800	1,538,726	1,756,137	2,037,322	2,062,252	2,300,485
	280,037	4,119	66,074	78,589	(6,185)	145,070	61,767
	53	56	59	61	57	64	66
	Three	Three	Four	Four	Four	Five	Five
	$ 1.43	$ 1.45	$ 1.40	$ 1.60	$ 1.92	$ 1.96	$ 2.16
	0.32	0.36	0.42	0.48	0.51	0.67	0.74
	11.72	12.83	13.81	14.75	15.75	17.09	18.80
	22.61%	24.98%	29.53%	29.82%	26.61%	33.94%	34.47%
	$ 389,365	$ 435,747	$ 499,215	$ 572,343	$ 595,255	$ 772,068	$ 857,751
	1.29%	1.23%	1.15%	1.21%	1.31%	1.22%	1.17%
	12.21%	11.67%	10.43%	11.17%	12.83%	11.89%	12.08%

Annual

Report

2002

Chardon *(Drive Up ATM)*
348 Center Street • P.O. Box 1078 • Chardon, Ohio 44024
888-801-1666 • 440-286-1222 • Fax 440-286-1111

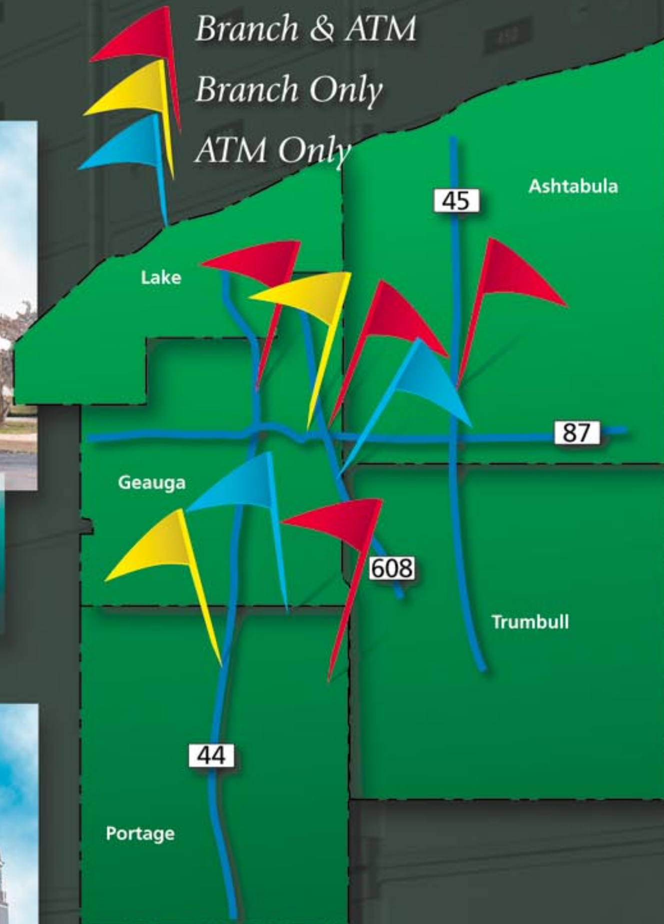
Garrettsville *(Drive Up ATM)*
8058 State Street • Garrettsville, Ohio 44231
888-801-2121 • 330-527-2121 • Fax 330-527-4210

Mantua
10519 South Main Street • P.O. Box 648 • Mantua, Ohio 44255
877-274-0881 • 330-274-0881 • Fax 330-274-0883

Middlefield Banc Corp.

Middlefield – West Branch

15545 W. High Street • P.O. Box 35 • Middlefield, Ohio 44062
888-801-1666 • 440-632-1666 • Fax 440-632-9781



Middlefield – Main Office *(Walk Up ATM)*

15985 E. High Street • P.O. Box 35 • Middlefield, Ohio 44062
888-801-1666 • 440-632-1666 • Fax 440-632-1700

ATM Locations –

Hiram College, Kennedy Center, Main Entrance, 11730 Garfield Avenue, Hiram, Ohio 44234

Kraftmaid Cabinentry, 15535 South State Street, Middlefield, Ohio 44062 (limited access)

New Branch Under Construction –

Orwell • 30 South Maple Avenue, P.O. Box 66 Orwell, Ohio 44076, (Drive Up ATM), 888-801-1666 • 440-437-7200 • Fax 440-437-1111

