MIDCAROLINA
FINANCIAL CORPORATION

2008 ANNUAL REPORT

To the Shareholders of MidCarolina Financial Corporation

It is my pleasure to present to you our operating results for 2008 in what was a challenging economic period for your bank and many of its customers. We are proud of our performance which focused on managed growth, loan quality and operating efficiencies.

In this, our 11th year, total assets increased to a record $541 million, an increase of 16% when compared to assets of $467 million at December 31, 2007. The bank's largest investment, our loan portfolio, increased by $62 million, or 17%, from $373 million at December 31, 2007 to $435 million at December 31, 2008. Our Deposits increased to record amounts totaling $468 million at December 31, 2008, a 25% increase over 2007 year-end.

For the 12 month period ended December 31, 2008, net income available to common shareholders was $3.3 million. Net income available to common shareholders at December 31, 2007 was $4.5. Diluted earnings per common share were $0.66 for 2008, compared to $0.92 for the twelve months ended December 31, 2007. Results for the 12 months ended December 31, 2008 included a one-time after tax reduction to earnings of $248,000 related to Other Than Temporary Impairment of Mortgage Backed securities. Results for the 2007 period included a one-time after tax increase to earnings of $579,000 related to the reversal of accrued benefits for a former executive officer. Excluding the effect of these adjustments, our diluted earnings per common share for 2008 would have been $0.71 compared to $0.80 for 2007.

The Bank's asset quality and performance remain sound in spite of the general market conditions of the local and national economy. In light of these conditions we chose to increase our provision to loan losses by an additional $1.2 million for 2008 compared to 2007. It is noteworthy that our 2008 operating earnings (pre-tax earnings before the loan loss provision, excluding one time adjustments for impaired investment securities in 2008 and benefit reversal in 2007) increased 12% over 2007.

We continue to pursue investments in our local communities through loan originations to residents and businesses. The very core of our strategy and the predominant goal of your board of directors is to be the banking partner of choice in the markets we serve.

We anticipate that 2009 will be another trying year for the banking industry. However, we feel very strongly that the community banking model, and your bank in particular, is well positioned to take advantage of opportunities that may arise in our markets as the financial services landscape changes.

We are appreciative of your continued support and we encourage you to visit us on-line, or at one of our branches, to experience the difference in banking with MidCarolina Bank!

Sincerely,

Charles T. Canaday, Jr.
President / CEO

Board of Directors

MidCarolina Financial Corporation
MidCarolina Bank

James R. Copland, III
Chairman
F. D. Hornaday, III
Vice Chairman
Charles T. Canaday, Jr.
Dexter R. Barbee, Sr.
H. Thomas Bobo
Thomas E. Chandler
James B. Crouch, Jr.
J. Anthony Holt, Sr.
Teena M. Koury
John H. Love
James B. Powell
John K. Roberts
James H. Smith, Jr.
Robert A. Ward
George C. Waldrep, Jr.

Senior Management Team

Charles T. Canaday, Jr.
President / CEO

Christopher Redcay
Senior Vice President
Chief Financial Officer

Craig Patterson
Senior Vice President
Chief Credit Officer

Steve Gilliam
Senior Vice President
Mortgage Lender

Bonnie Jones
Senior Vice President
Retail Banking Executive

Rhonda Joyce
Senior Vice President
Guilford County Executive

Nancy Walker
Senior Vice President
Controller

Troy Woodard
Senior Vice President
Alamance County Executive

U. S. Securities and Exchange Commission
Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended **December 31, 2008**

Commission File Number 000-49848

MIDCAROLINA FINANCIAL CORPORATION
(Name of Issuer in Its Charter)

North Carolina (State or Other Jurisdiction of Incorporation or Organization)	**55-6144577** (I.R.S. Employer Identification No.)
3101 South Church Street **Burlington, North Carolina** (Address of Principal Executive Offices)	**27215** (Zip Code)

(336) 538-1600
(Issuer's Telephone Number, Including Area Code)

Securities Registered Under Section 12(b) of the Act: **None**

Securities Registered Under Section 12(g) of the Act: **common stock, no par value**
Title of Class

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

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

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

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

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 definitions of "large accelerated filer", "accelerated filer", and smaller reporting company" in Rule 12b-2 of the exchange Act. (Check one).

Large Accelerated filer ☐ Accelerated filer ☐

Non-accelerated filer ☐ Smaller reporting company ☒

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

The aggregate market value of the Registrant's voting and non-voting equity, held by non affiliates, computed by reference to the average bid and asked price of such common equity, as of the last business day of the Registrant's most recently completed second fiscal quarter was $55.5 million.

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date. **4,927,828 shares of common stock, no par value, as of March 16, 2009**.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2009 Annual Meeting of Shareholders of MidCarolina Financial Corporation, to be held on May 27, 2009 (the "Proxy Statement"), are incorporated by reference into Part III.

Statement Regarding Forward Looking Statements

*Statements in this Report and its exhibits relating to plans, strategies, economic performance and trends, projections of results of specific activities or investments, expectations or beliefs about future events or results, and other statements that are not descriptions of historical facts, may be forward-looking statements as defined in Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking information is inherently subject to risks and uncertainties, and actual results could differ materially from those currently anticipated due to a number of factors which include, but are not limited to, factors discussed in our Annual Report on Form 10-K and in other documents we file with the Securities and Exchange Commission from time to time. Copies of those reports are available directly through the SEC's Internet website at **www.sec.gov** or through our Internet website at **www.midcarolinabank.com**. Forward-looking statements may be identified by terms such as "may," "will," "should," "could," "expects," "plans," "intends," "anticipates," "believes," "estimates," "predicts," "forecasts," "potential" or "continue," or similar terms or the negative of these terms, or other statements concerning opinions or judgments of our management about future events. Factors that could influence the accuracy of forward-looking statements include, but are not limited to, (a) pressures on the earnings, capital and liquidity of financial institutions resulting from current and future adverse conditions in the credit and capital markets and the banking industry in general,(b) the financial success or changing strategies of our customers, actions of government regulators, the level of market interest rates, and changes in general economic conditions and real estate values in our banking market (particularly changes that affect our loan portfolio, the abilities of our borrowers to repay their loans, and the values of loan collateral). Although we believe that the expectations reflected in the forward-looking statements are reasonable, they represent our management's judgments only as of the date they are made, and we cannot guarantee future results, levels of activity, performance or achievements. As a result, readers are cautioned not to place undue reliance on these forward-looking statements. All forward-looking statements attributable to us are expressly qualified in their entirety by the cautionary statements in this paragraph. We have no obligation, and do not intend, to update these forward-looking statements.*

PART I

ITEM 1. DESCRIPTION OF BUSINESS

General

MidCarolina Financial Corporation (the "Company") was formed in 2002 to serve as a holding company for MidCarolina Bank (the "Bank"). The Company is registered with the Board of Governors of the Federal Reserve System (the "Federal Reserve") under the Bank Holding Company Act of 1956, as amended (the "BHCA"), and the bank holding company laws of North Carolina. The Company's office is located at 3101 South Church Street, Burlington, North Carolina 27216. The Company's principal source of income is earnings on loans and investments, including any dividends that are declared and paid by the Bank on its capital stock.

The Bank is incorporated under the laws of North Carolina and began operations on August 14, 1997 as a North Carolina chartered commercial bank. The Bank is engaged in general commercial banking primarily in Alamance and Guilford Counties, North Carolina, and operates under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

As a North Carolina bank, the Bank is subject to examination and regulation by the FDIC and the Commissioner of Banks, North Carolina Department of Commerce (the "Commissioner"). The Bank is further subject to certain regulations of the Federal Reserve governing reserve requirements to be maintained against deposits and other matters. The business and regulation of the Bank are also subject to legislative changes from time to time. See "SUPERVISION AND REGULATION."

The Bank's primary market area is Alamance County and Guilford County, North Carolina. The Bank's main office is located in Burlington, North Carolina. The Bank also has one full-service branch in Burlington, NC, one full-service branch in Graham, North Carolina, two full-service branches in Greensboro, North Carolina and one full-service branch in Mebane, North Carolina. The Bank has limited service offices in the Alamance Regional Medical Center and the Village of Brookwood Retirement Center, both of which are located in Burlington. The Bank's loans and deposits are primarily generated from the areas where its offices are located.

The Bank's primary sources of revenue are interest and fee income from its lending activities. These lending activities consist principally of originating commercial operating and working capital loans, residential mortgage loans, home equity lines of credit, other consumer loans and loans secured by commercial real estate. The Bank's current lending strategy is to establish market share throughout Alamance and Guilford Counties, with an emphasis in Burlington, Graham, Greensboro and Mebane. At December 31, 2008, the largest amount the Bank had outstanding to any one borrower and its affiliates was approximately $6.8 million.

Interest and dividend income from investment activities generally provide the second largest source of income to the Bank after interest on loans. During 2008, the Bank chose to manage its overall liquidity position by re-deploying more of its funds into shorter duration risk adjustable rate mortgage-backed securities.

Deposits are the primary source of the Bank's funds for lending and other investment purposes. The Bank attracts both short-term and long-term deposits from the general public by offering a variety of accounts and rates. The Bank offers statement savings accounts, negotiable order of withdrawal accounts, money market demand accounts, non-interest-bearing accounts and fixed interest rate certificates with varying maturities. The Bank also utilizes alternative sources of funds such as brokered certificates of deposit and borrowings from the Federal Home Loan Bank (the "FHLB") of Atlanta, Georgia.

The Bank's savings deposits are obtained primarily from its primary market area. The Bank uses traditional marketing methods to attract new customers and savings deposits including print media advertising and direct mailings. Deposit flows are greatly influenced by economic conditions, the general level of interest rates, competition and other factors.

The Bank is the sole banking subsidiary of the Company. Two trusts (MidCarolina I and MidCarolina Trust II) were formed as subsidiaries of the Company to facilitate the infusion of Trust Preferred Securities as a form of non-dilutive equity into the Company. The trusts are not consolidated in these financial statements. The majority of the Company's operations are located at the Bank level. Throughout this Annual Report on Form 10-K, results of operations will be discussed on a consolidated basis by referring to the Bank's operations, unless a specific reference is made to the Company and its operating results apart from the Bank.

The Company has continued to experience steady growth since its formation in 1997. The Bank's assets totaled $540.8 million, $467.2 million and $420.9 million as of December 31, 2008, 2007 and 2006, respectively. The Company had net income available to common shareholders for the year ended December 31, 2008 of $3.3 million, or $0.66 per diluted share compared with $4.5 million, or $0.92 per diluted share for the year ended December 31, 2007. When adjusted for an after-tax one time adjustment of $579,000 related to the reversal of accrued benefits for a former executive officer, diluted earnings per common share for 2007 were $0.80. The per share amounts have been adjusted to reflect the 5-for-4 stock split effective January 19, 2007.

At December 31, 2008, the Company had total consolidated assets of $540.8 million, net loans of $429.0 million, deposits of $467.9 million, investment securities available-for-sale of $71.1 million and shareholders' equity of $37.2 million.

Subsidiaries

Other than the Bank, the Company has two trust subsidiaries: MidCarolina I and MidCarolina Trust II. The Bank's only subsidiary, MidCarolina Investments, Inc, was dormant during 2008. MidCarolina Investments formerly engaged in general securities brokerage and offered insurance and other financial services through a contract arrangement with a third-party provider. The Bank continues to offer these services through a third-party provider.

Employees

At December 31, 2008, the Bank had 79 full-time equivalent employees.

Competition and Market Area

The Bank faces strong competition both in attracting deposits and making real estate and other loans. Its most direct competition for deposits comes from commercial banks, savings institutions and credit unions located in its primary market area, including large financial institutions that have greater financial and marketing resources available to them. At December 31, 2008, there were 14 depository institutions with 30 offices in Alamance County. The Bank had a deposit market share of 19.7% in Alamance County. The Bank also faces additional significant competition for investors' funds from short-term money market securities and other corporate and government securities. The ability of the Bank to attract and retain savings deposits depends on its ability to generally provide a rate of return, liquidity and risk comparable to that offered by competing investment opportunities.

The Bank's competition for real estate loans is from savings institutions, credit unions, commercial banks, and mortgage banking companies. It competes for loans primarily through the interest rates and loan fees it charges and the efficiency and quality of services it provides borrowers. Competition is increasing as a result of the reduction of restrictions on the interstate operations of financial institutions.

The Bank's primary market area is Alamance County. The population of Alamance County is 145,360 and the median household income is $41,502. Alamance County has a diverse economy with no concentration in any one specific industry. Major businesses and industries in the area include LabCorp, a laboratory that provides specialized testing services for the medical industry, Alamance Health Services, Elon University, Honda Power Equipment Manufacturing and GKN Automotive, a manufacturer of automobile drive shafts.

Supervision and Regulation

Bank holding companies and state chartered commercial banks are extensively regulated under both federal and state law. The following is a brief summary of certain statutes and rules and regulations that affect or will affect the Company and the Bank. This summary is qualified in its entirety by reference to the particular statute and regulatory provisions referred to below and is not intended to be an exhaustive description of the statutes or regulations applicable to the business of the Company and the Bank. Supervision, regulation and examination of the Company and the Bank by the regulatory agencies are intended primarily for the protection of depositors rather than shareholders of the Company.

General. There are a number of obligations and restrictions imposed on bank holding companies and their depository institution subsidiaries by law and regulatory policy that are designed to minimize potential loss to the depositors of such depository institutions and the FDIC insurance fund in the event the depository institution becomes in danger of default or in default. For example, to avoid receivership of an insured depository institution subsidiary, a bank holding company is required to guarantee the compliance of any insured depository institution subsidiary that may become "undercapitalized" with the terms of any capital restoration plan filed by such subsidiary with its appropriate federal banking agency up to the lesser of (i) an amount equal to 5% of the bank's total assets at the time the bank became undercapitalized or (ii) the amount which is necessary (or would have been necessary) to bring the bank into compliance with all acceptable capital standards as of the time the bank fails to comply with such capital restoration plan. The Company, as a registered bank holding company, is subject to the regulation of the Federal Reserve. Under a policy of the Federal Reserve with respect to bank holding company operations, a bank holding company is required to serve as a source of financial strength to its subsidiary depository institutions and to commit resources to support such institutions in circumstances where it might not do so absent such policy. The Federal Reserve under the BHCA also has the authority to require a bank holding company to terminate any activity or to relinquish control of a non-bank subsidiary (other than a non-bank subsidiary of a bank) upon the Federal Reserve's determination that such activity or control constitutes a serious risk to the financial soundness and stability of any bank subsidiary of the bank holding company.

In addition, insured depository institutions under common control are required to reimburse the FDIC for any loss suffered by its deposit insurance fund as a result of the default of a commonly controlled insured depository institution or for any assistance provided by the FDIC to a commonly controlled insured depository institution in danger of default. The FDIC may decline to enforce the cross-guarantee provisions if it determines that a waiver is in the best interest of the deposit insurance fund. The FDIC's claim for damages is superior to claims of stockholders of the insured depository institution or its holding company but is subordinate to claims of depositors, secured creditors and holders of subordinated debt (other than affiliates) of the commonly controlled insured depository institutions.

As a result of the Company's ownership of the Bank, the Company is also registered under the bank holding company laws of North Carolina. Accordingly, the Company is also subject to regulation and supervision by the Commissioner.

Capital Adequacy Guidelines for Bank Holding Companies. The Federal Reserve has adopted capital adequacy guidelines for bank holding companies and banks that are members of the Federal Reserve System and have consolidated assets of $150 million or more. Bank holding companies subject to the Federal Reserve's capital adequacy guidelines are required to comply with the Federal Reserve's risk-based capital guidelines. Under these regulations, the minimum ratio of total capital to risk-weighted assets is 8%. At least half of the total capital is required to be "Tier I capital," principally consisting of common stockholders' equity, non-cumulative perpetual preferred stock, and a limited amount of cumulative perpetual preferred stock, less certain goodwill items. The remainder ("Tier II capital") may consist of a limited amount of subordinated debt, certain hybrid capital instruments and other debt securities, perpetual preferred stock and a limited amount of the allowance for loan losses. In addition to the risk-based capital guidelines, the Federal Reserve has adopted a minimum Tier I capital (leverage) ratio, under which a bank holding company must maintain a minimum level of Tier I capital to average total consolidated assets of at least 3% in the case of a bank holding company which has the highest regulatory examination rating and is not contemplating significant growth or expansion. All other bank holding companies are expected to maintain a Tier I capital (leverage) ratio of at least 1% to 2% above the stated minimum.

Capital Requirements for the Bank. The Bank, as a North Carolina commercial bank, is required to maintain a surplus account equal to 50% or more of its paid-in capital stock. As a North Carolina chartered, FDIC-insured commercial bank that is not a member of the Federal Reserve, the Bank is also subject to capital requirements imposed by the FDIC. Under the FDIC's regulations, state nonmember banks that (a) receive the highest rating during the examination process and (b) are not anticipating or experiencing any significant growth, are required to maintain a minimum leverage ratio of 3% of total consolidated assets; all other banks are required to maintain a minimum ratio of 1% or 2% above the stated minimum, with a minimum leverage ratio of not less than 4%. The Bank exceeded all applicable capital requirements as of December 31, 2008.

Dividend and Repurchase Limitations. The Company must obtain Federal Reserve approval prior to repurchasing common stock in excess of 10% of its net worth during any twelve-month period unless the Company (i) both before and after the redemption satisfies capital requirements for a "well capitalized" bank holding company; (ii) received a one or two rating in its last examination; and (iii) is not the subject of any unresolved supervisory issues.

Although the payment of dividends and the repurchase of stock by the Company are subject to certain requirements and limitations of North Carolina corporate law, except as set forth in this section, neither the Commissioner nor the FDIC have promulgated any regulations specifically limiting the right of the Company to pay dividends and repurchase shares. However, the ability of the Company to pay dividends or repurchase shares is largely dependent upon the Company's receipt of dividends from the Bank.

North Carolina commercial banks, such as the Bank, are subject to legal limitations on the amounts of dividends they are permitted to pay. The Bank may pay dividends from undivided profits, which are determined by deducting and charging certain items against actual profits, including any contributions to surplus required by North Carolina law. Also, an insured depository institution, such as the Bank, is prohibited from making capital distributions, including the payment of dividends, if, after making such distribution, the institution would become "undercapitalized" (as such term is defined in the applicable law and regulations).

Deposit Insurance. The deposits of the Bank are currently insured to a maximum of $250,000 per depositor, subject to aggregation rules. The FDIC establishes rates for the payment of premiums by federally insured banks and thrifts for deposit insurance. Since 1993, insured depository institutions like the Bank have paid for deposit insurance under a risk-based premium system. Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order, or condition imposed by the FDIC. Due to its severe consequences, the FDIC historically uses insurance termination as an enforcement action of last resort and the termination process itself involves substantial notice, a formal adjudicative hearing and federal appellate review. In instances where insurance deposit is terminated, the financial institution is required to notify its depositors and insured funds on the date of termination that they will continue to be insured for at least six months and up to two years, at the discretion of the FDIC. After the date of termination, no new deposits accepted by the financial institution will be federally insured.

Federal Deposit Insurance Reform. On February 8, 2006, President Bush signed the Federal Deposit Insurance Reform Act of 2005 (FDIRA). The FDIC was required to adopt rules implementing the various provisions of FDIRA by November 5, 2006. Among other things, FDIRA changes the federal deposit insurance system by:

- raising the coverage level for retirement accounts to $250,000;
- indexing deposit insurance coverage levels for inflation beginning in 2012;
- prohibiting undercapitalized financial institutions from accepting employee benefit plan deposits;
- merging the Bank Insurance Fund and Savings Association Insurance Fund into a new Deposit Insurance Fund (the DIF); and
- providing credits to financial institutions that capitalized the FDIC prior to 1996 to offset future assessment premiums.

FDIRA also authorizes the FDIC to revise the current risk-based assessment system, subject to notice and comment and caps the amount of the DIF at 1.50% of domestic deposits. The FDIC must issue cash dividends, awarded on a historical basis, for the amount of the DIF over the 1.50% ratio. Additionally, if the DIF exceeds 1.35% of domestic deposits at year-end, the FDIC must issue cash dividends, awarded on a historical basis, for half of the amount of the excess.

In prior years the Bank's deposits were generally insured up to $100,000 per insured non-IRA non-transaction account and up to $250,000 per IRA account by the Deposit Insurance Fund of the FDIC. The Emergency Economic Stabilization Act signed October 3, 2008, temporarily raised the basic limit of FDIC deposit insurance from $100,000 to$250,000 with an expected return to the $100,000 limit on December 31, 2009.

During the fourth quarter of 2008, the FDIC announced the creation of the Temporary Liquidity Guarantee Program (TGLP), which seeks to strengthen confidence and encourage liquidity in the banking system. The TGLP has two primary components that are available to financial institutions on a voluntary basis. The first component is a guarantee of newly issued senior unsecure debt issued on or before June 30, 2009 and would provide protection until June 30, 2012. Issuers electing to participate in this program would pay a 75 basis point fee for the guarantee. The second component available under the program is unlimited deposit insurance for non-interest bearing deposit transaction accounts which would include a 10 basis point premium in addition to the normal premiums paid for standard deposit insurance. The Company elected to participate in the TLGP's enhanced deposit insurance program and the guarantee of unsecured debt. The enhancement to the deposit insurance protection and the demands on the insurance fund due to current weakness in the banking system will result in significantly increased deposit insurance costs for all banks during 2009.

Deposit Insurance Assessments. The Bank is subject to insurance assessments imposed by the FDIC. Under current law, the insurance assessment to be paid by members of the Deposit Insurance Fund, such as the Bank, is specified in a schedule required to be issued by the FDIC. Prior to January 1, 2007, FDIC assessments for deposit insurance ranged from 0 to 27 basis points per $100 of insured deposits, depending on the institution's capital position and other supervisory factors. Effective January 1, 2009, the assessments range from 12 to 50 basis points per $100 of insured deposits. The assessment rate schedule can change from time to time, at the discretion of the FDIC, subject to certain limits. Under the current system, premiums are charged quarterly.

