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BAY NATIONAL CORP
Form 10QSB
May 13, 2005

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended March 31, 2005.

Commission file number: 333-87781

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

Maryland

52-2176710

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

2328 West Joppa Road, Lutherville, MD 21093

Address of principal executive offices

(410) 494-2580

Issuer's telephone number

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No
----- -----

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

At May 13, 2005, the issuer had 1,920,194 shares of Common Stock outstanding.

Transitional Small Business Disclosure Format (Check One): Yes No X
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PART I - FINANCIAL INFORMATION

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Item 1. Financial Statements

BAY NATIONAL CORPORATION

CONSOLIDATED BALANCE SHEETS

As of March 31, 2005 and December 31, 2004

	March 31, 2005

ASSETS	(Unaudited)
Cash and due from banks	\$ 1,162,644
Federal funds sold and other overnight investments	18,493,156
Loans held for sale	7,726,815
Investment securities available for sale (AFS) - at fair value	1,543,073
Other equity securities	654,790
Loans, net of unearned fees	142,194,796
Less: Allowance for credit losses	(1,842,000)

Loans, net	140,352,796
Premises and equipment, net	627,410
Accrued interest receivable and other assets	929,730

Total Assets	\$ 171,490,414
	=====
LIABILITIES	
Non-interest-bearing deposits	\$ 23,605,655
Interest-bearing deposits	130,746,300

Total deposits	154,351,955
Short-term borrowings	1,261,000
Note Payable	1,250,000
Accrued expenses and other liabilities	760,376

Total Liabilities	157,623,331

STOCKHOLDERS' EQUITY	
Common stock - \$.01 par value, authorized: 9,000,000 shares authorized, 1,920,194 and 1,917,710 issued and outstanding as of March 31, 2005 and December 31, 2004, respectively	19,202
Additional paid in capital	17,419,088
Accumulated deficit	(3,571,207)

Total Stockholders' Equity	13,867,083

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Total Liabilities and Stockholders' Equity \$ 171,490,414
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See accompanying notes to consolidated financial statements.

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BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

 For the three-month periods ended March 31, 2005 and 2004
 (Unaudited)

	Three Mon Mar
	----- 2005 -----
INTEREST INCOME:	
Interest and fees on loans	\$ 2,463,260
Interest on federal funds sold and other overnight investments	66,478
Taxable interest and dividends on investment securities	11,606
Total interest income	----- 2,541,344 -----
INTEREST EXPENSE:	
Interest on deposits	790,469
Interest on short-term borrowings	8,116
Interest on note payable	16,996
Total interest expense	----- 815,581 -----
Net interest income	1,725,763
Provision for credit losses	32,000
Net interest income after provision for credit losses	----- 1,693,763 -----
NON-INTEREST INCOME:	
Service charges on deposit accounts	49,239
Gain on sale of mortgage loans	41,604
Other income	11,386

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Total non-interest income	102,229
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NON-INTEREST EXPENSES:	
Salaries and employee benefits	748,595
Occupancy expenses	94,174
Furniture and equipment expenses	77,091
Legal and professional fees	40,000
Data processing and other outside services	208,825
Advertising and marketing related expenses	61,785
Other expenses	136,032
<hr/>	
Total non-interest expenses	1,366,502
<hr/>	
Income before income taxes	429,490
Income tax expense	-
<hr/>	
NET INCOME	\$ 429,490
<hr/>	
Per Share Data:	
Cash Dividends Paid	\$ -
Net Income (basic)	\$.22
Net Income (diluted)	\$.22
Weighted Average shares outstanding (basic)	1,919,725
Effect of Dilution - Stock options and Warrants	66,573
<hr/>	
Weighted Average shares outstanding (diluted)	1,986,298
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See accompanying notes to consolidated financial statements.

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BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the three-months ended March 31, 2005 and 2004
(Unaudited)

	Common Stock	Paid in Capital	Accumulated Deficit	
	<hr/>	<hr/>	<hr/>	
Balances at December 31, 2004	\$ 19,177	\$ 17,400,284	\$ (4,000,697)	\$
Issuance of Common Stock	25	18,804	-	
Net Income	-	-	429,490	

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Balances at March 31, 2005	\$ 19,202	\$ 17,419,088	\$ (3,571,207)
	-----	-----	-----
	=====	=====	=====
		Additional	Accumulated
	Common Stock	Paid in	Deficit
	-----	Capital	-----
Balances at December 31, 2003	\$ 18,627	\$ 16,850,834	\$ (4,802,961)
Net Income	-	-	61,076
	-----	-----	-----
Balances at March 31, 2004	\$ 18,627	\$ 16,850,834	\$ (4,741,885)
	=====	=====	=====

See accompanying notes to consolidated financial statements.