Our Locations

mbc

Staff

Main Office:

Karen Westover – 1983 – Head Teller
Louise Fenselon – 1984 – Teller
Bonnie Steele – 1985 – Customer Services
Diana Koller – 1998 – Teller
Summer Phillips – 1999 – Customer Services
*Elizabeth Pixley – 2001 – Teller**
Monica Szilagyi – 2001 – Teller
Amanda Wright – 2001 – Teller
*Rachel Strong – 2002 – Receptionist**
*Karah Vance – 2002 – Teller**
*Lauralyn Holmes – 2003 – Teller**
*Cathy Knippenberg – 2003 – Teller**

West Branch:

Patti Russo – 1982 – Customer Services
Rachel Lilly – 1985 – Head Teller
Kelly Gibney – 1987 – Teller
*Lori Sheridan – 2000 – Teller**
Stacy Siracki – 2000 – Teller
Lisa Sanborn – 2000 – Teller
Ellen Wilson – 2001 – Teller
*Jenni Trask – 2002 – Teller**

Garrettsville:

*Marian Nichols – 1986 – Teller**
Kathy Vanek – 1998 – Customer Services
*Colleen Steele – 1998 – Teller**
Vickie Moss – 1998 – Teller
Michelle Lutz – 2001 – Teller
*Jennifer Hoffman – 2001 – Teller**
*Jeremy Bailey – 2001 – Teller**
Janis Pollack – 2002 – Teller

Mantua:

Sara Hedge – 2000 – Teller
Robin Morris – 2002 – Teller
*Rebecca Reinard – 2002 – Teller**
Joan Sweet – 2002 – Branch Supervisor

Chardon:

Amanda Miller – 2001 – Teller
*Gretchen Mihalic – 2001 – Teller**
Karen Graham – 2002 – Teller
*Sarah Thompson – 2002 – Teller**

Orwell:

Pamela Hummel – 1999 – Teller
Jessica Osburn – 2001 – Customer Services
Alyssa Lipps – 2003 – Teller
Sharon Clements – 2003 – Branch Manager
*Diane Giel – 2003 – Teller**

Loan Department:

Helen Stowe – 1985 – Loan Administrative Assistant
Carole Triplett – 1993 – Loan Administrative Assistant
Jennifer Sponseller – 1997 – Loan Administrative Assistant
Jane Armstrong – 1998 – Loan Collection Manager
Vivian Helmick – 1998 – Loan Administrative Assistant
Carolyn Fackler – 2001 – Loan Administrative Assistant
Melissa Clark – 2002 – Loan Administrative Assistant

Operations:

Pamela Malcuit – 1989 – Bookkeeper
Donna Williams – 1990 – Bookkeeper
*Lauren Harth – 1995 – Audit Clerk**
Tara Morgan – 1997 – Proof Operator
Derrick Pilarczyk – 1999 – Facility Maintenance
Ashley Durst – 2001 – Bookkeeper
Kristina McGuire – 2001 – Network Support

Officers

Thomas G. Caldwell – 1986
President and Chief Executive Officer

James R. Heslop, II – 1996
Executive Vice President and
Chief Operating Officer

Teresa M. Hetrick – 1996
Senior Vice President
Operations/Administration

Jay P. Giles – 1998
Senior Vice President
Senior Commercial Lender

Donald L. Stacy – 1999
Senior Vice President
Chief Financial Officer

Nancy C. Snow – 1979
Vice President and Corporate Secretary
and West Branch Manager

Kathleen M. Johnson – 1971
Vice President
Chief Accounting Officer

Jack L. Lester – 1990
Vice President
Compliance and Security Officer

Joann Vance – 1986
Vice President
Garrettsville Branch Manager

Alfred F. Thompson, Jr. – 1996
Vice President
Senior Retail Lender

William L. Douglass – 1997
Vice President/Lending

R. E. West – 1998
Vice President
Main Office Manager

Sharon R. Jarold – 2001
Vice President/Lending

Edward F. Kent – 2002
Vice President/Lending

Gail Neikirk – 1983
Assistant Vice President

Karen Branhan – 1983
Assistant Vice President

Christine A. Polzer – 1989
Network Administrator

Thomas R. Neikirk – 1994
Banking Officer

Lori A. Graham – 1998
Banking Officer
Chardon Branch Supervisor

Marlin J. Moschell – 2000
Banking Officer

Directors

Donald D. Hunter – 1977
Chairman
Co-Owner: H&H Hardware, Inc.

