

FEDERAL DEPOSIT INSURANCE CORPORATION  
WASHINGTON, DC 20429

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

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

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

FDIC Certificate Number: 19101

HARFORD BANK

(Name of registrant as specified in its charter)

Maryland

(State or other jurisdiction of organization)

52-0799113

(IRS Employer incorporation or Identification No.)

8 West Bel Air Avenue, Aberdeen, Maryland 21001

(Address of principal executive offices)

(410) 272-5000

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Accelerated filer

Smaller reporting company

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date 1,055,725 shares of common stock as of November 2, 2011.

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

## **PART I**

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

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

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

The following discussion should be read and reviewed in conjunction with the interim financial statements and the notes thereto included elsewhere in this report, and with Management's Discussion and Analysis of Financial Condition and Results of Operation, the audited financial statements and notes thereto, and the other statistical information contained in the Bank's Annual Report on Form 10-K for the year ended December 31, 2010.

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

## **APPLICATION OF CRITICAL ACCOUNTING POLICIES**

The Bank's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the industry in which the Bank operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

The most significant accounting policies followed by the Bank are presented in Note 1 to the financial statements appearing elsewhere in this report. These policies, along with the disclosures presented in the other notes to the financial statements and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions,

and estimates underlying those amounts, management has identified the determination of the allowance for loan losses as the accounting area that requires the most subjective or complex judgments, and as such may be most subject to revision as new information becomes available.

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

## **RESULTS OF OPERATIONS**

### **Summary**

For the three-month period ended September 30, 2011, the Bank reported net income of \$666,512, compared to \$525,498 for the same period last year, representing an increase of \$141,014 or 26.8%. Net income for the nine months ended September 30, 2011 was \$1,457,728, compared to \$1,534,464 for the same period of 2010, representing a decrease of \$76,736 or 5.0%. Basic net income per share for the three- and nine-month periods ended September 30, 2011 was \$.63 and \$1.39, respectively, compared to \$.50 and \$1.49, respectively, for the same periods in 2010.

Return on average assets was .70% for the nine-month period ended September 30, 2011, compared to .77% for the same period in 2010. Return on average stockholders' equity for the nine months ended September 30, 2011 was 7.37%, compared to 8.07% for the nine months ended September 30, 2010. Comparing the nine months ended September 30, 2011 to the same period in 2010, average assets increased 5.52% to \$278,746,372, average net loans increased 0.01% to \$213,900,565, average deposits increased 7.10% to \$222,914,558 and average stockholders' equity increased 5.58% to \$26,771,859.

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

The primary source of income for the Bank is net interest income, which is the difference between revenue on interest-earning assets, such as investment securities and loans, and interest paid on interest-bearing liabilities, such as deposits and borrowings. The level of net interest income is determined primarily by the average balances of interest-earning assets and of interest-bearing liabilities, and by the various interest rate spreads between such assets and liabilities. The table below entitled "Average Balances, Interest, and Yields" shows the Bank's average volume of interest-earning assets and interest-bearing liabilities for the three- and nine- month periods ended September 30, 2011 and 2010 and related income/expense and yields. Changes in net interest income from period to period result from increases or decreases in the volumes of interest-earning assets and interest-bearing liabilities, and increases or decreases in the average rates earned and paid on such assets and liabilities. The volumes of interest-earning assets and interest-bearing liabilities are affected by management's ability to effectively and efficiently manage the earning-asset portfolio (which includes loans), and the availability of particular sources of funds, such as non-interest bearing deposits.

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

	For the three months ended September 30, 2011			For the three months ended September 30, 2010			For the nine months ended September 30, 2011			For the nine months ended September 30, 2010		
	Average balance	Interest	Yield	Average balance	Interest	Yield	Average balance	Interest	Yield	Average balance	Interest	Yield
<b>Assets</b>												
Federal funds sold	\$ 5,732,847	\$ 2,248	0.16%	\$ 10,286,926	\$ 6,017	0.23%	\$ 8,671,060	\$ 11,938	0.18%	\$ 5,975,168	\$ 10,455	0.23%
FRB interest bearing deposits	412,806	386	0.37%	770,460	595	0.31%	620,555	1,436	0.31%	1,257,290	2,230	0.24%
FHLB interest bearing deposits	413,810	27	0.03%	1,326,949	439	0.13%	408,433	153	0.05%	618,075	565	0.12%
Investment CDs	-	-	-	-	-	0.00%	-	-	-	468,249	3,461	0.99%
Other	1,732,230	3,220	0.74%	1,887,012	4,597	0.97%	1,751,946	12,591	0.96%	1,947,354	7,357	0.51%
Investment securities:												
U.S. Treasury Notes	2,100,962	5,069	0.96%	2,103,638	5,615	1.06%	2,101,629	15,097	0.96%	2,104,294	15,097	0.96%
U.S. government agency securities	13,411,747	35,629	1.05%	18,653,852	85,694	1.82%	12,149,268	83,963	0.92%	13,621,937	230,211	2.26%
GNMA MBS	4,386,173	26,803	2.42%	2,352,915	16,838	2.84%	4,580,488	80,878	2.36%	792,924	16,838	2.84%
SBA ABS	7,604,831	82,978	4.33%	1,180,215	12,607	4.24%	6,272,981	181,492	3.87%	397,728	12,607	4.24%
State and municipal	3,779,635	11,711	1.23%	1,852,491	12,036	2.58%	3,729,084	36,487	1.31%	1,507,380	29,493	2.62%
Total investment securities	31,283,348	162,190	2.06%	26,143,111	132,790	2.02%	28,833,450	397,917	1.85%	18,424,263	304,246	2.21%
Loans:												
Overdrafts	183,121	-	-	285,941	-	-	212,666	-	-	248,553	-	0.00%
Personal loans	19,715,127	346,229	6.97%	21,316,867	359,819	6.70%	19,817,852	1,027,335	6.93%	21,250,757	1,092,170	6.87%
Credit lines	9,159,739	79,965	3.46%	8,730,970	74,878	3.40%	8,857,922	226,752	3.42%	8,448,670	213,031	3.37%
Business loans	27,605,915	404,279	5.81%	26,062,561	381,876	5.81%	27,036,308	1,192,388	5.90%	25,892,122	1,137,574	5.87%
Real estate loans	163,826,536	2,709,179	6.56%	162,123,322	2,685,145	6.57%	160,470,348	7,938,894	6.61%	160,946,750	7,913,787	6.57%
Total loans	220,490,438	3,539,652	6.37%	218,519,661	3,501,718	6.36%	216,395,096	10,385,369	6.42%	216,786,852	10,356,562	6.39%
Allowance for loan losses	(2,489,496)	-	-	(3,151,177)	-	0.00%	(2,494,531)	-	-	(2,903,797)	-	0.00%
Total loans, net of allowance	218,000,942	3,539,653	6.44%	215,368,484	3,501,718	6.45%	213,900,565	10,385,369	6.49%	213,883,055	10,356,562	6.47%
Total interest-earning assets	257,575,983	\$3,707,722	5.71%	255,782,942	\$ 3,646,156	5.66%	254,186,009	\$10,809,404	5.69%	242,573,454	\$10,681,415	5.89%
Noninterest-bearing cash	5,808,453			5,847,695			5,730,313			5,975,670		
Premises and equipment	8,911,005			8,018,217			8,939,599			7,904,829		
Restricted stock	110,000			100,000			112,015			100,000		
Other assets	9,335,869			7,414,405			9,778,436			7,608,609		
Total assets	\$281,741,310			\$ 277,163,259			\$ 278,746,372			\$ 264,162,562		
<b>Liabilities and Stockholders' Equity</b>												
Interest-bearing Deposits												
NOW deposits	\$ 29,912,774	\$ 9,561	0.13%	\$ 23,723,125	\$ 7,950	0.13%	\$ 27,975,500	\$ 26,564	0.13%	\$ 21,509,995	\$ 22,870	0.14%
Savings	24,114,220	16,404	0.27%	22,209,645	16,794	0.30%	23,663,045	51,217	0.29%	22,032,689	49,403	0.30%
Money market	29,180,571	23,449	0.32%	30,674,276	59,494	0.77%	29,694,371	100,571	0.45%	26,568,473	170,284	0.86%
Personal investment	18,363,450	15,773	0.34%	16,307,834	30,564	0.74%	18,411,085	61,652	0.45%	15,358,975	97,459	0.85%
Time deposits	88,628,849	345,170	1.55%	93,281,248	477,081	2.03%	87,807,436	1,094,147	1.67%	89,563,978	1,466,901	2.19%
Total interest-bearing deposits	190,199,864	410,357	0.86%	186,196,128	591,883	1.26%	187,551,437	1,334,151	0.95%	175,034,110	1,806,917	1.38%
Noninterest-bearing deposits	35,198,443	-	0.00%	35,558,972	-	0.00%	35,363,121	-	-	33,110,575	-	0.00%
Total deposits	225,398,307	410,357	0.72%	221,755,100	591,883	1.06%	222,914,558	1,334,151	0.80%	208,144,685	1,806,917	1.16%
FHLB long term borrowing	28,000,000	240,554	3.41%	28,531,056	246,119	3.42%	28,036,107	716,324	3.42%	28,784,929	734,073	3.41%
Borrowed overnight funds	32,609	29	-	-	-	-	10,989	29	-	729,304	2,261	0.41%
Total borrowed funds	28,032,609	240,583	3.40%	28,531,056	246,119	3.42%	28,047,096	716,353	3.41%	29,514,233	736,334	3.34%
Total deposits and interest-bearing funds	253,430,916	\$ 650,940	1.02%	250,286,156	\$ 838,002	1.33%	250,961,654	\$ 2,050,504	1.09%	237,658,918	\$ 2,543,251	1.43%
Other liabilities	1,164,034			1,116,947		0.00%	1,012,859			1,146,215		
Stockholders' equity	27,146,360			25,760,156			26,771,859			25,357,429		
Total liabilities and stockholders' equity	\$281,741,310			\$ 277,163,259			\$ 278,746,372			\$ 264,162,562		
Net interest spread			4.69%			4.33%			4.59%			4.46%
Net interest income		\$3,056,782			\$ 2,808,154			\$ 8,758,900			\$ 8,138,164	
Net margin on interest-earning assets			4.71%			0			4.61%			4.49%

Interest and dividends on securities and loans are reported on fully taxable equivalent basis.

Non accrual loan balances are included in loan and interest earning asset balances.