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BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
For the three-months ended March 31, 2005 and 2004
(Unaudited)

	2005

Cash Flows From Operating Activities	
Net income	\$ 429,490
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation	41,113
Accretion of investment discounts	(9,009)
Provision for credit losses	32,000
Gain on sale of loans held for sale	(41,604)
Origination of loans held for sale	(29,932,146)
Proceeds from sale of loans	31,860,097
Net increase in accrued interest receivable and other assets	(188,976)
Net decrease in accrued expenses and other liabilities	(26,292)

Net cash provided by operating activities	2,164,673

Cash Flows From Investing Activities	
Purchases of investment securities - AFS	(1,539,568)
Maturities of investment securities - AFS	1,550,000
Purchase of Federal Home Loan Bank of Atlanta stock	(98,700)

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Loan disbursements in excess of principal payments	(781,359)
Capital expenditures	(74,940)

Net cash used by investing activities	(944,567)

Cash Flows From Financing Activities	
Net increase in deposits	424,913
Net (decrease) increase in short-term borrowings	(120,000)
Net proceeds from stock issuance	18,829

Net cash provided by financing activities	323,742

Net increase in cash and cash equivalents	1,543,848
Cash and cash equivalents at beginning of period	18,111,952

Cash and cash equivalents at end of period	\$ 19,655,800
	=====
Cash paid for:	
Interest	\$ 801,949
Income taxes	\$ -

See accompanying notes to consolidated financial statements.

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BAY NATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For The Three Months Ended March 31, 2005 and 2004
(Unaudited)

1. GENERAL

Organization

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

Basis of Presentation

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

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

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

Reclassifications

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

2. REGULATORY MATTERS

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

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Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios. Management believes, as of March 31, 2005, that the Bank meets all capital adequacy requirements to which it is subject.

As of March 31, 2005, the Bank has been categorized as "Well Capitalized" by the OCC under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios.

3. INCOME TAXES

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

4. EARNINGS PER SHARE

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

5. STOCK-BASED COMPENSATION

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123) and Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" (SFAS No. 148), and applies Accounting Principles Board Opinion No. 25 and related interpretations in accounting for its stock option plan. No compensation expenses related to the Company's stock option plan were recorded during the three-month periods ended March 31, 2005 and 2004.

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The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 and SFAS No. 148 to stock-based employee compensation for the three-month periods ended March 31:

	Three Months Ending March 31	
	2005	2004
INTEREST INCOME:		
Net income, as reported	\$ 429,490	\$ 61,076
Less pro forma stock-based compensation expense determined under the fair value method	(17,011)	(15,609)
Pro forma net income	\$ 412,479	\$ 45,467
Net income per share:		
Basic - as reported	\$.22	\$.03
Diluted - as reported	\$.22	\$.03
Basic - pro forma	\$.21	\$.02
Diluted - pro forma	\$.21	\$.02

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

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

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General

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

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

Overview

While the Company experienced a slow down in the growth of assets for the three-month period ended March 31, 2005, operating results continued a strong trend of improvement over prior year results. Key measurements for the three-month period ended March 31, 2005 include the following:

- o Total assets at March 31, 2005 increased marginally to \$171.5 million as compared to \$170.8 million as of December 31, 2004.
- o Net loans outstanding increased from \$139.6 million as of December 31, 2004 to \$140.4 million as of March 31, 2005.
- o There were no nonperforming loans at March 31, 2005. Appropriate reserves for loan losses continue to be maintained.
- o Deposits at March 31, 2005 were \$154.4 million, a small increase from \$153.9 million as of December 31, 2004.
- o The Company realized net income of \$429,490 for the three-month period ended March 31, 2005. This is a 603.21% increase over net income of \$61,076 for the three-month period ended March 31, 2004.
- o Net interest income, the Company's main source of income, was \$1.7 million during the three-month period ended March 31, 2005 compared to \$1.1 million for the same period in 2004. This represents an increase of 64.34% for the three-months ended March 31, 2005 as compared to the same period in 2004.
- o There were no charge-offs for the three-month period ended March 31, 2005. Loan charge-offs were \$6,221 for the three-month period ended March 31, 2004.
- o Non-interest income declined by \$23,098, or 18.43%, for the three-month period ended March 31, 2005, as compared to the same period in 2004.
- o Non-interest expenses increased by \$361,836, or 36.02%, for the three-month period ended March 31, 2005, as compared to the same period ended March 31, 2004.

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- o The market price of common shares ended the quarter at \$14.50, up 9.43% from the closing price of \$13.25 on December 31, 2004.

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

Results of Operations

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Overview

The Company recorded net income of \$429,490 for the three-month period ended March 31, 2005. This compares to net income of \$61,076 for the same period in 2004. This is an improvement of \$368,414 or 603.21% for the three-month period. This significant improvement in results for the period is due to the continued year over year growth of the loan portfolio.