On February 27, 2009 the FDIC voted to amend the restoration of the Deposit Insurance Fund. The Board took action by imposing a special assessment on insured institutions of 20 basis points, implementing changes to the risk-based assessment system, and increased regular premium rates for 2009, which banks must pay on top of the special assessment. The 20 basis point special assessment on the industry will be as of June 30, 2009, payable September 30, 2009. As a result of the special assessment and increased regular assessments the Company projects it will experience an increase in FDIC assessment by approximately $1.0 million from 2008 to 2009. The 20 basis point special assessment represents $940,000 of this increase.

On March 5, 2009, the FDIC Chairman announced that the FDIC intends to lower the special assessment from 20 basis points to 10 basis points. The approval of the cutback is contingent on whether Congress clears legislation that would expand the FDIC's line of credit with the Treasury to $100 billion. Legislation to increase the FDIC's borrowing authority on a permanent basis is also expected to advance to Congress, which should aid in reducing te burden on the industry. The assessment rates, including the special assessment, are subject to change at the discretion of the Board of Directors of the FDIC.

Federal Home Loan Bank System. The Federal Home Loan Bank System provides a central credit facility for member institutions. In December 2004, the FHLB of Atlanta implemented a new capital plan. As a member of the FHLB of Atlanta and under the new capital plan, the Bank is required to own capital stock in the FHLB of Atlanta in an amount equal to at least 0.20% (or 20 basis points) of the Bank's total assets at the end of each calendar year, plus 4.5% of its outstanding advances (borrowings) from the FHLB under the new activity-based stock ownership requirement. On December 31, 2008, the Bank was in compliance with this requirement.

Community Reinvestment. Under the Community Reinvestment Act ("CRA"), as implemented by regulations of the FDIC, an insured institution has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions, nor does it limit an institution's discretion to develop, consistent with the CRA, the types of products and services that it believes are best suited to its particular community. The CRA requires the federal banking regulators, in connection with their examinations of insured institutions, to assess the institutions' records of meeting the credit needs of their communities, using the ratings of "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance," and to take those records into account in its evaluation of certain applications by those institutions. All institutions are required to make public disclosure of their CRA performance ratings. The Bank received a "satisfactory" rating in its last CRA examination that was conducted during August 2007.

Prompt Corrective Action. The FDIC has broad powers to take corrective action to resolve the problems of insured depository institutions. The extent of these powers will depend upon whether the institution in question is "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" or "critically undercapitalized." Under the regulations, an institution is considered "well capitalized" if it has (i) a total risk-based capital ratio of 10% or greater, (ii) a Tier I risk-based capital ratio of 6% or greater, (iii) a leverage ratio of 5% or greater and (iv) is not subject to any order or written directive to meet and maintain a specific capital level for any capital measure. An "adequately capitalized" institution is defined as one that has (i) a total risk-based capital ratio of 8% or greater, (ii) a Tier I risk-based capital ratio of 4% or greater and (iii) a leverage ratio of 4% or greater (or 3% or greater in the case of an institution with the highest examination rating). An institution is considered (A) "undercapitalized" if it has (i) a total risk-based capital ratio of less than 8%, (ii) a Tier I risk-based capital ratio of less than 4% or (iii) a leverage ratio of less than 4% (or 3% in the case of an institution with the highest examination rating); (B) "significantly undercapitalized" if the institution has (i) a total risk-based capital ratio of less than 6%, or (ii) a Tier I risk-based capital ratio of less than 3% or (iii) a leverage ratio of less than 3%; and (C) "critically undercapitalized" if the institution has a ratio of tangible equity to total assets equal to or less than 2%. At December 31, 2008, the Bank had the requisite capital levels to qualify as "well capitalized".

Changes in Control. The BHCA prohibits the Company from acquiring direct or indirect control of more than 5% of the outstanding voting stock or substantially all of the assets of any bank or savings bank or merging or consolidating with another bank holding company or savings bank holding company without prior approval of the Federal Reserve. Similarly, Federal Reserve approval (or, in certain cases, non-disapproval) must be obtained prior to any person acquiring control of the Company. Control is conclusively presumed to exist if, among other things, a person acquires more than 25% of any class of voting stock of the Company or controls in any manner the election of a majority of the directors of the Company. Control is presumed to exist if a person acquires more than 10% of any class of voting stock and the stock is registered under Section 12 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") or the acquirer will be the largest shareholder after the acquisition.

Federal Securities Law. The Company has registered its common stock with the Securities and Exchange Commission (the "SEC") pursuant to Section 12(g) of the Exchange Act. As a result of such registration, the proxy and tender offer rules, insider trading reporting requirements, annual and periodic reporting and other requirements of the Exchange Act are applicable to the Company.

Transactions with Affiliates. Under current federal law, depository institutions are subject to the restrictions contained in Section 22(h) of the Federal Reserve Act with respect to loans to directors, executive officers and principal shareholders. Under Section 22(h), loans to directors, executive officers and shareholders who own more than 10% of a depository institution (18% in the case of institutions located in an area with less than 30,000 in population) and certain affiliated entities of any of the foregoing, may not exceed, together with all other outstanding loans to such person and affiliated entities, the institution's loans-to-one-borrower limit (as discussed below). Section 22(h) also prohibits loans above amounts prescribed by the appropriate federal banking agency to directors, executive officers and shareholders who own more than 10% of an institution and their respective affiliates, unless such loans are approved in advance by a majority of the board of directors of the institution. Any "interested" director may not participate in the voting. The FDIC has prescribed the loan amount (which includes all other outstanding loans to such person), as to which such prior board of director approval is required, as being the greater of $25,000 or 5% of capital and surplus (up to $500,000). Further, pursuant to Section 22(h), the Federal Reserve requires that loans to directors, executive officers, and principal shareholders be made on terms substantially the same as offered in comparable transactions with non-executive employees of the Bank. The FDIC has imposed additional limits on the amount a bank can loan to an executive officer.

Loans to One Borrower. The Bank is subject to the Commissioner's loans to one borrower limits, which are substantially the same as those applicable to national banks. Under these limits, no loans and extensions of credit to any borrower outstanding at one time and not fully secured by readily marketable collateral shall exceed 15% of the unimpaired capital and unimpaired surplus of the Bank. Loans and extensions of credit to such a borrower fully secured by readily marketable collateral may comprise an additional 10% of unimpaired capital and unimpaired surplus.

Gramm-Leach-Bliley Act. The federal Gramm-Leach-Bliley Act enacted in 1999 (the "GLB Act") dramatically changed various federal laws governing the banking, securities and insurance industries. The GLB Act has expanded opportunities for banks and bank holding companies to provide services and engage in other revenue-generating activities that previously were prohibited to them. In doing so it increased competition in the financial services industry, presenting greater opportunities to our larger competitors who were more able to expand their services and products than smaller oriented financial institutions, such as the Bank.

USA Patriot Act of 2001. The USA Patriot Act of 2001was enacted in response to the terrorist attacks that occurred in New York, Pennsylvania and Washington, D.C. on September 11, 2001. The Act is intended to strengthen the ability of U.S. law enforcement and the intelligence community to work cohesively to combat terrorism on a variety of fronts. The impact of the Act on financial institutions of all kinds is significant and wide ranging. The Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying customer identification at account opening and rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 was signed into law and included significant changes addressing accounting, corporate governance and disclosure issues. The impact of the Sarbanes-Oxley Act is wide-ranging as it applies to all public companies and imposes significant new requirements for public company governance and disclosure requirements.

In general, the Sarbanes-Oxley Act mandated corporate governance and financial reporting requirements intended to enhance the accuracy and transparency of public companies' reported financial results. It established new responsibilities for corporate chief executive officers, chief financial officers and audit committees in the financial reporting process and created a new regulatory body to oversee auditors of public companies. It backed these requirements with new SEC enforcement tools, increased criminal penalties for federal mail, wire and securities fraud and created new criminal penalties for document and record destruction in connection with federal investigations. It also increased the opportunity for more private litigation by lengthening the statute of limitations for securities fraud claims and providing new federal corporate whistleblower protection.

The economic and operational effects of this Act on public companies, including the Bank, has been and is expected to continue to be significant in terms of the time, resources and costs associated with complying with the law.

Other. The federal banking agencies, including the FDIC, have developed joint regulations requiring annual examinations of all insured depository institutions by the appropriate federal banking agency, with some exceptions for small, well-capitalized institutions and state chartered institutions examined by state regulators and establish operational and managerial, asset quality, earnings and stock valuation standards for insured depository institutions as well as compensation standards when such compensation would endanger the insured depository institution or would constitute an unsafe practice.

In addition, the Bank is subject to various other state and federal laws and regulations, including state usury laws, laws relating to fiduciaries, consumer credit and equal credit, fair credit reporting laws and laws relating to branch banking. The Bank, as an insured North Carolina commercial bank, is prohibited from engaging as a principal in activities that are not permitted for national banks, unless (i) the FDIC determines that the activity would pose no significant risk to the Deposit Insurance Fund and (ii) the Bank is, and continues to be, in compliance with all applicable capital standards.

Under Chapter 53 of the North Carolina General Statutes, if the capital stock of a North Carolina commercial bank is impaired by losses or otherwise, the Commissioner is authorized to require payment of the deficiency by assessment upon the bank's shareholders, pro rata, and to the extent necessary, if any such assessment is not paid by any shareholder, upon 30 days notice, to sell as much as is necessary of the stock of such shareholder to make good the deficiency.

Available Information. The Company makes its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports available free of charge on its internet website www.midcarolinabank.com, as soon as reasonably practicable after the reports are electronically filed with the SEC. Any materials that the Company files with the SEC may be read and/or copied at the SEC's Public Reference Room at 100 F Street, NE, Washington DC 20549. Information on the operation of the Public Reference room may be obtained by calling the SEC at 1-800-SEC-0330. These filings are also accessible on the SEC's website at www.sec.gov.

ITEM 2. DESCRIPTION OF PROPERTY

The Bank owns its main office, which is located at 3101 South Church Street in Burlington, as well as its full-service branch offices located at 5509-A West Friendly Avenue, Suite 102, Greensboro, North Carolina and 842 South Main Street, Graham, North Carolina. The Bank leases its full-service offices located at Cum-Park Plaza, 2214 North Church Street, Burlington; 703 Suite 101,Green Valley Road, Greensboro; and 1107 South Fifth Street, Mebane, North Carolina. The Bank occupies space in the Alamance Regional Medical Center in Burlington from which it operates a limited-service office as well as a limited-service office located in the Village of Brookwood Retirement Center located in Burlington.

The total net book value of the Bank's furniture, fixtures, leasehold improvements, land, buildings and equipment at December 31, 2008 was approximately $7.5 million. All properties are considered by the Bank's management to be in good condition and adequately covered by insurance. Additional information about this property is set forth in Note (F) to the Consolidated Financial Statements contained in Item 8 of this Annual Report on Form 10-K, which note is incorporated herein by reference.

ITEM 3. LEGAL PROCEEDINGS

On July 22, 2008, the Company and the Bank filed a civil action in the Superior Court of Alamance County, North Carolina, against their former President and Chief Executive Officer whose employment terminated during August 2007. The lawsuit alleges claims (which involve amounts that are not material to the Company's financial condition or results of operations) for fraud and misrepresentation, conversion of funds and breach of fiduciary duty as a director and officer. On July 24, 2008, the former officer filed a claim for arbitration pursuant to his employment agreement with the Bank, disputing that there was cause for the termination of his employment and seeking to be paid additional salary and benefits under the agreement and other compensatory agreements between him and the Bank. The Bank will vigorously defend its position that the former officer was discharged for cause and is not entitled to any additional compensation or benefits, and that he is obligated to repay the Bank for certain personal expenses and excesses incurred while he served as an officer

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted to a vote of the stockholders of the Company during the fourth quarter of the fiscal year ended December 31, 2008.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED SHAREHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

There currently is a limited trading market for the Company's common stock, and there can be no assurance that a more active market will develop. The Company's common stock is traded in the over-the-counter markets, with prices for the stock being published on the OTC Bulletin Board under the symbol "MCFI." There were 1,599 stockholders of record as of February 5, 2008, not including the persons or entities whose stock is held in nominee or "street" name and by various banks and brokerage firms.

The table below presents the high and low trade prices for the Company's common stock as published on the OTC bulletin Board for each quarter in the years ended December 31, 2008 and 2007. The prices in the table have been adjusted to reflect declared stock splits in the form of stock dividends in 2007, and reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not represent actual transactions.

	High	Low
2008		
First quarter	$ 11.55	$ 10.00
Second quarter	$ 11.20	$ 8.57
Third quarter	$ 10.10	$ 8.00
Fourth quarter	$ 9.60	$ 7.00
2007		
First quarter	$ 19.60	$ 12.75
Second quarter	$ 15.00	$ 13.70
Third quarter	$ 14.95	$ 12.25
Fourth quarter	$ 13.75	$ 9.00

Since it was organized in 2002, the Company has retained its earnings as additional capital to support growth in its earning assets, and it has not paid any cash dividends on its common stock. Information regarding regulatory restrictions on the Company's and the Bank's abilities to pay cash dividends is contain in this report under the captions "ITEM 1. DESCRIPTION OF BUSINESS -- Supervision and Regulation" above, and in NOTE P to the Company's financial statements included in this Report under Item 8. Although the Company is a legal entity separate and distinct from the Bank, the Company's principal source of funds with which it could pay cash dividends would be the dividends the Company receives from the Bank. For that reason, the Company 's ability to pay dividends effectively is subject to the same limitations that apply to the Bank. In the future, in addition to the regulatory considerations referenced above, the Company's ability to declare and pay cash dividends will be subject to the Board of Directors' evaluation of the Company's and the Bank's operating results, capital levels, financial condition, future growth plans, general business and economic conditions, and other relevant considerations, as well as to changes in applicable statutes, regulations or regulatory policies that could have a material effect on the Company's and the Bank's business.

Recent Repurchase of Company's Securities

The Company did not repurchase any of its securities in the last quarter of the fiscal year ending December 31, 2008.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth certain summary consolidated financial data, performance ratios and other data at, or for the periods indicated. As this information is only a summary, you should read it in conjunction with the historical financial statements (and related notes) of the Company and "Item 7. - Management's Discussion and Analysis of Financial Condition and Results of Operations".

MidCarolina Financial Corporation
Table 1
Selected Consolidated Financial Information and Other Data
($ in thousands, except per share and nonfinancial data)

	At or for the Year Ended December 31,				
	2008	2007	2006	2005	2004
Operating Data:					
Total interest income	$ 29,616	$ 31,053	$ 27,061	$ 19,208	$ 12,174
Total interest expense	15,294	17,721	14,241	8,327	4,383
Net interest income	14,322	13,332	12,820	10,881	7,791
Provision for loan losses	1,665	425	394	1,373	1,030
Net interest income after provision	12,657	12,907	12,426	9,508	6,761
Noninterest income	2,756	3,108	2,304	2,683	4,141
Noninterest expense	9,998	8,786	9,077	8,546	8,010
Income before income taxes	5,415	7,229	5,653	3,645	2,892
Provision for income taxes	1,741	2,342	1,757	1,277	950
Net income	3,674	4,887	3,896	2,368	1,942
Dividends on preferred stock	417	417	417	104	-
Net income available to common shareholders	$ 3,257	$ 4,470	$ 3,479	$ 2,264	$ 1,942
Per Share Data (1):					
Earnings per common share - basic	$ 0.66	$ 0.98	$ 0.80	$ 0.53	$ 0.45
Earnings per common share - diluted	0.66	0.92	0.73	0.48	0.42
Market price					
High	11.55	19.60	18.18	12.37	10.67
Low	7.00	9.00	10.51	8.44	7.52
Close	7.50	9.50	15.80	10.36	8.49
Book value - common shares	6.57	6.13	5.20	4.25	3.83
Weighted average common shares outstanding					
Basic	4,915,350	4,548,565	4,348,128	4,299,522	4,289,401
Diluted	4,916,876	4,851,738	4,775,853	4,669,601	4,621,764
Selected Year-End Balance Sheet Data:					
Total assets	$ 540,847	$ 467,186	$ 420,850	$ 370,440	$ 284,888
Loans, held to maturity	434,662	371,714	313,572	279,962	217,683
Allowance for loan losses	5,632	4,462	4,222	4,090	2,865
Deposits	467,948	373,897	339,275	300,262	216,791
Short-term borrowings	-	19,000	25,000	10,000	15,500
Long-term debt	33,764	38,764	26,764	34,764	34,764
Shareholders' equity	37,143	33,150	28,259	23,093	16,424
Selected Average Balances:					
Total assets	$ 506,581	$ 447,442	$ 397,514	$ 329,395	$ 253,352
Loans, net	405,119	344,620	301,405	252,914	204,121
Total interest-earning assets	486,979	427,142	379,168	309,935	241,992
Deposits	425,790	370,128	329,724	264,730	187,090
Total interest-bearing liabilities	432,436	380,288	338,283	280,412	215,080
Shareholders' equity	35,830	29,901	24,550	19,743	15,484
Shareholders' equity less average preferred equity	31,011	25,082	19,731	17,910	15,484

MidCarolina Financial Corporation
Table 1
Selected Consolidated Financial Information and Other Data
($ in thousands, except per share and nonfinancial data)

	At or for the Year Ended December 31,				
	2008	2007	2006	2005	2004
Selected Performance Ratios:					
Return on average assets	0.73%	1.09%	0.98%	0.72%	0.77%
Return on average equity excluding preferred equity	10.50%	17.82%	17.63%	12.64%	12.54%
Net interest spread	2.54%	2.61%	2.93%	3.23%	2.99%
Net interest margin	2.94%	3.12%	3.38%	3.51%	3.22%
Noninterest income to total net revenue	16.14%	18.91%	15.23%	19.78%	34.70%
Noninterest income to average assets	0.54%	0.69%	0.58%	0.81%	1.63%
Noninterest expense to average assets	1.97%	1.96%	2.28%	2.59%	3.16%
Asset Quality Ratios:					
Nonperforming loans to period-end loans	0.72%	0.19%	0.25%	0.08%	0.11%
Allowance for loan losses to period-end loans	1.30%	1.20%	1.35%	1.46%	1.32%
Allowance for loan losses to nonperforming loans	180.34%	637.43%	531.74%	1725.74%	1127.95%
Nonperforming assets to total assets	0.88%	0.21%	0.74%	0.83%	0.80%
Net loan charge-offs to average loans	0.12%	0.05%	0.05%	0.09%	0.06%
Capital Ratios:					
Total risk-based capital	11.19%	11.48%	11.28%	11.34%	11.13%
Tier 1 risk-based capital	9.97%	10.37%	10.12%	9.90%	8.78%
Leverage ratio	8.68%	8.95%	8.73%	8.64%	7.83%
Equity to assets ratio	6.87%	7.10%	6.71%	6.23%	5.77%
Other Data:					
Number of banking offices	8	8	8	6	6
Number of full time equivalent employees	79	77	71	69	77

(1) All per share data has been restated to reflect the effects of a stock split effected in the form of a 10% stock dividend in 2002, a stock split effected in the form of a 20% stock dividend in 2003 and 2004, a stock split effected in the form of a 25% stock dividend in 2005, a stock split effected in the form of a 10% stock dividend in 2006 and a 25% split effected dividend in January 2007.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The discussion and analysis that follows is intended to assist readers in the understanding and evaluation of the financial condition and results of operations of the Company. It should be read in conjunction with the audited consolidated financial statements and accompanying notes included in this Annual Report on Form 10-K and the supplemental financial data appearing throughout this discussion and analysis. Because the Company's primary asset is the Bank, the discussion that follows focuses on the Bank's business and operations.

EXECUTIVE OVERVIEW

Significant accomplishments
In the opinion of its management, the Company's most significant accomplishments during 2008, which are discussed in more detail in this Item 7, were as follows:

- Total loans classified as held for investment increased 16.9%
- Commercial and industrial loans outstanding at year end increased 34.9%
- Average non-interest bearing deposits increased 7.1%
- Total deposits at year end increased 25.2%
- Non interest income excluding gain (loss) on investments increased 3.8%
- Non interest expense excluding the reversal of accrued employee benefits increased 3.2%
- Improved operating efficiencies

Challenges.
The Bank has achieved significant growth without the advent of acquisitions or mergers since first opening its doors in 1997. The financial industry in general is faced with many uncertainties and challenges. As management plans its strategic goals and objectives, future expectations of economic activity, and how these uncertainties could impact the Company's performance, must be taken into consideration. The challenges that we believe are most likely to have an impact on the operations of the Company in the foreseeable future are presented below:

- Sustaining profitable growth
- Managing margins in an abnormally low interest rate cycle
- Competition from bank and non-bank entities, including fierce price competition
- Uncertainty of real estate values
- Obtaining adequate funding of asset growth
- Maintaining liquidity during an uncertain economic environment
- Managing equity in an unpredictable capital market
- Managing asset quality during a period of economic uncertainty

SELECTED CONSOLIDATED FINANCIAL INFORMATION AND OTHER DATA

Selected Consolidated Financial Information and Other Data are presented in Table 1 of Item 6. The information in this table is derived in part from the audited consolidated financial statements and notes thereto of the Company. The information in this table does not purport to be complete and should be read in conjunction with the Company's consolidated financial statements that are included in this Annual Report on Form 10-K.

FINANCIAL CONDITION
DECEMBER 31, 2008 AND 2007

The Company reported total assets increasing by \$73.7 million, or 15.8%, to \$540.8 million at year-end 2008. This growth was principally reflected in increased loans. Loans, excluding those held for sale, increased by \$62.9 million, or 16.9%, from \$371.7 million at the beginning of the year to \$434.7 million at year end. The increase in loans was composed principally of increases of \$16.1 million in commercial mortgage loans, \$16.3 million in residential mortgage loans (including income producing properties) and \$16.3 million in commercial and industrial loans, all of which are segments of lending the Company targets and intends to continue targeting in the future. Investment securities increased by \$323,000, or 0.5%, from \$70.8 million to \$71.1 million. Liquid assets, consisting of cash and demand balances due from banks, interest-earning deposits in other banks and investment securities, were 16.1% of total assets, at December 31, 2008 and 2007. The Bank, as a member of the FHLB of Atlanta, has an investment of \$2.0 million in FHLB stock. The Bank's investment in life insurance used to offset the cost of employee benefit plans, increased by $299 thousand during 2008 to $7.9 million. The increase was due to an increase in the cash surrender value of the policies.