## Net Interest Income and Net Interest Margin (continued)

Interest revenue on a fully taxable equivalent basis for the three- and nine-month periods ended September 30, 2011 was \$3,707,722 and \$10,809,404, respectively, compared to \$3,646,156 and \$10,681,415, respectively, for the same periods in 2010, representing increases of \$61,566 or 1.69%, and \$127,989 or 1.20%, respectively. Average net loan volume for the three- and nine-month periods ended September 30, 2011 increased 1.22% and 0.01%, respectively, when compared to the same periods in 2010. The weighted average rate received on the Bank's loan portfolio on a fully taxable equivalent basis increased 1 basis point to 6.37% for the third quarter of 2011 and 3 basis points to 6.42% for the first nine months of 2011 when compared to the same periods in 2010. Interest revenue on a fully taxable equivalent basis for federal funds sold, investment certificate of deposits, and interest-bearing deposits in the Federal Home Loan Bank (the "FHLB") of Atlanta and the Federal Reserve Bank decreased \$4,390, or 62.26%, and \$3,184, or 19.05%, for the three- and nine-month periods ended September 30, 2011, respectively, when compared to the same periods in 2010. Average balances for these instruments decreased \$5,824,872, or 47.03%, for the third quarter of 2011, and increased \$1,381,266, or 16.60%, for the nine-month period ended September 30, 2011 when compared to the same periods in 2010. The weighted average rate received on these investments on a fully taxable equivalent basis decreased 0.06% and 0.08% for the three- and nine-month periods ended September 30, 2011, respectively, when compared to the same periods in 2010.

The average balance of investment securities for the three- and nine-month periods ended September 30, 2011 increased 19.66% and 56.50%, respectively, over the same periods in 2010. Interest revenue on these investments on a tax equivalent basis for the three- and nine-month periods ended September 30, 2011 increased \$29,400 or 22.14%, and \$93,671 or 30.79%, respectively, over the same periods in 2010. The revenue increase for the third quarter of 2011 over the same quarter of last year was mainly attributable to an increase in the portfolio balance and an increase of 0.04% in the weighted average rates received. For the nine months ended September 30, 2011, the revenue increase over the prior year period was mainly attributable to an increase in the portfolio balance, offset by a 0.24% decrease in the weighted average rates received. The Bank is a member of the FHLB of Atlanta and is required to purchase capital stock of the FHLB of Atlanta as a condition to obtaining a line of credit. For the three- and nine-months ended September 30, 2011, the Bank recorded dividends on FHLB of Atlanta stock in the amount of \$3,220 and \$12,591, respectively, on a fully taxable equivalent basis, compared to \$4,597 and \$7,357, respectively, for the same periods in 2010.

During the three- and nine-month periods ended September 30, 2011, the average balance of interest-bearing deposits increased 2.15% and 7.15%, respectively, while the weighted average rate paid on these deposits decreased 40 basis points and 43 basis points, respectively, resulting in respective decreases in interest expense of \$181,526 and \$472,766 when compared to the same periods in 2010. The average balance of FHLB borrowed funds decreased 1.75%, or \$498,447, and 4.97%, or \$1,467,137, for the three- and nine-month periods ended September 30, 2011, respectively, when compared to the same periods in 2010.

The key performance measure for net interest income is the "net margin on interest-earning assets," or net interest income divided by average interest-earning assets. The Bank's net interest margin on a fully taxable equivalent basis increased 35 basis points to 4.71% for the quarter ended September 30, 2011, and increased 12 basis points to 4.61% for the nine-month period ended September 30, 2011 when compared to the same periods in 2010. The net margin may be adversely affected by increases in competition, volatile interest rates, decreases in loan demand, and the Bank's cost of funds where it outpaces the return on the Bank's loans and investment securities, and other unpredictable changes in the marketplace. The net interest spread is the rate earned on interest earning assets less the rate paid on interest bearing liabilities. The spread increased 36 basis points to 4.69% for the three months ended September 30, 2011, and increased 13 basis points to 4.59% for the nine months ended September 30, 2011 when compared to the same periods in 2010.

### Noninterest Revenue

Noninterest revenue for the three- and nine-month periods ended September 30, 2011 was \$393,996 and \$1,150,170, respectively, compared to \$355,677 and \$1,111,890, respectively, for the same periods in 2010, representing respective increases of \$38,319 and \$38,280. Other commission and fees for the three- and nine-month periods ended September 30, 2011 were \$94,497 and \$281,717, respectively, compared to \$80,660 and \$246,498, respectively, for the same periods in 2010, representing respective increases of \$13,837 and \$35,219.

Service charges and other deposit related fees for the three- and nine-month periods ended September 30, 2011 were \$263,071 and \$758,495, respectively, compared to \$237,817 and \$753,605, respectively, for the same periods in 2010, representing respective increases of \$25,254 and \$4,890.

### Noninterest Expenses

Noninterest expenses for the three- and nine-month periods ended September 30, 2011 were \$2,071,547 and \$6,639,449, respectively, compared to \$1,902,203 and \$5,852,237, respectively, for the same periods in 2010, representing respective increases of \$169,344 and

\$787,212. Comparing the third quarter of 2011 to the third quarter of 2010, the increased noninterest expenses were mainly attributable to increased write-downs on foreclosed real estate of \$16,510 and increased salary and benefit expense of \$78,064. The increase in noninterest expense for the first nine months of 2011 when compared to the same period of 2010 resulted primarily from increased write-downs on foreclosed real estate of \$380,880, a \$50,000 other than temporary impairment charge on restricted stock investment, and a \$228,314 increase in salary and benefit expense.

#### **Income Tax Expense**

Income tax expense for the three-month period ended September 30, 2011 was \$444,949, representing a \$167,324 increase over the \$277,625 expense recorded for the same period of 2010. Income tax expense for the first nine months of 2011 was \$768,497, compared to \$808,334 for the same period last year, representing a decrease of \$39,837. The differences were mainly attributable to an increase in pretax earnings for the three-month period and a decrease in pretax earnings for the nine-month period ended September 30, 2011 when compared to same periods in 2010. The Bank's effective tax rate was 34.5% for both the nine-month period ended September 30, 2011 and the nine-month period ended September 30, 2010.

## FINANCIAL CONDITION

### Assets

Total assets at September 30, 2011 increased \$7,662,423, or 2.8%, to \$284,356,189 from \$276,693,766 at December 31, 2010.

The Bank invests excess cash balances in interest-bearing accounts at other banks and federal funds sold to correspondent banks. These balances decreased \$4,495,038 to \$6,709,356 at September 30, 2011 from \$11,204,394 at December 31, 2010.

The balance of investment securities at September 30, 2011 was \$29,769,973, an increase of \$3,093,759 from investments at December 31, 2010.

### Loans

Loans, net of the allowance for loan losses, increased \$8,863,362, or 4.2%, to \$221,057,227 at September 30, 2011 from \$212,193,865 at December 31, 2010. The average net loan portfolio represented 84.15% of average earning assets for the nine-month period ended September 30, 2011, compared to 88.17% for the same period in 2010.

The following table sets forth the major classifications of the Bank's loan portfolio:

	<u>September 30, 2011</u>		<u>December 31, 2010</u>	
	<u>Amount</u>	<u>% of total</u>	<u>Amount</u>	<u>% of total</u>
Real estate				
Construction and land development	\$ 15,139,721	6.78%	\$ 13,794,715	6.41%
Secured by farmland	3,054,923	1.37%	2,811,032	1.31%
Residential	58,540,364	26.20%	58,437,061	27.20%
Commercial	109,570,710	49.04%	102,598,028	47.75%
Commercial	16,336,659	7.31%	15,985,503	7.44%
Lease financing	233,069	0.10%	445,276	0.21%
Consumer	20,573,820	9.20%	20,807,251	9.68%
	<u>223,449,266</u>	100.00%	<u>214,878,866</u>	100.00%
Deferred fees, net of costs	(233,610)		(209,235)	
Allowance for loan losses	<u>(2,158,429)</u>		<u>(2,475,766)</u>	
	<u>\$ 221,057,227</u>		<u>\$ 212,193,865</u>	

### Off-Balance Sheet Arrangements

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

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. Further information about these arrangements is provided in Note 5 to the financial statements included elsewhere in this report.

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

## Credit Risk Management

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

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

The provision for loan losses for the three-month period ended September 30, 2011 was \$230,000, which was \$145,000 less than the \$375,000 recorded for the same period of 2010. The provision for loan losses for the first nine months of 2011 was \$885,000, compared to \$850,000 for the same period of last year. The differences between the 2011 and 2010 periods resulted primarily from management's assessment of the current market conditions and analysis of inherent risk within the loan portfolio. The "Allowance for Loan Losses to Total Loans" ratio for the nine-month period ended September 30, 2011 decreased to 0.97% from 1.15% at December 31, 2010. The decrease relates primarily to the charge-off of impaired loans during the quarter.

The adequacy of the allowance for loan losses is determined based upon management's estimate of the inherent risks associated with lending activities, estimated fair value of collateral, past experience and present indicators such as loan delinquency trends, nonaccrual loans and current market conditions. Management believes that the allowance is adequate as of September 30, 2011; however, future changes in the composition of the loan portfolio and financial condition of borrowers may result in additions to the allowance. Examination of the portfolio and allowance by regulatory agencies and consultants engaged by the Bank may result in the need for additional provisions based upon information available at the time of examination.

## Credit Risk Management (continued)

The following table presents allowance for loan losses activity allocated by loan class for the nine- and twelve-month periods ended September 30, 2011 and December 31, 2010, respectively, and the allocation of allowance for loan losses and the balances of loans that were individually and collectively evaluated for impairment at September 30, 2011 and December 31, 2010.