Bay National Bank's mortgage origination operations, located in Lutherville and Salisbury, Maryland, originate conventional first and second lien residential mortgage loans. Bay National Bank sells most of its first and second lien residential mortgage loans in the secondary market and typically recognizes a gain on the sale of these loans after the payment of commissions to the loan origination officer. Since its inception in February 2001, the Salisbury mortgage division has been a significant contributor to operating results. The Lutherville mortgage operation was initiated in February 2005 and is expected to contribute to the Company's overall profitability by the second half of 2005. For the three-month periods ended March 31, 2005 and 2004, gains on the sale of mortgage loans totaled \$41,604 and \$56,949, respectively.

The level of gains on the sale of mortgage loans has declined from 2004 due to the strengthening of economic conditions and the resulting increase in long-term interest rates as compared to the rates in effect during the same period of 2004. An increase in rates traditionally has a negative impact on mortgage loan production due to a reduction in the incentive for borrowers to refinance existing mortgages or purchase new homes. The addition of the Lutherville origination operation is expected to offset this trend by focusing on construction and rehabilitation loans that will be modified to permanent financing upon completion of the project. This type of residential lending is expected to be less sensitive to the fluctuation of interest rates.

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

The primary risk to the Company is that the secondary market investor may decline to purchase the loans due to documentary deficiencies or errors. The Company attempts to manage this risk by conducting a thorough review of the documentation prior to purchasing the participation. If the secondary market investor declines to purchase the loan, the Company could attempt to sell the loan to other investors or hold the loan in its loan portfolio. As of March 31, 2005, the Company held \$7.2 million of these loans which were classified as held for sale. The Company earned \$104,558 of interest on this program for the three-month period ended March 31, 2005.

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

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fluctuations.

Net Interest Income

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

As previously stated, net interest income was \$1.7 million during the three-month period ended March 31, 2005 as compared to \$1.1 million for the same period in 2004. This represents an increase of 64.34% for the three-months ended March 31, 2005 as compared to the same period in 2004.

Interest income from loans and investments for the three-month period ended March 31, 2005 was \$2.5 million, compared to \$1.6 million for the three-month period ended March 31, 2004. The 62.75% increase is directly related to the 35.31% increase in average interest-earning assets for the three-months ended March 31, 2005 as compared to the same period in 2004. The increase in average interest-earning assets was also aided by a significant increase in average yields due to seven .25% increases in the target federal funds rate since June 30, 2004. The yields on these assets increased from 5.03% for the three-months ended March 31, 2004 to 6.05% for the three-months ended March 31, 2005.

The percentage of average interest-earning assets represented by loans was 89.63% and 85.98% for the three-month periods ended March 31, 2005 and 2004, respectively. An increase in the percentage of interest-earning assets represented by the loan portfolio would normally result in an increase in average yields on interest-earning assets. For the three-month period ended March 31, 2005, the average yield on the loan portfolio increased to 6.54% from 5.73% for the three-month period ended March 31, 2004. This increase is primarily due to the difference in the target federal funds rate in effect for the periods. The Federal Reserve has increased its target for the federal funds rate from 1.00% as of March 31, 2004 to 2.75% as of March 31, 2005 and most recently to its current target rate of 3.00%, which became effective on May 3, 2005. As can be seen by the yields discussed above, these increases have begun to have a significant effect on the Company's operating results. Yields on earning assets in future periods should continue to improve following any future actions by the Federal Reserve.

The average yield on the investment portfolio and other earning assets such as federal funds sold, was 1.79% for the three-month period ended March 31, 2005 as compared to .71% for the same period in 2004. The improvement in the average yield was a direct result of the Federal Reserve actions discussed above, as well as an increase in the holdings of Federal Reserve and Federal Home Loan bank stocks, which pay dividend yields greater than the prevailing federal funds rates. The percentage of average interest-earning assets represented by investments was 10.37% and 14.02% for the three-month periods ended March 31, 2005 and 2004, respectively.

Interest expense from deposits and borrowings for the three-month period ended March 31, 2005 was \$815,581. This compares to \$511,345 for the comparable period in 2004. The 59.50% increase is a result of a 34.30% increase in average interest-bearing liabilities for the

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three-month period ended March 31, 2005 as compared to the same period in 2004. The increase in interest expense was also related to the increase in average rates paid. Average rates paid on these liabilities increased from 2.08% for the three-month period ended March 31, 2004 to 2.47% for the three-month period ended March 31, 2005. The increase in rates paid is directly attributable to the Federal Reserve actions discussed above. Even though market rates of interest have increased significantly since June 30, 2004, management has been able to minimize deposit rate increases, which has allowed for significantly improved margins. Management expects that pressure to increase rates paid on deposits will increase as the target for the federal funds rate continues to rise. In fact, upward pressure began to appear on shorter term rates in the fourth quarter of 2004 and continued during the first quarter of 2005.