Deposits increased $94.1 million during 2008. Non-interest-bearing demand accounts increased $12.5 million, or 41.0%, time deposits increased $77.8 million or 29.6%, money market and NOW accounts increased $3.4 million, or 4.5%, and savings accounts increased 300,000 or 3.93%, over the amount of such deposits at December 31, 2007. The Bank also used wholesale brokered certificates of deposit and advances from the FHLB of Atlanta, Georgia as funding sources during 2008 to serve as a secondary source of funding asset growth. Borrowings from the FHLB decreased from $49.0 million at the end of 2007 to $25.0 million at December 31, 2008. Wholesale brokered certificates of deposit comprised approximately 22.8% of total certificate of deposit balances. Typically brokered certificates of deposit have similar terms to retail certificates of deposit issued in the Bank's local markets, with rates marginally lower than local market certificates of deposit rates.

Total shareholders' equity increased by $4.0 million, or 12.2%, during 2008. All capital ratios continue to place the Company and the Bank in excess of the minimum required to be a well-capitalized institution by regulatory measures. The proceeds from the exercising of stock options of $792,000 during 2008 increased shareholders' equity by that amount. The Company issued $4.8 million in Non-Cumulative Perpetual Preferred Stock on August 15, 2005 and $8.5 million in Trust Preferred Securities during prior years, so as to remain "well capitalized" under regulatory capital guidelines without diluting existing shareholders' ownership. The Trust Preferred Securities and Preferred Stock should provide sufficient capital to retain a "well-capitalized" designation as defined by regulatory capital guidelines for the foreseeable future. The Trust Preferred Securities qualify as Tier 1 regulatory capital and are reported in Federal Reserve regulatory reports as a qualifying security in a consolidated subsidiary. The junior subordinated debentures issued to guarantee the Trust Preferred Securities do not qualify as Tier 1 regulatory capital. On July 2, 2003, the Federal Reserve issued a letter, SR 03-13, stating that notwithstanding any potential implications FIN 46R may have on reporting trust preferred securities on financial statements, trust preferred securities will continue to be included in Tier 1 capital until notice is given to the contrary. There can be no assurance that the Federal Reserve will continue to allow institutions to include trust-preferred securities in Tier I capital for regulatory capital purposes. In the event of a disallowance, there would be a reduction in the Company's consolidated capital ratios. However, the Company believes that the Bank would remain "well capitalized" under FDIC guidelines.

At December 31, 2008, the Bank was considered to be "well capitalized" under the FDIC guidelines.

NET INTEREST INCOME

Similar to most financial institutions, the primary component of earnings for the Bank is net interest income. Net interest income is the difference between interest income, principally from the loan and investment securities portfolios, and interest expense, principally on deposits and borrowings. Changes in net interest income result from changes in volume, spread and margin. For this purpose, "volume" refers to the average dollar level of interest-earning assets and interest-bearing liabilities, "spread" refers to the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities and "margin" refers to net interest income divided by average interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities, as well as levels of non-interest-bearing liabilities. During the years ended December 31, 2008, 2007 and 2006, average interest-earning assets were $487.0 million, $427.1 million and $379.2 million, respectively. During these same years, the Bank's net yields on average interest-earning assets were 2.94%, 3.12% and 3.38%, respectively. The decrease in net yields from 2007 to 2008 is a reflection of the dramatic decrease in interest rates over the year. An overall decrease in spread which is the difference between yields earned on interest bearing assets less the interest paid on interest bearing liabilities was strongly influenced by extreme competitive pressures in our markets. The Bank's balance sheet is well positioned for changes in interest rates. When interest rates change, the Bank's earnings and net yields remain stable.

Table 2, following this discussion, "Average Balances and Net Interest Income", presents an analysis of the Bank's net interest income for 2008, 2007 and 2006.

Table 3, following this discussion, "Volume and Rate Variance Analysis", shows the amounts of changes in net interest income due to changes in volume and rates and illustrates that the change in the average volume of loans and the increase in average deposit rates were the predominant factors in the higher amount of net interest income realized by the Bank in 2008, when compared to 2007.

RESULTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 2008 AND 2007

Overview. The Company reported net income available to common shareholders of $3.3 million, or $0.66 per diluted common share, for the year ended December 31, 2008, compared with net income available to shareholders of $4.5 million, or $0.92 per diluted common share, for 2007, a decrease of $1.2 million or $0.26 per diluted share. Results for the 12 months ended December 31, 2008 included a one-time after tax adjustment of $248,000 related to Other Than Temporary Impairment of Mortgage Backed Securities. Results for the 12 months ended December 31, 2007 included a one-time after-tax adjustment of $579,000 related to the reversal of accrued benefits for a former executive officer. Excluding the effect of these adjustments, our diluted earnings per common share for 2008 would have been $0.71, compared to $0.80 for 2007.

Net Interest Income. Net interest income increased to $14.3 million for the year ended December 31, 2008, a $990,000 or 7.4% increase from the $13.3 million earned in 2007. Total interest income benefited from strong growth in the level of average earning assets offset by lower asset yields caused by the decrease in interest rates during the year. The rates earned on a significant portion of the Bank's loans adjust immediately when indexes like the prime rate change. Conversely, a large portion of interest-bearing liabilities, including certificates of deposit and Bank borrowings, have rates fixed until maturity. As a result, interest rate reductions will generally result in an immediate drop in the Bank's interest income on loans, with a more delayed impact on interest expense because reductions in interest costs will only occur upon renewals of certificates of deposit or borrowings. Interest rate increases will generally result in an immediate increase in the Bank's interest income on loans, with a more delayed impact on interest expense because increases in interest costs will only occur upon renewals of certificates of deposit or borrowings. Average total interest-earning assets increased $59.8 million, or 14.0%, during 2008 compared to 2007, while the average yield decreased by 119 basis points from 7.27% to 6.08%. As interest rates decreased during 2008, the average rate on loans decreased year over year. The average rate on investment securities increased in 2008 compared to 2007, reflecting management's decision to purchase higher yielding securities during 2008 taking advantage of the unusual extremes in mortgaged backed securities prices in 2008. Average total interest-bearing liabilities increased by $52.1 million, or 13.7%, consistent with the increase in interest-earning assets. The average cost of interest-bearing liabilities decreased by 113 basis points from 4.66% to 3.53%. With the yield on earning assets decreasing more significantly than the cost of interest bearing liabilities, the Bank's net interest margin decreased by 18 basis points. For the year ended December 31, 2008, the net interest margin was 2.94%, while for the year ended December 31, 2007, the net interest margin was 3.12%. Table 3 reflects the volume and rate variances from 2008 vs. 2007.

Provision for Loan Losses. The Bank recorded $1.7 million in the provision for loan losses in 2008, an increase of $1.2 million from the $425,000 provision made in 2007. Provisions for loan losses are charged to income to bring the allowance for loan losses to a level deemed appropriate by management. In evaluating the allowance for loan losses, management considers factors that include growth, composition and industry diversification of the portfolio, historical loan loss experience, current delinquency levels, adverse situations that may affect a borrower's ability to repay, estimated value of any underlying collateral, prevailing economic conditions and other relevant factors. For 2008 the provision to loan losses was made in response to the weakened economy and real estate market experienced during 2008, large provisions were made each quarter during the year, total loans outstanding, net of loans held for sale, increased by $62.9 million in 2008 and by $58.1 million in 2007. At December 31, 2008, the allowance for loan losses was $5.6 million, an increase of $1.2 million, or 26.22%, from the $4.5 million at the end of 2007. The allowance represented 1.30% and 1.20%, respectively, of loans outstanding at the end of 2008 and 2007, net of loans held for sale. At December 31, 2008, the Bank had $3.1 million in non-accrual loans. In 2007, the Bank had $700,000 in non-accrual loans. It is management's opinion that reserve levels are adequate.

Non-Interest Income. Non-interest income decreased to $2.8 million for the year ended December 31, 2008 compared to $3.1 million for the year ended December 31, 2007, a decrease of $352,000 or 11.3%. A one time gain on the sale of other real estate in the amount of $536,000 offset by a one time loss related to Other Than Temporary Impairment of private label collateralized mortgage obligation securities with market value decreases greater than 30%in the amount of $490,000, resulted in a net affect of one time benefit in the amount of $46,000 in 2008. During 2007, a one time gain on the sale of other real estate in the amount of $481,000 accounted for 15.5% of total non-interest income. Excluding the net gain on the sale of other real estate, offset by the Other Than Temporary Impairment charge, in 2008 and the gain on sale of other real estate during 2007, non-interest income increased $83,000 or 3.2% for 2008. Mortgage operations income decreased to $571 thousand in 2008, from $600 thousand in 2007, reflecting a softening in the overall mortgage origination market. Service charges on deposit accounts in 2008 were $1.2 million, an increase of $94,000, or 8.9%, compared to $1.1 million in 2007 reflecting the positive results of a focused marketing effort to increase demand deposit accounts. Table 4, following this discussion, is a comparative analysis of the components of non-interest income for 2008, 2007 and 2006.

Non-Interest Expenses. Non-interest expenses totaled $10 million for the year ended December 31, 2008, an increase of $1.2 million over the $8.8 million reported for 2007. Adjusting non-interest expense for a one-time adjustment of $905,000 related to the reversal of accrued benefits for a former executive officer, non-interest expense for 2007 would have totaled $9.7 million, an increase of $307,000 or 3.2%. Substantially all of this increase resulted from the Bank's growth and development during 2008 and 2007. Personnel costs after the one-time adjustment of $905 thousand related to the reversal of accrued benefits for a former executive officer increased by $3,000 in 2008. Professional and other services increased $74,000 or 15.6% primarily due to expenses incurred related to the preparation of anticipated regulatory changes and increases in legal fees and proceedings. Deposit and other insurance expense increased $80,000 or 22.7% because of increased FDIC premiums. Occupancy and equipment expense increased by $51,000 due to increases in maintenance costs and additional lease expense incurred with the relocation of our Green Valley Office located in Greensboro, NC. Data processing and other outside services decreased $19,000, or 1.7%, due to the renegotiation of our bank platform operating system contract. Advertising expense increased $131,000 reflecting new marketing strategies and programs during 2008. Table 5, following this discussion, presents a comparative analysis of the components of non-interest expenses for 2008, 2007 and 2006.

Income Taxes. The provision for income tax was $1.7 million in 2008 and $2.3 million in 2007. The effective tax rates were 32.2% and 32.4%, respectively, on income before income taxes..

RESULTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 2007 AND 2006

Overview. The Company reported net income available to common shareholders of $4.5 million, or $0.92 per diluted common share, for the year ended December 31, 2007, compared with net income available to shareholders of $3.5 million, or $0.73 per diluted common share, for 2006, an improvement of $1.0 million or $0.19 per diluted share. When adjusted for an after-tax one time adjustment of $579,000 related to the reversal of accrued benefits originally designated for the benefit of a former executive officer, net income available to common shareholders is $3.9 million, or $0.80 per diluted share, an increase of $412,000 or 11.8%. Net interest income increased $512,000, or 4.0%, in 2007, and the provision for loan losses increased $31,000, or 7.9%, while non-interest income increased by $804,000 or 34.9%. Non-interest expense decreased by $291,000 or 3.2% in 2007, when adjusted for a $905,000 pre-tax reversal of accrued benefits for a former executive officer, non-interest expense totaled $9.7 million in 2007 compared to $9.1 million in 2006, or an increase of 6.8%.

Net Interest Income. Net interest income increased to $13.3 million for the year ended December 31, 2007, a $512,000 or 4.0% increase from the $12.8 million earned in 2006. Total interest income benefited from strong growth in the level of average earning assets and higher asset yields caused by the increase in interest rates during the year. The rates earned on a significant portion of the Bank's loans adjust immediately when indexes like the prime rate change. Conversely, a large portion of interest-bearing liabilities, including certificates of deposit and Bank borrowings, have rates fixed until maturity. As a result, interest rate reductions will generally result in an immediate drop in the Bank's interest income on loans, with a more delayed impact on interest expense because reductions in interest costs will only occur upon renewals of certificates of deposit or borrowings. Interest rate increases will generally result in an immediate increase in the Bank's interest income on loans, with a more delayed impact on interest expense because increases in interest costs will only occur upon renewals of certificates of deposit or borrowings. Average total interest-earning assets increased $48.0 million, or 12.7%, during 2007 compared to 2006, while the average yield increased by 13 basis points from 7.14% to 7.27%. As interest rates increased during 2007, the average rate on loans increased year over year. The average rate on investment securities increased in 2007 compared to 2006, reflecting management's decision to purchase higher yielding securities during 2007 as interest rates began to rise. Average total interest-bearing liabilities increased by $42.0 million, or 12.4%, consistent with the increase in interest-earning assets. The average cost of interest-bearing liabilities increased by 45 basis points from 4.21% to 4.66%. With the yield on earning assets increasing less significantly than the cost of interest bearing liabilities, the Bank's net interest margin decreased by 26 basis points. For the year ended December 31, 2007, the net interest margin was 3.12%, while for the year ended December 31, 2006, the net interest margin was 3.38%. Table 3 reflects the volume and rate variances from 2007 vs. 2006.

Provision for Loan Losses. The Bank recorded $425,000 as the provision for loan losses in 2007, an increase of $31,000 from the $394,000 provision made in 2006. Provisions for loan losses are charged to income to bring the allowance for loan losses to a level deemed appropriate by management. In evaluating the allowance for loan losses, management considers factors that include growth, composition and industry diversification of the portfolio, historical loan loss experience, current delinquency levels, adverse situations that may affect a borrower's ability to repay, estimated value of any underlying collateral, prevailing economic conditions and other relevant factors. For 2007 the provision for loan losses was made in response to a weakening economy and real estate market in the 4th

quarter as well as growth in loans, as total loans outstanding, net of loans held for sale, increased by $58.1 million in 2007 and by $33.6 million in 2006. At December 31, 2007, the allowance for loan losses was $4.5 million, an increase of $240,000, or 5.7%, from the $4.2 million at the end of 2006. The allowance represented 1.20% and 1.35%, respectively, of loans outstanding at the end of 2007 and 2006, net of loans held for sale. At December 31, 2007, the Bank had $700,000 in non-accrual loans. In 2006, the Bank had $794,000 in non-accrual loans. It is management's opinion that reserve levels are adequate.

Non-Interest Income. Non-interest income increased to $3.1 million for the year ended December 31, 2007 compared to $2.3 million for the year ended December 31, 2006, an increase of $804,000 or 34.9%. A one time gain on the sale of other real estate in the amount of $481,000 accounted for 15.5% of total non-interest income. Excluding the gain on the sale of other real estate, non-interest income increased $323,000 or 14.0% for 2007. Mortgage operations income decreased to $600,000 in 2007, from $632,000 in 2006, reflecting a softening in the overall mortgage origination market. Service charges on deposit accounts in 2007 were $1.1 million, an increase of $114 thousand, or 12.1%, compared to $944,000 in 2006 reflecting the positive results of a focused marketing effort to increase demand deposit accounts. Table 4, following this discussion, is a comparative analysis of the components of non-interest income for 2007, 2006.

Non-Interest Expenses. Non-interest expenses totaled $8.8 million for the year ended December 31, 2007, a decrease of $291,000 over the $9.1 million reported for 2006. Adjusting non-interest expense for a one-time adjustment of $905,000 related to the reversal of accrued benefits for a former executive officer, non-interest expense for 2007 would have totaled $9.7 million, an increase of $614,000 or 6.8%. Substantially all of this increase resulted from the Bank's growth and development during 2007 and 2006. Personnel costs after a one-time adjustment of $905 thousand related to the reversal of accrued benefits originally designated for a former executive officer increased by $248,000 in 2007, or 4.8%. Professional and other services increased $69,000 primarily due to expenses incurred related to the preparation of anticipated regulatory changes. Deposit and other insurance expense increased $144,000 or 69.2% because of increased FDIC premiums. Occupancy and equipment expense increased by $7,000 due to increases in maintenance costs. Data processing and other outside services increased $99,000, or 14.7%, due to the enhancement of computer systems. Advertising expense decreased $90,000 reflecting new marketing strategies during 2007. Table 5, following this discussion, presents a comparative analysis of the components of non-interest expenses for 2007, 2006.

Income Taxes. The provision for income tax was $2.3 million in 2007 and $1.8 million in 2006. The effective tax rates were 32.4% and 31.1%, respectively, on income before income taxes. The increase in the effective tax rate for 2007 reflects an decrease in the proportion of tax-exempt income to total income for 2007 over 2006.

LIQUIDITY

The Bank's sources of liquidity are customer deposits, cash and demand balances due from other banks, interest-earning deposits in other banks and investment securities available for sale. These funds, together with loan and securities repayments, are used to fund loans and continuing operations. At December 31, 2008, the Bank had credit availability with the Federal Reserve Bank of $80.6 million and the FHLB of $125.8 million, with $25.0 million outstanding.

Total deposits were $467.9 million and $373.9 million at December 31, 2008 and 2007, respectively. The Bank's deposits increased 25.2% in 2008. Because the Bank's organic deposit growth was not sufficient in amount to meet the total funding needs of the Bank's asset growth, the Bank looked to alternative funding sources during 2008. In light of local market deposit competition during the year, the Bank found it less costly to access brokered certificates of deposits rather than compete for higher cost of funds sources within our local markets. The Bank will continue to evaluate all funding sources for cost, accessibility, dependability and efficiency. Brokered certificates of deposits increased $34.7 million during 2008, from $88.7 million in 2007 to $123.4 million in 2008, an increase of 39.2%. Brokered deposits as a percent of assets increased from 19.0% in 2007 to 22.8% in 2008.

At December 31, 2008 and 2007, time deposits represented 63.0% and 70.3%, respectively, of the Bank's total deposits. Certificates of deposit of $100,000 or more represented 59.9% and 51.5%, respectively, of the Bank's total deposits at December 31, 2008 and 2007. At December 31, 2008, the Bank had $7.0 million in public deposits and $123.4 million in brokered time deposits. These sources of funds are generally considered to be less stable than deposits from the Bank's local markets. However, management believes that other non-traditional funding time deposits are relationship oriented. While the Bank appreciates the need to pay competitive rates to retain these deposits, other subjective factors also influence deposit retention. Based upon prior experience, the Bank anticipates that a substantial portion of outstanding certificates of deposit will renew upon maturity. The Bank's aggregate wholesale funding (brokered CD's, wholesale NOW accounts, FHLB advances and FRB discount window borrowings) as a percentage of total assets decreased to 29.3% in 2008 from 32.6% in 2007. The wholesale funding aggregate decrease is due primarily to the strong acceptance by our retail customer base of CDARS (Certificate of Deposit Account Registry Service) a deposit placement network (an innovation that allows banks to offer up to $50 million of FDIC insurance per depositor by networking with other banks within the CDARS system). CDARS deposits have increased from $6.8 million in 2007 to $48.8 million in 2008, reflecting a strong flight to quality by our customer base during the 2008 unpredictable economic environment.

Management anticipates that the Bank will utilize non-local market funding sources such as wholesale NOW accounts, CDARS, FHLB advances, FRB advances and brokered certificates of deposits as a less costly diversified funding source to complement the Bank's local market deposits. Deposits, loan repayments, mortgage-backed securities prepayments, bond maturities, FHLB advances FRB discount window borrowings and current earnings will be employed to provide liquidity, generate loans, purchase securities, procure fixed assets and meet other operating needs incurred in normal banking activities.

In the normal course of business there are various outstanding contractual obligations of the Bank that will require future cash outflows. In addition, there are commitments and contingent liabilities, such as commitments to extend credit that may or may not require future cash outflows. Table 6, following this discussion, "Contractual Obligations and Commitments", summarizes the Bank's contractual obligations and commitments as of December 31, 2008.

CAPITAL RESOURCES

At December 31, 2008 and 2007, shareholders' equity of the Company totaled $37.2 million and $33.2 million, respectively. The Company's equity to asset ratio on those dates was 6.9% and 7.1%, respectively, reflecting the Company's aggressive growth. The Company and the Bank are subject to minimum capital requirements. See "PART 1, ITEM 1 - DESCRIPTION OF BUSINESS — SUPERVISION AND REGULATION." Because the Company's only significant asset is its investment in the Bank, information concerning capital ratios is essentially the same for the Company and the Bank.

All capital ratios place the Bank in excess of minimum requirements to be classified as "well capitalized' by regulatory measures. The Bank's Tier-1leverage ratio was 8.68% at December 31, 2008.

Note P to the accompanying consolidated financial statements presents an analysis of the Bank's regulatory capital position as of December 31, 2008 and 2007. Management anticipates that the Bank will remain "well-capitalized" for regulatory purposes throughout 2009.

ASSET/LIABILITY MANAGEMENT

The Bank's results of operations depend substantially on its net interest income. Like most financial institutions, the Bank's interest income and cost of funds are affected by general economic conditions and by competition in the market place. The purpose of asset/liability management is to provide stable net interest income growth by protecting the Bank's earnings from undue interest rate risk, which arises from volatile interest rates and changes in the balance sheet mix, and by managing the risk/return relationships between liquidity, interest rate risk, market risk and capital adequacy. The Bank maintains, and has complied with, an asset/liability management policy approved by the Board of Directors of the Company and the Bank that provides guidelines for controlling exposure to interest rate risk by utilizing the following ratios and trend analysis: liquidity, equity, volatile liability dependence, portfolio maturities, maturing assets and maturing liabilities. The Bank's policy is to control the exposure of its earnings to changing interest rates by generally endeavoring to maintain a position within a range around an "earnings neutral position," which is defined as the mix of assets and liabilities that generate a net interest margin that is least affected by interest rate changes.

When suitable lending opportunities are not sufficient to utilize available funds, the Bank has generally invested such funds in securities, primarily securities issued by U.S. governmental agencies, mortgage-backed securities and securities issued by local governmental municipalities. The securities portfolio contributes to the Bank's profits and plays an important part in the overall interest rate management. However, management of the securities portfolio alone cannot balance overall interest rate risk. The securities portfolio must be used in combination with other asset/liability techniques to actively manage the balance sheet. The primary objectives in the overall management of the securities portfolio are safety, liquidity, yield, asset/liability management (interest rate risk) and investing in securities that can be pledged for public deposits or as collateral for FHLB advances.