	Unallocated	Commercial	Residential Real Estate	Farmland & Commercial Real Estate	Construction and Land Development	Personal	Mobile Homes	Overdraft Lines	Total
<b>September 30, 2011</b>									
Allowance for Credit Losses									
Beginning balance	\$ -	\$ 273,676	\$ 463,921	\$ 1,287,577	\$ 375,299	\$ 12,929	\$ 59,852	\$ 2,512	\$ 2,475,766
Charge-offs	-	(37,464)	(65,419)	-	(1,023,873)	(23,748)	(63,761)	(7,373)	(1,221,637)
Recoveries	-	15,000	-	-	-	945	1,914	1,441	19,300
Provision	18	(58,529)	(268,283)	11,495	1,088,060	26,242	76,137	9,861	885,000
Ending balance	\$ 18	\$ 192,683	\$ 130,219	\$ 1,299,072	\$ 439,486	\$ 16,368	\$ 74,142	\$ 6,441	\$ 2,158,429
Allowance balance allocated to:									
Loans individually									
evaluated for impairment	\$ -	\$ 67	\$ 12,383	\$ 79,261	\$ 201,751	\$ -	\$ 3,029	\$ -	\$ 296,491
Loans collectively									
evaluated for impairment	18	192,616	117,836	1,219,811	237,735	16,368	71,113	6,441	1,861,938
	\$ 18	\$ 192,683	\$ 130,219	\$ 1,299,072	\$ 439,486	\$ 16,368	\$ 74,142	\$ 6,441	\$ 2,158,429
Loan balance:									
Individually evaluated for impairment		\$ 47,388	\$ 1,832,180	\$ 6,510,827	\$ 1,155,354	\$ -	\$ 212,346	\$ -	\$ 9,758,095
Collectively evaluated for impairment		\$ 15,309,812	\$ 56,708,184	\$ 106,114,806	\$ 13,984,367	\$ 4,276,669	\$ 13,555,368	\$ 21,258	\$ 209,970,464
<b>December 31, 2010</b>									
Allowance for Credit Losses									
Beginning balance	\$ 15,052	\$ 272,408	\$ 579,486	\$ 1,149,115	\$ 510,924	\$ 3,881	\$ 58,622	\$ 4,324	\$ 2,593,812
Charge-offs	-	(750,744)	(475,424)	-	-	(46,283)	(73,385)	(9,912)	(1,355,748)
Recoveries	-	12,145	-	-	-	-	-	557	12,702
Provision	(15,052)	739,867	359,859	138,462	(135,625)	55,331	74,615	7,543	1,225,000
Ending balance	\$ -	\$ 273,676	\$ 463,921	\$ 1,287,577	\$ 375,299	\$ 12,929	\$ 59,852	\$ 2,512	\$ 2,475,766
Ending balance allocated to:									
Loans individually									
evaluated for impairment	\$ -	\$ 5,146	\$ 79,724	\$ 335,296	\$ 299,874	\$ -	\$ -	\$ -	\$ 720,040
Loans collectively									
evaluated for impairment	-	268,530	384,197	952,281	75,425	12,929	59,852	2,512	1,755,726
	\$ -	\$ 273,676	\$ 463,921	\$ 1,287,577	\$ 375,299	\$ 12,929	\$ 59,852	\$ 2,512	\$ 2,475,766
Loan balance:									
Individually evaluated for impairment		\$ 25,731	\$ 1,028,743	\$ 4,333,498	\$ 1,110,409	\$ -	\$ -	\$ -	\$ 6,498,381
Collectively evaluated for impairment		\$ 14,680,700	\$ 57,408,320	\$ 102,928,156	\$ 12,684,306	\$ 4,807,038	\$ 13,919,137	\$ 20,744	\$ 206,448,401

## Risk Elements of Loan Portfolio

The following table analyzes the age of Past Due Loans at September 30, 2011 and December 31, 2010:

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 days	Total Past Due	Current	Total Loans	Loans over 90 Days and Accruing
<b>2011</b>							
Residential real estate	\$ 659,110	\$ 1,492,873	\$ 894,312	\$ 3,046,295	\$ 55,494,069	\$ 58,540,364	\$ -
Commercial real estate	588,439	2,240,374	376,998	3,205,811	109,419,822	112,625,633	376,998
Construction and land development	-	552,409	711,648	1,264,057	13,875,664	15,139,721	-
Commercial loans	30,700	-	-	30,700	16,539,028	16,569,728	-
Consumer-mobile homes	420,147	88,157	137,238	645,542	13,156,516	13,802,058	137,238
Consumer-other	277,126	-	-	277,126	6,494,636	6,771,762	-
	<u>\$ 1,975,522</u>	<u>\$ 4,373,813</u>	<u>\$ 2,120,196</u>	<u>\$ 8,469,531</u>	<u>\$ 214,979,735</u>	<u>\$ 223,449,266</u>	<u>\$ 514,236</u>
<b>2010</b>							
Residential real estate	\$ 1,230,473	\$ 305,829	\$ 494,893	\$ 2,031,195	\$ 56,405,866	\$ 58,437,061	\$ -
Commercial real estate	1,226,947	0	0	1,226,947	104,182,113	105,409,060	-
Construction and land development	2,148,484	-	-	2,148,484	11,646,231	13,794,715	-
Commercial loans	49,756	25,731	-	75,487	16,355,292	16,430,779	-
Consumer-mobile homes	494,013	250,315	35,686	780,014	13,139,123	13,919,137	35,686
Consumer-other	60,626	-	-	60,626	6,827,488	6,888,114	-
	<u>\$ 5,210,299</u>	<u>\$ 581,875</u>	<u>\$ 530,579</u>	<u>\$ 6,322,753</u>	<u>\$ 208,556,113</u>	<u>\$ 214,878,866</u>	<u>\$ 35,686</u>

The following table summarizes nonaccrual loans and other non-performing assets for the periods indicated:

<b>Non-performing Assets</b>	<b>At, and year to date through September 30, 2011</b>	<b>At, and year to date through December 31, 2011</b>
<b>Non-accrual loans by loan class:</b>		
Residential real estate	\$ 1,359,758	\$ 901,742
Commercial real estate	-	-
Construction and land development	1,264,057	-
Commercial loans	-	-
Consumer-mobile homes	35,000	49,484
Consumer-other	-	-
<b>Total non-accrual loans</b>	<b>2,658,815</b>	<b>951,226</b>
Foreclosed real estate	1,686,274	2,639,000
<b>Total non-performing assets</b>	<b>\$ 4,345,089</b>	<b>\$ 3,590,226</b>
<b>Interest not accrued on nonaccrual loans</b>	<b>\$ 127,910</b>	<b>\$ 60,806</b>

The table below shows troubled debt restructured loans by classification at the respective dates.

	<u>September 30, 2011</u>		<u>December 31, 2010</u>	
	<u>Number of of Contracts</u>	<u>Recorded Investment</u>	<u>Number of of Contracts</u>	<u>Recorded Investment</u>
<u>Troubled Debt Restructurings</u>				
Residential real estate	1	\$ 194,657	3	\$ 900,522
Commercial real estate	5	4,049,703	4	3,312,567
Construction and land development	1	552,409	1	1,110,409
Consumer	1	43,109	-	-
	<u>8</u>	<u>\$ 4,839,878</u>	<u>8</u>	<u>\$ 5,323,498</u>

### Deposits

Total deposits at September 30, 2011 were \$227,827,205, an increase of 3.1% over total deposits at December 31, 2010. Interest bearing deposits have increased 3.5% or \$6,559,382 since the beginning of the year. The Bank utilizes core deposits primarily to fund its earning assets. During the nine-month period ended September 30, 2011, average deposits provided funding for approximately 87.70% of average earning assets.

Certificates of deposit greater than \$100,000 are listed in the table below:

	<u>September 30, 2011</u>	<u>December 31, 2010</u>
Non-brokered	\$ 35,588,286	\$ 36,612,649
CDARS Network	8,952,403	5,622,717
	<u>\$ 44,540,689</u>	<u>\$ 42,235,366</u>

### Long-term borrowings

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

The following table summarizes the FHLB advances:

Note date	First Callable date Quarterly thereafter	Maturity date	Interest rate			Interest frequency
				9/30/2011	12/31/2010	
01/23/04	-	01/24/11	3.45%	\$ -	\$ 428,571	Monthly
10/31/07	10/30/09	10/31/17	3.76%	6,000,000	6,000,000	Quarterly
12/31,07	12/29/08	12/29/17	2.99%	5,000,000	5,000,000	Quarterly
06/20/08	06/20/12	06/20/18	3.93%	7,000,000	7,000,000	Quarterly
09/19/08	09/19/11	09/19/18	2.91%	10,000,000	10,000,000	Quarterly
				<u>\$ 28,000,000</u>	<u>\$ 28,428,571</u>	

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

### Capital

Total stockholders' equity was \$27,123,972 at September 30, 2011, an increase of 4.4%, or \$1,135,215, when compared to total stockholders' equity at December 31, 2010. Capital increased as a result of earnings in the amount of \$1,457,728 and stock transactions netting \$212,422. These transactions were offset by quarterly dividends paid on outstanding shares of common stock in the aggregate amount of \$534,935.

The Bank continues to maintain capital at levels in excess of the minimum risk based capital requirements adopted by the federal banking agencies and was considered to be “well capitalized” as of September 30, 2011. One measure of capital adequacy is the risk-based capital ratio, or the ratio of total capital to risk adjusted assets. Total capital is composed of both core capital (Tier 1) and supplemental capital (Tier 2). Total assets are adjusted for off-balance sheet items, such as letters of credit, and the different degrees of risk among various assets. Regulators require a minimum risk-based capital ratio of 8%, with 10% being the regulatory minimum for well-capitalized banks. At September 30, 2011, the Bank’s risk-based capital ratio was 12.9%.

Another measure of capital adequacy is the leverage capital ratio, which is calculated by dividing average total assets for the most recent quarter into Tier 1 capital. The regulatory minimum for this ratio is 4%, with 5% being the regulatory minimum for well-capitalized banks. The Bank’s leverage capital ratio as of September 30, 2011 was 9.6%.

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

**Liquidity**

Liquidity describes the ability of the Bank to meet financial obligations that arise during the normal course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of customers and to fund current and planned expenditures. Liquidity is derived through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in short-term funds markets. The Bank has arrangements with correspondent banks whereby it has \$5,000,000 available in federal funds lines of credit. The Bank is also a member of the FHLB of Atlanta, which provides another source of liquidity. The Bank may borrow up to 25% of its reported total assets from the FHLB through any combination of notes or line of credit advances. The line of credit interest rate is a variable rate set daily by the lender. The notes payable and the line of credit are secured by a floating lien on all of the Bank’s residential first mortgage loans, home equity loans and commercial real estate loans. The Bank was required to purchase shares of capital stock in the FHLB as a condition to obtaining the line of credit. Based on collateral available, the Bank could borrow an additional \$13,642,000 from the FHLB as of September 30, 2011.

The Bank is eligible to borrow from the Federal Reserve Bank Discount Window. The credit line will be secured by the Bank’s consumer loan portfolio. Based on available collateral, the Bank could borrow an additional \$13,719,000 from the Federal Reserve Bank Discount Window as of September 30, 2011.

The CDARS network is a form of brokered deposits and the Bank has participated in this program since June 2005. In addition to providing Bank clients enhanced FDIC insurance coverage, the CDARS network also allows the Bank to fund its balance sheet through the One-Way Buy program. This is a competitive bid process conducted each week. Due to the nature of the FDIC insurance coverage, the Bank believes that the CDARS network will be a viable source of liquidity in a funding shortfall scenario so long as the Bank remains well capitalized. As of September 30, 2011, the Bank could borrow up to 10% of its reported total assets, or \$28,435,619.