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

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

Three Months Ended March 31, 2005

	Average Balance -----	Interest and fees -----
ASSETS		
Loans and loans held for sale	\$ 150,681,459	\$ 2,463,260
Investment securities	2,104,452	11,606
Federal funds sold and other overnight investments	15,320,999	66,478
	-----	-----
Total earning assets	168,106,910	2,541,344
	-----	-----
Less: Allowance for credit losses	(1,821,378)	
Cash and due from banks	1,173,244	
Premises and equipment, net	608,415	
Accrued interest receivable and other assets	667,893	

Total assets	\$ 168,735,084	
	=====	
LIABILITIES AND STOCKHOLDERS' EQUITY		
Interest-bearing demand deposits	\$ 55,952,233	202,465
Regular savings deposits	5,335,595	8,538
Time deposits	67,856,868	579,466
Short-term borrowings	1,460,756	8,116
Note payable	1,250,000	16,996
	-----	-----

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Total interest-bearing liabilities	131,855,452	815,581
Net interest income and spread		\$ 1,725,763
Non-interest-bearing demand deposits	22,758,094	
Accrued expenses and other liabilities	614,716	
Stockholders' equity	13,506,822	
Total liabilities and stockholders' equity	\$ 168,735,084	
Interest income/earning assets	6.05%	
Interest expense/earning assets	1.94	
Net interest margin	4.11%	
Return on Average Assets (Annualized)	1.02%	
Return on Average Equity (Annualized)	12.72%	
Average Equity to Average Assets	8.00%	

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Three Months Ended March 31, 2004

	Average Balance	Interest and fees
ASSETS		
Loans and loans held for sale	\$ 106,823,760	\$ 1,530,644
Investment securities	1,938,267	4,895
Federal funds sold and other overnight investments	15,477,632	25,942
Total earning assets	124,239,659	1,561,481
Less: Allowance for credit losses	(1,307,128)	
Cash and due from banks	737,346	
Premises and equipment, net	627,785	
Accrued interest receivable and other assets	460,430	
Total assets	\$ 124,758,092	
LIABILITIES AND STOCKHOLDERS' EQUITY		
Interest-bearing demand deposits	\$ 39,595,098	101,222
Regular savings deposits	3,413,533	5,529
Time deposits	53,853,033	401,686
Short-term borrowings	1,321,406	2,908
Total interest-bearing liabilities	98,183,070	511,345
Net interest income and spread		\$ 1,050,136

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Non-interest-bearing demand deposits	14,020,473	=====
Accrued expenses and other liabilities	409,827	
Stockholders' equity	12,144,722	

Total liabilities and stockholders' equity	\$ 124,758,092	=====
Interest income/earning assets	5.03%	
Interest expense/earning assets	1.65	

Net interest margin	3.38%	=====
Return on Average Assets (Annualized)	.20%	=====
Return on Average Equity (Annualized)	2.01%	=====
Average Equity to Average Assets	9.74%	=====

Provision for Credit Losses

The provision for credit losses was \$32,000 for the three-month period ended March 31, 2005, as compared to \$109,721 for the three-month period ended March 31, 2004. The provisions for each period were reflective of the growth in loan balances outstanding in all segments of the portfolio. The provision for the three-month period ended March 31, 2005 was substantially lower than the same period in the prior year due to fact that gross loans outstanding increased by \$781,359 during that period as compared to an increase of approximately \$8.2 million for the same period in 2004. For additional information regarding the methodology used to determine the provision for credit losses, see the Management Discussion and Analysis section entitled "Allowance for Credit Losses and Credit Risk Management."

Non-Interest Income

Non-interest income consists primarily of gains on the sale of mortgage loans, deposit account service charges, and cash management fees. For the three-month period ended March 31, 2005, the Company realized non-interest income in the amount of \$102,229 as compared to \$125,327 for the three-month period ended March 31, 2004. Gains on the sale of mortgage loans of \$41,604 comprise 40.70% of the total for the three-month period ended March 31, 2005.

This compares to gains on the sale of mortgage loans of \$56,949, or 45.44% of total non-interest income, for the three-month period ended March 31, 2004.

The level of gains on the sale of mortgage loans has declined due to recent increases in long-term interest rates driven by stronger economic conditions. Additional increases in interest rates, or a slow down in the housing market, could further impact the Company's ability to maintain the same level of non-interest income associated with mortgage loan production.

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In February 2005, the Company added additional residential construction and mortgage capabilities in the Baltimore market area. It is expected that these additional capabilities will increase future levels of gains on the sale of mortgage loans, while also providing interest income on construction loans. This capability was added through the hiring of a team of eight individuals, including originators, processors and servicers from another financial institution. These individuals have extensive experience in the industry and the Company's market area.

Service charges on deposit accounts totaled \$49,239 for the three-month period ended March 31, 2005, as compared to \$54,455 for the three-month period ended March 31, 2004. The decrease of 9.58% for the period, as compared to the same period in 2004, can be directly attributed to a decline in analysis fees charged on commercial deposit accounts. This decline occurred as the rate used for the calculation of analysis credits increased in conjunction with the increase in the target federal funds rate discussed earlier. Analysis credits are fee reductions provided based upon the analysis credit rate and the average balance of the account subject to analysis fees.

