

SUSSEX BANCORP  
Form 10-Q  
May 13, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

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FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2016

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

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

Commission File Number 0-29030

SUSSEX BANCORP

(Exact name of registrant as specified in its charter)

New Jersey

22-3475473

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

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100 Enterprise Drive, Suite 700, Rockaway, NJ 07866  
(Address of principal executive offices) (Zip Code)

(844) 256-7328

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter 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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company  
(Do not check if a smaller reporting company)

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

As of May 6, 2016 there were 4,675,976 shares of common stock, no par value, outstanding.



SUSSEX BANCORP

FORM 10-Q

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## FORWARD-LOOKING STATEMENTS

We may, from time to time, make written or oral “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, including statements contained in our filings with the Securities and Exchange Commission (the “SEC”), our reports to shareholders and in other communications by us. This Report on Form 10-Q contains “forward-looking statements” which may be identified by the use of such words as “believe,” “expect,” “anticipate,” “should,” “planned,” “estimated” and “potential.” Examples of forward-looking statements include, but are not limited to, estimates with respect to our financial condition, results of operation and business that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, but are not limited to:

- § changes in the interest rate environment that reduce margins;
- § changes in the regulatory environment;
  - § the highly competitive industry and market area in which we operate;
- § general economic conditions, either nationally or regionally, resulting in, among other things, a deterioration in credit quality;
- § changes in business conditions and inflation;
- § changes in credit market conditions;
- § changes in the securities markets which affect investment management revenues;
- § increases in Federal Deposit Insurance Corporation (“FDIC”) deposit insurance premiums and assessments could adversely affect our financial condition;
- § changes in technology used in the banking business;
- § the soundness of other financial services institutions which may adversely affect our credit risk;
- § our controls and procedures may fail or be circumvented;
- § new lines of business or new products and services which may subject us to additional risks;
- § changes in key management personnel which may adversely impact our operations;
- § the effect on our operations of recent legislative and regulatory initiatives that were or may be enacted in response to the ongoing financial crisis;
- § severe weather, natural disasters, acts of war or terrorism and other external events which could significantly impact our business; and
- § other factors detailed from time to time in our filings with the SEC.

Although we believe that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from the results discussed in these forward-looking statements. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We do not undertake any obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.



## PART I – FINANCIAL INFORMATION

## Item 1 – Financial Statements

SUSSEX BANCORP  
CONSOLIDATED BALANCE SHEETS

| (Dollars in Thousands)   | March 31,<br>2016 | December<br>31, 2015 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Cash and due from banks  | \$ 3,060          | \$ 2,914             |
| Interest-bearing deposits with other banks   | 5,979             | 3,206                |
| Cash and cash equivalents  | 9,039             | 6,120                |
| Interest bearing time deposits with other banks  | 100               | 100                  |
| Securities available for sale, at fair value   | 86,523            | 93,776               |
| Securities held to maturity, at amortized cost (fair value of \$7,039 and \$7,008 at March 31, 2016 and December 31, 2015, respectively) | 6,816             | 6,834                |
| Federal Home Loan Bank Stock, at cost  | 3,839             | 5,165                |
| Loans receivable, net of unearned income   | 580,051           | 543,423              |
| Less: allowance for loan losses  | 5,812             | 5,590                |
| Net loans receivable   | 574,239           | 537,833              |
| Foreclosed real estate   | 3,328             | 3,354                |
| Premises and equipment, net  | 9,126             | 8,879                |
| Accrued interest receivable  | 2,257             | 1,764                |
| Goodwill   | 2,820             | 2,820                |
| Bank-owned life insurance  | 12,600            | 12,524               |
| Other assets   | 6,085             | 5,334                |
| <b>Total Assets</b>  | <b>\$ 716,772</b> | <b>\$ 684,503</b>    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                   |                      |
| <b>Liabilities:</b>  |                   |                      |
| <b>Deposits:</b>   |                   |                      |
| Non-interest bearing   | \$ 109,152        | \$ 87,209            |
| Interest bearing   | 466,148           | 430,647              |
| Total deposits   | 575,300           | 517,856              |
| Short-term borrowings  | 1,430             | 34,650               |
| Long-term borrowings   | 66,000            | 61,000               |
| Accrued interest payable and other liabilities   | 5,473             | 4,169                |
| Junior subordinated debentures   | 12,887            | 12,887               |



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|  |            |            |
|--|------------|------------|
| Total Liabilities  | 661,090    | 630,562    |
| Stockholders' Equity:  |            |            |
| Preferred stock, no par value, 1,000,000 shares authorized; none issued  | -          | -          |
| Common stock, no par value, 10,000,000 shares authorized; 4,735,218 and 4,705,480 shares issued and 4,675,976 and 4,646,238 shares outstanding at March 31, 2016 and December 31, 2015, respectively | 36,028     | 35,927     |
| Treasury stock, at cost; 59,242 shares at March 31, 2016 and December 31, 2015, respectively   | (592)      | (592)      |
| Retained earnings  | 19,909     | 18,520     |
| Accumulated other comprehensive income   | 337        | 86         |
| Total Stockholders' Equity   | 55,682     | 53,941     |
| Total Liabilities and Stockholders' Equity   | \$ 716,772 | \$ 684,503 |
| See Notes to Consolidated Financial Statements   |            |            |



SUSSEX BANCORP  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

|   | Three Months<br>Ended March 31, |          |
|---|---------------------------------|----------|
|   | 2016                            | 2015     |
| (Dollars in thousands except per share data)                                |                                 |          |
| <b>INTEREST INCOME</b>  |                                 |          |
| Loans receivable, including fees  | \$ 6,145                        | \$ 5,172 |
| Securities:   |                                 |          |
| Taxable   | 376                             | 267      |
| Tax-exempt  | 201                             | 208      |
| Interest bearing deposits   | 4                               | 4        |
| Total Interest Income   | 6,726                           | 5,651    |
| <b>INTEREST EXPENSE</b>   |                                 |          |
| Deposits  | 575                             | 416      |
| Borrowings  | 437                             | 380      |
| Junior subordinated debentures  | 68                              | 53       |
| Total Interest Expense  | 1,080                           | 849      |
| Net Interest Income   | 5,646                           | 4,802    |
| <b>PROVISION FOR LOAN LOSSES</b>  |                                 |          |
| Net Interest Income after Provision for Loan Losses                         | 5,435                           | 4,497    |
| <b>OTHER INCOME</b>   |                                 |          |
| Service fees on deposit accounts  | 225                             | 213      |
| ATM and debit card fees   | 187                             | 174      |
| Bank-owned life insurance   | 76                              | 78       |
| Insurance commissions and fees  | 1,721                           | 1,155    |
| Investment brokerage fees   | 27                              | 22       |
| Net gain on sales of securities   | 167                             | 168      |
| Net loss on disposal of premises and equipment                              | (13)                            | -        |
| Other   | 134                             | 91       |
| Total Other Income  | 2,524                           | 1,901    |
| <b>OTHER EXPENSES</b>   |                                 |          |
| Salaries and employee benefits  | 3,353                           | 2,780    |
| Occupancy, net  | 424                             | 477      |
| Data processing   | 549                             | 354      |
| Furniture and equipment   | 233                             | 210      |
| Advertising and promotion   | 105                             | 70       |
| Professional fees   | 174                             | 146      |
| Director fees   | 59                              | 166      |
| FDIC assessment   | 120                             | 124      |
| Insurance   | 73                              | 52       |
| Stationary and supplies   | 52                              | 56       |
| Loan collection costs   | 32                              | 97       |
| Net expenses and write-downs related to foreclosed real estate              | 75                              | 164      |
| Other   | 361                             | 374      |
| Total Other Expenses  | 5,610                           | 5,070    |
| Income before Income Taxes  | 2,349                           | 1,328    |
| <b>EXPENSE FOR INCOME TAXES</b>   |                                 |          |
| Net Income  | 1,574                           | 952      |
| <b>OTHER COMPREHENSIVE INCOME (LOSS):</b>                                   |                                 |          |
| Unrealized gains on available for sale securities arising during the period | 985                             | 316      |

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|  |          |          |
|--|----------|----------|
| Fair value adjustments on derivatives  | (400)    | -        |
| Reclassification adjustment for net gain on securities transactions included in net income | (167)    | (168)    |
| Income tax related to items of other comprehensive income                                  | (167)    | (60)     |
| Other comprehensive income, net of income taxes  | 251      | 88       |
| Comprehensive income   | \$ 1,825 | \$ 1,040 |
| <b>EARNINGS PER SHARE</b>  |          |          |
| Basic  | \$ 0.34  | \$ 0.21  |
| Diluted  | \$ 0.34  | \$ 0.21  |
| See Notes to Consolidated Financial Statements   |          |          |