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

The Bank’s principal market risk is the fluctuation of interest rates and the impact such fluctuation would have on the Bank’s lending, investing and deposit activities. Management has adopted procedures to evaluate and mitigate this risk. This risk and management’s procedures are discussed in detail in Item 7 of Part II of the Bank’s Annual Report on Form 10-K for the year ended December 31, 2010 under the caption “Market Risk Management”. Management believes that there have been no material changes in the Bank’s market risks or the procedures used to evaluate and mitigate these risks since December 31, 2010. The simulation models that the Bank uses to quantify the effect a hypothetical immediate plus 400 or minus 300 basis point change in rates produced the following results on net interest income and return on assets projected 12 months from September 30, 2011 as well as the net fair value of capital to fair value of assets ratio at September 30, 2011.

	+400 Basis Points	+300 Basis Points	+200 Basis Points	-100 Basis Points	-200 Basis Points	-300 Basis Points	Recommended Policy Guidelines
% Change in Net Interest Income	0.06%	(0.06%)	(0.41%)	0.03%	(0.41%)	(0.48%)	
ROA YTD	1.03%	1.02%	1.01%	1.02%	1.01%	1.00%	+ .50%
Net Fair Value of Capital Ratio	3.66%	4.56%	5.56%	7.43%	7.32%	7.51%	>(2.50)%

**Item 4. Controls and Procedures.**

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

An evaluation of the effectiveness of these disclosure controls as of September 30, 2011 was carried out under the supervision and with the participation of the Bank's management, including the CEO and CFO. Based on that evaluation, the Bank's management, including the CEO and CFO, has concluded that the Bank's disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the quarter ended September 30, 2011, there was no change in the Bank's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Bank's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

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

### **Item 1A. Risk Factors.**

The risks and uncertainties to which the Bank's financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Bank's Annual Report on Form 10-K for the year ended December 31, 2010 and in Item 1A of Part II of the Bank's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011. Management does not believe that any material changes in the Bank's risk factors have occurred since these risks were last discussed.

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

#### *Unregistered Sales of Stock*

Section 3(a)(2) of the Securities Act of 1933, as amended (the "Securities Act"), exempts from the definition of "security" any securities issued by a bank, and the FDIC, as the Bank's primary federal regulator, does not require the registration of the Bank's securities prior to offer or sale. From time to time, the Bank sells shares of its common stock pursuant to its dividend reinvestment plan ("DRIP") and upon exercise of options granted under its Director Stock Purchase Plan, Incentive Stock Option Plan, 2004 Director Non-Qualified Stock Option Plan (the "2004 Plan"), 2008 Employee Stock Purchase Plan (the "2008 Employee Plan") and the 2008 Key Employee Stock Option Plan (the 2008 "Key Employee Plan"). The DRIP and all equity compensation plans other than the 2004 Director Plan, 2008 Employee Plan and the 2008 Key Employee Plan were adopted before the Bank converted from a national banking association into a state chartered bank, and the Office of the Comptroller of the Currency required that the shares issuable under such plans be registered under the Securities Act prior to their offer and sale. During the third quarter of 2011, a total of 3,631.00 shares of common stock were issued pursuant to the DRIP at \$20.00 per share. There were a total of 39 shares of common stock issued pursuant to the exercise of options during the quarter ended September 30, 2011, at an average exercise price of \$15.50 per share.

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. (Removed and Reserved)**

**Item 5. Other Information**

None.

**Item 6. Exhibits**

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

**SIGNATURES**

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

HARFORD BANK

Date: November 14, 2011

/s/ Charles H. Jacobs, Jr.  
President/CEO  
(Principal Executive Officer)

Date: November 14, 2011

/s/ Charlotte A. Mock  
Executive Vice President/CFO  
(Principal Accounting Officer)

Date: November 14, 2011

/s/ Neil L. Christ, CPA  
Senior Vice President  
(Principal Financial Officer)

## EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Description</u>
Exhibit 31.1	Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
Exhibit 31.2	Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
Exhibit 31.3	Certifications of the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
Exhibit 32.1	Certification of the Periodic Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).

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

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

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

Date: November 14, 2011

/s/ Charles H. Jacobs, Jr.  
President/CEO  
(Principal Executive Officer)

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

I, Charlotte A. Mock, certify that:

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

Date: November 14, 2011

/s/ Charlotte A. Mock  
Executive Vice President/CFO  
(Principal Accounting Officer)

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

I, Neil L. Christ, CPA, certify that:

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

Date: November 14, 2011

/s/ Neil L. Christ, CPA  
Senior Vice President  
(Principal Financial Officer)

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

Pursuant to, and for purposes only of, 18 U.S.C. § 1350, each of the undersigned hereby certifies that (i) the Quarterly Report of Harford Bank on Form 10-Q for the quarter ended September 30, 2011, filed with the Federal Deposit Insurance Corporation (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (ii) information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Harford Bank.

Date: November 14, 2011

/s/ Charles H. Jacobs, Jr.  
President/CEO  
(Principal Executive Officer)

Date: November 14, 2011

/s/ Charlotte A. Mock  
Executive Vice President/CFO  
(Principal Accounting Officer)

Date: November 14, 2011

/s/ Neil L. Christ, CPA  
Senior Vice President  
(Principal Financial Officer)

**HARFORD BANK**  
**STATEMENTS OF CONDITION**

	<u>September 30, 2011</u>	<u>December 31, 2010</u>
<b>ASSETS</b>	(Unaudited)	
Cash and due from banks	\$ 6,843,586	\$ 5,802,693
Federal funds sold and Federal Home Loan Bank deposit	<u>6,709,356</u>	<u>11,204,394</u>
Cash and cash equivalents	13,552,942	17,007,087
Investment securities held to maturity (fair value of \$30,151,862 at 9/30/11 and \$26,545,513 at 12/31/10)	29,769,973	26,676,214
Federal Home Loan Bank stock, at cost	1,721,200	1,769,300
Loans, net	221,057,227	212,193,865
Bank premises and equipment	8,850,656	8,759,962
Accrued interest receivable	1,149,108	978,261
Prepaid income taxes	-	125,683
Deferred income taxes	788,724	788,724
Bank owned life insurance	4,398,095	4,288,137
Foreclosed real estate	1,686,274	2,639,000
Other assets	<u>1,381,990</u>	<u>1,467,533</u>
	<u>\$ 284,356,189</u>	<u>\$ 276,693,766</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits:		
Noninterest-bearing	\$ 35,349,064	\$ 35,138,847
Interest-bearing	<u>192,478,141</u>	<u>185,918,759</u>
Total deposits	227,827,205	221,057,606
Federal Home Loan Bank advances	28,000,000	28,428,571
Accrued interest payable	215,318	268,452
Income taxes payable	167,050	-
Dividend payable	168,312	198,254
Other liabilities	<u>854,332</u>	<u>752,126</u>
	<u>257,232,217</u>	<u>250,705,009</u>
Stockholders' equity		
Common stock, par value \$10 per share; authorized 5,000,000 shares: issued and outstanding 1,051,951.0 shares at 9/30/11, and 1,043,443.7 shares at 12/31/10	10,519,510	10,434,437
Surplus	12,055,973	11,928,624
Undivided profits	<u>4,548,489</u>	<u>3,625,696</u>
	<u>27,123,972</u>	<u>25,988,757</u>
	<u>\$ 284,356,189</u>	<u>\$ 276,693,766</u>

*The accompanying notes are an integral part of these financial statements.*

**HARFORD BANK**  
**STATEMENTS OF INCOME (Unaudited)**

September 30,	For the three months ended		For the nine months ended	
	2011	2010	2011	2010
<b>Interest revenue</b>				
Loans, including fees	\$ 3,509,358	\$3,430,109	\$ 10,245,426	\$ 10,167,903
Investment securities held to maturity	154,890	121,169	380,158	284,857
Federal funds sold and Federal Home Loan Bank deposit	2,660	6,432	13,519	10,989
Interest bearing deposits in other banks	-	595	-	5,691
Other	3,044	4,346	11,905	6,956
Total interest revenue	<u>3,669,952</u>	<u>3,562,651</u>	<u>10,651,008</u>	<u>10,476,396</u>
<b>Interest expense</b>				
Deposits	410,357	591,883	1,334,151	1,806,917
Borrowed funds	240,583	246,119	716,353	736,334
Total interest expense	<u>650,940</u>	<u>838,002</u>	<u>2,050,504</u>	<u>2,543,251</u>
Net interest income	3,019,012	2,724,649	8,600,504	7,933,145
<b>Provision for loan losses</b>	<u>230,000</u>	<u>375,000</u>	<u>885,000</u>	<u>850,000</u>
Net interest income after provision for loan losses	<u>2,789,012</u>	<u>2,349,649</u>	<u>7,715,504</u>	<u>7,083,145</u>
<b>Noninterest revenue</b>				
Service charges on deposit accounts	263,071	237,817	758,495	753,605
Earnings on bank owned life insurance	36,428	37,200	109,958	111,787
Other fees and commissions	94,497	80,660	281,717	246,498
Total noninterest revenue	<u>393,996</u>	<u>355,677</u>	<u>1,150,170</u>	<u>1,111,890</u>
<b>Noninterest expenses</b>				
Salaries and benefits	1,104,043	1,025,979	3,273,361	3,045,047
Occupancy	160,945	156,176	489,245	480,910
Furniture and equipment	104,693	99,920	309,175	327,023
Data processing expense	197,429	173,312	565,877	519,860
Professional fees	48,501	22,198	126,470	108,338
Director and committee fees	47,596	47,894	147,106	144,429
Stationery and supplies	35,467	29,776	149,127	120,135
FDIC and State Assessments	80,468	92,218	294,906	271,132
Advertising	25,975	22,970	74,637	70,238
Net gains (losses) and expenses of repossessed assets and foreclosed real estate	15,050	(1,460)	421,429	40,549
Other than temporary impairment of restricted stock	-	-	50,000	-
Other operating	251,380	233,220	738,116	724,576
Total noninterest expenses	<u>2,071,547</u>	<u>1,902,203</u>	<u>6,639,449</u>	<u>5,852,237</u>
Income before income taxes	1,111,461	803,123	2,226,225	2,342,798
Income taxes	444,949	277,625	768,497	808,334
<b>Net income</b>	<u>\$ 666,512</u>	<u>\$ 525,498</u>	<u>\$ 1,457,728</u>	<u>\$ 1,534,464</u>
Basic earnings per share	\$ 0.63	\$ 0.50	\$ 1.39	\$ 1.49
Diluted earnings per share	\$ 0.63	\$ 0.50	\$ 1.39	\$ 1.49
Dividends declared per share	\$ 0.16	\$ 0.17	\$ 0.51	\$ 0.51