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

Non-Interest Expense

Non-interest expense for the three-month period ended March 31, 2005, totaled \$1,366,502. This compares to non-interest expense for the comparable period in 2004 of \$1,004,666. The increase of \$361,836, or 36.02%, for the three-month period resulted from an increase in salaries and benefits of \$153,918 related to staffing growth, including the addition of an eight person mortgage lending operation in February 2005, as well as the addition of four commercial account portfolio managers and other operational support personnel. These additions were made to continue to expand the marketing efforts of the Bank, as well as to manage the growth of the loan and deposit portfolios and support increased operational volume.

Occupancy expenses increased by \$24,353, or 34.88%, for the three-month period as compared to the same period in 2004. This increase was due in part to scheduled rent increases as well as a reduction in sublease income due to expansion of the Company's corporate office into previously sublet space, and the acquisition of new space obtained to facilitate the expansion of the Company's corporate offices and accommodate the new mortgage lending group.

The \$78,154, or 59.82%, increase in data processing and other outside services for the three-months ended March 31, 2005 as compared to the same period in 2004 is the result of increased data and item processing costs and other costs paid to external service providers. The costs include one time expenses of approximately \$45,000 incurred in conjunction with the Bank's planned change of core processors scheduled for May 2005, \$13,000 of recruiting fees paid to hire an additional corporate finance and compliance staff person, and approximately \$8,000 of systems support costs incurred to facilitate network infrastructure changes required for a bank processing system upgrade. The remaining increase is due to the fact that systems and

item processing costs are volume-driven based upon the number of customer accounts and related transaction volume. As a result, these costs increase with

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the growth of the Company.

The \$18,287, or 42.04%, increase in advertising and marketing-related expenses for the three-months ended March 31, 2005 as compared to the same period in 2004 is related to an increase in the number of marketing events conducted and the number of business development professionals on staff. The increase of \$62,884, or 85.97%, in other expenses includes director fees of approximately \$21,000, related to the director compensation plan adopted in the second half of 2004 and an increase of approximately \$6,000 in regulatory fees related to the growth of the Bank. The remaining increase in non-interest expense relates to various costs associated with the increased size and complexity of the Company.

The rate of increase in non-interest expenses, including non-recurring expenses, is substantially less than the 64.34% increase in net interest income for the three-month period ended March 31, 2005 as compared to the three-month period ended March 31, 2004. Management believes this indicates that the Company is continuing to effectively leverage its cost structure to generate profitable growth. While management expects that the ongoing growth of the Company's customer base will continue to require additional staffing in order to appropriately service customers and manage the business effectively, management believes that additional growth in the customer base can continue to be accomplished without proportionate increases in these costs.

Income Taxes

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

Financial Condition

Composition of the Balance Sheet

As of March 31, 2005, total assets were \$171,490,414. This represents growth of \$726,940 or .43% since December 31, 2004. The growth in total assets included increases of \$1,784,628 in federal funds sold and other overnight investments, \$98,700 in other equity securities, \$749,359 in loans net of the allowance for credit losses and \$222,803 in other non-earning assets. These increases were offset by decreases of \$240,780 in cash and due from banks, \$1,886,347 in loans held for sale and \$1,423 in investment securities available for sale.

During the second quarter of 2004, the Company introduced a new loan program for conventional first and second residential mortgage loans. Under this program the Company purchases a 100% participation in mortgage loans originated by a mortgage company in the Baltimore metropolitan area. These participations are for loans that a secondary market investor has committed to purchase. The participations are typically held for a period of three to four weeks before being sold to the secondary market investor. The Company earns interest on these loans at a rate indexed to the prime rate. As of March 31, 2005, the Company held \$7.2 million of these loans which were classified as held for sale, a decline from the \$8.0 million held as of December 31, 2004.

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As of March 31, 2005, loans, excluding loans held for sale (net of a \$1,842,000 allowance for credit losses), totaled \$140,352,796. The increase of \$749,359, or .54%, from a balance of \$139,603,437 as of December 31, 2004, is a slow down from the growth trend established in prior periods. This modest growth is the result of significant pay downs and payoffs in the first quarter of 2005. A total of approximately \$11.8 million in loans that were outstanding as of December 31, 2004 were paid off during the first quarter of 2005. This activity combined with normal fluctuations in revolving credit balances and installment payments on amortizing loans offset most of the approximately \$14.8 million in new loans funded during the quarter. Management does not believe that the first quarter loan growth is an indicator of any ongoing trend that will result in further moderation of growth. The Company continues to emphasize prudent growth through the hiring of experienced commercial lenders, and the development and use of referral sources including accountants, lawyers and existing customers, as well as members of the Board of Directors and the Baltimore and Salisbury Advisory Boards.

The composition of the loan portfolio as of March 31, 2005 was approximately \$72.9 million of commercial loans, \$2.2 million of consumer loans, and \$67.1 million of real estate loans (excluding mortgage loans held for sale). The composition of the loan portfolio as of December 31, 2004 was approximately \$73.8 million of commercial loans, \$2.2 million of consumer loans, and \$65.4 million of real estate loans (excluding mortgage loans held for sale). Mortgage loans held for sale were \$7.7 million and \$9.6 million as of March 31, 2005 and December 31, 2004, respectively.