In reviewing the needs of the Bank with regard to proper management of its asset/liability program, the Bank's management estimates its future needs, taking into consideration historical periods of high loan demand and low deposit balances, estimated loan and deposit increases (due to increased demand through marketing) and forecasted interest rate changes. A number of measures are used to monitor and manage interest rate risk, including income simulations and interest sensitivity (gap) analyses. An income simulation model is the primary tool used to assess the direction and magnitude of changes in net interest income resulting from changes in interest rates. Key assumptions in the model include prepayments on loan and loan-backed assets, cash flows and maturities of other investment securities, loan and deposit volumes and pricing. These assumptions are inherently uncertain and, as a result, the model cannot precisely estimate net interest income or precisely predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and changes in market conditions and management strategies, among other factors.

Based on the results of the income simulation model, as of December 31, 2008, due to the extremely low interest rate environment, the Bank would expect an increase in net interest income of $253,000 if interest rates increase from current rates by an instantaneous 100 basis points and an increase in net interest income of $414,000 thousand if interest rates decrease from current rates by an instantaneous 100 basis points.

The analysis of an institution's interest rate gap (the difference between the repricing of interest-earning assets and interest-bearing liabilities during a given period of time) is another standard tool for the measurement of the exposure to interest rate risk. Management believes that because interest rate gap analysis does not address all factors that can affect earnings performance, it should be used in conjunction with other methods of evaluating interest rate risk.

Table 7, following this discussion, "Interest Rate Sensitivity Analysis", sets forth the amounts of interest-earning assets and interest-bearing liabilities outstanding at December 31, 2008, which are projected to reprice or mature in each of the future time periods shown. Except as stated below, the amounts of assets and liabilities shown which reprice or mature within a particular period were determined in accordance with the contractual terms of the assets or liabilities. Loans with adjustable rates are shown as being due at the end of the next upcoming adjustment period. Money market deposit accounts are considered rate sensitive and are placed in the shortest period. Negotiable order of withdrawal or other transaction accounts are also assumed to be rate sensitive and are placed in the shortest period. In making the gap computations, none of the assumptions sometimes made regarding prepayment rates and deposit decay rates are used for any interest-earning assets or interest-bearing liabilities. In addition, the table does not reflect scheduled principal payments that will be received throughout the lives of the loans. The interest rate sensitivity of the Bank's assets and liabilities illustrated in the table would vary substantially if different assumptions were used or if actual experience differs from that indicated by such assumptions.

Table 7 illustrates that if assets and liabilities reprice in the time intervals indicated in the table, the Bank is asset sensitive within three months, liability sensitive over three months to twelve months, liability sensitive within twelve months and asset sensitive thereafter. As stated above, certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market interest rates. For instance, while the table is based on the assumption that money market accounts are immediately sensitive to movements in rates, the Bank expects that in a changing rate environment the amount of the adjustment in interest rates for such accounts would be less than the adjustment in categories of assets that are considered to be immediately sensitive. The same is true for all other interest-bearing transaction accounts. Additionally, certain assets have features that restrict changes in the interest rates of such assets both on a short-term basis and over the lives of such assets. Further, in the event of a change in market interest rates, prepayment and early withdrawal levels could deviate significantly from those assumed in calculating the tables. Finally, the ability of many borrowers to service their adjustable-rate debt may decrease in the event of an increase in market interest rates. Due to these shortcomings, the Bank places primary emphasis on its income simulation model when managing its exposure to changes in interest rates. The Bank does not normally make interest rate predictions, or take undue risk on potential changes in interest rate direction. The Bank is currently neutral in its rate sensitivity. Should interest rates increase or decrease, the Bank's earnings, margins and spreads would be positively impacted.

LENDING ACTIVITIES

General. The Bank provides to its customers a full range of short- to medium-term commercial, mortgage, construction and personal loans, both secured and unsecured. The Bank also makes real estate mortgage and construction loans.

The Bank's loan policies and procedures establish the basic guidelines governing its lending operations. Generally, the guidelines address the types of loans that the Bank seeks, target markets, underwriting and collateral requirements, terms, interest rate and yield considerations and compliance with laws and regulations. All loans or credit lines are subject to approval procedures and amount limitations. These limitations apply to the borrower's total outstanding indebtedness to the Bank, including the indebtedness of any guarantor. The policies are reviewed and approved at least annually by the Board of Directors of the Bank. The Bank supplements its own supervision of the loan underwriting and approval process with periodic loan audits by internal loan examiners and outside professionals experienced in loan review work. The Bank has focused its portfolio lending activities on typically higher yielding commercial, construction and consumer loans. The Bank also originates 1-4 family mortgages that are typically sold into the secondary market, servicing released.
Table 8, "Loan Portfolio Composition", following this discussion, provides an analysis of the Bank's loan portfolio composition by type of loan as of the end of each of the last five years.

Table 9, "Loan Maturities", following this discussion, presents, at December 31, 2008, (i) the aggregate maturities or re-pricings of commercial, industrial and commercial mortgage loans and of real estate constructions loans and (ii) the aggregate amounts of such loans by variable and fixed rates.

Commercial and Industrial Loans. At December 31, 2008, the Bank's commercial and industrial loan portfolio equaled $63.2 million, or 14.6% of total loans, as compared with $46.9 million, or 12.6% of total loans, at December 31, 2007. Commercial and industrial loans include both secured and unsecured loans for working capital, expansion and other business purposes. Short-term working capital loans generally are secured by accounts receivable, inventory and/or equipment. The Bank also makes term commercial loans secured by equipment and real estate. Lending decisions are based on an evaluation of the financial strength, management and credit history of the borrower, and the quality of the collateral securing the loan. With few exceptions, the Bank requires personal guarantees and secondary sources of repayment.

Commercial and industrial loans generally provide greater yields and reprice more frequently than other types of loans, such as real estate loans, as most commercial loan yields are tied to the prime rate index. Therefore, yields on most commercial loans adjust with changes in the prime rate.

Real Estate Loans. Real estate loans are originated for the purpose of purchasing, constructing or refinancing one to four family, five or more family and commercial properties. The Bank offers fixed and adjustable rate options. The Bank provides customers access to long-term conventional real estate loans through its mortgage loan department which makes Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Company ("FHLMC") and Government National Mortgage Association ("GNMA")-- conforming loans that are originated with a commitment from a correspondent bank to purchase the loan within 30-45 days of closing.

Residential 1- 4 family loans are classified into two categories: conforming loans, that are originated under the underwriting guidelines established by FNMA, FHLMC or GNMA and held for sale and nonconforming loans that are originated and retained in the Bank's loan portfolio. The terms "conforming" and "nonconforming" do not refer to credit quality, but rather to whether the loan is underwritten so that it can be sold in the secondary market. At December 31, 2008, the Bank had no loans held for sale while nonconforming loans held in the Bank's permanent portfolio amounted to $457,000. The Bank's permanent residential mortgage loans are generally secured by properties located within the Bank's market area. Most of the one to four family residential mortgage loans that the Bank makes are conforming loans and are sold within 30 days of closing to a correspondent bank. The Bank originated 217 loans in the amount of $21.5 million for sale in the secondary market during 2008. The Bank receives a fee for each loan originated, with fees aggregating $571,000 for the year ended December 31, 2008 and $600,000 for the year ended December 31, 2007. The Bank anticipates that it will continue to be an active originator of residential loans. Nonconforming residential mortgage loans that are retained in the Bank's loan portfolio generally have rate terms of five years or less, with amortizations up to 20 years.

The Bank has made, and anticipates continuing to make, commercial real estate loans. Commercial real estate loans amounted to $156.3 million at December 31, 2008. These loans are secured principally by commercial buildings for office, storage and warehouse space, and by agricultural properties. Generally in underwriting commercial real estate loans, the Bank requires the personal guarantee of borrowers and a demonstrated cash flow capability sufficient to service the debt. Loans secured by commercial real estate usually involve a greater degree of risk than 1-4 family residential mortgage loans. Payments on such loans are often dependent on successful operation or management of the properties.

The Bank originates 1- 4 family residential construction loans for the construction of custom homes (where the home buyer is the borrower) and provides financing to builders and consumers for the construction of pre-sold homes. The Bank generally receives a pre-arranged permanent financing commitment from an outside entity prior to financing the construction of pre-sold homes. The Bank lends to builders who have demonstrated a favorable record of performance and profitable operations and who are building in markets that management believes it understands and in which it is comfortable with the economic conditions. The Bank also makes commercial real estate construction loans, generally for owner-occupied properties. The Bank further endeavors to limit its construction lending risk through adherence to established underwriting procedures. The Bank generally requires documentation for all draw requests and utilizes loan officers to inspect the project prior to honoring draw requests from the builder. With few exceptions, the Bank requires personal guarantees and secondary sources of repayment on construction loans.

Consumer Loans and Home Equity Lines of Credits. Loans to individuals include automobile loans, boat and recreational vehicle financing, home equity and home improvement loans and miscellaneous secured and unsecured personal loans. Consumer loans generally can carry significantly greater risks than other loans, even if secured, if the collateral consists of rapidly depreciating assets such as automobiles and equipment. Repossessed collateral securing a defaulted consumer loan may not provide an adequate source of repayment of the loan. Consumer loan collections are sensitive to job loss, illness and other personal factors. The Bank attempts to manage the risks inherent in consumer lending by following established credit guidelines and underwriting practices designed to minimize risk of loss.

Loan Approvals. The Bank's loan policies and procedures establish the basic guidelines governing its lending operations. Generally, the guidelines address the type of loans that the Bank seeks, target markets, underwriting and collateral requirements, terms, interest rate and yield considerations and compliance with laws and regulations. All loans or credit lines are subject to approval procedures and amount limitations. These limitations apply to the borrower's total outstanding indebtedness to the Bank, including the indebtedness of any guarantor. The policies are reviewed and approved at least annually by the Board of Directors of the Bank. The Bank supplements its own supervision of the loan underwriting and approval process with periodic loan audits by independent, outside professionals experienced in loan review analysis.

Responsibility for loan production rests with the Senior Commercial Lending Officer in each market. The responsibility for loan underwriting, loan processing and approval is with the Chief Credit Officer. The Board of Directors of the Bank reviews the President's lending authority annually. The Board, in turn delegates loan authority to the Chief Credit Officer and other loan officers of the Bank. Delegated authorities may include loans, letters of credit, overdrafts, uncollected funds and such other authority as determined by the Board of Directors or the President.

The President and the Chief Credit Officer each have the authority to approve loans up to $400 thousand. The President in conjunction with the Chief Credit Officer have the combined authority to approve loans up to $2 million which is the maximum staff, in-house lending limit set by the Board of Directors. The Board's Loan Committee approves all loans in excess of the staff's in-house lending limit. The Committee consists of the President, the Chairman and Vice Chairman of the Bank's Board and four outside directors as appointed by the Board of the Bank

Additionally, all loans of $50 thousand or greater and all loans with relationship exposure of $200,000 or above are reviewed by the Management Loan Committee comprised of the President, Chief Credit Officer, and the Senior Commercial Loan Officers for Burlington, Graham and Greensboro. The Bank's Loan Committee reviews all loans with total exposure of $1.0 million or greater and approves all loans with total exposure of $2.0 million or greater. The Bank's legal lending limit was $7.8 million at December 31, 2008. The Bank seldom makes loans approaching its legal lending limit.

COMMITMENTS TO EXTEND CREDIT

In the ordinary course of business, the Bank enters into various types of transactions that include commitments to extend credit that are not included in loans receivable, net, presented on the Company's consolidated balance sheets. The Bank applies the same credit standards to these commitments as it uses in all its lending activities and has included these commitments in its lending risk evaluations. The Bank's exposure to credit loss under commitments to extend credit is represented by the amount of these commitments. See Note O to the accompanying consolidated financial statements and Table 6.

ASSET QUALITY

The Bank considers asset quality to be of primary importance, and employs a formal internal loan review process to ensure adherence to the lending policy as approved by the Bank's Board of Directors. It is the responsibility of each loan officer to assign an appropriate risk grade to loans when originated. Credit Administration, through the loan review process, validates the accuracy of the initial risk grade assessment. In addition, as a given loan's credit quality changes, it is the responsibility of Credit Administration to change the borrower's risk grade accordingly. The process of determining the allowance for loan losses is fundamentally driven by the risk grade system. In determining the allowance for loan losses and any resulting provision to be charged against earnings, particular emphasis is placed on the results of the loan review process. Consideration is also given to historical loan loss experience, the value and adequacy of collateral, economic conditions in the Bank's market area and other factors. For loans determined to be impaired, the allowance is based on discounted cash flows using the loan's initial effective interest rate or the fair value of the collateral for certain collateral dependent loans. This evaluation is inherently subjective, as it requires material estimates, including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The allowance for loan losses represents management's estimate of the appropriate level of reserve to provide for probable losses inherent in the loan portfolio.

The Bank's policy regarding past due loans normally requires a prompt charge-off to the allowance for loan losses following timely collection efforts and a thorough review. Further efforts are then pursued through various means available. Loans carried in a non-accrual status are generally collateralized and are considered in the determination of the allowance for loan losses.

NONPERFORMING ASSETS

Table 10, "Nonperforming Assets", following this discussion, sets forth, for the last five years, information with respect to the Bank's nonperforming assets.

The Company's consolidated financial statements are prepared on the accrual basis of accounting, including the recognition of interest income on loans, unless a loan is placed on non-accrual basis. Loans are accounted for on a non-accrual basis when management has serious concerns about the collectibility of principal or interest. Generally, the Bank's policy is to place a loan on non-accrual status when the loan becomes 90 days past due. Loans are also placed on non-accrual status in cases where management is uncertain whether the borrower can satisfy the contractual terms of the loan agreement. Payments received on non-accrual loans generally are applied to principal first, and then to interest after all principal payments have been satisfied. Restructured loans are those for which concessions, including the reduction of interest rates below a rate otherwise available to that borrower or the deferral of interest or principal, have been granted due to the borrower's weakened financial condition. The Bank accrues interest on restructured loans at the restructured rate when management anticipates that no loss of original principal will occur. Potential problem loans are defined as loans currently performing that are not included in non-accrual or restructured loans, but are loans that management has concerns as to the borrower's ability to comply with present repayment terms. These loans could deteriorate to non-accrual, past due or restructured loans status. Therefore, management quantifies the risk associated with problem loans in assessing the adequacy of the allowance for loan losses. At December 31, 2008, the Bank identified $3.1million in non-accrual loans. Management anticipates that the vast majority of the non-accruing loans at December 31, 2008 will be paid out or returned to accrual status. At December 31, 2007, the Bank identified $700,000 in non-accrual loans.

Real estate owned consists of foreclosed, repossessed and idled properties. At December 31, 2008, there were $1.6 million assets classified as real estate owned. At December 31, 2007, there were $264,000 assets classified as real estate owned.

ANALYSIS OF ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged-off against the allowance when management believes that the collectibility of principal is unlikely. Recoveries of amounts previously charged-off are credited to the allowance.

The allowance for loan losses relating to loans that are determined to be impaired under SFAS No. 114 is based on discounted cash flows using the loan's initial effective interest rate or the estimated fair value of the collateral, less costs to sell, for certain collateral dependent loans. Large groups of smaller balance homogeneous loans that are collectively evaluated for impairment (such as residential mortgage and consumer installment loans) are excluded from impairment evaluation, and their allowance for loan losses is calculated in accordance with the allowance for loan losses policy described below.

The provision for loan losses charged to operating expense is based on factors which, in management's judgment, deserve current recognition in estimating probable loan losses. Such factors considered by management include growth and composition of the loan portfolio, the relationship of the allowance for loan losses to outstanding loans and economic conditions. While management uses the best information available to make evaluations, this evaluation is inherently subjective as it requires material estimates, including the amounts and timing of future cash flows expected to be received on impaired loans, that may be susceptible to significant change.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

Growth in loans outstanding has, throughout the Bank's history, been the primary reason for increases in the Bank's allowance for loan losses and the resultant provisions for loan losses necessary to provide for those increases. This growth has been spread among the Bank's major loan categories, with the concentrations of major loan categories being relatively consistent. Between December 31, 2007 and December 31, 2008, the range of each major category of loans as a percentage of total loans outstanding is as follows: residential mortgage loans – 15.4% to 16.9%; commercial mortgage loans – 37.7% to 36.0%; construction loans – 21.5% to 21.1%; commercial and industrial loans – 12.6% to 14.6%; loans to individuals – 1.6% to 1.4%; and home equity lines of credit – 11.1% to 10.0%. For the past five fiscal years through 2008, the Bank's loan loss experience has been similar to that of other peer banks in North Carolina, with net loan charge-offs in each year of ranging from 0.05% to 0.12% of average loans outstanding. Charge offs are typically recognized when it is the opinion of management that all or a portion of an outstanding loan becomes uncollectible. Loan repayment may be realized through a contractual agreement, or through liquidation of assets pledged as collateral. Net charge-offs totaled $185,000 or 0.05% of outstanding loans for 2007 and $495,000 or 0.12% of outstanding loans for 2008. The Bank's allowance for loan losses at December 31, 2007 of $4.5 million represents 1.20% of total loans outstanding, net of loans held for sale. The Bank's allowance for loan losses at December 31, 2008 was $5.6 million or 1.30% of outstanding loans, net of loans held for sale. The allowance for loan losses as a percentage of loans outstanding increased in 2008 compared to 2007 due to an increase in loans outstanding as well as increases in non performing loans reflecting the decline in the local, national and international economic environment. Non performing loans increased $2.4 million during 2008 to $3.1 million compared to $700,000 at December 31, 2007. $2.8 million of the non performing loans at December 31, 2008, or 88.5%, were concentrated in commercial real estate.

Table 11, "Allocation for the Allowance of Loan Losses", following this discussion, presents the allocation of the allowance for loan losses at the end of each of the last five years. The allocation is based on an evaluation of defined loan problems, historical ratios of loan losses and other factors that may affect future loan losses in the categories of loans shown.

Table 12, "Loan Loss and Recovery Experience", following this discussion, sets forth for each of the last five years information regarding changes in the Bank's allowance for loan losses.

INVESTMENT ACTIVITIES

The Bank's portfolio of investment securities, all of which are available for sale, consists primarily of U.S. government agency securities, mortgage-backed securities and securities issued by local governments. Securities to be held for indefinite periods of time and not intended to be held to maturity are classified as available for sale and carried at fair value, with any unrealized gains or losses reflected as an adjustment to stockholders' equity. Securities held for indefinite periods of time include securities that management intends to use as part of its asset/liability management strategy and that may be sold in response to changes in interest rates and/or significant prepayment risks. It is the Bank's policy to classify its investment securities as available for sale. Table 13, "Securities Portfolio Composition", following this discussion, summarizes investment securities by type at December 31, 2008, 2007 and 2006.

Table 14, "Securities Portfolio Composition", following this discussion, summarizes the amortized costs, fair values and weighted average yields of the Bank's investment securities at December 31, 2008, by contractual maturity groups.

The Bank does not engage in, nor does it presently intend to engage in, securities trading activities and therefore does not maintain a trading account. At December 31, 2008, there were no securities of any issuer (other than governmental agencies) held in the Bank's portfolio that exceeded 10% of the Company's shareholders' equity.

SOURCES OF FUNDS

Deposit Activities. The Bank provides a range of deposit services, including non-interest-bearing checking accounts, interest-bearing checking and savings accounts, money market accounts and certificates of deposit. These accounts generally earn interest at rates established by management based on competitive market factors and management's desire to increase or decrease certain types or maturities of deposits. As described in "-Liquidity" above, the Bank uses wholesale deposits as a funding source. However, the Bank strives to establish customer relations to attract core deposits in non-interest-bearing transactional accounts and thus to reduce the Bank's costs of funds.

Table 15, "Average Deposits", following this discussion, sets forth for the for the years ended December 31, 2008, 2007 and 2006 the average balances outstanding and average interest rates for each major category of deposits.

Table 16, "Maturities of Time Deposits of $100,000 or More", which follows this discussion, presents maturities of certificates of deposit with balances of $100,000 or more at December 31, 2008.

Borrowings. As additional sources of funding, the Bank uses advances from the FHLB under a line of credit equal to 30% of the Bank's total assets, subject to qualifying collateral. The available aggregate line of credit was $78.1 million at December 31, 2008. Outstanding advances at December 31, 2008 totaled $25.0 million, $4.0 million maturing in 2010, bearing interest at a weighted average rate of 5.79%; $5 million maturing in 2011 at 2.37%, $6 million maturing in 2010 bearing interest at 3.98%, $10 million maturing in 2018 at 2.98% and $5 million maturing in 2011 at 2.37%.The Bank had no daily rate credit advances outstanding at December 31, 2008. Pursuant to collateral agreements with the FHLB, at December 31, 2008, advances are secured by loans with a carrying amount of $140.5 million, which approximates market value. Advances outstanding at December 31, 2007 totaled $49.0 million.

The Bank opened a new line of credit with the FRB through their discount window in the amount of $80.6 million during 2008. No borrowings were outstanding at December 31, 2008. The line of credit is secured by loans with a carrying amount of $102.9 million, which approximates market value.

In addition to FHLB advances, the Company issued $8.8 million of junior subordinated debentures to its wholly owned capital trusts, MidCarolina I and MidCarolina Trust II, to fully and unconditionally guarantee the preferred securities issued by the Trusts. These long term obligations, which currently qualify as Tier I capital for the Company, constitute a full and unconditional guarantee by the Company of the Trusts' obligations under the Capital Trust Securities.

CRITICAL ACCOUNTING POLICY

Allowance for Loan Losses. The Company's most significant critical accounting policy is the determination of the Bank's allowance for loan losses. A critical accounting policy is one that is both very important to the portrayal of the Company's financial condition and results, and requires management's most difficult, subjective or complex judgments. What makes these judgments difficult, subjective and/or complex is the need to make estimates about the effects of matters that are inherently uncertain. If the mix and amount of future write-offs differ significantly from those assumptions used in making a determination, the allowance for loan losses and provision for loan losses on the income statement could be materially affected. For further discussion of the allowance for loan losses and a detailed description of the methodology used in determining the adequacy of the allowance, see the sections of this discussion titled "Asset Quality", "Analysis of Allowance for Loan Losses" and "Other Than Temporarily Impaired Investments" and Note B to the consolidated financial statements contained in this Annual Report.