*The accompanying notes are an integral part of these financial statements*

**HARFORD BANK**  
**STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
**Nine months ended September 30, 2011 and 2010**  
**(Unaudited)**

	Common Stock		Surplus	Undivided profits
	Shares	Par value		
<b>Balance, January 1, 2010</b>	1,003,338.4	\$ 10,033,384	\$ 11,533,953	\$ 2,936,972
Net income	-	-	-	1,534,464
Cash dividends, \$.51 per share	-	-	-	(533,080)
Common stock issued				
Options exercised	742.0	7,420	15,526	-
Dividend reinvestment plan	10,034.5	100,345	129,456	-
Stock compensation expense	-	-	28,680	-
Stock acquired and cancelled	<u>(5,429.9)</u>	<u>(54,299)</u>	<u>(72,989)</u>	<u>-</u>
<b>Balance, September 30, 2010</b>	<u>1,008,685.1</u>	<u>\$ 10,086,851</u>	<u>\$ 11,634,626</u>	<u>\$ 3,938,356</u>
<b>Balance, January 1, 2011</b>	1,043,443.7	\$ 10,434,437	\$ 11,928,624	\$ 3,625,696
Net income	-	-	-	1,457,728
Cash dividends, \$.51 per share	-	-	-	(534,935)
Common stock issued				
Options exercised	650.0	6,500	7,158	-
Stock sold and dividend reinvestment	12,587.7	125,877	141,212	-
Stock compensation expense	-	-	31,458	-
Stock acquired and cancelled	<u>(4,730.4)</u>	<u>(47,304)</u>	<u>(52,479)</u>	<u>-</u>
<b>Balance, September 30, 2011</b>	<u>1,051,951.0</u>	<u>\$ 10,519,510</u>	<u>\$ 12,055,973</u>	<u>\$ 4,548,489</u>

*The accompanying notes are an integral part of these financial statements.*

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

	For the nine months ended September 30,	
	2011	2010
<b>Cash flows from operating activities</b>		
Interest received	\$ 10,649,636	\$ 10,390,585
Fees and commissions received	1,151,456	1,125,777
Interest paid	(2,103,638)	(2,588,283)
Cash paid to suppliers and employees	(5,849,569)	(5,557,798)
Income taxes paid	<u>(475,764)</u>	<u>(1,211,400)</u>
	<u>3,372,121</u>	<u>2,158,881</u>
<b>Cash flows from investing activities</b>		
Proceeds from maturities and principal repayments of investment securities	10,774,081	7,860,594
Purchase of investment securities	(14,012,940)	(21,933,650)
Certificates of deposit (net)	-	1,494,000
Redemption of FHLB stock	48,100	135,600
Loans originated, net of principal repayments	(9,772,737)	(2,435,175)
Purchases of premises, equipment, and software	(385,878)	(733,320)
Proceeds from sale of foreclosed real estate	<u>565,993</u>	<u>532,987</u>
	<u>(12,783,381)</u>	<u>(15,078,964)</u>
<b>Cash flows from financing activities</b>		
Net increase (decrease) in time deposits	(708,092)	7,801,426
Net increase in other deposits	7,477,691	13,499,095
Net (decrease) in borrowed funds	(428,571)	(857,143)
Dividends paid	(564,877)	(522,085)
Dividends reinvested	267,089	229,801
Stock options exercised, including tax benefit	13,658	22,946
Stock acquired and cancelled	<u>(99,783)</u>	<u>(127,288)</u>
	<u>5,957,115</u>	<u>20,046,752</u>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(3,454,145)</b>	<b>7,126,669</b>
Cash and cash equivalents at beginning of period	<u>17,007,087</u>	<u>8,918,795</u>
Cash and cash equivalents at end of period	<u>\$ 13,552,942</u>	<u>\$ 16,045,464</u>

*The accompanying notes are an integral part of these financial statements*



# Harford Bank

## Notes to Financial Statements

### 1. Summary of Significant Accounting Policies

The accompanying unaudited financial statements of Harford Bank (the "Bank") have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for audited year-end financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the period ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011 or any other future interim period. The financial statements contained herein should be read in conjunction with the financial statements and related notes contained in the Bank's Annual Report on Form 10-K for the year ended December 31, 2010.

#### *Use of estimates*

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

#### *Nature of operations*

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

#### *Cash and cash equivalents*

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

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

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

#### *Investment securities*

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

#### *Restricted equity securities*

As a member of the Federal Home Loan Bank (FHLB) of Atlanta, the Bank is required to hold FHLB stock as a condition of membership as well as in relation to the Bank's use of products and services. FHLB stock is not publicly traded and is sold and redeemed by the FHLB at par. The Bank views its investment in FHLB stock as a long-term investment and as a restricted equity security, which is carried at cost, because there is a minimal market for the stock. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Bank does not consider this investment to be other-than-temporarily impaired at September 30, 2011, and no impairment has been recognized.

The Bank owns stock in an area banker's bank. This stock is not publicly traded and there is a minimal market for the stock. The Bank views this stock as a long-term investment and as a restricted equity security, which is carried at cost, and grouped with other assets. During the second quarter of 2011, the Bank recorded an other than temporary impairment charge of \$50,000 related to this equity holding.

# Harford Bank

## Notes to Financial Statements

### 1. Summary of Significant Accounting Policies – continued

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

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

Interest on loans is accrued based on the principal amounts outstanding. Origination fees and costs are recognized as an adjustment to the related loan yield using an approximate interest method. The accrual of interest is discontinued when any portion of the principal or interest is ninety days past due and collateral is insufficient to discharge the debt in full. Past due status is based on the contractual terms of the loan.

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

A troubled debt restructuring is the restructuring of a loan in which a concession is granted to a borrower experiencing financial difficulty.

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

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are individually evaluated for impairment and for which impairment is determined to exist. The general component covers the remaining loan portfolio and is based on historical loss experience adjusted for qualitative factors. An unallocated component may be maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

#### *Bank premises and equipment*

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

#### *Foreclosed real estate*

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

#### *Income taxes*

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

## Harford Bank

### Notes to Financial Statements

#### 1. Summary of Significant Accounting Policies – continued

##### *Per share data*

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

The weighted average number of common shares outstanding, dilutive common equivalent number of shares, and anti-dilutive shares for the three- and nine-month periods ending September 30, are as follows:

	2011	2010	2011	2010
Basic weighted average EPS shares	1,051,409	1,038,068	1,048,332	1,035,496
Dilutive common stock equivalents	679	213	1,056	283
Dilutive EPS shares	<u>1,052,088</u>	<u>1,038,281</u>	<u>1,049,388</u>	<u>1,035,779</u>
Anti-dilutive shares	<u>59,534</u>	<u>61,725</u>	<u>57,696</u>	<u>61,725</u>

##### *Stock-based compensation*

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

##### *New accounting standards*

*ASU No. 2010-20, "Receivables (Topic 310) – Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses."* ASU 2010-20 requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a roll-forward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 became effective for the Bank's financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period became effective for the Bank's financial statements beginning on January 1, 2011. *ASU 2011-01, "Receivables (Topic 310) - Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20,"* temporarily deferred the effective date for disclosures related to troubled debt restructurings to coincide with the effective date of the then proposed *ASU 2011-02, "Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring,"* which is further discussed below.

*ASU No. 2011-02, "Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring."* ASU 2011-02 clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-02, that both of the following exist: (i) the restructuring constitutes a concession; and (ii) the debtor is experiencing financial difficulties. ASU 2011-02 was effective for the Bank on July 1, 2011, and applies retrospectively to restructurings occurring on or after January 1, 2011. Adoption of ASU 2011-02 did not have a significant impact on the Bank's financial statements.

**Harford Bank**  
**Notes to Financial Statements**

**2. Cash and Cash Equivalents**

The Bank normally carries balances with other banks that exceed the federally insured limit. However, under the Dodd-Frank regulatory reform changes all funds in a “noninterest-bearing transaction account” are insured in full by the FDIC from December 31, 2010 through December 31, 2012. This temporary unlimited coverage is in addition to, and separate from, the coverage of at least \$250,000 available to depositors under the FDIC’s general deposit insurance rules. The average balance carried in unsecured federal funds sold to the same banks, for the nine months ended September 30, 2011 was \$8,671,060 and \$7,250,703 for the year ended December 31, 2010.

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

**3. Securities Held to Maturity**

Investment securities are summarized as follows:

<b>September 30, 2011</b>	Amortized cost	Unrealized gains	Unrealized losses	Fair value
U.S. government agency	\$ 12,007,123	\$ 143,617	\$ -	\$ 12,150,740
Mortgage-backed securities	4,289,403	33,616	-	4,323,019
Asset-backed securities	7,601,447	143,931	-	7,745,378
U.S. Treasury notes	2,100,527	3,963	-	2,104,490
State and municipal	<u>3,771,473</u>	<u>56,762</u>	-	<u>3,828,235</u>
	<u>\$ 29,769,973</u>	<u>\$ 381,889</u>	<u>\$ -</u>	<u>\$ 30,151,862</u>
<hr/>				
<b>December 31, 2010</b>				
U.S. government agency	\$ 12,027,808	\$ 14,742	\$ 2,772	\$ 12,039,778
Mortgage-backed securities	4,858,791	-	93,930	4,764,861
Asset-backed securities	3,867,246	16,737	54,596	3,829,387
U.S. Treasury notes	2,102,529	10,768	-	2,113,297
State and municipal	<u>3,819,840</u>	<u>976</u>	<u>22,626</u>	<u>3,798,190</u>
	<u>\$ 26,676,214</u>	<u>\$ 43,223</u>	<u>\$ 173,924</u>	<u>\$ 26,545,513</u>

**Harford Bank**  
**Notes to Financial Statements**

**3. Securities Held to Maturity – continued**

Investment securities with unrealized losses as of September 30, 2011 are as follows:

	Less than 12 months		12 months or longer		Total	
	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value
U.S. government agency	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Mortgage-backed securities	-	-	-	-	-	-
Asset-backed securities	-	-	-	-	-	-
State and municipal	-	-	-	-	-	-
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

There were no investment securities with unrealized losses as of September 30, 2011.