Funds not extended in loans are invested in cash and due from banks, and various investments including federal funds sold and other overnight investments, U.S. Treasury securities, Federal Reserve Bank stock and Federal Home Loan Bank stock. These investments totaled approximately \$21.9 million as of March 31, 2005 compared to approximately \$20.2 million as of December 31, 2004. At March 31, 2005, the Company had federal funds sold and other overnight investments totaling \$18,493,156 as compared to \$16,708,528 as of December 31, 2004. The Company held \$312,690 of Federal Reserve Bank stock as of both March 31, 2005 and December 31, 2004. The Company also held Federal Home Loan Bank of Atlanta stock of \$342,100 and \$243,400 as of March 31, 2005 and December 31, 2004, respectively, and United States Treasury bills with a maturity value of \$1,550,000 as of both March 31, 2005 and December 31, 2004. The Treasury securities are used to collateralize repurchase agreements, which are classified as short-term borrowings under which \$1,261,000 and \$1,381,000 were outstanding as of March 31, 2005 and December 31, 2004, respectively.

The increase in total assets was funded with operating earnings and an increase in deposits of \$424,913, or .28% since December 31, 2004. Short-term borrowings decreased by \$120,000. Management has made a decision to maintain an appropriate level of liquidity in the investment portfolio in order to ensure that funds are readily available to fund the growth of the loan portfolio and to meet the needs of deposit customers.

Deposits at March 31, 2005 were \$154,351,955, of which approximately \$15.0 million, or 9.69% were related to two customers in one industry and a third customer in another industry. Deposits at December 31, 2004 were \$153,927,042, of which deposits for these same customers stood at approximately \$16.6 million, or 10.79%, of total deposits. The deposits for these customers tend to fluctuate significantly; as a result, management monitors these deposits on a daily basis to ensure that liquidity levels are adequate to compensate for these fluctuations. Management was able to manage the rate of deposit growth, to closely match loan growth, by allowing maturing certificates of deposit obtained by listing rates on the internet, to run off without making any significant

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effort to retain these deposits.

The market in which the Company operates is very competitive; therefore, the rates of interest paid on deposits are affected by rates paid by other depository institutions. Management

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closely monitors rates offered by other institutions and seeks to be competitive within the market. The Company has chosen to selectively compete for large certificates of deposits. The Company will choose to pursue such deposits when expected loan growth provides for adequate spreads to support the cost of those funds. As of March 31, 2005, the Company had outstanding certificates of deposit of approximately \$22.6 million that were obtained through the listing of certificate of deposit rates on two Internet-based listing services (such deposits are sometimes referred to herein as national market certificates of deposit). These certificates of deposit were issued with an average yield of 3.15% and an average term of 36 months. Included in the \$22.6 million of Internet-originated certificates of deposit is \$195,322 that has been classified as "Brokered Deposits" for bank regulatory purposes. These "Brokered Deposits" were issued in average amounts of approximately \$97,661 with an average yield of 2.79% and an average term of 45 months. As of December 31, 2004, the total certificates of deposit obtained through the listing of certificate of deposit rates on the Internet-based listing services were approximately \$29 million, of which \$394,666 were classified as "Brokered Deposits." The Company has never paid broker fees for deposits. Additionally, the Company has not accepted any new "Brokered Deposits" since August 2002.

Core deposits, which management categorizes as all deposits other than national market certificates of deposit and all but \$5.0 million of deposits from the three large customers described above (which management considers to be a stable deposit amount from these customers based upon historical trends), stood at \$121,826,504 as of March 31, 2005, up 7.42% from \$113,412,507 as of December 31, 2004. Core deposits are closely monitored by management because they consider such deposits not only a relatively stable source of funding but also reflective of the growth of commercial and consumer depository relationships.

Short-term borrowings consist of repurchase agreements collateralized by pledges of U.S. Government Treasury Securities, based upon their market values, equal to 100% of the principal and accrued interest of its short-term borrowings. The outstanding balance of short-term borrowings decreased from \$1,381,000 at December 31, 2004 to \$1,261,000 at March 31, 2005, due to decreases in the balance of available funds for customers participating in this program.

Note payable consists of \$1,250,000 borrowed under a \$5 million, three-year unsecured non-revolving credit facility executed on September 28, 2004 with another financial institution. Borrowings under the credit facility are used to provide regulatory capital to the Bank. The loan bears interest at the prime rate.

Total stockholders' equity at March 31, 2005 was \$13,867,083 as compared to \$13,418,764 at December 31, 2004. The increase in stockholders' equity is a result of the positive operating results for the three-months ended March 31, 2005, and \$18,829 received upon the issuance of 2,484 shares of common stock upon the exercise of options.