Off-Balance Sheet Arrangements. The Company does not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect of the Company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

RISKS ASSOCIATED WITH THE BANK AND THE COMPANY

Concentration of Operations. The Bank's operations are concentrated in the Piedmont region of North Carolina. As a result of this geographic concentration, the Bank's results may correlate to the economic conditions in this area. A deterioration in economic conditions in this market area, particularly in the industries on which these geographic areas depend, may adversely affect the quality of the Bank's loan portfolio and the demand for the Bank's products and services, and accordingly, its results of operations.

Risks Associated with Loans. A significant source of risk for the Bank arises from the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans. The Bank has underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for loan losses, that management believes are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan performance and diversifying the Bank's loan portfolio. Such policies and procedures, however, may not prevent unexpected losses that could adversely affect results of operations.

Competition with Larger Financial Institutions. The banking and financial services business in the Bank's market area continues to be a competitive field and is becoming more competitive as a result of:

- changes in regulations;
- changes in technology and product delivery systems; and
- the accelerating pace of consolidation among financial services providers.

It may be difficult to compete effectively in the Bank's market, and results of operations could be adversely affected by the nature or pace of change in competition. The Bank competes for loans, deposits and customers with various bank and non-bank financial services providers, many of which are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services.

Trading Volume. The Company's trading volume is relatively low when compared with more seasoned companies listed on the Nasdaq Capital Market, the Nasdaq Global & Global Select Market System, the New York Stock Exchange or other consolidated reporting systems or stock exchanges. The market in the Company's common stock may be limited in scope relative to other companies. The Company cannot guarantee that a more active and liquid trading market for the Company's common stock will develop in the future.

Technological Advances. The banking industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to improving customer services, the effective use of technology increases efficiency and enables financial institutions to reduce costs. The Bank's future success will depend, in part, on its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in the Bank's operations. Many of our competitors have substantially greater resources than the Company and the Bank to invest in technological improvements.

Government Regulations. Current and future legislation and the policies established by federal and state regulatory authorities will affect the Company's and the Bank's operations. The Bank is subject to supervision and periodic examination by the FDIC and the Commissioner. The Company is subject to the supervision and regulation of the Federal Reserve and the Commissioner. Banking regulations, designed primarily for the protection of depositors, may limit the Company's and the Bank's growth and the return to our shareholders by restricting certain of the Company's and the Bank's activities, such as:

- the payment of dividends to the Company's shareholders;
- possible mergers with or acquisitions of or by other institutions;

- investment policies;
- loans and interest rates on loans;
- interest rates paid on deposits;
- expansion of branch offices; and/or
- the possibility to provide or expand securities or trust services.

The Company cannot predict what changes, if any, will be made to existing federal and state legislation and regulations or the effect that any changes may have on future business and earnings prospects. The cost of compliance with regulatory requirements may adversely affect the Company's and the Bank's ability to operate profitably.

MidCarolina Financial Corporation
Table 2
Average Balances and Net Interest Income (1)
($ in thousands)

	Year Ended December 31, 2008			Year Ended December 31, 2007			Year Ended December 31, 2006		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:									
Loans, net	$ 405,119	$ 25,763	6.36%	$ 344,620	$ 27,037	7.85%	$ 301,405	$ 23,429	7.77%
Investment securities	69,728	3,561	5.11%	72,013	3,581	4.97%	67,590	3,215	4.76%
Interest-earning cash deposits	9,678	131	1.35%	8,080	264	3.27%	8,017	304	3.79%
Other	2,454	161	6.56%	2,429	171	7.04%	2,156	113	5.24%
Total interest-earning assets	486,979	29,616	6.08%	427,142	31,053	7.27%	379,168	27,061	7.14%
Other assets	19,602			20,300			18,346		
Total assets	$ 506,581			$ 447,442			$ 397,514		
Interest-bearing liabilities:									
Deposits:									
Demand deposits	74,531	1,275	1.71%	80,529	2,796	3.47%	64,189	1,983	3.09%
Savings deposits	5,772	29	0.50%	6,024	60	1.00%	6,449	65	1.01%
Fixed maturity deposits	308,562	12,192	3.95%	249,096	12,501	5.02%	226,927	10,125	4.46%
Short term borrowed funds	9,807	288	2.94%	16,636	1,094	6.58%	14,044	711	5.06%
Long term borrowed funds	33,764	1,510	4.47%	28,003	1,270	4.54%	26,674	1,357	5.09%
Total interest-bearing liabilities	432,436	15,294	3.54%	380,288	17,721	4.66%	338,283	14,241	4.21%
Noninterest-bearing deposits	36,925			34,479			32,159		
Other liabilities	1,390			2,774			2,522		
Stockholders' equity	35,830			29,901			24,550		
Total liabilities and stockholders' equity	$ 506,581			$ 447,442			$ 397,514		
Net interest income and interest rate spread		$ 14,322	2.54%		$ 13,332	2.61%		$ 12,820	2.93%
Net yield on average interest-earning assets			2.94%			3.12%			3.38%
Ratio of average interest-earning assets to average interest-bearing liabilities	112.61%			112.32%			112.09%		

(1) includes nonaccrual and nonperforming loans, the impact of which is not significant. Tax exempt income is not computed on a tax equivalent basis.

MidCarolina Financial Corporation
Table 3
Volume and Rate Variance Analysis
(In Thousands)

	Year Ended December 31, 2008 vs. 2007			Year Ended December 31, 2007 vs. 2006		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Loans, net	$ 4,297	$ (5,571)	$ (1,274)	$ 3,375	$ 233	$ 3,608
Investment securities	(115)	95	(20)	215	151	366
Interest-earning cash deposits	37	(170)	(133)	2	(42)	(40)
Other	2	(12)	(10)	17	41	58
Total interest income	4,221	(5,658)	(1,437)	3,609	383	3,992
Interest expense:						
Deposits						
Demand deposits	(155)	(1,366)	(1,521)	536	277	813
Savings deposits	(2)	(29)	(31)	(4)	(1)	(5)
Fixed maturity deposits	2,667	(2,976)	(309)	1,051	1,325	2,376
Short term borrowed funds	(325)	(481)	(806)	151	232	383
Long term borrowed funds	259	(19)	240	64	(151)	(87)
Total interest expense	2,444	(4,871)	(2,427)	1,798	1,682	3,480
Net interest income increase (decrease)	$ 1,777	$ (787)	$ 990	$ 1,811	$ (1,299)	$ 512

MidCarolina Financial Corporation
Table 4
Noninterest Income
(In thousands)

	Year Ended December 31,		
	2008	2007	2006
Service charges on deposit accounts	$ 1,152	$ 1,058	$ 944
Mortgage operations	571	600	632
Investment brokerage fees	300	288	229
Increase in cash surrender value of life insurance	299	290	267
Core noninterest income	2,322	2,236	2,072
Securities gains (losses), net	29	8	(217)
Impairment on investment securities	(490)	-	-
Gain on sale of other real estate	536	481	-
Other noninterest income	359	383	449
Total noninterest income	$ 2,756	$ 3,108	$ 2,304

MidCarolina Financial Corporation
Table 5
Noninterest Expenses
(In thousands)

	Year Ended December 31,		
	2008	2007	2006
Salaries	$ 4,338	$ 4,085	$ 3,800
Employee benefits	1,049	1,299	1,336
Reversal of accrued employee benefits	-	(905)	-
Total salaries and benefits	5,387	4,479	5,136
Occupancy expense	699	428	397
Equipment expense	434	425	449
Data processing	787	774	675
Office supplies and postage	350	317	352
Deposit and other insurance	432	352	208
Professional and other services	550	476	407
Advertising	387	256	346
Other	972	1,279	1,107
Total noninterest expenses	$ 9,998	$ 8,786	$ 9,077

MidCarolina Financial Corporation
Table 6
Contractual Obligations and Commitments
($ in thousands)

	Payments Due by Period				
Contractual Obligations	Total	On Demand or Within 1 Year	2 - 3 Years	4 - 5 Years	After 5 Years
Short-term borrowings	$ -	$ -	$ -	$ -	$ -
Long-term debt	38,764	-	15,000	-	23,764
Operating leases	4,680	286	572	477	3,345
Total contractual cash obligations excluding deposits	43,444	286	15,572	477	27,109
Time deposits	340,751	326,322	14,429	-	-
Total contractual cash obligations	$ 384,195	$ 326,608	$ 30,001	$ 477	$ 27,109

	Amount of Commitment Expiration Per Period				
Commercial Commitments	Total Amounts Committed	Within 1 Year	2 - 3 Years	4 - 5 Years	After 5 Years
Lines of credit and loan commitments (1)	$ 74,659	$ 39,246	$ 3,345	$ -	32,068

(1) includes financial standby letters of credit, net

MidCarolina Financial Corporation
Table 7
Interest Rate Sensitivity Analysis
($ in thousands)

	At December 31, 2008				
	3 Months or Less	Over 3 Months to 12 Months	Total Within 12 Months	Over 12 Months	Total
Interest-earning assets:					
Loans and loans held for sale	$ 238,373	$ 46,523	$ 284,896	$ 149,766	$ 434,662
Securities available for sale	3,847	6,472	10,319	60,805	71,124
Other earning assets	14,040	-	14,040	-	14,040
Total interest-earning assets	$ 256,260	$ 52,995	$ 309,255	$ 210,571	$ 519,826
Interest-bearing liabilities					
Fixed maturity deposits	$ 130,134	196,188	326,322	$ 14,429	$ 340,751
All other deposits	84,093	-	84,093	-	84,093
Borrowings	-	-	-	33,764	33,764
	$ 214,227	$ 196,188	$ 410,415	$ 48,193	$ 458,608
Interest sensitivity gap	$ 42,033	$ (143,193)	$ (101,160)	$ 162,378	$ 61,218
Cumulative interest sensitivity gap	42,033	(101,160)	(101,160)	61,218	61,218
Cumulative interest sensitivity gap as a percent of total interest-earning assets	8.09%	-19.46%	-19.46%	11.78%	11.78%
Cumulative ratio of interest-sensitive assets to interest-sensitive liabilities	119.62%	75.35%	75.35%	113.35%	113.35%

MidCarolina Financial Corporation
Table 8
Loan Portfolio Composition
($ in thousands)

	At December 31,									
	2008		2007		2006		2005		2004	
	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans
Real Estate:										
Construction loans	$ 91,933	21.15%	$ 80,051	21.49%	$ 71,348	22.61%	$ 67,170	23.92%	$ 27,715	12.41%
Commercial mortgage loans	156,333	35.97%	140,198	37.63%	124,385	39.41%	100,292	35.71%	88,220	39.51%
Home equity lines of credit	43,290	9.96%	41,479	11.13%	33,090	10.49%	30,072	10.71%	34,715	15.55%
Residential mortgage loans	73,595	16.93%	57,342	15.39%	37,163	11.78%	38,656	13.76%	28,630	12.82%
Residential mortgage loans held for sale	-	0.00%	823	0.22%	2,016	0.63%	893	0.32%	5,657	2.53%
Total real estate loans	365,151	84.01%	319,893	85.86%	268,002	84.92%	237,083	84.42%	184,937	82.82%
Commercial and industrial loans	63,239	14.55%	46,893	12.59%	38,965	12.35%	38,929	13.86%	30,464	13.64%
Loans to individuals for household, family and other personal expenditures	6,306	1.44%	5,796	1.55%	8,625	2.73%	4,836	1.72%	7,911	3.54%
Loans, gross	434,696	100.00%	372,582	100.00%	315,592	100.00%	280,848	100.00%	223,312	100.00%
Less net deferred loan origination (fees) costs	(34)		(45)		(4)		7		28	
Total loans	$ 434,662		$ 372,537		$ 315,588		$ 280,855		$ 223,340	

MidCarolina Financial Corporation
Table 9
Loan Maturities
(In thousands)

	At December 31, 2008							
	Due within one year		Due after one year but within five		Due after five years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
By loan type:								
Commercial and industrial and commerical mortgage	$ 102,340	4.29%	$ 106,291	6.85%	$ 14,254	6.70%	$ 222,885	5.66%
Real estate - construction	70,245	3.83%	8,573	6.78%	4,301	7.18%	83,119	4.31%
Total	$ 172,585	4.10%	$ 114,864	6.84%	$ 18,555	6.81%	$ 306,004	5.29%
By interest rate type:								
Fixed rate loans	$ 29,445		$ 114,864		$ 18,555		$ 162,864	
Variable rate loans	143,140		-		-		143,140	
	$ 172,585		$ 114,864		$ 18,555		$ 306,004	

The above table is based on contractual scheduled maturities. Early repayment of loans or renewals at maturity are not considered in this table.

MidCarolina Financial Corporation
Table 10
Nonperforming Assets
($ in thousands)

	At December 31,				
	2008	2007	2006	2005	2004
Nonaccrual loans	$ 3,123	$ 700	$ 794	$ 237	$ 254
Restructured loans	-	-	-	-	-
Total nonperforming loans	3,123	700	794	237	254
Repossessed Assets	47	-	-	19	-
Other real estate owned	1,608	264	2,337	2,803	2,031
Total nonperforming assets	$ 4,778	$ 964	$ 3,131	$ 3,059	$ 2,285
Accruing loans past due 90 days or more	$ -	$ -	$ -	$ -	$ -
Allowance for loan losses	5,632	4,462	4,222	4,090	2,865
Nonperforming loans to year end loans	0.72%	0.19%	0.25%	0.08%	0.11%
Allowance for loan losses to year end loans	1.30%	1.20%	1.35%	1.46%	1.32%
Nonperforming assets to loans and other real estate	1.11%	0.27%	0.99%	1.08%	1.01%
Nonperforming assets to total assets	0.88%	0.21%	0.74%	0.83%	0.80%
Allowance for loan losses to nonperforming loans	180.34%	637.43%	531.74%	1725.74%	1127.95%

MidCarolina Financial Corporation
Table 11
Allocation of the Allowance for Loan Losses
(In thousands)

	2008 Amount	2008 % of Total Loans (1)	2007 Amount	2007 % of Total Loans (1)	2006 Amount	2006 % of Total Loans (1)	2005 Amount	2005 % of Total Loans (1)	2004 Amount	2004 % of Total Loans (1)
Real estate loans:										
Construction loans	$ 1,191	21.15%	$ 959	21.49%	$ 954	22.61%	$ 978	23.92%	$ 356	12.41%
Commercial mortgage loans	2,026	35.97%	1,679	37.63%	1,664	39.41%	1,461	35.71%	1,023	35.71%
Home equity lines of credit	561	9.96%	497	11.13%	443	10.49%	438	10.71%	307	10.71%
Residential mortgage loans	954	16.93%	687	15.39%	482	11.41%	553	13.76%	394	13.76%
Residential mortgage loans held for sale	-	0.00%	10	0.22%	-	1.00%	-	0.32%	-	0.32%
Total real estate loans	4,732	84.01%	3,832	85.86%	3,543	84.92%	3,430	84.42%	2,080	84.42%
Commercial and industrial loans	819	14.55%	562	12.59%	534	12.35%	665	13.86%	495	13.86%
Loans to individuals	81	1.44%	69	1.55%	115	2.73%	70	1.72%	49	1.72%
	$ 5,632	100.00%	$ 4,462	100.00%	$ 4,222	100.00%	$ 4,090	100.00%	$ 2,865	100.00%

(1) Represents total of all outstanding loans in each category as a percent of total loans outstanding

MidCarolina Financial Corporation
Table 12
Loan Loss and Recovery Experience
($ in thousands)

	At or for the Year Ended December 31,				
	2008	2007	2006	2005	2004
Loans outstanding at the end of the year	$ 434,662	$ 371,714	$ 313,572	$ 279,962	$ 217,683
Average loans outstanding during the year	$ 405,119	$ 344,620	$ 301,405	$ 252,914	$ 204,121
Allowance for loan losses at beginning of year	$ 4,462	$ 4,222	$ 4,090	$ 2,865	$ 2,522
Provision for loan losses	1,665	425	394	1,373	1,030
	6,127	4,647	4,484	4,238	3,552
Loans charged off:					
Real estate loans	(411)	(268)	(214)	-	(5)
Commercial and industrial loans	(106)	-	(87)	(137)	(693)
Installment loans	(16)	(28)	(17)	(44)	(56)
Total charge-offs	(533)	(296)	(318)	(181)	(754)
Recoveries of loans previously charged off:					
Real estate loans	11	66	2	-	-
Commercial and industrial loans	26	38	46	26	14
Installment loans	1	7	8	7	53
Total recoveries	38	111	56	33	67
Net charge-offs	(495)	(185)	(262)	(148)	(687)
Allowance for loan losses at end of year	$ 5,632	$ 4,462	$ 4,222	$ 4,090	$ 2,865
Ratios:					
Net charge-offs as a percent of average loans	0.12%	0.05%	0.09%	0.06%	0.34%
Allowance for loan losses as a percent of loans at end of year	1.30%	1.20%	1.35%	1.46%	1.32%

MidCarolina Financial Corporation
Table 13
Securities Portfolio Composition
(In thousands)

	At December 31		
	2008	2007	2006
Securities available for sale:			
U. S. Government agencies	$ 2,533	$ 19,372	$ 20,113
Mortgage-backed securities	50,431	31,986	25,308
State and municipal governments	17,607	19,275	28,219
Other	553	168	155
Total securities available for sale	71,124	70,801	73,795

MidCarolina Financial Corporation
Table 14
Securities Portfolio Composition
($ in thousands)

	Amortized Cost	Fair Value	Book Yield
Securities available for sale:			
U. S. Government agencies			
Due within one year	$ -	$ -	0.00%
Due after one but within five years	$0	$0	0.00%
Due after five but within ten years	1,500	1,501	5.25%
Due after ten years	1,000	1,032	5.75%
	2,500	2,533	5.45%
Mortgage-backed securities			
Due within one year	2,808	2,836	5.23%
Due after one but within five years	7,685	8,264	5.23%
Due after five but within ten years	11,900	11,539	5.33%
Due after ten years	27,673	27,792	5.23%
	50,066	50,431	5.26%
State and municipal securities			
Due within one year	-	-	-
Due after one but within five years	2,861	2,709	4.22%
Due after five but within ten years	5,145	4,758	4.26%
Due after ten years	11,287	10,140	4.27%
	19,293	17,607	4.26%
Other			
Due within one year	-	-	0.00%
Due after one but within five years	-	-	0.00%
Due after five but within ten years	-	-	0.00%
Due after ten years	500	350	3.91%
	500	350	3.91%
Equity securities	203	203	0.00%
Total securities available for sale			
Due within one year	3,011	3,039	4.88%
Due after one but within five years	10,546	10,973	4.98%
Due after five but within ten years	18,545	17,798	5.04%
Due after ten years	40,460	39,314	4.99%
	$ 72,562	$ 71,124	4.99%

Yields on tax exempt securities are stated on an actual basis.

MidCarolina Financial Corporation
Table 15
Average Deposits
($ in thousands)

	For the Year Ended December 31,					
	2008		2007		2006	
	Average Amount	Average Rate	Average Amount	Average Rate	Average Amount	Average Rate
Demand deposits	74,531	1.71%	$ 80,529	3.47%	$ 64,189	3.09%
Savings deposits	5,772	0.50%	6,024	1.00%	6,449	1.01%
Fixed maturity deposits	308,562	3.95%	249,096	5.02%	226,927	4.46%
Total interest-bearing deposits	388,865	3.47%	335,649	4.58%	297,565	4.09%
Noninterest-bearing deposits	36,925	-	34,479	-	32,159	-
Total deposits	$ 425,790	3.17%	$ 370,128	4.15%	$ 329,724	3.69%

MidCarolina Financial Corporation
Table 16
Maturities of Time Deposits of $100,000 or More
(In thousands)

	At December 31, 2008				
	3 Months or Less	Over 3 Months to 6 Months	Over 6 Months to 12 Months	Over 12 Months	Total
Time Deposits of $100,000 or more	$ 93,130	$ 90,674	$ 51,862	$ 10,006	$ 245,672

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Market risk reflects the risk of economic loss resulting from adverse changes in market price and interest rates. This risk of loss can be reflected in diminished current market values and/or reduced potential net interest income in future periods. Our market risk arises primarily from interest rate risk inherent in our lending and deposit-taking activities. The structure of our loan and deposit portfolios is such that a significant change in interest rates may adversely impact net market values and net interest income. We do not maintain a trading account nor are we subject to currency exchange risk or commodity price risk. Interest rate risk is monitored as part of the Bank's Asset/Liability Management function.