Contractual maturities and the amount of pledged securities at September 30, 2011 and December 31, 2010 are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	September 30, 2011		December 31, 2010	
	Amortized cost	Fair value	Amortized cost	Fair value
Maturing				
Within one year	\$ 8,426,355	\$ 8,441,199	\$ 6,778,166	\$ 6,792,238
Over one to five years	9,452,768	9,642,266	10,736,456	10,732,119
Greater than five years	-	-	435,555	426,910
	<u>17,879,123</u>	<u>18,083,465</u>	<u>17,950,177</u>	<u>17,951,267</u>
Mortgage-backed and asset-backed securities	<u>11,890,850</u>	<u>12,068,397</u>	<u>8,726,037</u>	<u>8,594,246</u>
	<u>\$ 29,769,973</u>	<u>\$ 30,151,862</u>	<u>\$ 26,676,214</u>	<u>\$ 26,545,513</u>
Pledged securities	<u>\$ 7,015,212</u>	<u>\$ 7,056,659</u>	<u>\$ 15,039,300</u>	<u>\$ 15,057,471</u>

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

**Harford Bank**  
**Notes to Financial Statements**

**4. Loans**

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

Major classifications of loans are as follows:

	September 30, 2011	December 31, 2010
Real estate		
Construction and land development	\$ 15,139,721	\$ 13,794,715
Secured by farmland	3,054,923	2,811,032
Residential	58,540,364	58,437,061
Commercial	109,570,710	102,598,028
Commercial	16,336,659	15,985,503
Lease financing	233,069	445,276
Consumer	<u>20,573,820</u>	<u>20,807,251</u>
	223,449,266	214,878,866
Deferred fees, net of costs	(233,610)	(209,235)
Allowance for loan losses	<u>(2,158,429)</u>	<u>(2,475,766)</u>
	<u>\$ 221,057,227</u>	<u>\$ 212,193,865</u>

The maturity distribution of the loan portfolio follows:

	September 30, 2011	December 31, 2010
Maturing within one year	\$ 77,938,049	\$ 61,622,981
Maturing over one to five years	85,570,355	88,531,430
Maturing over five years	<u>59,940,862</u>	<u>64,724,455</u>
	<u>\$ 223,449,266</u>	<u>\$ 214,878,866</u>
Variable rate loans included above	<u>\$ 156,559,106</u>	<u>\$ 146,912,128</u>

**Harford Bank**  
**Notes to Financial Statements**

4. Loans - continued

The following table analyzes the age of Past Due Loans at September 30, 2011 and December 31, 2010:

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 days	Total Past Due	Current	Total Loans	Loans over 90 Days and Accruing
<b>2011</b>							
Residential real estate	\$ 659,110	\$ 1,492,873	\$ 894,312	\$ 3,046,295	\$ 55,494,069	\$ 58,540,364	\$ -
Commercial real estate	588,439	2,240,374	376,998	3,205,811	109,419,822	112,625,633	376,998
Construction and land development	-	552,409	711,648	1,264,057	13,875,664	15,139,721	-
Commercial loans	30,700	-	-	30,700	16,539,028	16,569,728	-
Consumer-mobile homes	420,147	88,157	137,238	645,542	13,156,516	13,802,058	137,238
Consumer-other	277,126	-	-	277,126	6,494,636	6,771,762	-
	<u>\$ 1,975,522</u>	<u>\$ 4,373,813</u>	<u>\$ 2,120,196</u>	<u>\$ 8,469,531</u>	<u>\$ 214,979,735</u>	<u>\$ 223,449,266</u>	<u>\$ 514,236</u>
<b>2010</b>							
Residential real estate	\$ 1,230,473	\$ 305,829	\$ 494,893	\$ 2,031,195	\$ 56,405,866	\$ 58,437,061	\$ -
Commercial real estate	1,226,947	-	-	1,226,947	104,182,113	105,409,060	-
Construction and land development	2,148,484	-	-	2,148,484	11,646,231	13,794,715	-
Commercial loans	49,756	25,731	-	75,487	16,355,292	16,430,779	-
Consumer-mobile homes	494,013	250,315	35,686	780,014	13,139,123	13,919,137	35,686
Consumer-other	60,626	-	-	60,626	6,827,488	6,888,114	-
	<u>\$ 5,210,299</u>	<u>\$ 581,875</u>	<u>\$ 530,579</u>	<u>\$ 6,322,753</u>	<u>\$ 208,556,113</u>	<u>\$ 214,878,866</u>	<u>\$ 35,686</u>

The following table summarizes nonaccrual loans and other non-performing assets:

<b>Non-performing Assets</b>	<b>At, and year to date through September 30, 2011</b>	<b>At, and year to date through December 31, 2011</b>
Non-accrual loans by loan class:		
Residential real estate	\$ 1,359,758	\$ 901,742
Commercial real estate	-	-
Construction and land development	1,264,057	-
Commercial loans	-	-
Consumer-mobile homes	35,000	49,484
Consumer-other	-	-
Total non-accrual loans	<u>2,658,815</u>	<u>951,226</u>
Foreclosed real estate	<u>1,686,274</u>	<u>2,639,000</u>
Total non-performing assets	<u>\$ 4,345,089</u>	<u>\$ 3,590,226</u>
Interest not accrued on nonaccrual loans	<u>\$ 127,910</u>	<u>\$ 60,806</u>

**Harford Bank**  
**Notes to Financial Statements**

**4. Loans - continued**

The following table illustrates the recorded investment in impaired loans segmented by those with and without a related allowance recorded at September 30, 2011 and December 31, 2010.

	Recorded Investment	Current Loan Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>September 30, 2011</b>					
<u>With no related allowance recorded</u>					
Residential real estate	\$ -	\$ -	\$ -	\$ -	-
Commercial real estate	-	-	-	-	-
Construction and land development	-	-	-	-	-
Commercial loans	-	-	-	-	-
Consumer loans	-	-	-	-	-
<u>With an allowance recorded</u>					
Residential real estate	1,832,180	1,832,180	12,383	1,457,592	69,354
Commercial real estate	6,510,827	6,510,827	79,261	6,273,833	317,722
Construction and land development	1,155,354	1,155,354	201,751	1,022,316	15,317
Commercial loans	47,388	47,388	67	26,841	1,496
Consumer Loan	212,346	212,346	3,029	121,097	1,528
<u>Total</u>					
Residential real estate	1,832,180	1,832,180	12,383	1,457,592	69,354
Commercial real estate	6,510,827	6,510,827	79,261	6,273,833	317,722
Construction and land development	1,155,354	1,155,354	201,751	1,022,316	15,317
Commercial loans	47,388	47,388	67	26,841	1,496
Consumer loans	212,346	212,346	3,029	121,097	1,528
	\$ 9,758,095	\$ 9,758,095	\$ 296,491	\$ 8,901,679	\$ 405,417
<b>December 31, 2010</b>					
<u>With no related allowance recorded</u>					
Residential real estate	\$ 362,746	\$ 362,746	\$ -	\$ 364,313	\$ 13,081
Commercial real estate	1,639,876	1,639,876	-	1,626,184	72,689
Construction and land development	-	-	-	-	-
Commercial loans	-	-	-	-	-
<u>With an allowance recorded</u>					
Residential real estate	1,028,743	1,028,743	79,724	1,006,428	67,509
Commercial real estate	4,333,498	4,333,498	335,296	4,351,680	296,945
Construction and land development	1,110,409	1,110,409	299,874	1,110,409	55,308
Commercial loans	25,731	25,731	5,146	25,754	362
<u>Total</u>					
Residential real estate	1,391,489	1,391,489	79,724	1,370,741	80,590
Commercial real estate	5,973,374	5,973,374	335,296	5,977,864	369,634
Construction and land development	1,110,409	1,110,409	299,874	1,110,409	55,308
Commercial loans	25,731	25,731	5,146	25,754	362
	\$ 8,501,003	\$ 8,501,003	\$ 720,040	\$ 8,484,768	\$ 505,894

## Harford Bank

### Notes to Financial Statements

#### 4. Loans - continued

The following table presents allowance for loan losses activity allocated by loan class for the nine- and twelve-month periods ended September 30, 2011 and December 31, 2010, respectively, and the allocation of allowance for loan losses on loans that were individually and collectively evaluated for impairment at September 30, 2011 and December 31, 2010.

	Unallocated	Commercial	Residential Real Estate	Farmland & Commercial Real Estate	Construction and Land Development	Personal	Mobile Homes	Overdraft Lines	Total
<b>September 30, 2011</b>									
Allowance for Credit Losses									
Beginning balance	\$ -	\$ 273,676	\$ 463,921	\$ 1,287,577	\$ 375,299	\$ 12,929	\$ 59,852	\$ 2,512	\$ 2,475,766
Charge-offs	-	(37,464)	(65,419)	-	(1,023,873)	(23,748)	(63,761)	(7,373)	(1,221,637)
Recoveries	-	15,000	-	-	-	945	1,914	1,441	19,300
Provision	18	(58,529)	(268,283)	11,495	1,088,060	26,242	76,137	9,861	885,000
Ending balance	<u>\$ 18</u>	<u>\$ 192,683</u>	<u>\$ 130,219</u>	<u>\$ 1,299,072</u>	<u>\$ 439,486</u>	<u>\$ 16,368</u>	<u>\$ 74,142</u>	<u>\$ 6,441</u>	<u>\$ 2,158,429</u>
Allowance balance allocated to:									
Loans individually									
evaluated for impairment	\$ -	\$ 67	\$ 12,383	\$ 79,261	\$ 201,751	\$ -	\$ 3,029	\$ -	\$ 296,491
Loans collectively									
evaluated for impairment	18	192,616	117,836	1,219,811	237,735	16,368	71,113	6,441	1,861,938
	<u>\$ 18</u>	<u>\$ 192,683</u>	<u>\$ 130,219</u>	<u>\$ 1,299,072</u>	<u>\$ 439,486</u>	<u>\$ 16,368</u>	<u>\$ 74,142</u>	<u>\$ 6,441</u>	<u>\$ 2,158,429</u>
Loan balance:									
Individually evaluated for impairment		<u>\$ 47,388</u>	<u>\$ 1,832,180</u>	<u>\$ 6,510,827</u>	<u>\$ 1,155,354</u>	<u>\$ -</u>	<u>\$ 212,346</u>	<u>\$ -</u>	<u>\$ 9,758,095</u>
Collectively evaluated for impairment		<u>\$ 15,309,812</u>	<u>\$ 56,708,184</u>	<u>\$ 106,114,806</u>	<u>\$ 13,984,367</u>	<u>\$ 4,276,669</u>	<u>\$ 13,555,368</u>	<u>\$ 21,258</u>	<u>\$ 209,970,464</u>
<b>December 31, 2010</b>									
Allowance for Credit Losses									
Beginning balance	\$ 15,052	\$ 272,408	\$ 579,486	\$ 1,149,115	\$ 510,924	\$ 3,881	\$ 58,622	\$ 4,324	\$ 2,593,812
Charge-offs	-	(750,744)	(475,424)	-	-	(46,283)	(73,385)	(9,912)	(1,355,748)
Recoveries	-	12,145	-	-	-	-	-	557	12,702
Provision	(15,052)	739,867	359,859	138,462	(135,625)	55,331	74,615	7,543	1,225,000
Ending balance	<u>\$ -</u>	<u>\$ 273,676</u>	<u>\$ 463,921</u>	<u>\$ 1,287,577</u>	<u>\$ 375,299</u>	<u>\$ 12,929</u>	<u>\$ 59,852</u>	<u>\$ 2,512</u>	<u>\$ 2,475,766</u>
Ending balance allocated to:									
Loans individually									
evaluated for impairment	\$ -	\$ 5,146	\$ 79,724	\$ 335,296	\$ 299,874	\$ -	\$ -	\$ -	\$ 720,040
Loans collectively									
evaluated for impairment	-	268,530	384,197	952,281	75,425	12,929	59,852	2,512	1,755,726
	<u>\$ -</u>	<u>\$ 273,676</u>	<u>\$ 463,921</u>	<u>\$ 1,287,577</u>	<u>\$ 375,299</u>	<u>\$ 12,929</u>	<u>\$ 59,852</u>	<u>\$ 2,512</u>	<u>\$ 2,475,766</u>
Loan balance:									
Individually evaluated for impairment		<u>\$ 25,731</u>	<u>\$ 1,028,743</u>	<u>\$ 4,333,498</u>	<u>\$ 1,110,409</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 6,498,381</u>
Collectively evaluated for impairment		<u>\$ 14,680,700</u>	<u>\$ 57,408,320</u>	<u>\$ 102,928,156</u>	<u>\$ 12,684,306</u>	<u>\$ 4,807,038</u>	<u>\$ 13,919,137</u>	<u>\$ 20,744</u>	<u>\$ 206,448,401</u>