Management believes that the Company will need additional capital, in excess of the \$3.75 million still available under the credit facility, to

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

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Allowance for Credit Losses and Credit Risk Management

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

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

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

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

The allowance for credit losses as of March 31, 2005 and December 31,

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2004 was \$1,842,000 and \$1,810,000, respectively. The amount equates to 1.30% and 1.28% of outstanding loans, net of loans held for sale, as of March 31, 2005 and December 31, 2004, respectively. This percentage has remained fairly consistent because no additional information has indicated that the overall level of reserves is inappropriate. The Company has no exposure to foreign countries or foreign borrowers. Management believes that the allowance for credit losses is adequate for each period presented.

As of March 31, 2005 the Company had no loans more than 90 days past due and no loans classified as non-accrual loans. The Company had no loan charge-offs during the three-months ended March 31, 2005. The Company had loan charge-offs of \$6,221 during the three-months ended March 31, 2004.

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Liquidity

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

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

The Company's most liquid assets are cash and assets that can be readily converted into cash, including investment securities maturing within one year. As of March 31, 2005, the Company had \$1,162,644 in cash and due from banks, \$18,493,156 in federal funds sold and other overnight investments and \$1,543,073 in three-month U.S. Treasury Securities. As of December 31, 2004, the Company had \$1,403,424 in cash and due from banks, \$16,708,528 in federal funds sold and other overnight investments and \$1,544,496 in three-month U.S. Treasury Securities.

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

The Company has commitments for a total of \$7.0 million of borrowing availability under unsecured Federal funds lines of credit with three separate financial institutions. The Company also has approximately \$17 million of borrowing capacity with the Federal Home Loan Bank of Atlanta as of March 31, 2005 and \$3,750,000 of borrowing capacity under its three-year note payable. These credit facilities can be used in conjunction with the normal deposit strategies, which include pricing changes to increase deposits as necessary. From time to time, the Company may sell or participate out loans to create additional liquidity as required.

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

Management is not aware of any known trends, events or uncertainties that will have or are reasonably likely to have a material effect on liquidity,

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capital or operations, nor is management aware of any current recommendation by regulatory authorities, which if implemented, would have a material effect on liquidity, capital or operations.

Interest Rate Sensitivity

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

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

The following table sets forth the amount of the Company's interest-earning assets and interest-bearing liabilities as of March 31, 2005, which are expected to mature or reprice in each of the time periods shown:

	Amount	Percent of Total	0 to 3 Months	Maturity or 4 to 12 Months
Interest-earning assets				
Federal funds sold and other overnight investments	\$ 18,493,156	10.84%	\$ 18,493,156	\$ -
Loans held for sale	7,726,815	4.53	7,726,815	
Loans - Variable rate	104,213,168	61.08	104,213,168	-
Loans - Fixed rate	37,981,628	22.26	3,317,415	5,847,542
Other earning assets	2,197,863	1.29	1,543,073	-
	-----	-----	-----	-----
Total interest-earning assets	\$170,612,630	100.00%	\$135,293,627	\$ 5,847,542
	=====	=====	=====	=====
Interest-bearing liabilities				
Deposits - Variable rate	\$ 63,988,131	48.02%	\$ 63,988,131	\$ -
Deposits - Fixed rate	66,758,169	50.10	8,547,100	19,171,929
Short-term borrowings - Variable rate	1,261,000	.94	1,261,000	-
Note Payable	1,250,000	.94	1,250,000	-
	-----	-----	-----	-----
Total interest-bearing liabilities	\$133,257,300	100.00%	\$ 75,046,231	\$19,171,929
	=====	=====	=====	=====

Periodic repricing differences

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Periodic gap	\$ 60,247,396	\$ (13,324,38
	=====	=====
Cumulative gap	\$ 60,247,396	\$46,923,009
	=====	=====
Ratio of rate sensitive assets to rate sensitive liabilities	180.28%	30.50

The Company has 77.74% of its interest-earning assets and 49.90% of its interest-bearing liabilities in variable rate balances. Interest-earning assets exceed interest-bearing liabilities by \$37,355,330. The majority of this gap is concentrated in items maturing or repricing within 12 months. This gap is generally reflective of the Company's emphasis on originating variable rate loans and the demand in the market for higher yielding fixed rate deposits. This analysis indicates that the Company generally will benefit from increasing market rates of interest. However, since all interest rates and yields do not adjust at the same pace, the gap is only a general indicator of interest rate sensitivity. The analysis of the Company's interest-earning assets and interest-bearing liabilities presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration the fact that changes in interest rates do not affect all assets and liabilities equally. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

Management constantly monitors and manages the structure of the Company's balance sheet, seeks to control interest rate exposure, and evaluate pricing strategies. Strategies to better match maturities of interest-earning assets and interest-bearing liabilities include structuring loans with rate

floors and ceilings on variable-rate notes and providing for repricing opportunities on fixed rate notes. Management believes that a lending strategy focusing on variable-rate loans and short-term fixed rate loans will best facilitate the goal of minimizing interest rate risk. However, management will opportunistically enter into longer term fixed-rate loans and/or investments when, in management's judgment, rates adequately compensate the Company for the interest rate risk. The Company's current investment concentration in federal funds sold and other overnight investments provides the most flexibility and control over rate sensitivity since it generally can be restructured more quickly than the loan portfolio. On the liability side, deposit products can be restructured so as to offer incentives to attain the maturity distribution desired although competitive factors sometimes make control over deposit maturity difficult.