See the section entitled Asset/Liability Management for a more detailed discussion of market risk.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

MIDCAROLINA FINANCIAL CORPORATION

CONSOLIDATED FINANCIAL STATEMENTS

Years Ended December 31, 2008, 2007 and 2006

MIDCAROLINA FINANCIAL CORPORATION AND SUBSIDIARY
INDEX TO THE CONSOLIDATED FINANCIAL STATEMENTS

DIXON HUGHES PLLC
Certified Public Accountants and Advisors

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
MidCarolina Financial Corporation and Subsidiary
Burlington, North Carolina

We have audited the accompanying consolidated statements of financial condition of MidCarolina Financial Corporation and Subsidiary (hereinafter referred to as the "Company") as of December 31, 2008 and 2007, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of MidCarolina Financial Corporation and Subsidiary as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

Dixon Hughes PLLC

Raleigh, North Carolina
March 24, 2009

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

December 31, 2008 and 2007

	2008	2007
	(Amounts in thousands, except share data)	
Assets		
Cash and due from banks	$ 1,694	$ 1,632
Federal funds sold and interest-earning deposits	14,040	2,979
Investment securities:		
Available for sale	71,124	70,801
Loans held for sale	-	823
Loans	434,662	371,714
Allowance for loan losses	(5,632)	(4,462)
Net loans	429,030	367,252
Investment in stock of Federal Home Loan Bank of Atlanta	1,969	2,966
Investment in life insurance	7,893	7,594
Premises and equipment, net	7,455	6,834
Other assets	7,642	6,305
Total assets	$ 540,847	$ 467,186
Liabilities and Shareholders' Equity		
Deposits:		
Noninterest-bearing demand deposits	$ 43,104	$ 30,568
Interest-bearing demand deposits	78,309	74,913
Savings	5,784	5,462
Time	340,751	262,954
Total deposits	467,948	373,897
Short-term borrowings	-	19,000
Long-term debt	33,764	38,764
Accrued expenses and other liabilities	1,939	2,375
Total liabilities	503,651	434,036
Shareholders' equity:		
Noncumulative, perpetual preferred stock, no par value, 20,000,000 shares authorized; 5,000 shares issued and outstanding at December 31, 2008 and 2007	4,819	4,819
Common stock, no par value; 80,000,000 shares authorized; 4,927,828 and 4,618,528 shares issued and outstanding at December 31, 2008 and 2007, respectively	14,626	13,290
Retained earnings	18,635	15,378
Accumulated other comprehensive loss	(884)	(337)
Total shareholders' equity	37,196	33,150
Total liabilities and shareholders' equity	$ 540,847	$ 467,186

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

Years Ended December 31, 2008, 2007 and 2006

	2008	2007	2006
	(Amounts in thousands, except per share data)		
Interest Income			
Loans	$ 25,763	$ 27,037	$ 23,429
Investment securities:			
Taxable	2,725	2,556	2,249
Tax-exempt	836	1,025	966
Federal funds sold and interest-earning deposits	131	264	304
Other	161	171	113
Total interest income	29,616	31,053	27,061
Interest Expense			
Demand deposits	1,275	2,796	1,983
Savings deposits	29	60	65
Time deposits	12,192	12,501	10,125
Short-term borrowings	288	1,094	711
Long-term debt	1,510	1,270	1,357
Total interest expense	15,294	17,721	14,241
Net Interest Income	14,322	13,332	12,820
Provision for loan losses	1,665	425	394
Net interest income after provision for loan losses	12,657	12,907	12,426
Noninterest Income			
Service charges on deposit accounts	1,152	1,058	944
Mortgage operations	571	600	632
Investment services	300	288	229
Increase in cash surrender value of life insurance	299	290	267
Gain (loss) on sale of investment securities	29	8	(217)
Impairment of investment securities	(490)	-	-
Gain on sale of other real estate	536	481	21
Other	359	383	428
Total noninterest income	2,756	3,108	2,304
Noninterest Expense			
Salaries and employee benefits	5,387	5,384	5,136
Reversal of accrued employee benefits	-	(905)	-
Occupancy and equipment	1,133	853	846
Data processing	787	774	675
Office supplies and postage	350	317	352
Deposit and other insurance	432	352	208
Professional and other services	550	476	407
Advertising	387	256	346
Other	972	1,279	1,107
Total noninterest expense	9,998	8,786	9,077
Income before income taxes	5,415	7,229	5,653
Provision for income taxes	1,741	2,342	1,757
Net income	3,674	4,887	3,896
Dividends on preferred stock	(417)	(417)	(417)
Net income available to common shareholders	$ 3,257	$ 4,470	$ 3,479
Net Income Per Common Share:			
Basic	$ .66	$ .98	$ .80
Diluted	$ .66	$ .92	$ .73

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2008 2007 and 2006

	2008	2007	2006
	(Amounts in thousands)		
Net income	$ 3,674	$ 4,887	$ 3,896
Other comprehensive income:			
Securities available for sale:			
Change in unrealized holding gains (losses) on available for sale securities, net of actual gains	(1,350)	232	21
Tax effect	521	(89)	(8)
Reclassification of impairment on mortgage-backed securities	490	-	-
Tax effect	(189)	-	-
Reclassification of (gains) losses recognized in net income	(29)	(8)	217
Tax effect	10	3	(84)
Net of tax amount	(547)	138	146
Cash flow hedging activities:			
Unrealized holding gains (losses) on cash flow hedging activities	-	-	(12)
Tax effect	-	-	4
Reclassification of gains recognized in net income	-	-	(108)
Tax effect	-	-	42
Net of tax amount	-	-	(74)
Total other comprehensive income (loss)	(547)	138	72
Comprehensive income	$ 3,127	$ 5,025	$ 3,968

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years Ended December 31, 2008, 2007 and 2006

	Preferred stock		Common stock			Accumulated	
						other com-	Total
					Retained	prehensive	shareholders'
	Shares	Amount	Shares	Amount	earnings	income (loss)	equity
			(Amounts in thousands, except share data)				
Balance at December 31, 2005	5,000	$ 4,819	3,131,380	$ 11,392	$ 7,429	$ (547)	$ 23,093
Net income	-	-	-	-	3,896	-	3,896
Other comprehensive loss	-	-	-	-	-	72	72
Effect of 11-for-10 stock split	-	-	312,719	(7)	-	-	(7)
Preferred dividends paid	-	-	-	-	(417)	-	(417)
Stock options exercised	-	-	175,687	1,072	-	-	1,072
Current income tax benefit	-	-	-	550	-	-	550
Balance at December 31, 2006	5,000	4,819	3,619,786	13,007	10,908	(475)	28,259
Net income	-	-	-	-	4,887	-	4,887
Other comprehensive loss	-	-	-	-	-	138	138
Effect of 5-for-4 stock split	-	-	904,481	(10)	-	-	(10)
Preferred dividends paid	-	-	-	-	(417)	-	(417)
Stock options exercised	-	-	94,137	279	-	-	279
Expense recognized in connection with stock awards and stock options	-	-	124	14	-	-	14
Balance at December 31, 2007	5,000	4,819	4,618,528	13,290	15,378	(337)	33,150
Net income	-	-	-	-	3,674	-	3,674
Other comprehensive loss	-	-	-	-	-	(547)	(547)
Preferred dividends paid	-	-	-	-	(417)	-	(417)
Stock options exercised	-	-	309,300	792	-	-	792
Current income tax benefit	-	-	-	498	-	-	498
Expense recognized in connection with stock awards and stock options	-	-	-	46	-	-	46
Balance at December 31, 2008	5,000	$ 4,819	4,927,828	$ 14,626	$ 18,635	$ (884)	$ 37,196

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2008, 2007 and 2006

	2008	2007	2006
	(Amounts in thousands)		
Operating Activities			
Net income	$ 3,674	$ 4,887	$ 3,896
Depreciation and amortization	481	458	496
Provision for loan loss	1,665	425	394
Stock option expense	46	14	-
Deferred income tax liability (benefit)	(573)	138	(233)
(Gain) loss on sale of investment securities available for sale	(29)	(8)	217
Impairment of investment securities	490	-	-
(Gain) loss on disposal of foreclosed assets	(536)	(481)	(21)
Gain on sale of derivative contract	-	-	(108)
Gain on sale of loans	(571)	(598)	(632)
Origination of loans held for sale	(21,489)	(27,280)	(31,582)
Proceeds from sales of loans held for sale	22,883	29,071	31,091
Increase in cash surrender value life insurance	(299)	(290)	(267)
Changes in assets and liabilities:			
(Increase) decrease in other assets	572	(1,877)	(379)
(Increase) decrease in other real estate	-	-	-
Increase (decrease) in accrued expenses and other liabilities	(93)	729	(701)
Net cash provided by operating activities	6,221	5,188	2,171
Investing Activities			
Purchases of investment securities available for sale	(51,091)	(33,316)	(47,857)
Maturities and calls of investment securities available for sale.	4,818	4,845	6,445
Maturities and calls of investment security held to maturity	-	-	250
Sales of investment securities available for sale	44,570	31,677	25,947
Net increase in loans from originations and principal repayments	(65,347)	(58,591)	(35,341)
(Purchase) redemption of FHLB stock	997	(290)	(487)
Purchases of premises and equipment	(1,065)	(632)	(934)
Improvement costs on foreclosed assets	(16)	-	-
Proceeds from sale of foreclosed assets	1,112	2,818	1,935
Net cash used by investing activities	(66,022)	(53,489)	(50,042)
Financing Activities			
Net increase in deposits	94,051	34,622	39,013
Net increase (decrease) in short-term borrowings	(19,000)	(6,000)	15,000
Proceeds from (repayment of) long-term debt	(5,000)	12,000	(8,000)
Non-cumulative perpetual preferred stock dividends paid	(417)	(417)	(417)
Purchase of fractional shares	-	(10)	(7)
Proceeds from stock options exercised	792	279	1,072
Tax benefit from exercise of stock options	498	-	550
Net cash provided by financing activities	70,924	40,474	47,211
Net increase (decrease) in cash and cash equivalents	11,123	(7,827)	(660)
Cash and cash equivalents, beginning of year	4,611	12,438	13,098
Cash and cash equivalents, end of year	$ 15,734	$ 4,611	$ 12,438
Supplemental Cash Flow Disclosure			
Interest paid on deposits and borrowed funds	$ 15,305	$ 17,614	$ 14,445
Income taxes paid	2,349	1,573	1,757
Summary of Noncash Investing and Financing Activities			
Unrealized gain (loss) on investment securities available for sale, net of tax effect	$ (547)	$ 138	72
Transfer of loans to foreclosed assets	1,904	264	-

See accompanying notes to consolidated financial statements.

Note A - Organization and Operations

In April 2002, the shareholders of MidCarolina Bank (the "Bank") approved an Agreement and Plan of Reorganization pursuant to which the Bank became a wholly owned banking subsidiary of MidCarolina Financial Corporation (the "Company"), a North Carolina corporation formed as a holding company for the Bank. At the closing of the holding company reorganization, one share of the Company's no par value common stock was exchanged for each of the outstanding shares of the Bank's common stock.

The Bank was incorporated and began operations on August 14, 1997. The Bank is engaged in general commercial banking primarily in Alamance and Guilford Counties, North Carolina, and operates under the banking laws of North Carolina and the Rules and Regulations of the Federal Deposit Insurance Corporation. The Bank undergoes periodic examinations by those regulatory authorities.

Note B - Summary of Significant Accounting Policies

The consolidated financial statements include the accounts and transactions of the Company, the Bank, and the Bank's wholly owned subsidiary, MidCarolina Investments, Inc. The Company wholly owns the capital trusts used to issue trust preferred securities. The trusts are not consolidated as a part of these financial statements. All intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

Preparing consolidated 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, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses.

Cash and Cash Equivalents

For the purpose of presentation in the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks, federal funds sold and interest-earning deposits. Federal regulations require institutions to set aside specified amounts of cash as reserves against transactions and time deposits. As of December 31, 2008, the daily average gross reserve requirement was $25,000.

Investment Securities

Investment securities that the Company has the positive intent and ability to hold to maturity are classified as held to maturity and reported at amortized cost. Investment securities held for current resale are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. The Company currently has no such securities. Investment securities not classified either as securities held to maturity or trading securities are classified as available for sale and reported at fair value, with net unrealized gains and losses net of related taxes excluded from earnings and reported as accumulated other comprehensive income in shareholders' equity. The classification of investment securities as held to maturity, trading or available for sale is determined at the date of purchase. Realized gains and losses from sales of investment securities are determined based upon the specific identification method on a trade-date basis. Premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

Loans and Interest Income

Loans are carried at their principal amount outstanding. Interest income is recorded as earned on an accrual basis. The Company discontinues the recognition of interest income when, in the opinion of management, collection of such interest is doubtful. It is the general policy of the Company to discontinue the accrual of interest on loans, including loans impaired under Statement of Financial Accounting Standards ("SFAS") No. 114, *Accounting by Creditors for Impairment of a Loan*, when principal or interest payments are contractually delinquent 90 days or more. Any unpaid amounts previously accrued on these loans are reversed from income, and thereafter interest is recognized only to the extent payments are received.

Loans Held for Sale
The Company originates single family, residential first mortgage loans on a presold basis. Loans held for sale are carried at the lower of cost or fair value in the aggregate as determined by outstanding commitments from investors. At closing, these loans, together with their servicing rights, are sold to other financial institutions under prearranged terms. The Company recognizes certain origination and servicing release fees upon the sale which are classified as mortgage operations on the consolidated statements of operations.

Allowance for Loan Losses
The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged-off against the allowance when management believes that the collectibility of principal is unlikely. Recoveries of amounts previously charged-off are credited to the allowance.

The allowance for loan losses relating to loans that are determined to be impaired under SFAS No. 114 is based on discounted cash flows using the loan's initial effective interest rate or the estimated fair value, less costs to sell, of the collateral for certain collateral dependent loans. Large groups of smaller balance homogeneous loans that are collectively evaluated for impairment (such as residential mortgage and consumer installment loans) are excluded from impairment evaluation, and their allowance for loan losses is calculated in accordance with the allowance for loan losses policy described below.

The provision for loan losses charged to operating expense is based on factors which, in management's judgment, deserve current recognition in estimating probable loan losses. Such factors considered by management include growth and composition of the loan portfolio, the relationship of the allowance for loan losses to outstanding loans and economic conditions. While management uses the best information available to make evaluations, this evaluation is inherently subjective as it requires material estimates, including the amounts and timing of future cash flows expected to be received on impaired loans, that may be susceptible to significant change.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

Premises and Equipment
Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation and amortization is calculated on the straight-line method over the estimated useful lives of the respective assets as follows:

Buildings	15 - 40 years
Leasehold improvements	Shorter of lease term or 15 years
Furniture and equipment	3 - 10 years

Foreclosed Assets
Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less estimated costs to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management to ensure the assets are carried at fair value less cost to sell. Revenue and expenses from operations and the impact of any subsequent changes in the carrying value are included in other noninterest expense.

Stock in Federal Home Loan Bank of Atlanta

As a requirement for membership, the Company invests in stock of the Federal Home Loan Bank of Atlanta ("FHLB"). This investment is carried at cost. Due to the redemption provisions of the FHLB, the Company estimated that fair value equals cost and that this investment was not impaired at December 31, 2008.

Income Taxes

Deferred income taxes are recognized for the tax consequences of temporary differences between financial statement carrying amounts and the tax bases of existing assets and liabilities that will result in taxable or deductible amounts in future years. These temporary differences are multiplied by the enacted income tax rate expected to be in effect when the taxes become payable or receivable. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced, if necessary, by the amount of such benefits that are not expected to be realized based on available evidence.

Comprehensive Income

Comprehensive income is defined as the change in equity during a period for non-owner transactions and is composed of net income and other comprehensive income. Other comprehensive income includes revenues, expenses, gains and losses that are excluded from earnings under current accounting standards. As of and for the years presented, the components of other comprehensive income for the Company consisted of the unrealized gains and losses, net of taxes, in the Company's available for sale securities portfolio and unrealized gains and losses, net of taxes, for the Company's cash flow hedging activity.

Accumulated other comprehensive income (loss) at December 31, 2008, 2007 and 2006 consists of the following:

	2008	2007	2006
	(Amounts in thousands)		
Unrealized holding losses - securities available for sale	$ (1,438)	$ (548)	$ (773)
Deferred income taxes	554	211	298
Net unrealized holding losses - securities available for sale	(884)	(337)	(475)
Total other accumulated other comprehensive loss	$ (884)	$ (337)	$ (475)

Stock Compensation Plans

Effective January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment*, ("SFAS No. 123R") which was issued by the FASB in December 2004. SFAS No. 123R revises SFAS No. 123 *Accounting for Stock Based Compensation,* and supersedes APB No. 25, *Accounting for Stock Issued to Employees*, (APB No. 25) and its related interpretations. SFAS No. 123R requires recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements over the period the employee is required to perform the services in exchange for the award (usually the vesting period). SFAS No. 123R also requires measurement of the cost of employee services received in exchange for an award based on the grant-date fair value of the award. SFAS No. 123R also amends SFAS No. 95 *Statement of Cash Flows*, to require that excess tax benefits be reported as financing cash inflows, rather than as a reduction of taxes paid, which is included within operating cash flows.

Since the Company's stock options had vested prior to January 1, 2006, there was no impact on income from the adoption of SFAS 123R. Cash flows provided by financing activities from the exercise of stock options amounted to $1.3 million, $279,000 and $1.6 million for the years ended December 31, 2008, 2007 and 2006 respectively.

Net Income Per Common Share

Basic and diluted net income per share has been computed based on the weighted average number of shares outstanding during each period after retroactively adjusting for all applicable declared stock splits effected in the form of stock dividends. Diluted net income per share reflect additional shares of common stock that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. At December 31, 2008 there were 148,228 antidilutive options. At December 31, 2007 and 2006, there were no antidilutive options.

Basic and diluted net income per share have been computed based upon net income available to common shareholders as presented in the accompanying consolidated statements of operations divided by the weighted average number of common shares outstanding or assumed to be outstanding as summarized below:

	2008	2007	2006
Weighted average number of common shares used in computing basic net income per share	4,915,350	4,548,565	4,348,128
Effect of dilutive stock options	1,526	303,172	427,725
Weighted average number of common shares and dilutive potential common shares used in computing diluted net income per share	4,916,876	4,851,738	4,775,853

Segment Reporting

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information,* requires management to report selected financial and descriptive information about reportable operating segments. It also establishes standards for related disclosures about products and services, geographic areas and major customers. Generally, disclosures are required for segments internally identified to evaluate performance and resource allocation. In all material respects, the Company's operations are entirely within the commercial banking segment, and the consolidated financial statements presented herein reflect the results of that segment. Also, the Company has no foreign operations or customers.

Derivative Instruments

Interest rate swaps are contractual agreements between two parties to exchange a series of cash flows representing interest payments. A swap allows both parties to alter the repricing characteristics of assets or liabilities without affecting the underlying principal positions. Through the use of a swap, assets and liabilities may be transformed from fixed to floating rates, from floating rates to fixed rates or from one type of floating rate to another.

The net interest payable or receivable on interest rate swaps that are designated as hedges is accrued and recognized as an adjustment to the interest income or expense of the related asset or liability. Gains and losses from early terminations of derivatives are deferred and amortized as yield adjustments over the shorter of the remaining term of the hedged asset or liability or the remaining term of the derivative instrument. Upon disposition or settlement of the asset or liability being hedged, deferral accounting is discontinued and any gains or losses are recognized in income. Unrealized holding gains and losses on derivatives designated as hedges are reported, net of applicable income tax effect, in accumulated other comprehensive income.

Derivative financial instruments that fail to qualify as a hedge are carried at fair value with gains and losses recognized in current earnings.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS 141(R), "Business Combinations". SFAS 141 (R) will significantly change how entities apply the acquisition method to business combinations. The most significant changes affecting how the corporation will account for business combinations under this Statement include: the acquisition date will be the date the acquirer obtains control; all (and only) identifiable assets acquired, liabilities assumed, and noncontrolling interests in the acquiree will be stated at fair value on the acquisition date; assets or liabilities arising from noncontractual contingencies will be measured at their acquisition date fair value only if it is more likely than not that they meet the definition of an asset or liabiblity on the acquisition date; adjustments subsequently made to the provisional amounts recorded on the acquisition date will be made retroactively during a measurement period not to exceed one year; acquisition-related restructuring costs that do not meet the criteria in SFAS 146, "Accounting for Costs Associated with Exit or Disposal Activities", will be expensed as incurred; transaction costs will be expensed as incurred; reversals of deferred income tax valuation allowances and income tax contingencies will be recognized in earnings subsequent to the measurement period; and the allowance for loan losses of an acquiree will not be permitted to be recognized by the acquirer. Additionally, SFAS 141 (R) will require new and modified disclosures surrounding subsequent changes to acquisition-related contingencies, contingent consideration, noncontrolling interests, acquisition-related transaction costs, fair values and cash flows not expected to be collected for acquired loans, and enhanced goodwill rollforward.

The Company will be required to prospectively apply SFAS 141 (R) to all business combinations completed on or after January 1, 2009. Early adoption is not permitted. Management is currently evaluating the effects of SFAS 141 (R) will have on the financial condition, results of operations, liquidity, and the disclosures that will be presented in the consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161). SFAS 161 requires enhanced disclosures about how and why derivative instruments are used, how derivative instruments and related hedge items affect the balance sheet, income statement and statement of cash flows. SFAS 161 is effective for the Company on January 1, 2009 will not have a material impact on the financial condition, results of operations or liquidity.

From time to time the FASB issues exposure drafts for proposed statements of financial accounting standards. Such exposure drafts are subject to comment from the public, to revisions by the FASB and to final issuance by the FASB as statements of financial accounting standards. Management considers the effect of the proposed statements on the consolidated financial statements of the Company and monitors the status of changes to and proposed effective dates of exposure drafts.

Note C - Investment Securities

The following is a summary of investment securities by major classification at December 31, 2008 and 2007:

	December 31, 2008			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(Amounts in thousands)			
Securities available for sale:				
U.S. government agency securities	$ 2,500	$ 33	$ -	$ 2,533
Mortgage-backed securities........	50,066	669	304	50,431
State and municipal	19,293	-	1,686	17,607
Other...	703	-	150	553
Total...............................	$ 72,562	$ 702	$ 2,140	$ 71,124

	December 31, 2007			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(Amounts in thousands)			
Securities available for sale:				
U.S. government agency securities	$ 21,434	$ 220	$ 44	$ 21,610
Mortgage-backed securities	30,057	54	350	29,761
State and municipal	19,704	10	439	19,275
Other	155	-	-	155
Total	$ 71,350	$ 284	$ 833	$ 70,801

The following tables show investments' gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at December 31, 2008 and 2007. All unrealized losses on investment securities are considered by management to be temporarily impaired given the credit ratings on these investment securities and the short duration of the unrealized loss.