Donald E. Villers – 1987
Retired: Copperweld Steel

Thomas C. Halstead – 1988
Co-Owner: Settlers' Farm

George F. Hasman – 1989
Retired: Chairman & President of
The Twinsburg Banking Company

Frances H. Frank – 1995
Secretary/Treasurer
The Frank Agency, Inc.

Thomas G. Caldwell – 1997
President and Chief Executive Officer
Middlefield Banc Corp.
The Middlefield Banking Company

Richard T. Coyne – 1997
General Manager
Jaco Products

Martin S. Paul – 1998
Vice President
Paul's Lumber

James R. Heslop, II – 2001
Executive Vice President &
Chief Operating Officer
Middlefield Banc Corp.
The Middlefield Banking Company

James J. McCaskey – 2003
Senior Vice President
Pattie Group, Inc.

Carolyn J. Turk, C.P.A. – 2003
Regional Controller
Molded Fiber Glass Companies

Staff & Directors

Corporate Headquarters

The Corporation's headquarters is located at:

Middlefield Banc Corp.
15985 East High Street
P. O. Box 35
Middlefield, Ohio 44062
(440) 632 - 1666
(888) 801 – 1666

Form 10-K And 10-Q Availability

A copy of Middlefield Banc Corp.'s Annual Report on Form 10-K and Quarterly Reports on 10-Q filed with the Securities and Exchange Commission will be furnished to any shareholder, free of charge, upon written or e-mail request to:

Donald L. Stacy
Treasurer and CFO
Middlefield Banc Corp.
P. O. Box 35
Middlefield, Ohio 44062
or
dstacy@middlefieldbank.com

Stock Trading

The symbol for Middlefield Banc Corp. common stock is MBCN and the CUSIP is 596304204.

Sweney Cartwright & Co.
George Geissbuhler
17 South High Street
Columbus, Ohio 43215
(614) 228-5391
(800) 334-7481

Robert W. Baird & Co., Inc.
Rolly Rastetter &
Richard W. Comstock
3875 Embassy Parkway,
Suite 300
Akron, Ohio 44333
(330) 670-0350
(877) 792-7868

Notice Of Annual Meeting

The Annual Meeting of Shareholders of Middlefield Banc Corp. will be held at 1:00 p.m. on Wednesday, May 14, 2003, at Grandview Inn, 13404 Old State Road, Middlefield, Ohio.

Transfer Agent And Registrar

The Middlefield Banking Company
Shareholder Relations Department
P. O. Box 35
Middlefield, Ohio 44062

Independent Auditors

S. R. Snodgrass, A. C.
1000 Stonewood Drive, Suite 200
Wexford, Pennsylvania 15090-8399
(724) 934-0344

Internet Information

Information on The Middlefield Banking Company's products and services is available on the Internet at www.middlefieldbank.com.

Dividend Payment Dates

Subject to action by the Board of Directors, Middlefield Banc Corp. will pay dividends in March, June, September, and December.

Dividend Reinvestment And Stock Purchase Plan

Shareholders may elect to reinvest their dividends in additional shares of Middlefield Banc Corp.'s common stock through the company's Dividend Reinvestment Plan. To arrange automatic purchase of shares with quarterly dividend proceeds, please call 1-888-801-1666.

Direct Deposit Of Dividends

The direct deposit program, which is offered at no charge, provides for automatic deposit of quarterly dividends directly to a checking or savings account with The Middlefield Banking Company. For information regarding this program, please call 1-888-801-1666.

Shareholder Information

The Middlefield Banking Company

Main Office
15985 East High Street
440-632-1666

West Branch
15545 West High Street
440-632-1666

Garrettsville
8058 State Street
330-527-2121

Mantua
10519 South Main Street
330-274-0881

Chardon
348 Center Street
440-286-1222

Orwell
30 South Maple Street
440-437-7200

Middlefield Banc Corp.

15985 East High Street • Middlefield, Ohio • 440-632-1666
www.middlefieldbank.com

And Its Wholly-Owned Subsidiary