SUSSEX BANCORP  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
Three Months Ended March 31, 2016 and 2015

| (Dollars in<br>Thousands)  | Number of<br>Shares<br>Outstanding | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Treasury<br>Stock | Total<br>Stockholder<br>Equity |
|--|------------------------------------|-----------------|----------------------|---|-------------------|--------------------------------|
| Balance<br>December 31,<br>2014  | 4,662,606                          | \$ 35,553       | \$ 15,566            | \$ 169  | \$ (59)           | \$ 51,229                      |
| Net income   | -                                  | -               | 952                  | -   | -                 | 952                            |
| Other<br>comprehensive<br>income   | -                                  | -               | -                    | 88  | -                 | 88                             |
| Treasury shares<br>purchased   | (19,450)                           | -               | -                    | -   | (204)             | (204)                          |
| Restricted<br>stock granted  | 26,441                             | -               | -                    | -   | -                 | -                              |
| Compensation<br>expense related<br>to stock option<br>and restricted<br>stock grants | -                                  | 91              | -                    | -   | -                 | 91                             |
| Dividends<br>declared on<br>common stock<br>(\$0.04 per<br>share)                    | -                                  | -               | (187)                | -   | -                 | (187)                          |
| Balance March<br>31, 2015  | 4,669,597                          | \$ 35,644       | \$ 16,331            | \$ 257  | \$ (263)          | \$ 51,969                      |
| Balance<br>December 31,<br>2015  | 4,646,238                          | \$ 35,927       | \$ 18,520            | \$ 86   | \$ (592)          | \$ 53,941                      |
| Net income   | -                                  | -               | 1,574                | -   | -                 | 1,574                          |
|  | -                                  | -               | -                    | 251   | -                 | 251                            |

|  |           |           |           |        |          |           |
|--|-----------|-----------|-----------|--------|----------|-----------|
| Other comprehensive loss   |           |           |           |        |          |           |
| Restricted stock granted   | 30,822    | -         | -         | -      | -        | -         |
| Restricted stock forfeited   | (1,084)   | -         | -         | -      | -        | -         |
| Compensation expense related to stock option and restricted stock grants | -         | 101       | -         | -      | -        | 101       |
| Dividends declared on common stock (\$0.04 per share)                    | -         | -         | (185)     | -      | -        | (185)     |
| Balance March 31, 2016   | 4,675,976 | \$ 36,028 | \$ 19,909 | \$ 337 | \$ (592) | \$ 55,682 |

See Notes to Consolidated Financial Statements

## SUSSEX BANCORP

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| (Dollars in thousands)  | Three Months Ended March 31, |          |
|---|------------------------------|----------|
|   | 2016                         | 2015     |
| Cash Flows from   |                              |          |
| Operating Activities  |                              |          |
| Net income  | \$ 1,574                     | \$ 952   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |          |
| Provision for loan losses   | 211                          | 305      |
| Depreciation and amortization   | 258                          | 243      |
| Net amortization of securities premiums and discounts                             | 412                          | 428      |
| Net realized gain on sale of securities   | (167)                        | (168)    |
| Net realized loss on disposal of premises and equipment                           | 13                           | -        |
| Net realized gain on sale of foreclosed real estate                               | (3)                          | (27)     |
| Write-downs of and provisions for foreclosed real estate                          | -                            | 97       |
| Deferred income tax benefit   | (192)                        | (111)    |
| Earnings on bank-owned life insurance   | (76)                         | (78)     |
| Compensation expense for stock options and stock awards                           | 101                          | 91       |
| Increase in assets:   |                              |          |
| Accrued interest receivable   | (493)                        | (112)    |
| Other assets  | (726)                        | (563)    |
| Increase in accrued interest payable and other liabilities                        | 904                          | 654      |
| Net Cash Provided by Operating Activities   | 1,816                        | 1,711    |
| Cash Flows from Investing Activities  |                              |          |
| Securities available for sale:  |                              |          |
| Purchases   | (2,044)                      | (21,632) |

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|  |          |  |          |
|--|----------|--|----------|
| Sales  | 8,088    |  | 12,767   |
| Maturities, calls and principal repayments                           | 1,789    |  | 2,161    |
| Securities held to maturity:   |          |  |          |
| Purchases  | (480)    |  | (491)    |
| Maturities, calls and principal repayments                           | 491      |  | -        |
| Net increase in loans  | (36,617) |  | (1,552)  |
| Proceeds from the sale of foreclosed real estate                     | 29       |  | 1,566    |
| Purchases of bank premises and equipment                             | (518)    |  | (343)    |
| Decrease in Federal Home Loan Bank stock                             | 1,326    |  | 369      |
| Net Cash Used in Investing Activities                                | (27,936) |  | (7,155)  |
| Cash Flows from Financing Activities                                 |          |  |          |
| Net increase in deposits   | 57,444   |  | 15,242   |
| Increase in short-term borrowed funds                                | (33,220) |  | (18,300) |
| Proceeds from long-term borrowings                                   | 5,000    |  | 15,000   |
| Repayment of long-term borrowings                                    | -        |  | (5,000)  |
| Purchase of treasury stock   | -        |  | (204)    |
| Dividends paid   | (185)    |  | (187)    |
| Net Cash Provided by Financing Activities                            | 29,039   |  | 6,551    |
| Net Increase in Cash and Cash Equivalents                            | 2,919    |  | 1,107    |
| Cash and Cash Equivalents - Beginning                                | 6,120    |  | 5,859    |
| Cash and Cash Equivalents - Ending                                   | \$ 9,039 |  | \$ 6,966 |
| Supplementary Cash Flows Information                                 |          |  |          |
| Interest paid  | \$ 975   |  | \$ 827   |
| Income taxes paid  | \$ 795   |  | \$ 250   |
| Supplementary Schedule of Noncash Investing and Financing Activities |          |  |          |
| Foreclosed real estate acquired in settlement of loans               | \$ -     |  | \$ 39    |

See Notes to Consolidated Financial Statements



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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of Sussex Bancorp (“we,” “us,” “our” or the “company”) and our wholly owned subsidiary Sussex Bank (the “Bank”). The Bank’s wholly owned subsidiaries are SCB Investment Company, Inc., SCBNY Company, Inc., ClassicLake Enterprises, LLC, Wheatsworth Properties Corp., PPD Holding Company, LLC, and Tri-State Insurance Agency, Inc. (“Tri-State”), a full service insurance agency located in Sussex County, New Jersey with a satellite office located in Bergen County, New Jersey. Tri-State’s operations are considered a separate segment for financial disclosure purposes. All inter-company transactions and balances have been eliminated in consolidation. The Bank operates twelve banking offices, eight located in Sussex County, New Jersey, one located in Bergen County, New Jersey, one located in Warren County, New Jersey, one in Queens County, New York and one in Orange County, New York.

We are subject to the supervision and regulation of the Board of Governors of the Federal Reserve System (the “FRB”). The Bank’s deposits are insured by the Deposit Insurance Fund (“DIF”) of the FDIC up to applicable limits. The operations of the company and the Bank are subject to the supervision and regulation of the FRB, the FDIC and the New Jersey Department of Banking and Insurance (the “Department”) and the operations of Tri-State are subject to supervision and regulation by the Department.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by the accounting principles generally accepted in the United States of America (“U.S. GAAP”) for full year financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal, recurring nature. Operating results for the three month period ended March 31, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto that are included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

New Accounting Standards

In May 2014, Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, Revenue from Contracts with Customers. The ASU’s core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. For public entities, the guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted only as of annual reporting periods beginning after December 15, 2016, including interim periods within that year. We do not expect the adoption of this guidance to have a material impact on our consolidated financial statements.

In June 2014, FASB issued ASU 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (a consensus of the FASB Emerging Issues Task Force), to clarify that a performance target in a share-based compensation award that could be achieved after an employee completes the requisite service period should be treated as a performance condition that affects the vesting of the award. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. For all entities, the amendments are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In April 2015, FASB issued ASU 2015-05, Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement, to clarify whether a hosting arrangement (e.g., cloud computing, software as a service, infrastructure as a service, etc.) contains a software license, and thus, whether it is to be accounted for by the customer similarly to other internal-use software. Specifically, the amendments revise the scope of Subtopic 350-40 to include internal-use software accessed through a hosting arrangement only if both of the following criteria are met: (1) the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty. There is no significant penalty if the customer has the ability to take delivery of the software without incurring significant cost and the ability to use the software separately without significant loss of utility or value and (2) it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. If both of the above criteria are present in a hosting arrangement, then the arrangement contains a software license and the customer should account for that element in accordance with Subtopic 350-40 (i.e., generally capitalize and subsequently amortize the cost of the license). If both

of the above criteria are not present, the customer should account for the arrangement as a service contract (i.e., expense fees as incurred). The amendments are effective for public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. An entity can elect to adopt the amendments either (1) prospectively to all arrangements entered into or materially modified after the effective date or (2) retrospectively. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In January 2016, FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01, among other things; (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. For public entities, the guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

In February 2016, FASB issued ASU 2016-02, Leases (Topic 842). Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (i) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (ii) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Public business entities should apply the amendments in ASU 2016-02 for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted for all public business entities upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

In March 2016, FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. FASB is issuing ASU 2016-09 as part of its initiative to reduce complexity in accounting standards. The areas for simplification in this ASU 2016-09 involve several aspects of the accounting for employee share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Some of the areas for simplification apply only to nonpublic entities. For public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for any entity in any interim or annual period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim

period. An entity that elects early adoption must adopt all of the amendments in the same period. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

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## NOTE 2 – SECURITIES

## Available for Sale

The amortized cost and approximate fair value of securities available for sale as of March 31, 2016 and December 31, 2015 are summarized as follows:

| (Dollars in thousands)  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2016  |                   |                              |                               |               |
| U.S. government agencies  | \$ 12,485         | \$ 71                        | \$ (28)                       | \$ 12,528     |
| State and political subdivisions                                      | 29,611            | 656                          | (23)                          | 30,244        |
| Mortgage-backed securities -<br>U.S. government-sponsored enterprises | 43,466            | 369                          | (84)                          | 43,751        |
|   | \$ 85,562         | \$ 1,096                     | \$ (135)                      | \$ 86,523     |
| December 31, 2015   |                   |                              |                               |               |
| U.S. government agencies  | \$ 12,792         | \$ 51                        | \$ (55)                       | \$ 12,788     |
| State and political subdivisions                                      | 37,771            | 507                          | (129)                         | 38,149        |
| Mortgage-backed securities -<br>U.S. government-sponsored enterprises | 43,069            | 206                          | (436)                         | 42,839        |
|   | \$ 93,632         | \$ 764                       | \$ (620)                      | \$ 93,776     |

Securities with a carrying value of approximately \$32.8 million and \$33.4 million at March 31, 2016 and December 31, 2015, respectively, were pledged to secure public deposits and for borrowings at the Federal Reserve Bank as required or permitted by applicable laws and regulations.