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

Off-Balance Sheet Arrangements

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

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

	March 31, 2005	December 31, 2004
	-----	-----
Loan commitments	\$ 8,511,575	\$ 9,867,893
Unused lines of credit	44,900,594	40,423,986
Letters of credit	1,363,521	1,578,379

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

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

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

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

Capital Resources

The Company had stockholders' equity at March 31, 2005 of \$13,867,083 as compared to \$13,418,764 at December 31, 2004. The increase in capital is a result of the positive operating results for the three-months ended March 31, 2005, and \$18,829 received upon the issuance of 2,484 shares of common stock upon the exercise of options. Management believes that the Company will need additional capital, in excess of the \$3.75 million still available under the credit facility, to support projected asset growth over the next 12 months. Management and the Capital Committee of the Board of Directors are currently evaluating available alternatives. Any additional capital, if available at all, may be on terms which are not as favorable to the Company as that desired by management and may result in dilution to the Company's shareholders. If adequate

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capital is not available, the Company may be required to curtail significantly its expected growth strategy.

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

Banking regulations also limit the amount of dividends that may be paid without prior approval of the Bank's regulatory agencies. Regulatory approval is required to pay dividends that exceed the Bank's net profits for the current year plus its retained net profits for the preceding two years. The Bank could not have paid dividends to the Company without approval from bank regulatory agencies at March 31, 2005.

Reconciliation of Non-GAAP Measures

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

	March 31, 2005	December 31 2004
	-----	-----
Total deposits	\$ 154,351,955	\$ 153,927,042
National market certificates of deposit	(22,568,884)	(28,908,592)
Variable balance accounts (3 customers)	(14,956,567)	(16,605,943)
Portion of variable balance accounts considered to be core	5,000,000	5,000,000
	-----	-----
Core deposits	\$ 121,826,504	\$ 113,412,507
	=====	=====

Application of Critical Accounting Policies

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing

results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

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

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

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

Item 3. Controls and Procedures

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

In addition, there were no changes in Bay National Corporation's internal controls over financial reporting (as defined in Rule 13a-15 or Rule 15d-15 under the Securities Act of 1934, as amended) during the quarter ended March 31, 2005, that have materially affected, or are reasonably likely to materially affect, Bay National Corporation's internal control over financial reporting.

Information Regarding Forward-Looking Statements

In addition to the historical information contained in Part I of this Quarterly Report on Form 10-QSB, the discussion in Part I of this Quarterly Report on Form 10-QSB contains certain forward-looking statements. Forward-looking statements often use words such as "believe," "expect," "plan," "may," "will," "should," "project," "contemplate," "anticipate," "forecast," "intend" or other words of similar meaning. You can also identify them by the fact that they do

not relate strictly to historical or current facts. Our actual results and the actual outcome of our expectations and strategies could be different from those

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anticipated or estimated.

The statements presented herein with respect to, among other things, Bay National Corporation's plans, objectives, expectations and intentions, including statements regarding profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk and financial and other goals are forward looking. These statements are based on Bay National Corporation's beliefs and assumptions, and on information available to Bay National Corporation as of the date of this filing, and involve risks and uncertainties. These risks and uncertainties include, among others, those discussed in this Quarterly Report on Form 10-QSB; Bay National Corporation's limited operating history; dependence on key personnel; risks related to Bay National Bank's choice of loan portfolio; risks related to Bay National Bank's lending limit; risks of a competitive market; impact of government regulation on operating results; and effect of developments in technology. For a more complete discussion of these risks and uncertainties see the discussion under the caption "Factors Affecting Future Results" in Bay National Corporation's Form 10-KSB.

Bay National Corporation's actual results could differ materially from those discussed herein and you should not put undue reliance on any forward-looking statements. All forward-looking statements speak only as of the date of this filing, and Bay National Corporation undertakes no obligation to make any revisions to the forward-looking statements to reflect events or circumstances after the date of this filing or to reflect the occurrence of unanticipated events.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

None

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

(a) None

(b) None

(c) None

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

None

Item 5. Other Information.

None

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Item 6. Exhibits.

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

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SIGNATURES

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

Bay National Corporation

Date: May 13, 2005

By: /s/ Hugh W. Mohler

Hugh W. Mohler, President
(Principal Executive Officer)

Date: May 13, 2005

By: /s/ Mark A. Semanie

Mark A. Semanie, Treasurer
(Principal Accounting and Financial Officer)

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