**Harford Bank**  
**Notes to Financial Statements**

4. **Loans - continued**

***Credit Quality Indicators***

As part of the on-going monitoring of the quality of the Bank's loan portfolio management tracks certain credit quality indicators.

The Bank does not credit score new loans, but does, however, utilize a risk grading system for non-consumer loans. Loans are risk rated on the scale listed below:

Grade 1 and 2 – These grades include “pass grade” loans to borrowers of acceptable credit quality and risk.

Grade 3 – This grade includes loans that are on Management's “watch list” and are classified as “Pass Watch”. It is the intent of Management to utilize this rating on a temporary basis for pass grade borrowers where a significant risk-modifying action is anticipated in the near future.

Grade 4 – This grade is for “Other Assets Especially Mentioned” or “Special Mention” in accordance with regulatory guidelines. This grade is intended to be temporary and includes loans to borrowers whose credit quality has clearly deteriorated and are at risk of further decline unless active measures are taken to correct the situation. This grade may include loans not fully secured where a specific valuation allowance may be necessary.

Grade 5 – This grade includes “Substandard” loans, in accordance with regulatory guidelines, for which accrual of interest may have stopped. This grade includes loans that are past due or not fully secured where a specific valuation allowance may be necessary.

The following table illustrates loans by class at September 30, 2011 and December 31, 2010. Classified loans included loans in Risk Grades 3, 4, and 5.

	<u>Pass Watch</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Total</u>
<b><u>2011</u></b>				
Real estate consumer	\$ 2,776,862	\$ 1,835,175	\$ 916,046	\$ 5,528,083
Real estate commercial	10,365,932	3,053,672	3,454,305	16,873,909
Construction & land development	2,871,168	-	1,264,057	4,135,225
Commercial	2,167,161	47,388	30,700	2,245,249
Consumer Loans	<u>55,289</u>	<u>-</u>	<u>122,069</u>	<u>177,358</u>
	<u>\$ 18,236,412</u>	<u>\$ 4,936,235</u>	<u>\$ 5,787,177</u>	<u>\$ 28,959,824</u>
<b><u>2010</u></b>				
Real estate consumer	\$ 2,557,085	\$ 958,122	\$ 433,364	\$ 3,948,571
Real estate commercial	6,987,796	2,728,729	3,244,648	12,961,173
Construction & land development	1,727,683	-	1,110,409	2,838,092
Commercial	2,336,261	-	25,731	2,361,992
Consumer Loans	<u>19,602</u>	<u>-</u>	<u>-</u>	<u>19,602</u>
	<u>\$ 13,628,427</u>	<u>\$ 3,686,851</u>	<u>\$ 4,814,152</u>	<u>\$ 22,129,430</u>

**Harford Bank**  
**Notes to Financial Statements**

**4. Loans - continued**

Under a troubled debt restructured loan (TDR), the Bank has granted a concession that it would not otherwise make to a borrower who has experienced financial difficulty. At the time of restructure, the borrower is expected to pay the full amounts due under the renegotiated terms.

The table below shows troubled debt restructured loans outstanding by classification included in impaired loans for the respective dates.

	<u>September 30, 2011</u>		<u>December 31, 2010</u>	
	<u>Number of of Contracts</u>	<u>Recorded Investment</u>	<u>Number of of Contracts</u>	<u>Recorded Investment</u>
<u>Troubled Debt Restructurings</u>				
Residential real estate	1	\$ 194,657	3	\$ 900,522
Commercial real estate	5	4,049,703	4	3,312,567
Construction and land development	1	552,409	1	1,110,409
Consumer	1	43,109	-	-
	<u>8</u>	<u>\$ 4,839,878</u>	<u>8</u>	<u>\$ 5,323,498</u>

The Bank did not grant any troubled debt restructurings for the nine month period ended September 30, 2011. There were no TDRs made within the 12 months preceding September 30, 2011. The Bank granted 4 TDRs totaling \$3,259,318 during the twelve month period ending December 31, 2010. There were 3 TDRs totaling \$1,795,896 made within the 12 months preceding December 31, 2010 which had payment defaults.

**5. Credit Commitments**

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

	<u>September 30, 2011</u>	<u>December 31, 2010</u>
<u>Commitments to extend credit</u>		
Loan origination commitments	\$ 11,269,600	\$ 4,716,900
Unused consumer real estate construction	99,013	480,000
Unused home equity lines of credit	5,751,935	6,468,055
Unused overdraft lines of credit	2,523,353	2,549,224
Unused commercial lines of credit	<u>14,822,105</u>	<u>14,453,202</u>
	<u>\$ 34,466,006</u>	<u>\$ 28,667,381</u>
 Letters of credit	 <u>\$ 2,649,770</u>	 <u>\$ 2,898,053</u>

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

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

**Harford Bank**  
**Notes to Financial Statements**

**6. Related Party Transactions**

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

	September 30, 2011	December 31, 2010
Beginning balance	\$ 7,381,421	\$ 7,209,060
Advances	1,964,991	956,916
Payments	<u>(416,773)</u>	<u>(784,555)</u>
Ending balance	<u>\$ 8,929,639</u>	<u>\$ 7,381,421</u>

In addition to the outstanding balances listed above, the officers and directors of the Bank have \$1,103,553 in unused loans committed but not funded as of September 30, 2011.

The Bank obtains services from firms in which owners are also members of the Board of Directors. Fees charged for these services are at comparable rates charged by unrelated parties for similar work. Amounts paid to these related parties for the nine month periods ended September 30, 2011 and September 30, 2010 totaled \$9,631 and \$38,552, respectively.

Deposits from the officers and directors of the Bank were \$5,168,517 at September 30, 2011 and \$4,330,243 at December 31, 2010.

**7. Bank Premises and Equipment**

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

	Useful lives	September 30, 2011	December 31, 2010
Land		\$ 3,191,486	\$ 3,191,486
Building and improvements	15 - 60 years	5,993,825	5,833,061
Leasehold improvements	10 - 19 years	512,942	512,942
Furniture, fixtures, and equipment	3 - 10 years	<u>2,922,783</u>	<u>2,728,150</u>
		12,621,036	12,265,639
Accumulated depreciation		<u>3,770,380</u>	<u>3,505,677</u>
Net bank premises and equipment		<u>\$ 8,850,656</u>	<u>\$ 8,759,962</u>
Depreciation expense		<u>\$ 280,546</u>	<u>\$ 349,793</u>

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

Cost	3 years	\$ 447,291	\$ 433,941
Accumulated amortization		<u>395,624</u>	<u>363,405</u>
Net computer software		<u>\$ 51,667</u>	<u>\$ 70,536</u>
Amortization expense		<u>\$ 32,220</u>	<u>\$ 55,897</u>

**Harford Bank**  
**Notes to Financial Statements**

**8. Lease Commitments**

The Bank leases various banking facilities under noncancellable operating leases expiring on various dates through 2021.

As of September 30, 2011, future minimum payments remaining for the current year, and annually thereafter by year and in the aggregate, of noncancellable operating leases are as follows:

Year	Amount
2011	\$ 30,147
2012	120,611
2013	118,881
2014	117,737
2015	115,356
2016	116,957
2017 and after	571,393
	\$ 1,191,082

The Bank has leased excess parking spaces at its main office for a two year term at an annual rate of \$2,160.

Rent expense for the nine-month periods ending September 30, 2011 and September 30, 2010 was \$87,588 and \$87,695, respectively.

**9. Borrowings and Available Lines of Credit**

Federal Home Loan Bank advances are summarized as follows:

Maturity date	Interest rate	September 30, 2011	December 31, 2010	Interest frequency
January 24, 2011	3.450%	\$ -	\$ 428,571	Monthly
October 31, 2017	3.760%	6,000,000	6,000,000	Quarterly
December 29, 2017	2.986%	5,000,000	5,000,000	Quarterly
June 20, 2018	3.930%	7,000,000	7,000,000	Quarterly
September 19, 2018	2.913%	10,000,000	10,000,000	Quarterly
	3.362%	\$ 28,000,000	\$ 28,428,571	

As of September 30, 2011, required principal repayments remaining for the current year, and annually thereafter by year and in the aggregate, on Federal Home Loan Bank advances are as follows:

Year	Principal repayments
2011	\$ -
2012	-
2013	-
2014	-
2015	-
2016	-
2017 and after	28,000,000
	\$ 28,000,000

## Harford Bank Notes to Financial Statements

### 9. Borrowings and Available Lines of Credit - continued

Federal Home Loan Bank - The Bank may borrow up to 25% of its reported total assets from the FHLB through any combination of notes or line of credit advances. The line of credit interest rate is a variable rate set daily by the lender. The notes payable and the line of credit are secured by a floating lien on all of the Bank's residential first mortgage loans, home equity loans and commercial real estate loans. The Bank was required to purchase shares of capital stock in the FHLB as a condition to obtaining the line of credit. Based on collateral available, the Bank could borrow an additional \$13,642,000 from the FHLB as of September 30, 2011.