The amortized cost and fair value of securities available for sale at March 31, 2016 are shown below by contractual maturity. Actual maturities may differ from contractual maturities as issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments which pay principal on a periodic basis are not included in the maturity categories.

| (Dollars in thousands) | Amortized<br>Cost | Fair<br>Value |
|------------------------|-------------------|---------------|
|------------------------|-------------------|---------------|

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|  |           |           |
|--|-----------|-----------|
| Due in one year or less                | \$ -      | \$ -      |
| Due after one year through five years  | 699       | 704       |
| Due after five years through ten years | 3,643     | 3,728     |
| Due after ten years                    | 25,269    | 25,812    |
| Total bonds and obligations            | 29,611    | 30,244    |
| U.S. government agencies               | 12,485    | 12,528    |
| Mortgage-backed securities:            |           |           |
| U.S. government-sponsored enterprises  | 43,466    | 43,751    |
| Total available for sale securities    | \$ 85,562 | \$ 86,523 |

Gross gains on sales of securities available for sale were \$167 thousand and \$216 thousand and gross losses were less than \$1 thousand and \$48 thousand for the three months ended March 31, 2016 and 2015, respectively.

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## Temporarily Impaired Securities

The following table shows gross unrealized losses and fair value of securities with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by category and length of time that individual available for sale securities have been in a continuous unrealized loss position at March 31, 2016 and December 31, 2015.

| (Dollars in thousands)                | Less Than 12 Months |                         | 12 Months or More |                         | Total      |                         |
|---------------------------------------|---------------------|-------------------------|-------------------|-------------------------|------------|-------------------------|
|                                       | Fair Value          | Gross Unrealized Losses | Fair Value        | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| March 31, 2016                        |                     |                         |                   |                         |            |                         |
| U.S. government agencies              | \$ 4,587            | \$ (6)                  | \$ 2,452          | \$ (22)                 | \$ 7,039   | \$ (28)                 |
| State and political subdivisions      | 1,414               | (3)                     | 1,048             | (20)                    | 2,462      | (23)                    |
| Mortgage-backed securities -          |                     |                         |                   |                         |            |                         |
| U.S. government-sponsored enterprises | 12,922              | (79)                    | 1,512             | (5)                     | 14,434     | (84)                    |
| Total temporarily impaired securities | \$ 18,923           | \$ (88)                 | \$ 5,012          | \$ (47)                 | \$ 23,935  | \$ (135)                |
| December 31, 2015                     |                     |                         |                   |                         |            |                         |
| U.S. government agencies              | \$ 5,888            | \$ (23)                 | \$ 2,473          | \$ (32)                 | \$ 8,361   | \$ (55)                 |
| State and political subdivisions      | 5,780               | (107)                   | 2,998             | (22)                    | 8,778      | (129)                   |
| Mortgage-backed securities -          |                     |                         |                   |                         |            |                         |
| U.S. government-sponsored enterprises | 31,885              | (436)                   | -                 | -                       | 31,885     | (436)                   |
| Total temporarily impaired securities | \$ 43,553           | \$ (566)                | \$ 5,471          | \$ (54)                 | \$ 49,024  | \$ (620)                |

For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred. As of March 31, 2016, we reviewed our available for sale securities portfolio for indications of impairment. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and the intent and likelihood of selling the security. The intent and likelihood of sale of debt and equity securities are evaluated based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy and interest rate risk position.

## U.S. Government Agencies

At March 31, 2016 and December 31, 2015, the decline in fair value and the unrealized losses for our U.S. government agencies securities were primarily due to changes in spreads and market conditions and not credit quality. At March 31, 2016, there were five securities with a fair value of \$7.0 million that had an unrealized loss that amounted to \$28 thousand. As of March 31, 2016, we did not intend to sell and it was not more-likely-than-not that we would be required to sell any of these securities before recovery of their amortized cost basis. Therefore, none of the U.S. government agency securities at March 31, 2016 were deemed to be other-than-temporarily impaired (“OTTI”).



At December 31, 2015, there were six securities with a fair value of \$8.4 million that had an unrealized loss that amounted to \$55 thousand.

#### State and Political Subdivisions

At March 31, 2016 and December 31, 2015, the decline in fair value and the unrealized losses for our state and political subdivisions securities were caused by changes in interest rates and spreads and were not the result of credit quality. At March 31, 2016, there were four securities with a fair value of \$2.5 million that had an unrealized loss that amounted to \$23 thousand. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates. As of March 31, 2016, we did not intend to sell and it was not more-likely-than-not that we would be required to sell any of these securities before recovery of their amortized cost basis. Therefore, none of our state and political subdivision securities at March 31, 2016 were deemed to be OTTI.

At December 31, 2015, there were 15 securities with a fair value of \$8.8 million that had an unrealized loss that amounted to \$129 thousand.

#### Mortgage-Backed Securities

At March 31, 2016 and December 31, 2015, the decline in fair value and the unrealized losses for our mortgage-backed securities guaranteed by U.S. government-sponsored enterprises were primarily due to changes in spreads and market conditions and not credit quality. At March 31, 2016, there were eight securities with a fair value of \$14.4 million that had an unrealized loss that amounted to \$84 thousand. As of March 31, 2016, we did not intend to sell and it was not

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more-likely-than-not that we would be required to sell any of these securities before recovery of their amortized cost basis. Therefore, none of our mortgage-backed securities at March 31, 2016 were deemed to be OTTI.

At December 31, 2015, there were 18 securities with a fair value of \$31.9 million that had an unrealized loss that amounted to \$436 thousand.

Held to Maturity Securities

The amortized cost and approximate fair value of securities held to maturity as of March 31, 2016 and December 31, 2015 are summarized as follows:

| (Dollars in thousands)           | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|----------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2016                   |                   |                              |                               |               |
| State and political subdivisions | \$ 6,816          | \$ 223                       | \$ -                          | \$ 7,039      |
| December 31, 2015                |                   |                              |                               |               |
| State and political subdivisions | \$ 6,834          | \$ 174                       | \$ -                          | \$ 7,008      |

The amortized cost and carrying value of securities held to maturity at March 31, 2016 are shown below by contractual maturity. Actual maturities may differ from contractual maturities as issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in thousands)                 | Amortized<br>Cost | Fair<br>Value |
|--|-------------------|---------------|
| Due in one year or less                | \$ 2,942          | \$ 2,942      |
| Due after one year through five years  | 1,000             | 1,003         |
| Due after five years through ten years | 1,827             | 1,926         |
| Due after ten years                    | 1,047             | 1,168         |
| Total held to maturity securities      | \$ 6,816          | \$ 7,039      |

Temporarily Impaired Securities

For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred. As of March 31, 2016, we did not have any held to maturity investments with unrealized losses. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and the intent and likelihood of selling the security. The intent and likelihood of sale of debt securities is evaluated based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy and interest rate risk position. For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred.

At December 31, 2015, we did not have any held to maturity securities in an unrealized loss position.

## NOTE 3 – LOANS

The composition of net loans receivable at March 31, 2016 and December 31, 2015 is as follows:

| (Dollars in thousands)             | March 31,<br>2016 | December<br>31, 2015 |
|------------------------------------|-------------------|----------------------|
| Commercial and industrial          | \$ 24,278         | \$ 20,023            |
| Construction                       | 15,827            | 13,348               |
| Commercial real estate             | 409,358           | 382,262              |
| Residential real estate            | 130,189           | 127,204              |
| Consumer and other                 | 1,172             | 1,253                |
| Total loans receivable             | 580,824           | 544,090              |
| Unearned net loan origination fees | (773)             | (667)                |
| Allowance for loan losses          | (5,812)           | (5,590)              |
| Net loans receivable               | \$ 574,239        | \$ 537,833           |

Mortgage loans serviced for others are not included in the accompanying balance sheets. The total amount of loans serviced for the benefit of others was approximately \$448 thousand and \$454 thousand at March 31, 2016 and December 31, 2015, respectively. Mortgage servicing rights were immaterial at March 31, 2016 and December 31, 2015.

## NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY OF FINANCING RECEIVABLES

The following table presents changes in the allowance for loan losses disaggregated by the class of loans receivable for the three months ended March 31, 2016 and 2015:

| (Dollars in thousands) | Commercial<br>and<br>Industrial | Construction | Commercial<br>Real<br>Estate | Residential<br>Real<br>Estate | Consumer<br>and<br>Other | Unallocated | Total    |
|------------------------|---------------------------------|--------------|------------------------------|-------------------------------|--------------------------|-------------|----------|
| Three Months Ended:    |                                 |              |                              |                               |                          |             |          |
| March 31, 2016         |                                 |              |                              |                               |                          |             |          |
| Beginning balance      | \$ 85                           | \$ 220       | \$ 3,646                     | \$ 784                        | \$ 87                    | \$ 768      | \$ 5,590 |
| Charge-offs            | -                               | -            | -                            | (9)                           | (19)                     | -           | (28)     |
| Recoveries             | 7                               | -            | 31                           | -                             | 1                        | -           | 39       |
| Provision              | 6                               | 47           | 170                          | 133                           | 52                       | (197)       | 211      |

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|                   |        |        |          |        |        |        |          |
|-------------------|--------|--------|----------|--------|--------|--------|----------|
| Ending balance    | \$ 98  | \$ 267 | \$ 3,847 | \$ 908 | \$ 121 | \$ 571 | \$ 5,812 |
| March 31, 2015    |        |        |          |        |        |        |          |
| Beginning balance | \$ 231 | 383    | \$ 3,491 | \$ 903 | \$ 19  | \$ 614 | \$ 5,641 |
| Charge-offs       | (19)   | -      | (188)    | -      | (7)    | -      | (214)    |
| Recoveries        | 4      | -      | 12       | 12     | 3      | -      | 31       |
| Provision         | (78)   | 5      | 472      | (74)   | 73     | (93)   | 305      |
| Ending balance    | \$ 138 | \$ 388 | \$ 3,787 | \$ 841 | \$ 88  | \$ 521 | \$ 5,763 |