	2008					
	Less Than 12 Months		12 Months or More		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
	(Amounts in thousands)					
Securities available for sale:						
U.S. government agency securities	$ -	$ -	$ -	$ -	$ -	$ -
Mortgage-backed securities	6,095	283	576	21	6,671	304
State and municipal	16,690	1,366	917	320	17,607	1,686
Other	350	150	-	-	350	150
Total temporarily impaired securities	$ 23,135	$ 1,799	$ 1,493	$ 341	$ 24,628	$ 2,140

	2007					
	Less Than 12 Months		12 Months or More		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
	(Amounts in thousands)					
Securities available for sale:						
U.S. government agency securities	$ -	$ -	$ 2,226	$ 44	$ 2,226	$ 44
Mortgage-backed securities	6,515	74	16,782	276	23,297	350
State and municipal	15,381	415	376	24	15,757	439
Total temporarily impaired securities	$ 21,896	$ 489	$ 19,384	$ 344	$ 41,280	$ 833

The aggregate amortized cost and fair value of debt securities at December 31, 2008, by remaining contractual maturity, are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Available for Sale	
	Amortized cost	Fair value
	(Amounts in thousands)	
U.S. agency securities:		
Due in 1 year through 5 years	$	$
Due after 5 years through 10 years	1,500	1,501
Due after 10 years	1,000	1,032
State and municipal securities:		
Due in 1 year through 5 years	2,861	2,709
Due after 5 years through 10 years	5,145	4,758
Due after 10 years	11,287	10,140
Other:		
Due after 10 years	500	350
Other equity securities	203	203
Mortgage-backed securities	50,066	50,431
Total	$ 72,562	$ 71,124

Proceeds from sales of investment securities available for sale amounted to $44.7 million, $31.7 million, and $25.9 million for the years ended December 31, 2008, 2007 and 2006, respectively. Aggregate gross realized gains (losses) from the sales of investment securities available for sale amounted to $29,000, $8,000, and $(217,000) for the years ended December 31, 2008, 2007 and 2006, respectively. Realized losses from the impairment of private label mortgage backed securities amounted to $490,000 for the year ended December 31, 2008 resulting from increased default rates on underlying collateral payments and credit rating deterioration.

Investment securities with amortized cost of $8.7 million and fair value of $8.6 million at December 31, 2008 were pledged to secure both financing from the FHLB and for public monies on deposit as required by law.

Note D - Loans

Following is a summary of loans at December 31, 2008 and 2007:

	2008	2007
	(Amounts in thousands)	
Real estate:		
Construction loans	$ 91,933	$ 80,051
Commercial mortgage loans	156,333	140,198
Home equity lines of credit	43,290	41,479
Residential mortgage loans	73,595	57,342
Total real estate loans	365,151	319,070
Commercial and industrial loans	63,239	46,893
Loans to individuals for household, family and other personal expenditures	6,306	5,796
Net deferred loan origination (fees) costs	(34)	(45)
Total loans	$ 434,662	$ 371,714

At December 31, 2008 and 2007, the recorded investment in loans considered impaired in accordance with SFAS No. 114 totaled $4.0 million and $1.5 million, respectively. Impaired loans of $3.3 million and $1.1 million at December 31, 2008 and 2007 had corresponding valuation allowances of $520,000 and $104,000, respectively. Impaired loans of

$704,000 and $400,000 at December 31, 2008 and 2007 had no valuation allowances. For the years ended December 31, 2008 and 2007, the average recorded investment in impaired loans was approximately $2.9 million and $1.6 million, respectively. The amount of interest recognized on impaired loans during the portion of the year that they were impaired was not material.

The Company's lending is concentrated primarily in Alamance and Guilford Counties and the surrounding areas. The Company had loan and deposit relationships with most of its directors and executive officers and with companies with which certain directors and executive officers are associated. The following is a reconciliation of loans directly outstanding to executive officers, directors and their affiliates (amounts in thousands):

Balance at December 31, 2007	$ 3,765
New loans	9,996
Principal repayments	(3,973)
Balance at December 31, 2008	$ 9,788

As a matter of policy, these loans and credit lines are approved by the Bank's Board of Directors and are made with interest rates, terms, and collateral requirements comparable to those required of other borrowers. In the opinion of management, these loans do not involve more than the normal risk of collectibility.

Note E - Allowance for Loan Losses

An analysis of activity in the allowance for loan losses for the years ended December 31, 2008, 2007 and 2006 follows:

	2008	2007	2006
	(Amounts in thousands)		
Balance at beginning of year	$ 4,462	$ 4,222	$ 4,090
Provision for loan losses	1,665	425	394
Charge-offs	(533)	(296)	(318)
Recoveries	38	111	56
Net charge-offs	(495)	(185)	(262)
Balance at end of year	$ 5,632	$ 4,462	$ 4,222

Note F - Premises and Equipment

The following is a summary of premises and equipment:

	2008	2007
	(Amounts in thousands)	
Land	$ 1,864	$ 1,829
Buildings and leasehold improvements	5,466	5,203
Furniture and equipment	2,207	2,609
	9,537	9,641
Less accumulated depreciation	(2,082)	(2,807)
Total	$ 7,455	$ 6,834

Depreciation expense for the years ended December 31, 2008, 2007 and 2006 amounted to approximately $444,000, $422,000 and $425,000, respectively.

Note G - Time Deposits

Time deposits in denominations of $100,000 or more were $245.7 million and $192 million at December 31, 2008 and 2007, respectively. Interest expense on such deposits aggregated approximately $9.8 million and $9.2 million in 2008 and 2007, respectively. Related party deposits totaled $8.3 million at December 31, 2008. Time deposits in denominations of $100,000 or more, maturing subsequent to December 31, 2008 are as follows (amounts in thousands):

2009	$	235,672
2010		10,006
	$	245,678

Note H - Leases

As of December 31, 2008, the Company leases office space under non-cancelable operating leases. Future minimum lease payments required under the leases are as follows (amounts in thousands):

Year Ending December 31,		
2009	$	286
2010		286
2011		286
2012		254
2013		223
There after		3,345
	$	4,680

The leases contain options for renewals after the expiration of the current lease terms. The cost of such rentals is not included above. Total rent expense for the years ended December 31, 2008, 2007 and 2006 amounted to $189,000, $135,000, and $127,000, respectively.

Note I - Borrowings

Short-term borrowings

The Company has remaining credit availability totaling approximately $78.1 million from the FHLB, with no short term outstanding balances at December 31, 2008. At December 31, 2007, the outstanding short-term borrowings amounted to $19 million. The Company also has credit availability totaling approximately $80.6 million from the Federal Reserve Bank ("FRB"), with no short term outstanding balances at December 31, 2008. Any outstanding borrowings held by the Bank are appropriately collateralized.

Long-term debt

The Company is a member of the FHLB. As a member, the Company is required to invest in the stock of the FHLB. The stock is carried at cost since it has no quoted fair value. All stock in the FHLB, together with various investment securities and a blanket lien of $140.5 million on qualifying loans, are pledged as collateral to secure any borrowings. At December 31, there were the following borrowings:

Maturity	Fixed Interest Rate	2008	2007
		(Amounts in thousands)	
March 17, 2010	5.92%	$ 1,500	$ 1,500
March 17, 2010	5.71%	2,500	2,500
September 21, 2010	3.98%	6,000	-
February 28, 2011	2.37%	5,000	-
March 10, 2013	2.91%	-	10,000
September 21, 2017	3.98%	-	6,000
November 30, 2018	2.98%	10,000	10,000
		$ 25,000	$ 30,000

At December 31, 2008 and 2007, the weighted average interest rates on the above advances were 3.54% and 3.53%, respectively. The above borrowings have been classified as long-term debt in the balance sheet.

The Company has issued $8.8 million of Junior Subordinated debentures to its wholly owned capital trusts, MidCarolina I and MidCarolina Trust II, to fully and unconditionally guarantee the preferred securities issued by the Trusts. These long term obligations, which currently qualify as Tier I capital for the Company, constitute a full and unconditional guarantee by the Company of the Trusts' obligations under the Capital Trust Securities. In accordance with FIN 46R, the trusts are not consolidated in the Company's financial statements.

A description of the Junior Subordinated debentures outstanding payable to the trusts is as follows:

Issuing Entity	Date of Issuance	Interest Rate	Maturity Date	(Amounts in thousands) Principal Amount 2008	2007
MidCarolina I	10/29/2002	Libor plus 3.45%	11/07/2032	$ 5,155	$ 5,155
MidCarolina Trust II	12/03/2003	Libor plus 2.90%	10/07/2033	3,609	3,609
				$ 8,764	$ 8,764

The Company is able to repay the debt five years after the issuance date.

Note J - Income Taxes

The significant components of the provision for income taxes are as follows for the years ended December 31:

	2008	2007	2006
	(Amounts in thousands)		
Current tax provision:			
Federal	$ 1,836	$ 1,787	$ 1,697
State	478	417	293
	2,314	2,204	1,990
Deferred tax provision (benefit):			
Federal	(458)	112	(193)
State	(115)	26	(40)
	(573)	138	(233)
Net provision for income taxes	$ 1,741	$ 2,342	$ 1,757

A reconciliation of expected income taxes at the statutory federal income tax rate of 34% with the recorded provision for income taxes follows:

	2008	2007	2006
	(Amounts in thousands)		
Income tax at statutory rate	$ 1,841	$ 2,458	$ 1,922
Increase (decrease) in income tax resulting from:			
State income taxes, net of federal tax effect	240	293	167
Income from bank-owned life insurance	(102)	(99)	(91)
Nontaxable interest	(246)	(286)	(272)
Other	7	(24)	31
Provision for income taxes	$ 1,741	$ 2,342	$ 1,757

The tax effects of temporary differences that give rise to significant portions of deferred tax assets (liabilities) at December 31 were are follows:

	2008	2007
	(Amounts in thousands)	
Deferred tax assets relating to:		
Allowance for loan losses	$ 2,032	$ 1,567
Deferred compensation	423	353
Impairment	189	-
Other	27	-
Other comprehensive income	555	212
Total deferred tax assets	3,225	2,132
Deferred tax liabilities relating to:		
Property and equipment	(171)	(27
Deferred loan fees	(189)	(161)
Other	4	-
Total deferred tax liabilities	(364)	(188)
Net recorded deferred tax asset	$ 2,861	$ 1,944

The Bank has adopted the provisions of FASB Interpretation No. 48 ("FIN 48"). There was no material impact from the adoption of FIN 48. It is the Bank's policy to recognize interest and penalties associated with uncertain tax positions as components of income taxes. There were no interest or penalties accrued during the year. The Bank's federal and state income tax returns are subject to examination for the years 2005, 2006 and 2007.

Note K - Savings Plan

The Company maintains a contributory savings plan under Section 401(k) of the Internal Revenue Code covering all employees who have completed three months of service and are at least eighteen years of age. Under the plan, employee contributions are matched by the Company in an amount equal to 100% of the first 6% of compensation contributed by the employee. Total savings plan expense for the years ended December 31, 2008, 2007 and 2006 was $223,000, $208,000 and $203,000, respectively.

Note L - Stock Options

During 2008, the Board of Directors and shareholders of the Bank approved a Non-Qualified Stock Option Plan for certain original directors of the Bank, and 250,000 shares of authorized and unissued stock were reserved for award.

In 2008, the Board of Directors and shareholders of the Bank amended the Incentive Stock Option Plan for officers and key employees, originally approved in 2004, to increase the number of shares available for award by 159,571. Under the provisions of the Plan, grants are made at the discretion of an administrative committee appointed by the Board of Directors at the fair value of the stock on the date of grant. The Board originally reserved 326,700 shares of authorized and unissued stock for grant.

In 2004, the Board of Directors and shareholders of the Company approved the MidCarolina Financial Corporation Omnibus Stock Ownership and Long Term Incentive Plan ("2004 Omnibus Plan") for officers and key employees. Under the provisions of the 2004 Omnibus Plan, Rights (as defined in the 2004 Omnibus Plan) are awarded at the discretion of an administrative committee appointed by the Board of Directors at the fair value of the stock on the date of grant. The Board reserved 412,500 shares of authorized and unissued stock for grant.

During 1998, the Board of Directors and shareholders of the Bank approved a Non-Qualified Stock Option Plan for certain original directors of the Bank, and 326,700 shares of authorized and unissued stock were reserved for award. At adoption, all options were granted at a split-adjusted exercise price of $2.75 per share, the split-adjusted fair value of the stock on the date of grant. Director options vested 100% on the date of grant. The options are granted for a ten-year term.

During 1998, the Board of Directors and shareholders of the Bank approved an Incentive Stock Option Plan for officers and key employees. Under the provisions of the Plan, grants are made at the discretion of an administrative committee appointed by the Board of Directors at the fair value of the stock on the date of grant. The Board reserved 326,700 shares of authorized and unissued stock for grant. Options have a vesting schedule that provides that 20% of the options granted will be vested and exercisable on the date of grant and 20% will vest and become exercisable on each of the next four annual anniversary dates thereafter. The options are granted for a ten-year term. The two 1998 plans were adopted by the Company and its shareholders in the 2002 organization of the Company.

A summary of the Company's stock option activity and related information for the years ended December 31, 2007 reflecting the effects of stock splits in the form of stock dividends declared, including the 25% stock split in the form of a stock dividend declared in December 2006 and distributed in January 2007, the 10% stock split in the form of a stock dividend declared in May 2006 and distributed in June 2006, the 25% stock split in the form of a stock dividend distributed in November 2005, and the 20% stock split in the form of a stock dividend declared in 2004 and distributed in 2005:

	Number shares	Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
At December 31, 2007	536,519	$ 5.53	-	-
Options granted	91,000	8.61	-	-
Options vested	-	-	-	-
Options exercised	(321,040)	2.87	-	-
Options forfeited.........................	(10,550)	14.66	-	-
Outstanding at December 31, 2008	295,929	$ 9.04	7.21 years	$ 76,946
Exercisable at December 31, 2008	219,252	$ 9.13	6.41 years	$ 76,816

The estimated per share fair value of options granted together with the assumptions used in estimating these fair values, are displayed below:

	2008	2007	2006
Estimated fair value of options granted	$ 3.16	$ 3.60	$ -

The risk-free interest rate is based upon a U.S. Treasury instrument with a life that is similar to the expected life of the option grant. Expected volatility is based upon the historical volatility of the Company based upon the previous 3 years trading history. The expected term of the options is based upon the average life of previously issued stock options. The expected dividend yield is based upon current yield on date of grant. No post-vesting restrictions exist for these options. The following table illustrates the assumptions for the Black-Scholes model used in determining the fair value of options granted to employees in the year ended December 31, 2008, 2007 and 2006.

The estimated average per share fair value of options granted, using the Black-Scholes methodology, together with the assumptions used in estimating those fair values, are displayed below.

	2008	2007	2006
Assumptions in estimating option values:			
Risk-free rate	3.22%	4.71%	-
Dividend yield	0%	0%	-
Volatility	29.26%	26.87%	-
Expected life	6.5 years	3 years	-

For the years ended December 31, 2008, 2007 and 2006, the intrinsic value of options exercised was approximately:

2008	2007	2006
$ 2.6 Million	$ 971,000	$ -

Cash received from options exercised under all share-based payment arrangements for year ended December 31, 2008 was approximately $792,000. The actual tax benefit in shareholders equity realized for the tax deduction from option exercise in the share-based payment arrangements totaled $498,000 for the year ended December 31, 2008.

The unrecognized compensation expense for outstanding options at December 31, 2008 was $276,000 which will be recognized over the vesting period of each award.

Note M - Officers' Deferred Compensation

In 2002, the Company implemented a non-qualifying deferred compensation plan for certain key executive officers. The Company has purchased life insurance policies on the participating officers in order to offset the cost of benefit payments. Benefits for each officer participating in the plan will accrue and vest during the period of employment, and will be paid in monthly benefit payments over the participant's life after retirement. The plan also provides for payment of disability or death benefits in the event a participating officer becomes permanently disabled or dies while employed at the Bank. Provisions of $180,000 in 2008, $278,000 in 2007, and $370,000 in 2006 were expensed for future benefits to be provided under this plan. The total liability under this plan was $1.1 million at December 31, 2008 and $915,000 after the reversal of accrued benefits for a former executive officer at December 31, 2007, and is included in accrued expenses and other liabilities in the accompanying consolidated statements of financial condition.

Note N - Employment Agreement

The Company has entered into employment agreements with certain key officers to ensure a stable and competent management base. In the event of a change in control of the Company, as defined in the agreements, the acquirer will be bound to the terms of the agreements.

Note O - Contingent Liabilities and Commitments

The Company's consolidated financial statements do not reflect various commitments and contingent liabilities which arise in the normal course of business and which involve elements of credit risk, interest rate risk and liquidity risk. These commitments and contingent liabilities are commitments to extend credit, letters of credit and commitments to sell loans.

A summary of the Company's commitments and contingent liabilities at December 31, 2008 is as follows (amounts in thousands):

	2008
Unfunded commitments to extend credit under existing equity line and commercial lines of credit	$ 71,077
Commitments to sell loans held for sale	-
Financial standby letters of credit, net	3,582

Commitments to originate new loans or extend credit and letters of credit all include exposure to some credit loss in the event of nonperformance by the customer. The Company's credit policies and procedures for credit commitments are the same as those for extensions of credit that are recorded in the balance sheets. Because these instruments have fixed maturity dates, and because many of them expire without being drawn upon, they do not generally present any significant liquidity risk to the Company. The Company has not incurred any losses on its commitments in 2008, 2007 or 2006.

The capital and credit markets have experienced volatility for more than a year. More recently, the volatility and disruption has increased, and the markets have produced a downward pressure on stock prices and credit availability for many issuers without regard to their underlying financial strength. This has been particularly the case with respect to financial institutions, and the market prices of the stock of financial services companies in general, including the Company's, are at their lowest levels in recent history. If current levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience an adverse effect, which may be material, on the Company's ability to access capital and on our business, financial condition and results of operations.

Commitments to sell loans held for sale are agreements to sell loans to a third party at an agreed upon price. The aggregate fair value of the commitments is immaterial.

Financial standby letters of credit are conditional lending commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

Note P - Shareholders' Equity

Regulatory Matters

As a North Carolina banking corporation, the Bank may pay cash dividends to the Company only out of undivided profits as determined pursuant to North Carolina banking laws. However, regulatory authorities may limit payment of dividends when it is determined that such a limitation is in the public interest and is necessary to ensure a bank's financial soundness.

The Bank is subject to the capital requirements of the FDIC. The FDIC requires the Bank to maintain minimum ratios of Tier I capital to total risk-weighted assets and total capital to risk-weighted assets of 4% and 8%, respectively. To be "well-capitalized," the FDIC requires ratios of Tier I capital to risk-weighted assets and total capital to risk-weighted assets of 6% and 10%, respectively. Tier I capital consists of total shareholders' equity calculated in accordance with accounting principles generally accepted in the United States of America less intangible assets, and total capital is comprised of Tier I capital plus certain adjustments, the only one of which applicable to the Bank is the allowance for loan losses. Risk-weighted assets refer to the on- and off-balance sheet exposures of the Bank adjusted for their relative risk levels using formulas set forth in FDIC regulations. The Bank is also subject to a FDIC leverage capital requirement, which calls for a minimum ratio of Tier I capital to quarterly average total assets of 4% and a ratio of 5% to be "well-capitalized."

As of December 31, 2008 and 2007, the Bank's capital ratios exceeded levels deemed "well-capitalized" under the regulatory framework for prompt corrective action. There are no events or conditions since the notification that management believes have changed the Bank's category.

	For the Bank		Minimum Requirements	
	Capital Amount	Capital Ratio	For Capital Adequacy	To Be Well Capitalized
	(Dollars in thousands)			
As of December 31, 2008				
Tier I capital (to risk-weighted assets)	$ 46,135	9.97%	4.00%	6.00%
Total capital - Tier II capital (to risk-weighted assets)	51,767	11.19%	8.00%	10.00%
Leverage - Tier I capital (to average assets)	46,135	8.68%	4.00%	5.00%
As of December 31, 2007				
Tier I capital (to risk-weighted assets)	$ 41,696	10.37%	4.00%	6.00%
Total capital - Tier II capital (to risk-weighted assets)	46,158	11.48%	8.00%	10.00%
Leverage - Tier I capital (to average assets)	41,696	8.95%	4.00%	5.00%

The Company is also subject to these capital requirements except for the prompt corrective action requirements of the FDIC. At December 31, 2008, the Company's total capital to risk-weighted assets, Tier I capital to risk-weighted assets and Tier I capital to average assets were 11.27%, 10.05% and 8.77%, respectively. At December 31, 2007, the Company's total capital to risk-weighted assets, Tier I capital to risk-weighted assets and Tier I capital to average assets were 11.52%, 10.41% and 8.99%, respectively.

Note Q - Derivatives

Although off-balance sheet derivative financial instruments do not expose the Company to credit risk equal to the notional amount, such agreements generate credit risk to the extent of the fair value gain in an off-balance sheet derivative financial instrument if the counterparty fails to perform. Such risk is minimized through the creditworthiness of the counterparties and the consistent monitoring of these agreements. The counterparties to these arrangements were primarily large commercial banks and investment banks. Where appropriate, master netting agreements are arranged or collateral is obtained in the form of rights to securities. On August 14, 2006, the Company determined that the derivatives did not meet the hedge accounting qualifications and hedge accounting was immediately discontinued and the derivative was sold. The impact of the transaction was immaterial to the financial statements.

Note R - Fair Value of Financial Instruments

SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*, requires a company to disclose the fair value of its financial instruments, whether or not recognized in the balance sheet, where it is practical to estimate that value.

Fair value estimates are made at a specific point in time based on relevant market information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holding of a particular financial instrument. In cases where quoted market prices are not available, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates. Finally, the fair value estimates presented herein are based on pertinent information available to management as of December 31, 2008 and 2007, respectively.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and Due from Banks, Federal Funds Sold and Interest-Earning Deposits

The carrying amounts for cash and due from banks, federal funds sold and interest-earning deposits approximate fair value because of the short maturities of those instruments. These instruments are considered cash and cash equivalents.

Investment Securities

Fair value for investment securities, excluding FHLB stock, is based on quoted market price if such information is available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The carrying value of FHLB stock approximates fair value based on the redemption provisions of the FHLB.

Loans Held for Sale

Fair values of mortgage loans held for sale are based on commitments on hand from investors or prevailing market prices.

Loans

For certain homogenous categories of loans, such as residential mortgages, fair value is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics. The fair value of other types of loans is estimated by discounting the future cash flows using the current rate at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Investment in Life Insurance

The carrying value of life insurance approximates fair value because this investment is carried at cash surrender value, as determined by the insurer.

Deposits, Short-term Borrowings and Long-term Debt

Deposits and short-term borrowings without a stated maturity, or insignificant term to maturity, including demand, interest bearing demand, savings accounts and FHLB borrowings are reported at their carrying value in accordance with SFAS 107. No value has been assigned to the franchise value of deposits. For other types of deposits and long-term debt, with fixed rates and longer maturities is estimated based upon the discounted value of projected future cash outflows using the rates currently offered for instruments of similar remaining maturities.