Federal Reserve Bank - The Bank is eligible to borrow from the Federal Reserve Bank (FRB) Discount Window. This credit line is secured by the Bank's consumer loan portfolio. Based on collateral available the Bank could borrow an additional \$13,719,000 from the FRB Discount Window as of September 30, 2011.

CDARS – The Certificate of Deposit Account Registry Service is a form of brokered deposits and we have been involved in this program since June 2005. In addition to allowing us to offer our own clients enhanced FDIC insurance coverage, CDARS also allows us to fund our balance sheet through their One-Way Buy program. This is a competitive bid process conducted each week. The Bank believes that this will be a viable source of funds in a crisis situation so long as we retain our well capitalized status. Currently, the Bank may borrow up to 10% of its reported total assets or \$28,435,619 at September 30, 2011.

Correspondent Banks - The Bank has unsecured credit lines with correspondent banks for \$2,000,000 and an additional secured line of \$3,000,000.

### 10. Retirement Plan

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

The Bank offers a Supplemental Executive Retirement Plans (SERPs) to its executive officers providing for retirement income benefits. The Bank accrues the present value of these benefits over the remaining number of years to the executives' retirement dates. As of September 30, 2011, the Bank has recorded a liability of \$495,764 related to these benefits. The expense for the SERPs totaled \$101,401 for the period ending September 30, 2011.

### 11. Interest-Bearing Deposits

Major classifications of interest-bearing deposits are as follows:

	September 30, 2011	December 31, 2010
Money market and NOW	\$ 77,977,823	\$ 72,217,607
Savings	24,473,905	22,966,647
Certificates of deposit	90,026,413	90,734,505
	<u>\$ 192,478,141</u>	<u>\$ 185,918,759</u>

Certificates of deposit \$100,000 or greater are listed in the table below:

	September 30, 2011	December 31, 2010
Non-brokered	\$ 35,588,286	\$ 36,612,649
CDARS Network	8,952,403	5,622,717
	<u>\$ 44,540,689</u>	<u>\$ 42,235,366</u>

**Harford Bank**  
**Notes to Financial Statements**

**11. Interest-Bearing Deposits - continued**

Maturities of certificates of deposit are as follows:

	September 30, 2011	December 31, 2010
Maturing within twelve months	\$ 65,426,152	\$ 61,933,804
Maturing over one to three years	16,037,285	22,884,906
Maturing over three to five years	<u>8,557,976</u>	<u>5,915,795</u>
	<u>\$ 90,021,413</u>	<u>\$ 90,734,505</u>

Interest expense for interest-bearing deposits is as follows:

	September 30, 2011	September 30, 2010
Money market and NOW	\$ 188,787	\$ 290,614
Savings	51,217	49,403
Certificates of deposit	<u>1,094,147</u>	<u>1,466,900</u>
	<u>\$ 1,334,151</u>	<u>\$ 1,806,917</u>

**12. Income Taxes**

The components of income tax expense are as follows:

	September 30, 2011	September 30, 2010
Current		
Federal	\$ 627,334	\$ 655,537
State	<u>141,163</u>	<u>152,797</u>
	<u>\$ 768,497</u>	<u>\$ 808,334</u>

The differences between the federal income tax rate of 34 percent and the effective tax rate for the Bank are reconciled as follows:

	September 30, 2011	September 30, 2010
Statutory federal income tax rate	34.0 %	34.0 %
Increase (decrease) resulting from		
State income taxes, net of federal		
income tax benefit	4.2	4.3
Tax-exempt income	(4.3)	(4.4)
Nondeductable expenses	<u>0.6</u>	<u>0.6</u>
	<u>34.5 %</u>	<u>34.5 %</u>

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**Notes to Financial Statements**

**13. Stock Option and Purchase Plans**

The Bank has adopted a stock option plan for directors and officers. Option exercise prices are equal to the fair market value of the stock on the date of grant. The Bank has also adopted a qualified employee stock purchase plan that allows the Bank to grant options to employees to acquire shares of common stock through payroll deductions or direct payment over a twenty-seven month period from the dates of the grants. In general, options to directors vest immediately upon grant. Officer options vest after three years.

The total number of shares originally authorized for stock options was 226,745 restated for stock dividends as of September 30, 2011. As of September 30, 2011 a total of 90,641 shares remain available for grant.

Information with respect to stock options is as follows for the periods ended:

	September 30, 2011		September 30, 2010	
	Number of shares	Weighted average exercise price	Number of shares	Weighted average exercise price
Outstanding, beginning of year	64,016	\$ 29.94	49,554	\$ 33.20
Options granted	14,543	17.88	18,937	21.87
Options exercised	(650)	24.02	(770)	30.01
Options forfeited	<u>(3,908)</u>	26.44	<u>(3,493)</u>	32.71
Outstanding, end of period	<u>74,001</u>	27.84	<u>64,228</u>	29.93

During the nine months ended September 30, 2011 and September 30, 2010 there were no shares relinquished by individuals exercising options in accordance with the Bank's stock option plans.

A summary of information about stock options outstanding at September 30, 2011 is as follows:

	Weighted average exercise price	Total shares	Average remaining life (years)	Vested shares
\$	24.67	1,140	0.58	1,140
	27.11	1,417	1.58	1,417
	30.36	6,161	2.58	6,161
	32.71	6,204	3.67	6,204
	34.43	7,658	4.58	7,658
	38.16	4,688	5.50	4,688
	39.81	7,409	6.92	7,409
	30.40	7,229	7.50	3,501
	22.33	15,790	8.58	6,798
	18.35	12,043	9.67	5,500
	18.98	1,838	0.83	1,838
	15.60	2,424	1.92	2,424
\$	<u>27.84</u>	<u>74,001</u>	4.49	54,738
Intrinsic value		<u>\$ 13,755</u>		<u>\$ 10,549</u>

**Harford Bank**  
**Notes to Financial Statements**

**13. Stock Option and Purchase Plans - continued**

At September 30, 2011 and September 30, 2010, options to purchase 54,738 and 46,638 shares of the Bank's common stock, respectively, were vested and exercisable at weighted average prices of \$29.70 and \$30.58, respectively.

At September 30, 2011, there was \$26,745 of total unrecognized compensation expense related to nonvested stock options to be recognized over the next 2.25 years.

For the nine months ended September 30, 2011, and 2010, the Bank recorded stock based compensation expense of \$31,458 and \$28,680, respectively. The intrinsic value of stock options exercised during the nine month periods ended September 30, 2011 and September 30, 2010 was \$773 and \$0, respectively.

**14. Capital Standards**

The Federal Reserve Board and the Federal Deposit Insurance Corporation have adopted risk-based capital standards for banking organizations. These standards require ratios of capital to assets for minimum capital adequacy and to be classified as well capitalized under prompt corrective action provisions. As of September 30, 2011 and December 31, 2010, the capital ratios and minimum capital requirements are as follows:

(in thousands)	Actual		Minimum capital adequacy		To be well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>September 30, 2011</b>						
Total capital (to risk-weighted assets)	\$ 29,282	12.9%	\$ 18,109	8.0%	\$ 22,637	10.0%
Tier 1 capital (to risk-weighted assets)	27,124	12.0%	9,055	4.0%	13,582	6.0%
Tier 1 capital (to average assets)	27,124	9.6%	11,367	4.0%	14,209	5.0%
<b>December 31, 2010</b>						
Total capital (to risk-weighted assets)	\$ 28,465	13.0%	\$ 17,446	8.0%	\$ 21,808	10.0%
Tier 1 capital (to risk-weighted assets)	25,989	11.8%	8,723	4.0%	13,085	6.0%
Tier 1 capital (to average assets)	25,989	9.3%	11,126	4.0%	13,909	5.0%

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

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

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

## Harford Bank

### Notes to Financial Statements

#### 15. Fair Value Measurements

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

The fair value hierarchy is as follows:

Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect the Bank's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

During the period ended September 30, 2011 the Bank did not measure any assets or liabilities on a recurring basis. Nonrecurring fair value adjustments to foreclosed real estate owned reflect values that are based on the real estate's observable market price or current appraised value of the collateral. Since the market for foreclosed real estate is not active, nonrecurring fair value adjustments based on the current offered price or appraised value of the collateral are classified as Level 2. The estimated fair value of foreclosed real estate at September 30, 2011 was \$1,686,274. The estimated fair value of foreclosed real estate at December 31, 2010 was \$2,639,000. Nonrecurring fair value adjustments to collateral dependent impaired loans through a specific valuation allowance reflect values that are based on the collateral's observable market price or current appraised value of the collateral less estimated selling costs. Fair value adjustments based on the appraised value of the collateral less costs to sell are classified as Level 2. The estimated fair value of collateral dependent impaired loans at September 30, 2011 was \$677,113. Non-collateral dependent impaired loans were measured for fair value using the present value of expected cash flows, and are classified as Level 3 in the hierarchy. The estimated fair value of non-collateral dependent impaired loans at September 30, 2011 was \$8,784,491. The estimated fair value of impaired loans at December 31, 2010 was \$7,780,963.

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

	<u>September 30, 2011</u>		<u>December 31, 2010</u>	
	Carrying amount	Fair value	Carrying amount	Fair value
<b>Financial assets</b>				
Investment securities	\$ 29,769,973	\$ 30,151,862	\$ 26,676,214	\$ 26,545,513
Loans, net	221,057,227	220,138,135	212,193,865	211,945,486
<b>Financial liabilities</b>				
Interest-bearing deposits	\$ 192,478,141	\$ 193,684,427	\$ 185,918,759	\$ 191,676,249
FHLB advances	28,000,000	31,497,737	28,428,571	29,770,410

**Harford Bank**  
**Notes to Financial Statements**

**15. Fair Value - continued**

*Investment securities*

The fair value of investment securities is estimated based on quoted market prices, when available. If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data.

*Loans, net*

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

*Interest-bearing deposits*

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

*FHLB advances*

The fair value of FHLB advances are obtained from directly from the FHLB Atlanta, and are mathematical approximations of market values derived from its proprietary models.

*Commitments to extend credit, lines of credit, and letters of credit*

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

**16. Legal Proceedings**

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