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The following table presents the balance of the allowance of loan losses and loans receivable by class at March 31, 2016 and December 31, 2015 disaggregated on the basis of our impairment methodology.

| (Dollars in thousands)    | Allowance for Loan Losses |  |  | Loans Receivable |  |  |
|---------------------------|---------------------------|--|--|------------------|--|--|
|                           | Balance                   | Balance<br>Related to<br>Loans<br>Individually<br>Evaluated<br>for<br>Impairment | Balance<br>Related to<br>Loans<br>Collectively<br>Evaluated<br>for<br>Impairment | Balance          | Individually<br>Evaluated<br>for<br>Impairment | Collectively<br>Evaluated<br>for<br>Impairment |
| March 31, 2016            |                           |  |  |                  |  |  |
| Commercial and industrial | \$ 98                     | \$ -   | \$ 98  | \$ 24,278        | \$ 20  | \$ 24,258                                      |
| Construction              | 267                       | -  | 267  | 15,827           | -  | 15,827   |
| Commercial real estate    | 3,847                     | 249  | 3,598  | 409,358          | 5,130  | 404,228  |
| Residential real estate   | 908                       | 68   | 840  | 130,189          | 1,333  | 128,856  |
| Consumer and other loans  | 121                       | 107  | 14   | 1,172            | 138  | 1,034  |
| Unallocated               | 571                       | -  | -  | -                | -  | -  |
| Total                     | \$ 5,812                  | \$ 424   | \$ 4,817   | \$ 580,824       | \$ 6,621                                       | \$ 574,203                                     |
| December 31, 2015         |                           |  |  |                  |  |  |
| Commercial and industrial | \$ 85                     | \$ -   | \$ 85  | \$ 20,023        | \$ 20  | \$ 20,003                                      |
| Construction              | 220                       | -  | 220  | 13,348           | -  | 13,348   |
| Commercial real estate    | 3,646                     | 112  | 3,534  | 382,262          | 5,160  | 377,102  |
| Residential real estate   | 784                       | 79   | 705  | 127,204          | 1,546  | 125,658  |
| Consumer and other loans  | 87                        | 73   | 14   | 1,253            | 138  | 1,115  |
| Unallocated               | 768                       | -  | -  | -                | -  | -  |
| Total                     | \$ 5,590                  | \$ 264   | \$ 4,558   | \$ 544,090       | \$ 6,864                                       | \$ 537,226                                     |

An age analysis of loans receivable, which were past due as of March 31, 2016 and December 31, 2015, is as follows:

| (Dollars in thousands) | 30-59<br>Days | 60-89<br>days | Greater<br>Than | Total<br>Past<br>Due | Current | Total<br>Financing<br>Receivables | Recorded<br>Investment<br>> 90 Days |
|------------------------|---------------|---------------|-----------------|----------------------|---------|-----------------------------------|-------------------------------------|
|                        |               |               |                 |                      |         |                                   | and<br>Accruing                     |

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|                           | Past<br>Due | Past<br>Due | 90 Days<br>(a) |           |            |            |      |  |
|---------------------------|-------------|-------------|----------------|-----------|------------|------------|------|--|
| March 31, 2016            |             |             |                |           |            |            |      |  |
| Commercial and industrial | \$ -        | \$ 4        | \$ 20          | \$ 24     | \$ 24,254  | \$ 24,278  | \$ - |  |
| Construction              | -           | -           | -              | -         | 15,827     | 15,827     | -    |  |
| Commercial real estate    | 2,306       | 1,280       | 3,993          | 7,579     | 401,779    | 409,358    | -    |  |
| Residential real estate   | 1,001       | 247         | 1,202          | 2,450     | 127,739    | 130,189    | -    |  |
| Consumer and other        | 4           | -           | 138            | 142       | 1,030      | 1,172      | -    |  |
| Total                     | \$ 3,311    | \$ 1,531    | \$ 5,353       | \$ 10,195 | \$ 570,629 | \$ 580,824 | \$ - |  |
| December 31, 2015         |             |             |                |           |            |            |      |  |
| Commercial and industrial | \$ 5        | \$ -        | \$ 20          | \$ 25     | \$ 19,998  | \$ 20,023  | \$ - |  |
| Construction              | -           | -           | -              | -         | 13,348     | 13,348     | -    |  |
| Commercial real estate    | 758         | 1,461       | 4,016          | 6,235     | 376,027    | 382,262    | -    |  |
| Residential real estate   | 335         | 247         | 1,138          | 1,720     | 125,484    | 127,204    | -    |  |
| Consumer and other        | 16          | 1           | 138            | 155       | 1,098      | 1,253      | -    |  |
| Total                     | \$ 1,114    | \$ 1,709    | \$ 5,312       | \$ 8,135  | \$ 535,955 | \$ 544,090 | \$ - |  |

(a) includes loans greater than 90 days past due and still accruing and non-accrual loans.

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Loans for which the accrual of interest has been discontinued at March 31, 2016 and December 31, 2015 were:

| (Dollars in thousands)    | March<br>31, 2016 | December<br>31, 2015 |
|---------------------------|-------------------|----------------------|
| Commercial and industrial | \$ 20             | \$ 20                |
| Commercial real estate    | 3,993             | 4,016                |
| Residential real estate   | 1,202             | 1,138                |
| Consumer and other        | 138               | 138                  |
| Total                     | \$ 5,353          | \$ 5,312             |

In determining the adequacy of the allowance for loan losses, we estimate losses based on the identification of specific problem loans through our credit review process and also estimate losses inherent in other loans on an aggregate basis by loan type. The credit review process includes the independent evaluation of the loan officer assigned risk ratings by the Chief Credit Officer and a third party loan review company. Such risk ratings are assigned loss component factors that reflect our loss estimate for each group of loans. It is management's and the Board of Directors' responsibility to oversee the lending process to ensure that all credit risks are properly identified, monitored, and controlled, and that loan pricing, terms and other safeguards against non-performance and default are commensurate with the level of risk undertaken and is rated as such based on a risk-rating system. Factors considered in assigning risk ratings and loss component factors include: borrower specific information related to expected future cash flows and operating results, collateral values, financial condition and payment status; levels of and trends in portfolio charge-offs and recoveries; levels in portfolio delinquencies; effects of changes in loan concentrations and observed trends in the economy and other qualitative measurements.

Our risk-rating system is consistent with the classification system used by regulatory agencies and with industry practices. Loan classifications of Substandard, Doubtful or Loss are consistent with the regulatory definitions of classified assets. The classification system is as follows:

- Pass: This category represents loans performing to contractual terms and conditions and the primary source of repayment is adequate to meet the obligation. We have five categories within the Pass classification depending on strength of repayment sources, collateral values and financial condition of the borrower.
- Special Mention: This category represents loans performing to contractual terms and conditions; however the primary source of repayment or the borrower is exhibiting some deterioration or weaknesses in financial condition that could potentially threaten the borrowers' future ability to repay our loan principal and interest or fees due.



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- **Substandard:** This category represents loans that the primary source of repayment has significantly deteriorated or weakened which has or could threaten the borrowers' ability to make scheduled payments. The weaknesses require close supervision by management and there is a distinct possibility that we could sustain some loss if the deficiencies are not corrected. Such weaknesses could jeopardize the timely and ultimate collection of our loan principal and interest or fees due. Loss may not be expected or evident, however, loan repayment is inadequately supported by current financial information or pledged collateral.
- **Doubtful:** Loans so classified have all the inherent weaknesses of a substandard loan with the added provision that collection or liquidation in full is highly questionable and not reasonably assured. The probability of at least partial loss is high, but extraneous factors might strengthen the asset to prevent loss. The validity of the extraneous factors must be continuously monitored. Once these factors are questionable the loan should be considered for full or partial charge-off.
- **Loss:** Loans so classified are considered uncollectible, and of such little value that their continuance as active assets is not warranted. Such loans are fully charged off.