Accrued Interest Receivable and Accrued Interest Payable

The carrying amounts of accrued interest receivable and accrued interest payable are assumed to approximate fair values.

Financial Instruments with Off-Balance Sheet Risk
With regard to financial instruments with off-balance sheet risk discussed in Note O, it is not practicable to estimate the fair value of future financing commitments.

The following table presents the carrying values and estimated fair values of the Company's financial instruments at December 31, 2008 and 2007:

	Carrying value	Estimated fair value
	(Amounts in thousands)	
As of December 31, 2008		
Financial assets:		
Cash and cash equivalents	$ 15,734	$ 15,734
Investment securities available for sale	71,124	71,124
Loans held for sale	-	-
Loans	429,030	430,502
Federal Home Loan Bank stock	1,969	1,969
Investment in life insurance	7,893	7,893
Accrued interest receivable	2,108	2,108
Financial liabilities:		
Deposits	$ 467,948	$ 472,000
Short-term borrowings	-	-
Long-term debt	33,764	34,244
Accrued interest payable	626	626
As of December 31, 2007		
Financial assets:		
Cash and cash equivalents	$ 4,611	$ 4,611
Investment securities available for sale	70,801	70,801
Loans held for sale	823	823
Loans	367,252	367,571
Federal Home Loan Bank stock	2,966	2,966
Investment in life insurance	7,594	7,594
Accrued interest receivable	2,443	2,443
Financial liabilities:		
Deposits	$ 373,897	$ 374,297
Short-term borrowings	19,000	19,000
Long-term debt	38,764	39,082
Accrued interest payable	684	684

Note S - Fair Values of Assets and Liabilities
Effective January 1, 2008, the Company adopted SFAS 157, *Fair Value Measurements* (SFAS 157) and SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment for FASB Statement No. 115 (SFAS 159).* The effect of adopting these two pronouncements was not material to the financial statements.

SFAS 157 defines fair value establishes a framework for measuring fair value according to generally accepted accounting principles, and expands disclosures about fair value measurements. This statement establishes a three level fair value hierarchy that is fully described below. While this standard does not require any financial instruments to be measured at fair value the provisions of the statement must be applied in situations where other accounting pronouncements either permit or require fair value measurement. The Company reports fair value on a recurring basis for certain financial instruments, most notably for available for sale investment securities and certain derivative instruments in compliance with the provisions of SFAS 157. The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis. These include assets that are measured at the lower of cost or market that were recognized at fair value which was below cost at the end of the period. Assets subject to nonrecurring use of fair value measurements could include loans held for sale, goodwill, and foreclosed assets. At December 31, 2008, the Company had certain impaired loans and foreclosed assets that are measured at fair value on a nonrecurring basis.

In accordance with SFAS 157, we group our financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 – Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes U.S. Treasury, other U.S. government and agency mortgage-backed securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

- Level 2 – Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party services for similar or comparable assets or liabilities.

- Level 3 – Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or brokered traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

The table below presents the balances of assets and liabilities measured at fair value on a recurring basis.

		Fair Value Measurements at December 31, 2008, Using		
Description	Assets/Liabilities Measured at Fair Value 12/31/2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Inputs (Level 3)
Available-for-sale securities	$ 71,124	$ -	$ 68,349	$ 2,775

The Company utilizes a third party pricing service to provide valuations on its securities portfolio. Most of these securities are U.S. government agency debt obligations and agency mortgage-backed securities traded in active markets. The third party valuations are determined based on the characteristics of each security (such as maturity, duration, rating, etc.) and in reference to similar or comparable securities. The service indentifies 6 third-party vendors and 2 internal pricing models they consider level 2 pricing. The service indentifies 2 models that provide level 3 pricing applying discounted cash flow modeling. As of December 31, 2008, 3 securities comprised of two private label mortgage backed securities and one floating rate debenture, were priced using level 3 modeling and or estimated values provided by their trading desk heavily influenced by unobservable inputs.

SFAS 159 allows an entity to make an irrevocable election to measure certain financial instruments at fair value. The changes in fair value from one reporting period to the next period must be reported in the income statement with additional disclosures to identify the effect on net income. The Company continued to account for securities available for sale at fair value as reported in prior years which is required by SFAS 115. Upon adoption of SFAS 159, no additional financial assets or liabilities were reported at fair value and there was no material effect on earnings.

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Loans

The Company records loans in the ordinary course of business and does not record loans at fair value on a recurring basis. Loans are considered impaired when it is determined to be probable that all amounts due under the contractual terms of the loan will not be collected when due. Loans considered individually impaired are evaluated under the provisions of SFAS 114 and a specific allowance is established if required based on the most appropriate of the three measurement methods: present value of expected future cash flows, fair value of collateral, or the observable market price of a loan method. A specific allowance is required if the fair value of the expected repayments or the collateral is less than the recorded investment in the loan. At December 31, 2008, loans with a book value of $4.0 million were evaluated for impairment. Of this total, $3.3 million required a specific allowance totaling $520 thousand for a net fair value of $2.8 million. The methods used to determine the fair value of these loans were generally either the present value of expected future cash flows or fair value of collateral and were considered level three.

Foreclosed Assets

Foreclosed and repossessed assets are adjusted to fair value upon transfer of the loans to the Company's books. Subsequently, foreclosed and repossessed assets are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Corporation records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Corporation records the foreclosed asset as nonrecurring Level 3.

The table below presents the balances of assets and liabilities measured at fair value on a nonrecurring basis.

		December 31, 2008		
Description	Total	(Level 1)	(Level 2)	(Level 3)
Foreclosed real estate	$ 1,608	$ -	$ -	$ 1,608
Impaired loans	2,821	-	-	2,821

Note T - Parent Company Financial Data

The Company's condensed statement of financial condition as of December 31, 2008 and 2007, and its related condensed statements of operations and cash flows for the three year period ended December 31, 2008, are as follows:

Condensed Statement of Financial Condition
December 31, 2008 and 2007
(Amounts in thousands)

	2008	2007
Assets:		
Investment in subsidiaries	$ 45,516	$ 41,359
Other assets	550	680
Total assets	$ 46,066	$ 42,039
Liabilities and Shareholders' Equity:		
Liabilities:		
Junior subordinated debentures	$ 8,764	$ 8,764
Other liabilities	106	125
Total liabilities	8,870	8,889
Shareholders' Equity:		
Preferred stock	4,819	4,819
Common stock	14,626	13,290
Retained earnings	18,635	15,378
Accumulated other comprehensive loss	(884)	(337)
Total shareholders' equity	37,196	33,150
Total liabilities and shareholders' equity	$ 46,066	$ 42,039

Condensed Statements of Operations
Years ended December 31, 2008, 2007 and 2006
(Amounts in thousands)

	2008	2007	2006
Undistributed earnings of subsidiaries	$ 3,105	$ 4,354	$ 3,299
Subsidiary dividend income	1,140	1,155	1,121
Interest expense	(571)	(742)	(698)
Income tax benefit	-	120	174
Net income	3,674	4,887	3,896
Dividends on preferred stock	(417)	(417)	(417)
Net income available to common shareholders	$ 3,257	$ 4,470	$ 3,479

Condensed Statements of Cash Flow
Years ended December 31, 2008, 2007 and 2006
(Amounts in thousands)

	2008	2007	2006
Cash flows from operating activities:			
Net income	$ 3,674	$ 4,887	$ 3,896
Adjustments to reconcile net income to net cash used by operating activities:			
Equity in undistributed earnings of subsidiaries	(3,105)	(4,354)	(3,299)
Stock compensation expense	46	14	-
Amortization	9	8	8
Increase in other assets	(144)	(117)	(222)
Increase (decrease) in other liabilities	(18)	(7)	34
Net cash provided by operating activities	462	431	417
Cash flows from investing activities:			
Capital contributions to bank subsidiary	(1,335)	(283)	(1,615)
Net cash used by investing activities	(1,335)	(283)	(1,615)
Cash flows from financing activities:			
Proceeds from exercise of stock options	792	279	1,072
Tax benefit from exercise of stock options	498	-	550
Purchase of fractional common shares	-	(10)	(7)
Non-cumulative perpetual preferred stock dividends paid	(417)	(417)	(417)
Net cash (used) provided by financing activities	873	(148)	1,198
Net increase in cash and cash equivalents	-	-	-
Cash and cash equivalents, beginning	-	-	-
Cash and cash equivalents, ending	$ -	$ -	$ -

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

N/A

Item 9A(T). DISCLOSURE CONTROLS AND PROCEDURES.

The Company's management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Exchange Act. As of December 31, 2008, an evaluation was performed under the supervision and with the participation of the Company's management, including it's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures at December 31, 2008, to provide reasonable assurance that information required to be disclosed by the Company in reports it files under the Exchange Act is recorded, processed, summarized, and reported on a timely basis.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING.

The Company's management is responsible for establishing and maintaining effective disclosure controls and procedures as defined under Rules 13a-15(e) and 15-d-15(e) of the Exchange Act. As of December 31, 2008, an evaluation was performed under supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at December 31, 2008, to provide reasonable assurance that information required to be disclosed by the Company in reports it files under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

- Management has implemented a process to monitor and assess both design and operating effectiveness of internal control over financial reporting.

- Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

This Annual Report on Form 10-K does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the SEC that permit the Company to provide only Management's report on this Annual Report on Form 10-K.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

In connection with the above evaluation of the Company's disclosure controls and procedures, no change in the Company's internal control over financial reporting was identified that occurred during the quarter ended December 31, 2008 that has materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 9B. OTHER INFORMATION

None.

PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Directors and Executive Officers. Information regarding the Company's directors and executive officers under the headings "*Proposal 1: Election of Directors*" and "*Executive Officers*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting is incorporated into this Report by reference.

Audit Committee. Information regarding the Audit Committee of the Company's Board of Directors under the captions "*Committees of Our Board - General*" and "*- Audit Committee*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting is incorporated into this Report by reference.

Audit Committee Financial Expert. Information regarding the determination of the Company's Board of Directors that its Audit Committee includes an audit committee financial expert under the caption "*Committees of Our Board - Audit Committee*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting is incorporated into this Report by reference.

Code of Ethics. Information regarding the Company's Code of Ethics that applies to its directors and to all its executive officers, including without limitation its principal executive officer and principal financial officer, is incorporated by reference from the information under the caption "*Code of Ethics*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting.

Section 16(a) Beneficial Ownership Reporting Compliance. Information regarding compliance by the Company's directors, executive officers and principal shareholders with the reporting requirements of Section 16(a) of the Securities Exchange Act of 1934 under the caption "*Section 16(a) Beneficial Ownership Reporting Compliance*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting incorporated into this Report by reference.

Item 11. EXECUTIVE COMPENSATION

Information regarding compensation paid or provided to the Company's executive officers and directors under the headings "*Executive Compensation*" and "*Director Compensation*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting of Shareholders is incorporated into this Report by reference.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Beneficial Ownership of Securities. Information regarding the beneficial ownership of the Company's common stock by its directors, executive officers and principal shareholders under the caption "*Beneficial Ownership of Our Common Stock*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting is incorporated into this Report by reference.

Securities Authorized for Issuance Under Equity Compensation Plans. The following table summarizes all compensation plans and individual compensation arrangements which were in effect on December 31, 2008, and under which shares of the Company's common stock have been authorized for issuance.

EQUITY COMPENSATION PLAN INFORMATION

Plan category	(a) Number of shares to be issued upon exercise of outstanding options	(b) Weighted-average exercise price of outstanding options	(c) Number of shares remaining available for future issuance under equity compensation plans (excluding shares reflected in column (a))
Equity compensation plans approved by security holders (1)	**295,929**	**$9.04**	**425,050**
Equity compensation plans not approved by security holders......	-0-	-0-	-0-
Total..................................	**295,929**	**$9.04**	**425,050**

(1) Of the 295,929 stock options outstanding under the Plans, a total of 219,252 of those stock options have vested or are exercisable within 60 days.

(2) All per share data has been restated to reflect the effects of a stock split effected in the form of a 10% stock dividend in 2002, a stock split effected in the form of a 20% stock dividend in 2003 and 2004, a stock split effected in the form of a 25% stock dividend in 2005, a stock split effected in the form of a 10% stock dividend in 2006 and a 25% stock split in the form of a stock dividend in January 2007.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Related Person Transactions. Information regarding transactions between the Company and its directors, executive officers and other related persons under the caption "*Transactions with Related Persons*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting is incorporated into this Report by reference.

Director Independence. Information regarding the Company's independent directors under the caption "*Corporate Governance – Director Independence*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting is incorporated into this Report by reference.

Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information regarding services provided by, and fees paid to, the Company's independent accountants under the caption "*Services and Fees During 2008 and 2007*" in the Company's definitive Proxy Statement filed in connection with its 2009 Annual Meeting is incorporated into this Report by reference.

Part IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

An index listing exhibits that are being filed or furnished with, or incorporated by reference into, this Report appears immediately following the signature page and is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MIDCAROLINA FINANCIAL CORPORATION

Date: March 24, 2009

By: /s/ CHARLES T. CANADAY, JR.
Charles T. Canaday, Jr.
President and Chief Executive Officer

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

Signature	Title	Date
/s/ CHARLES T. CANADAY Charles T. Canaday	President, Chief Executive Officer and Director	March 24, 2009
/s/ CHRISTOPHER B. REDCAY Christopher B. Redcay	Senior Vice President and Chief Financial Officer	March 24, 2009
/s/ JAMES R. COPLAND III James R. Copland, III	Chairman and Director	March 24, 2009
/s/ DEXTER R. BARBEE, SR. Dexter R. Barbee, Sr.	Director	March 31, 2009
/s/ H. THOMAS BOBO H. Thomas Bobo	Director	March 31, 2009
/s/ JAMES B. CROUCH, JR James B. Crouch, Jr.	Director	March 31, 2009
/s/ THOMAS E. CHANDLER Thomas E. Chandler	Director	March 31, 2009
/s/ J. ANTHONY HOLT J. Anthony Holt	Director	March 24, 2009
/s/ F. D. HORNADAY F.D. Hornaday, III	Vice Chairman and Director	March 24, 2009
/s/ TEENA M. KOURY Teena M. Koury	Director	March 31, 2009
/s/ JOHN LOVE John Love	Director	March 24, 2009
/s/ JAMES B. POWELL James B. Powell	Director	March 31, 2009
/s/ JOHN K. ROBERTS John K. Roberts	Director	March 24, 2009
/s/ JAMES H. SMITH, JR. James H. Smith, Jr.	Director	March 24, 2009
/s/ GEORGE C. WELDROP,JR. George C. Weldrop, Jr.	Director	March 31, 2009
/s/ ROBERT A. WARD Robert A. Ward	Director	March 31, 2009

INDEX TO EXHIBITS

Exhibit No.	Description
Exhibit 3.1	Amended and Restated Articles of Incorporation, incorporated herein by reference to Exhibit 3(i) to the Form 8-A12G filed with the SEC on June 5, 2002, as amended on August 15, 2005 by Articles of Amendment, incorporated herein by reference to Exhibit 3(i) to the Form 8-K filed with the SEC on August 29, 2005.
Exhibit 3.2	Bylaws, incorporated herein by reference to Exhibit 3(ii) to the Form 8-A12G filed with the SEC on June 5, 2002.
Exhibit 4.1	Form of Stock Certificate, incorporated herein by reference to the Form 10-QSB filed with the SEC on November 12, 2002.
Exhibit 4.2	Certain instruments defining the rights of the holders of long-term debt of the Company and of a subsidiary, involving a total amount of indebtedness not in excess of 10% of the total assets of the Company and its subsidiaries on a consolidated basis, have not been filed as exhibits. The Company hereby agrees to furnish a copy of any of these agreements to the SEC upon request.
Exhibit 10.1	Bank Employee Stock Option Plan, incorporated herein by reference to Exhibit 6(ii) to the Form 10-SB filed with the FDIC on April 30, 1998
Exhibit 10.2	Land Lease dated October 15, 1997 between the Bank and Crescent Center Associates, incorporated herein by reference to Exhibit 10(iv) to the Form 10-KSB for the fiscal year ended December 31, 1998.
Exhibit 10.3	Lease dated June 27, 2000 between the Bank and Cum-Park Plaza, LLC incorporated herein by reference to Exhibit 10(v) to the Form 10-KSB, filed with the SEC for the fiscal year ended December 31, 2000.
Exhibit 10.4	Form of stock option award agreements for incentive stock options and nonqualified stock options granted under the Omnibus Stock Ownership and Long-Term Incentive Plan, incorporated herein by reference to Exhibit 10.7 to the Form 10-KSB, filed with the SEC on March 29, 2006.
Exhibit 10.5	Amendment of Stock Option Agreements granted under the Bank Employee Stock Option Plan, incorporated herein by reference to Exhibit 99.2 to the Form 8-K, filed with the SEC on December 27, 2005.
Exhibit 10.6	Amendment of Stock Option Agreement, with resale restrictions, granted under the Bank Employee Stock Option Plan, incorporated herein by reference to Exhibit 99.3 to the Form 8-K, filed with the SEC on December 27, 2005.
Exhibit 10.7	Employment Agreement dated May 27, 2008 between the Company and Charles T. Canaday, incorporated herein by reference to Exhibits to Form 10-Q for the quarter ended June 30, 2008.
Exhibit 10.8	Employment Agreement dated May 27, 2008 between the Company and Christopher Redcay, incorporated herein by reference to Exhibits to Form 10-Q for the quarter ended June 30, 2008
Exhibit 10.9	Employment Agreement dated May 27, 2008 between the Company and R. Craig Patterson, incorporated herein by reference to Exhibits to the Form 10-Q for the quarter ended June 30, 2008.
Exhibit 10.10	Salary Continuation Agreement dated May 27, 2008 between the Company and Charles T. Canaday, incorporated herein by reference to Exhibit 99s to the Form 10-Q for the quarter ended June 30, 2008.

Exhibit 10.11	Salary Continuation Agreement dated May 27, 2008 between the Company and Christopher Redcay, incorporated herein by reference to Exhibits to the Form 10-Q for the quarter ended June 30, 2008.
Exhibit 10.12	Salary Continuation Agreement dated May 27, 2008 between the Company and R. Craig Patterson, Incorporated herein by reference to Exhibits to the Form 10-Q for the quarter ended June 30, 2008.
Exhibit 10.13	Indemnification Agreement with directors, incorporated herein by reference to Exhibit 99.1 to the Form 8-K, filed with the SEC on December 27, 2005.
Exhibit 10.14	2008 Director Stock Option Plan (incorporated by reference from appendices to registrant's Definitive Proxy Statement filed with the Commission in connection with its 2008 Annual Meeting)
Exhibit 10.15	Omnibus Stock Ownership and Long Term Incentive Plan, as amended and restated as of January 1, 2005, and as further amended on May 27, 2008 (incorporated by reference from appendices to registrant's Definitive Proxy Statement filed with the Commission in connection with its 2008 Annual Meeting.
Exhibit 10.16	Form of Amendment to Endorsement Split Dollar Agreement, between MidCarolina Bank and (i) Charles T. Canaday; and (ii) Christopher B. Redcay, dated December 7, 2007 incorporated herein by reference to Exhibit 10.01 to the Form 8-K, filed with the SEC on March 21, 2008.
Exhibit 10.17	Form of Amendment to Endorsement Split Dollar Agreement, between MidCarolina Bank and R. Craig. Patterson; dated December 7, 2007 incorporated herein by reference to Exhibit 10.01 to the Form 8-K, filed with the SEC on March 21, 2008.
Exhibit 11	Statement Regarding Computation of Per Share Earnings
Exhibit 14	Code of Ethics incorporated herein by reference to Exhibit 14 to the Form 10-KSB for the fiscal year ended December 31, 2003.
Exhibit 21	Schedule of Subsidiaries.
Exhibit 23	Consent of Dixon Hughes PLLC
Exhibit 31.1	Rule 13a-14(a)/15d-14(a) Certification by Chief Executive Officer
Exhibit 31.2	Rule 13a-14(a)/15d-14(a) Certification by Chief Financial Officer
Exhibit 32	Section 1350 Certifications

COPIES OF EXHIBITS ARE AVAILABLE UPON WRITTEN REQUEST TO:
Christopher B. Redcay
Chief Financial Officer
MidCarolina Financial Corporation
3101 South Church Street
Burlington, NC 27215

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SHAREHOLDER INFORMATION

SHAREHOLDER CONTACT

Chris Redcay
Corporate Secretary
MidCarolina Financial Corporation
PO Box 968
Burlington, NC 27216
336-538-1600
Fax 336-538-1603

INDEPENDENT AUDITORS

Dixon Hughes PLLC
2501 Blue Ridge Road, Suite 500
Raleigh, NC 27607

STOCK TRANSFER AGENT

First Citizens Bank
PO Box 29522
Raleigh, NC 27626-0522

ANNUAL REPORT ON FORM 10-K

A copy of MidCarolina Financial Corporation's 2008 Annual Report on Form 10-K, as filed with the Securities & Exchange Commission, is available without charge to shareholders upon written request to Chris Redcay.

BANKING LOCATIONS

BURLINGTON OFFICES

South Church Street Office
3101 South Church Street

Cum-Park Plaza Office
2214 North Church Street

Alamance Regional Medical Center
1240 Huffman Mill Road

Village at Brookwood
1840 Brookwood Avenue

GRAHAM OFFICE

South Main Street Office
842 South Main Street

MEBANE OFFICE

South Fifth Street Office
1107 South Fifth Street

GREENSBORO OFFICES

Green Valley Office
703 Green Valley Road, Suite 101

Guilford College Office
5509-A West Friendly Avenue, Suite 102

OTHER SERVICES

Mortgage Services

Mortgage Loan Specialists are available
at each MidCarolina Bank office.

MidCarolina Telebanking

1-800-813-7678

MidCarolina Investment Services

3101 South Church Street
Burlington, NC 27215

Online Banking & Bill Pay Services

www.midcarolinabank.com

MIDCAROLINA

FINANCIAL CORPORATION

MidCarolina Bank is an Equal Opportunity Employer

Member FDIC

EQUAL HOUSING LENDER