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The following tables illustrate our corporate credit risk profile by creditworthiness category as of March 31, 2016 and December 31, 2015:

| (Dollars in thousands)    | Pass       | Special<br>Mention | Substandard | Doubtful | Total      |
|---------------------------|------------|--------------------|-------------|----------|------------|
| March 31, 2016            |            |                    |             |          |            |
| Commercial and industrial | \$ 24,224  | \$ 19              | \$ 35       | \$ -     | \$ 24,278  |
| Construction              | 15,827     | -                  | -           | -        | 15,827     |
| Commercial real estate    | 394,515    | 8,887              | 5,956       | -        | 409,358    |
| Residential real estate   | 128,119    | 737                | 1,333       | -        | 130,189    |
| Consumer and other        | 1,034      | -                  | 138         | -        | 1,172      |
|                           | \$ 563,719 | \$ 9,643           | \$ 7,462    | \$ -     | \$ 580,824 |
| December 31, 2015         |            |                    |             |          |            |
| Commercial and industrial | \$ 19,983  | \$ 5               | \$ 35       | \$ -     | \$ 20,023  |
| Construction              | 13,348     | -                  | -           | -        | 13,348     |
| Commercial real estate    | 367,305    | 8,957              | 6,000       | -        | 382,262    |
| Residential real estate   | 124,915    | 743                | 1,546       | -        | 127,204    |
| Consumer and other        | 1,115      | -                  | 138         | -        | 1,253      |
|                           | \$ 526,666 | \$ 9,705           | \$ 7,719    | \$ -     | \$ 544,090 |

The following table reflects information about our impaired loans by class as of March 31, 2016 and December 31, 2015:

| (Dollars in thousands)              | March 31, 2016         |                                |                      | December 31, 2015      |                                |                      |
|-------------------------------------|------------------------|--------------------------------|----------------------|------------------------|--------------------------------|----------------------|
|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
| With no related allowance recorded: |                        |                                |                      |                        |                                |                      |
| Commercial and industrial           | \$ 20                  | \$ 20                          | \$ -                 | \$ 20                  | \$ 20                          | \$ -                 |
| Commercial real estate              | 2,207                  | 2,218                          | -                    | 2,684                  | 2,684                          | -                    |
| Residential real estate             | 999                    | 999                            | -                    | 1,123                  | 1,152                          | -                    |
| With an allowance recorded:         |                        |                                |                      |                        |                                |                      |
| Commercial real estate              | 2,923                  | 2,923                          | 249                  | 2,476                  | 2,476                          | 112                  |

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|                           |          |          |        |          |          |        |
|---------------------------|----------|----------|--------|----------|----------|--------|
| Residential real estate   | 334      | 364      | 68     | 423      | 423      | 79     |
| Consumer and other        | 138      | 138      | 107    | 138      | 138      | 73     |
| Total:                    |          |          |        |          |          |        |
| Commercial and industrial | 20       | 20       | -      | 20       | 20       | -      |
| Commercial real estate    | 5,130    | 5,141    | 249    | 5,160    | 5,160    | 112    |
| Residential real estate   | 1,333    | 1,363    | 68     | 1,546    | 1,575    | 79     |
| Consumer and other        | 138      | 138      | 107    | 138      | 138      | 73     |
|                           | \$ 6,621 | \$ 6,662 | \$ 424 | \$ 6,864 | \$ 6,893 | \$ 264 |

The following table presents the average recorded investment and income recognized for the three months ended March 31, 2016 and 2015:

|  | For the Three Months<br>Ended March 31, 2016 |                        | For the Three Months<br>Ended March 31, 2015 |                        |
|--|--|------------------------|--|------------------------|
|  | Average<br>Recorded<br>Investment            | Interest<br>Recognized | Average<br>Recorded<br>Investment            | Interest<br>Recognized |
| (Dollars in thousands)                           |  |                        |  |                        |
| With no related allowance recorded:              |  |                        |  |                        |
| Commercial and industrial                        | \$ 20  | \$ -                   | \$ 10  | \$ -                   |
| Commercial real estate                           | 2,446  | 8                      | 2,759  | 5                      |
| Residential real estate                          | 1,061  | 1                      | 1,631  | 1                      |
| Total impaired loans without a related allowance | 3,527  | 9                      | 4,400  | 6                      |
| With an allowance recorded:                      |  |                        |  |                        |
| Commercial real estate                           | 2,699  | 8                      | 2,766  | 8                      |
| Residential real estate                          | 379  | -                      | 513  | 3                      |
| Consumer and other                               | 138  | -                      | 69   | -                      |
| Total impaired loans with an allowance           | 3,216  | 8                      | 3,395  | 11                     |
| Total impaired loans                             | \$ 6,743                                     | \$ 17                  | \$ 7,795                                     | \$ 17                  |

We recognize interest income on performing impaired loans as payments are received. On non-performing impaired loans we do not recognize interest income as all payments are recorded as a reduction of principal on such loans.

Impaired loans include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, postponement or forgiveness of principal, forbearance or other actions intended to maximize collection. The concessions rarely result in the forgiveness of principal or accrued interest. In addition, we attempt to obtain additional collateral or guarantor support when modifying such loans. Non-accruing restructured loans may be returned to accrual status when there has been a sustained period of repayment performance (generally six consecutive months of payments) and both principal and interest are deemed collectible.

The following table presents the recorded investment in troubled debt restructured loans, based on payment performance status:

| (Dollars in thousands) | Commercial Real Estate | Residential<br>Real<br>Estate | Total    |
|------------------------|------------------------|-------------------------------|----------|
| March 31, 2016         |                        |                               |          |
| Performing             | \$ 1,137               | \$ 131                        | \$ 1,268 |
| Non-performing         | 1,828                  | 194                           | 2,022    |
| Total                  | \$ 2,965               | \$ 325                        | \$ 3,290 |
| December 31, 2015      |                        |                               |          |
| Performing             | \$ 1,144               | \$ 409                        | \$ 1,553 |
| Non-performing         | 1,831                  | 194                           | 2,025    |
| Total                  | \$ 2,975               | \$ 603                        | \$ 3,578 |

Troubled debt restructured loans are considered impaired and are included in the previous impaired loans disclosures in this footnote. As of March 31, 2016, we have not committed to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

There were no troubled debt restructurings that occurred during the three months ended March 31, 2016 and 2015.

There were no troubled debt restructurings for which there was a payment default within twelve months following the date of the restructuring for the three months ended March 31, 2016 and 2015.

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We may obtain physical possession of residential real estate collateralizing a consumer mortgage loan via foreclosure on an in-substance repossession. As of both March 31, 2016 and December 31, 2015, we held \$130 thousand in foreclosed residential real estate properties as a result of obtaining physical possession. In addition, as of March 31, 2016 and December 31, 2015, respectively, we had consumer loans with a carrying value of \$878 thousand and \$945 thousand collateralized by residential real estate property for which formal foreclosure proceedings were in process.

NOTE 5 – EARNINGS PER SHARE

Basic earnings per share are calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares (unvested restricted stock grants and stock options) had been issued, as well as any adjustment to income that would result from the assumed issuance of potential common shares that may be issued by us. Potential common shares related to stock options are determined using the treasury stock method.

| (In thousands, except share and per share data)                      | Three Months Ended March 31, 2016 |                         |                        | Three Months Ended March 31, 2015 |                         |                        |
|--|-----------------------------------|-------------------------|------------------------|-----------------------------------|-------------------------|------------------------|
|  | Income<br>(Numerator)             | Shares<br>(Denominator) | Per<br>Share<br>Amount | Income<br>(Numerator)             | Shares<br>(Denominator) | Per<br>Share<br>Amount |
| Basic earnings per share:  |                                   |                         |                        |                                   |                         |                        |
| Net earnings applicable to common stockholders                       | \$ 1,574                          | 4,578,598               | \$ 0.34                | \$ 952                            | 4,571,142               | \$ 0.21                |
| Effect of dilutive securities:                                       |                                   |                         |                        |                                   |                         |                        |
| Unvested stock awards  | -                                 | 27,828                  |                        | -                                 | 31,768                  |                        |
| Diluted earnings per share:  |                                   |                         |                        |                                   |                         |                        |
| Net income applicable to common stockholders and assumed conversions | \$ 1,574                          | 4,606,426               | \$ 0.34                | \$ 952                            | 4,602,910               | \$ 0.21                |

There were 57,038 and 21,244 shares of unvested restricted stock awards and options outstanding during the quarter ended March 31, 2016 and 2015, respectively, which were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive. .

NOTE 6 – OTHER COMPREHENSIVE INCOME

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale

securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

The components of other comprehensive income, both before tax and net of tax, are as follows:

|  | Three Months Ended<br>March 31, 2016 |               |               | Three Months Ended<br>March 31, 2015 |               |               |
|--|--------------------------------------|---------------|---------------|--------------------------------------|---------------|---------------|
|  | Before<br>Tax                        | Tax<br>Effect | Net of<br>Tax | Before<br>Tax                        | Tax<br>Effect | Net of<br>Tax |
| (Dollars in thousands)   |                                      |               |               |                                      |               |               |
| Other comprehensive income (loss):   |                                      |               |               |                                      |               |               |
| Unrealized gains on available for sale securities  | \$ 985                               | \$ 394        | \$ 591        | \$ 316                               | \$ 127        | \$ 189        |
| Fair value adjustments on derivatives  | (400)                                | (160)         | (240)         | -                                    | -             | -             |
| Reclassification adjustment for net gains on securities<br>transactions included in net income | (167)                                | (67)          | (100)         | (168)                                | (67)          | (101)         |
| Total other comprehensive income   | \$ 418                               | \$ 167        | \$ 251        | \$ 148                               | \$ 60         | \$ 88         |

## NOTE 7 – SEGMENT INFORMATION

Our insurance agency operations are managed separately from the traditional banking and related financial services that we also offer. The insurance agency operation provides commercial, individual, and group benefit plans and personal coverage.

|   | Three Months Ended March 31,<br>2016    |                       |          | Three Months Ended March 31,<br>2015    |                       |          |
|---|---|-----------------------|----------|---|-----------------------|----------|
|   | Banking<br>and<br>Financial<br>Services | Insurance<br>Services | Total    | Banking<br>and<br>Financial<br>Services | Insurance<br>Services | Total    |
| (Dollars in thousands)                    |   |                       |          |   |                       |          |
| Net interest income from external sources | \$ 5,646                                | \$ -                  | \$ 5,646 | \$ 4,802                                | \$ -                  | \$ 4,802 |
| Other income from external sources        | 786                                     | 1,738                 | 2,524    | 743                                     | 1,158                 | 1,901    |
| Depreciation and amortization             | 252                                     | 6                     | 258      | 239                                     | 4                     | 243      |
| Income before income taxes                | 1,514                                   | 835                   | 2,349    | 928                                     | 400                   | 1,328    |
| Income tax expense (1)                    | 441                                     | 334                   | 775      | 216                                     | 160                   | 376      |
| Total assets                              | 709,893                                 | 6,879                 | 716,772  | 598,265                                 | 5,986                 | 604,251  |

(1) Insurance Services calculated at statutory tax rate of 40%

## NOTE 8 – STOCK-BASED COMPENSATION



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We currently have stock-based compensation plans in place for our directors, officers, employees, consultants and advisors. Under the terms of these plans we may grant restricted shares and stock options for the purchase of our common stock. The stock-based compensation is granted under terms determined by our Compensation Committee. Our standard stock option grants have a maximum term of 10 years, generally vest over periods ranging between one and four years, and are granted with an exercise price equal to the fair market value of the common stock on the date of grant. Restricted stock is valued at the market value of the common stock on the date of grant and generally vests over periods of two to seven years. All dividends paid on restricted stock, whether vested or unvested, are paid to the shareholder.

Information regarding our stock option plans for the three months ended March 31, 2016 is as follows:

|  | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price per<br>Share | Weighted<br>Average<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|--|---------------------|---|--|---------------------------------|
| Options outstanding, beginning of year | 51,985              | \$ 10.06  |  |                                 |
| Options granted                        | 26,216              | 12.83   |  |                                 |
| Options outstanding, end of quarter    | 78,201              | \$ 10.99  | 9.1  | \$ 127,046                      |
| Options exercisable, end of quarter    | 10,396              | \$ 10.06  | 8.7  | \$ 25,407                       |
| Option price range at end of quarter   | \$9.97 to \$12.83   |   |  |                                 |
| Option price of exercisable shares     | \$9.97 to \$10.25   |   |  |                                 |

The following table summarizes information about stock option assumptions:

|                         | 2016      | 2015      |
|-------------------------|-----------|-----------|
| Expected dividend yield | 1.25%     | 1.56%     |
| Expected volatility     | 22.72%    | 34.32%    |
| Risk-free interest rate | 1.71%     | 1.37%     |
| Expected option life    | 7.5 Years | 7.5 Years |

During the three months ended March 31, 2016 and 2015, we expensed \$11 thousand and \$9 thousand, respectively, in stock-based compensation under stock option awards.



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The weighted average grant date fair values of options granted during the three months ended March 31, 2016 and 2015, were \$3.37 per share and \$3.56 per share, respectively. Expected future expense relating to the unvested options outstanding as of March 31, 2016 is \$227 thousand over a weighted average period of 4.1 years. Upon exercise of vested options, management expects to draw on treasury stock as the source of the shares.

The summary of changes in unvested restricted stock awards for the three months ended March 31, 2016, is as follows:

|  | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|--|---------------------|---|
| Unvested restricted stock, beginning of year | 93,570              | \$ 7.67   |
| Granted                                      | 30,822              | 12.68   |
| Forfeited                                    | (1,084)             | 9.58  |
| Vested                                       | (35,362)            | 7.00  |
| Unvested restricted stock, end of period     | 87,946              | \$ 9.67   |

During the three months ended March 31, 2016 and 2015, we expensed \$90 thousand and \$82 thousand, respectively, in stock-based compensation under restricted stock awards.

At March 31, 2016, unrecognized compensation expense for unvested restricted stock was \$722 thousand, which is expected to be recognized over an average period of 1.9 years.

### NOTE 9 – GUARANTEES

We do not issue any guarantees that would require liability recognition or disclosure, other than standby letters of credit. Standby letters of credit are conditional commitments issued by us to guarantee the performance of a customer to a third party. Generally, all letters of credit, when 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. Generally, we hold collateral and/or personal guarantees supporting these commitments. As of March 31, 2016, we had \$729 thousand of outstanding letters of credit. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of March 31, 2016, for guarantees under standby letters of credit issued is not material.

### NOTE 10 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Management uses its best judgment in estimating the fair value of our financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts we could have realized in a sale transaction on the dates indicated. The fair value amounts have been measured as of their respective period ends, and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period end.

In accordance with U.S. GAAP, we use a hierarchical disclosure framework associated with the level of pricing observability utilized in measuring assets and liabilities at fair value. The three broad levels defined by the hierarchy are as follows:

- Level I - Quoted prices are available in active markets for identical assets or liabilities as of the reported date.
  
- Level II - Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these asset and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.
  
- Level III - Assets and liabilities that have little to no pricing observability as of reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

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The following table summarizes the fair value of our financial assets measured on a recurring basis by the above pricing observability levels as of March 31, 2016 and December 31, 2015:

| (Dollars in thousands)  | Fair<br>Value<br>Measurements | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level I) | Significant<br>Other<br>Observable<br>Inputs<br>(Level II) | Significant<br>Unobservable<br>Inputs<br>(Level III) |
|---|-------------------------------|---|--|--|
| <b>March 31, 2016</b>   |                               |   |  |  |
| U.S. government agencies  | \$ 12,528                     | \$ -  | \$ 12,528  | \$ -   |
| State and political subdivisions                                      | 30,244                        | -   | 30,244   | -  |
| Mortgage-backed securities -<br>U.S. government-sponsored enterprises | 43,751                        | -   | 43,751   | -  |
| Derivative instruments<br>Interest rate swaps                         | (400)                         | -   | (400)  | -  |
| <b>December 31, 2015</b>  |                               |   |  |  |
| U.S. government agencies  | \$ 12,788                     | \$ -  | \$ 12,788  | \$ -   |
| State and political subdivisions                                      | 38,149                        | -   | 38,149   | -  |
| Mortgage-backed securities -<br>U.S. government-sponsored enterprises | 42,839                        | -   | 42,839   | -  |

Our available for sale and held to maturity securities portfolios contain investments, which were all rated within our investment policy guidelines at time of purchase, and upon review of the entire portfolio all securities are marketable and have observable pricing inputs.

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at March 31, 2016 and December 31, 2015 are as follows:

| Quoted<br>Prices in<br>Other | Significant<br>Other | Significant |
|------------------------------|----------------------|-------------|
|------------------------------|----------------------|-------------|

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|                        | Fair Value Measurements | Active Markets for Identical Assets (Level I) | Observable Inputs (Level II) | Unobservable Inputs (Level III) |
|------------------------|-------------------------|---|------------------------------|---------------------------------|
| (Dollars in thousands) |                         |   |                              |                                 |
| March 31, 2016         |                         |   |                              |                                 |
| Impaired loans         | \$ 1,051                | \$ -  | \$ -                         | \$ 1,051                        |
| December 31, 2015      |                         |   |                              |                                 |
| Impaired loans         | \$ 801                  | \$ -  | \$ -                         | \$ 801                          |
| Foreclosed real estate | 756                     | -   | -                            | 756                             |

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The following table presents additional qualitative information about assets measured at fair value on a nonrecurring basis and for which Level III inputs were used to determine fair value:

| (Dollars in thousands) | Qualitative Information about Level III Fair Value Measurements |                         |                           |                             |
|------------------------|---|-------------------------|---------------------------|-----------------------------|
|                        | Fair Value Estimate   | Valuation Techniques    | Unobservable Input        | Range (Weighted Average)    |
| March 31, 2016         |   |                         |                           |                             |
| Impaired loans         | \$ 1,051  | Appraisal of collateral | Appraisal adjustments (1) | 0% to<br>-27.30%<br>(-2.5%) |
| December 31, 2015      |   |                         |                           |                             |
| Impaired loans         | \$ 801  | Appraisal of collateral | Appraisal adjustments (1) | 0% to<br>-61.8%<br>(-5.8%)  |
| Foreclosed real estate | 756   | Appraisal of collateral | Selling expenses (1)      | -7.0%<br>(-7.0%)            |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated selling expenses. The range and weighted average of selling expenses and other appraisal adjustments are presented as a percentage of the appraisal.

The following information should not be interpreted as an estimate of the fair value of the entire company since a fair value calculation is only provided for a limited portion of our assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between our disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair value of our financial instruments at March 31, 2016 and December 31, 2015:

**Cash and Cash Equivalents (Carried at Cost):** The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair value.

**Deposits (Carried at Cost):** Fair value for fixed-rate time certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits. We generally purchase amounts below the insured limit,

limiting the amount of credit risk on these time deposits.

**Securities:** The fair value of securities, available for sale (carried at fair value) and securities held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level I), or matrix pricing (Level II), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level III). In the absence of such evidence, management's best estimate is used.

**Federal Home Loan Bank Stock (Carried at Cost):** The carrying amount of restricted investment in bank stock approximates fair value and considers the limited marketability of such securities.

**Loans Receivable (Carried at Cost):** The fair values of non-impaired loans are estimated using discounted cash flow analyses, using the market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

**Impaired Loans (Carried at Lower of Cost or Fair Value):** Fair value of impaired loans is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included in Level III fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value of impaired loans totaled \$1.1 million and \$801 thousand at March 31, 2016 and



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December 31, 2015, respectively. These balances consist of loans that were written down or required additional reserves during the periods ended March 31, 2016 and December 31, 2015, respectively.

**Deposit Liabilities (Carried at Cost):** The fair values disclosed for demand, savings and money market accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

**Borrowings (Carried at Cost):** Fair values of Federal Home Loan Bank (“FHLB”) advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

**Derivatives (Carried at Fair Value):** The Company also uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges, and which satisfy hedge accounting requirements, involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without the exchange of the underlying notional amount. These derivatives were used to hedge the variable cash outflows associated with FHLB borrowings along with our junior subordinated debenture at U.S. Capital Trust. The effective portion of changes in the fair value of these derivatives are recorded in accumulated other comprehensive income, and are subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of these derivatives are recognized directly in earnings.

The fair value of the Company's derivatives are determined using discounted cash flow analysis using observable market-based inputs, which are considered Level 2 inputs.

**Junior Subordinated Debentures (Carried at Cost):** Fair values of junior subordinated debt are estimated using discounted cash flow analysis, based on market rates currently offered on such debt with similar credit risk characteristics, terms and remaining maturity.

**Accrued Interest Receivable and Accrued Interest Payable (Carried at Cost):** The carrying amounts of accrued interest receivable and payable approximate its fair value.

**Off-Balance Sheet Instruments (Disclosed at Cost):** Fair values for our off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties’ credit standing.



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The fair values of our financial instruments at March 31, 2016 and December 31, 2015, were as follows:

| (Dollars in thousands)             | March 31, 2016     |               | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level I) | Significant<br>Other<br>Observable<br>Inputs<br>(Level II) | Significant<br>Unobservable<br>Inputs<br>(Level III) |
|------------------------------------|--------------------|---------------|---|--|--|
|                                    | Carrying<br>Amount | Fair<br>Value |   |  |  |
| <b>Financial assets:</b>           |                    |               |   |  |  |
| Cash and cash equivalents          | \$ 9,039           | \$ 9,039      | \$ 9,039  | \$ -   | \$ -   |
| Time deposits with other banks     | 100                | 100           | -   | 100  | -  |
| Securities available for sale      | 86,523             | 86,523        | -   | 86,523   | -  |
| Securities held to maturity        | 6,816              | 7,039         | -   | 7,039  | -  |
| Federal Home Loan Bank stock       | 3,839              | 3,839         | -   | 3,839  | -  |
| Loans receivable, net of allowance | 574,239            | 572,914       | -   | -  | 572,914  |
| Accrued interest receivable        | 2,257              | 2,257         | -   | 2,257  | -  |
| <b>Financial liabilities:</b>      |                    |               |   |  |  |
| Non-maturity deposits              | 419,030            | 419,030       | -   | 419,030  | -  |
| Time deposits                      | 156,270            | 156,175       | -   | 156,175  | -  |
| Short-term borrowings              | 1,430              | 1,430         | 1,430   | -  | -  |
| Long-term borrowings               | 66,000             | 67,358        | -   | 67,358   | -  |
| Junior subordinated debentures     | 12,887             | 10,374        | -   | 10,374   | -  |
| Accrued interest payable           | 386                | 386           | -   | 386  | -  |
| <b>Derivative instruments:</b>     |                    |               |   |  |  |
| Interest rate swaps                | (400)              | (400)         | -   | (400)  | -  |

| (Dollars in thousands) | December 31, 2015  |               | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level I) | Significant<br>Other<br>Observable<br>Inputs<br>(Level II) | Significant<br>Unobservable<br>Inputs<br>(Level III) |
|------------------------|--------------------|---------------|---|--|--|
|                        | Carrying<br>Amount | Fair<br>Value |   |  |  |

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Financial assets:

|                                    |          |          |          |        |         |
|------------------------------------|----------|----------|----------|--------|---------|
| Cash and cash equivalents          | \$ 6,120 | \$ 6,120 | \$ 6,120 | \$ -   | \$ -    |
| Time deposits with other banks     | 100      | 100      | -        | 100    | -       |
| Securities available for sale      | 93,776   | 93,776   | -        | 93,776 | -       |
| Securities held to maturity        | 6,834    | 7,008    | -        | 7,008  | -       |
| Federal Home Loan Bank stock       | 5,165    | 5,165    | -        | 5,165  | -       |
| Loans receivable, net of allowance | 537,833  | 528,065  | -        | -      | 528,065 |
| Accrued interest receivable        | 1,764    | 1,764    | -        | 1,764  | -       |

Financial liabilities:

|                                |         |         |        |         |   |
|--------------------------------|---------|---------|--------|---------|---|
| Non-maturity deposits          | 380,983 | 380,983 | -      | 380,983 | - |
| Time deposits                  | 136,873 | 136,619 | -      | 136,619 | - |
| Short-term borrowings          | 34,650  | 34,650  | 34,650 | -       | - |
| Long-term borrowings           | 61,000  | 58,685  | -      | 58,685  | - |
| Junior subordinated debentures | 12,887  | 9,344   | -      | 9,344   | - |
| Accrued interest payable       | 281     | 281     | -      | 281     | - |

## NOTE 11 – DERIVATIVES

The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges are recorded in accumulated other comprehensive income and are subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During the three months ended March 31, 2016 such derivatives were used to hedge the variable cash outflows associated with four FHLB borrowings totaling \$26.0 million. The Company entered into an interest rate swap agreement to hedge its \$12.5 million variable rate (3 Mo Libor +1.44%) junior subordinated debt issued by Sussex Capital Trust II, a non-consolidated wholly-owned subsidiary of the Company, for 10 years at a fixed rate of 3.10%. The ineffective portion of the change in fair value of the derivatives are recognized directly in earnings. The Company implemented this program during the quarter ended March 31, 2016. During the three months ended March 31, 2016 the Company's did not record any hedge ineffectiveness.

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Consolidated Statements of Financial Condition at March 31, 2016:

|   | March 31, 2016                  |               |                              |                    |
|---|---------------------------------|---------------|------------------------------|--------------------|
|   | Notional/<br>Contract<br>Amount | Fair<br>Value | Balance<br>Sheet<br>Location | Expiration<br>Date |
| (Dollars in thousands)                        |                                 |               |                              |                    |
| Derivatives designated as hedging instruments |                                 |               |                              |                    |
| Interest rate swaps by effective date:        |                                 |               |                              |                    |
| March 15, 2016                                | \$ 12,500                       | \$ (64)       | Other Liabilities            | March 15, 2026     |
| December 15, 2016                             | 5,000                           | (97)          | Other Liabilities            | December 15, 2026  |
| June 15, 2017                                 | 6,000                           | (114)         | Other Liabilities            | June 15, 2027      |
| December 15, 2017                             | 10,000                          | (71)          | Other Liabilities            | December 15, 2027  |
| December 15, 2017                             | 5,000                           | (54)          | Other Liabilities            | December 15, 2027  |
| Total   | \$ 38,500                       | \$ (400)      |                              |                    |



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The table below presents the Company's derivative financial instruments that are designated as cash flow hedgers of interest rate risk and their effect on the Company's Consolidated Statements of Financial Conditions during the three months ended March 31, 2016:

|  | Three Months Ended March 31, 2016  |   |  |
|--|--|---|--|
|  | Amount of Loss<br>Recognized in OCI<br>on<br>Derivatives, net of<br>Tax<br>(Effective Portion) | Location of Gain<br>(Loss) Recognized in<br>Income of<br>Derivatives<br>(Ineffective Portion) | Amount of Gain (Loss)<br>Recognized in Income of<br>Derivatives<br>(Ineffective Portion) |
| (Dollars in thousands)                 |  |   |  |
| Derivatives in cash flow hedges        |  |   |  |
| Interest rate swaps by effective date: |  |   |  |
| March 15, 2016                         | \$ (38)  | Not applicable  | \$ -   |
| December 15, 2016                      | (58)   | Not applicable  | -  |
| June 15, 2017                          | (68)   | Not applicable  | -  |
| December 15, 2017                      | (43)   | Not applicable  | -  |
| December 15, 2017                      | (32)   | Not applicable  | -  |
| Total                                  | \$ (240)   |   | \$ -   |

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

MANAGEMENT STRATEGY

We are a community-oriented financial institution serving northern New Jersey, northeastern Pennsylvania, New York City, New York and Orange County, New York. During the first quarter of 2016 our presence in northern New Jersey continued to grow to new markets in Bergen County, NJ, with the opening of a new branch in Oradell, NJ. On April 29, 2016 we closed a branch location in Port Jervis, NY in Orange County. While offering traditional community bank loan and deposit products and services, we obtain non-interest income through our insurance brokerage operations and the sale of non-deposit products.

We continue to focus on strengthening our core operating performance by improving our net interest income and margin by closely monitoring our yield on earning assets and adjusting the rates offered on deposit products. We have been focused on building for the future and strengthening our core operating results within our risk management framework.

CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are prepared in accordance with U.S. GAAP and practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in our consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Actual results could differ from those estimates.

Critical accounting estimates are necessary in the application of certain accounting policies and procedures, and are particularly susceptible to significant change. Critical accounting policies are defined as those that are reflective of



significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. There have been no material changes to our critical accounting policies during the three months ended March 31, 2016. For additional information on our critical accounting policies, please refer to Note 1 of the consolidated financial statements included in our 2015 Annual Report on Form 10-K.

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## COMPARISON OF OPERATING RESULTS FOR THREE MONTHS ENDED MARCH 31, 2016 AND 2015

Overview – For the quarter ended March 31, 2016, we reported net income of \$1.6 million as compared to net income of \$952 thousand for the same period last year. The improvement for the first quarter of 2016 as compared to the same period last year was driven by a 17.6% increase in net interest income as a result of strong growth in average loans and deposits, which increased \$89.0 million, or 18.9%, and \$86.2 million, or 18.5%, respectively, and a \$435 thousand, or 108.9%, increase in income before taxes from our insurance agency, Tri-State Insurance Agency. For the first quarter of the 2016, return on average assets and equity were 0.90% and 11.4%, respectively, as compared to the same period last year of 0.64% and 7.3%, respectively.

Comparative Average Balances and Average Interest Rates – The following table presents, on a fully tax equivalent basis, a summary of our interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for the three month periods ended March 31, 2016 and 2015:

| (Dollars in thousands)             | Three Months Ended March 31,<br>2016 |          |                     | 2015               |          |                     |
|------------------------------------|--------------------------------------|----------|---------------------|--------------------|----------|---------------------|
|                                    | Average<br>Balance                   | Interest | Average<br>Rate (2) | Average<br>Balance | Interest | Average<br>Rate (2) |
| <b>Earning Assets:</b>             |                                      |          |                     |                    |          |                     |
| <b>Securities:</b>                 |                                      |          |                     |                    |          |                     |
| Tax exempt (3)                     | \$ 30,236                            | \$ 300   | 3.99%               | \$ 31,339          | \$ 312   | 4.04%               |
| Taxable                            | 69,870                               | 376      | 2.16%               | 54,267             | 267      | 2.00%               |
| Total securities                   | 100,106                              | 676      | 2.72%               | 85,606             | 579      | 2.74%               |
| Total loans receivable (1) (4)     | 559,879                              | 6,145    | 4.41%               | 470,870            | 5,172    | 4.45%               |
| Other interest-earning assets      | 8,638                                | 4        | 0.19%               | 7,118              | 4        | 0.23%               |
| Total earning assets               | 668,623                              | \$ 6,825 | 4.11%               | \$ 563,594         | \$ 5,755 | 4.14%               |
| Non-interest earning assets        | 38,701                               |          |                     | 41,353             |          |                     |
| Allowance for loan losses          | (5,659)                              |          |                     | (5,742)            |          |                     |
| Total Assets                       | \$ 701,665                           |          |                     | 599,205            |          |                     |
| <b>Sources of Funds:</b>           |                                      |          |                     |                    |          |                     |
| <b>Interest bearing deposits:</b>  |                                      |          |                     |                    |          |                     |
| NOW                                | \$ 140,031                           | \$ 71    | 0.20%               | \$ 128,160         | \$ 50    | 0.16%               |
| Money market                       | 29,951                               | 28       | 0.38%               | 14,511             | 5        | 0.14%               |
| Savings                            | 138,528                              | 70       | 0.20%               | 140,497            | 71       | 0.20%               |
| Time                               | 146,344                              | 406      | 1.12%               | 112,067            | 290      | 1.05%               |
| Total interest bearing deposits    | 454,854                              | 575      | 0.51%               | 395,235            | 416      | 0.43%               |
| Borrowed funds                     | 75,965                               | 437      | 2.31%               | 63,715             | 380      | 2.42%               |
| Junior subordinated debentures     | 12,887                               | 68       | 2.12%               | 12,887             | 53       | 1.67%               |
| Total interest bearing liabilities | 543,706                              | \$ 1,080 | 0.80%               | \$ 471,837         | \$ 849   | 0.73%               |
| Non-interest bearing liabilities:  |                                      |          |                     |                    |          |                     |
| Demand deposits                    | 98,264                               |          |                     | 71,695             |          |                     |

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|  |            |            |
|--|------------|------------|
| Other liabilities                          | 4,381      | 3,595      |
| Total non-interest bearing liabilities     | 102,645    | 75,290     |
| Stockholders' equity                       | 55,314     | 52,078     |
| Total Liabilities and Stockholders' Equity | \$ 701,665 | \$ 599,205 |

|                                   |          |       |          |       |
|-----------------------------------|----------|-------|----------|-------|
| Net Interest Income and Margin(5) | 5,745    | 3.46% | 4,906    | 3.53% |
| Tax-equivalent basis adjustment   | (99)     |       | (104)    |       |
| Net Interest Income               | \$ 5,646 |       | \$ 4,802 |       |

(1) Includes loan fee income.

(2) Average rates on securities are calculated on amortized costs.

(3) Full tax equivalent basis, using a 39% effective tax rate and adjusted for TEFRA (Tax and Equity Fiscal Responsibility Act) interest expense disallowance.

(4) Loans outstanding include non-accrual loans.

(5) Represents the difference between interest earned and interest paid, divided by average total interest-earning assets.

Net Interest Income – Net interest income is the difference between interest and fees on loans and other interest-earning assets and interest paid on interest-bearing liabilities. Net interest income is directly affected by changes in volume and mix of interest-earning assets and interest-bearing liabilities that support those assets, as well as changing interest rates when differences exist in repricing dates of assets and liabilities.

Net interest income on a fully tax equivalent basis increased \$839 thousand, or 17.1%, to \$5.7 million for the first quarter of 2016, as compared to \$4.9 million for the same period in 2015. The increase in net interest income was largely due to a \$105.0 million, or 18.6%, increase in average interest earning assets, principally loans receivable, which increased \$89.0 million, or 18.9%. The improvement in net interest income was partly offset by a decline in the net interest margin of 7 basis points to 3.46% for the first quarter of 2016 as compared to the same period in 2015. The decline in the net interest margin was mostly attributed to an 8 basis point increase in the average rate on interest bearing deposits, which was primarily driven by market competition and the Company's strategy to use longer term wholesale deposit funding to manage interest rate risk. Included in the net interest margin decrease is a 4 basis point decline in the average rate earned on loans, which is mostly due to loan growth and loan repricing in a low rate environment.

Interest Income – Our total interest income, on a fully tax equivalent basis, increased \$1.1 million, or 18.6%, to \$6.8 million for the quarter ended March 31, 2016, as compared to the same period last year. The increase was due to higher average earning assets, which increased \$105.0 million for the quarter ended March 31, 2016, as compared to the same period in 2015.

Our total interest income earned on loans receivable increased \$973 thousand, or 18.8%, to \$6.1 million for the first quarter of 2016, as compared to the same period in 2015. The increase was driven by an increase in average balance of loans receivable of \$89.0 million, or 18.9%, for the three months ended March 31, 2016, as compared to the same period last year. The increase in interest income earned on loans receivable was partially offset by a 4 basis point decline in the average yield to 4.41% for the quarter ended March 31, 2016, as compared to the same period in 2015.

Our total interest income earned on securities, on a fully tax equivalent basis, increased \$97 thousand, to \$676 thousand for the quarter ended March 31, 2016 from \$579 thousand for the same period in 2015. This increase was largely due to an increase in the average balance of securities of \$14.5 million, or 16.9%, for the quarter ended March 31, 2016, as compared to the same period last year.

Other interest-earning assets include federal funds sold and interest bearing deposits in other banks. Our interest earned on total other interest-earning assets remained flat at \$4 thousand for the first quarter of 2016, as compared to the same period in 2015. The average balances in other interest-earning assets increased \$1.5 million to \$8.6 million in the first quarter of 2016 from \$7.1 million during the first quarter a year earlier. The increase in average balance was partially offset by a 4 basis point decline in the average yield to 0.19% as compared to 0.23% in the same period in 2015.

Interest Expense – Our interest expense for the three months ended March 31, 2016 increased \$231 thousand, or 27.2%, to \$1.1 million from \$849 thousand for the same period in 2015. The increase was principally due to higher average balances in interest-bearing liabilities, which increased \$71.9 million, or 15.2%, to \$543.7 million for the first quarter of 2016 from \$471.8 million for the same period in 2015.

Our interest expense on deposits increased \$159 thousand, or 38.2%, for the quarter ended March 31, 2016, as compared to the same period last year. The increase was largely attributed to the increase in the average balance of total interest bearing deposits, which increased \$59.6 million during the first quarter of 2016, as compared to the same period in 2015. The increase in interest expense was attributable to an eight basis point increase in the average rate on interest bearing deposits.

Our interest expense on borrowed funds increased \$72 thousand, or 16.6%, for the quarter ended March 31, 2016, as compared to the same period last year. The increase was largely attributed to the average balance of borrowed funds increasing \$12.3 million during the first quarter of 2016, as compared to the same period in 2015.

Provision for Loan Losses – Provision for loan losses decreased \$94 thousand, or 30.8%, to \$211 thousand for the first quarter of 2016, as compared to \$305 thousand for the same period in 2015. The decrease in the provision for loan losses for the quarter ended March 31, 2016 was largely attributed to the resolution of problem loans. The provision for loan losses reflects management’s judgment concerning the risks inherent in our existing loan portfolio and the size of the allowance necessary to absorb the risks, as well as the activity in the allowance during the periods. Management reviews the adequacy of its allowance on an ongoing basis and will provide additional provisions, as management may deem necessary.

Non-Interest Income – Our non-interest income increased \$623 thousand, or 32.8%, to \$2.5 million for the first quarter of 2016, as compared to the same period last year. The increase was primarily due to higher insurance commissions and fees, which increased \$566 thousand, or 49.0%, for the first quarter of 2016 as compared to the same period in 2015. The growth in Tri-State Insurance Agency’s commissions and fees was principally due to an increase in contingency fee income of \$405 thousand or 127.7% for the quarter ended March 31, 2016 as compared to the same period last year.

Non-Interest Expense – Our non-interest expenses increased \$540 thousand, or 10.7%, to \$5.6 million for the first quarter of 2016, as compared to the same period last year. The increase for the first quarter of 2016, as compared to the

same period in 2015, was largely due to increases in salaries and employee benefits of \$573 thousand and in data processing expenses of \$195 thousand, which were partially offset by decreases in director fees and expenses and write-downs related to foreclosed real estate of \$107 thousand and \$89 thousand, respectively. The increase in salaries and employee benefits expense was partially due to an increase in personnel to support our growth initiative in new markets, including the opening of our Oradell branch in the first quarter of 2016. The increase in data processing is related to the reinvestment of the Company's infrastructure due to continued growth. The decrease in director fees was principally related to a deferred compensation plan that is tied to the performance of the Company's stock. The decrease in expenses related to foreclosed real estate was attributable to the stabilization of the market value of other real estate owned.

**Income Taxes** – Our income tax expense, which includes both federal and state tax expenses, was \$775 thousand for the three months ended March 31, 2016, compared to \$376 thousand for the three months ended March 31, 2015. Our effective tax rate was 33.0% and 28.3% for the quarter ended March 31, 2016 and 2015, respectively. The increased effective tax rate was the result of a smaller percentage of our pre-tax income resulting from tax exempt sources.

COMPARISION OF FINANCIAL CONDITION AT MARCH 31, 2016 TO DECEMBER 31, 2015

Total Assets – At March 31, 2016, our total assets were \$716.8 million, an increase of \$32.3 million, or 4.7%, as compared to total assets of \$684.5 million at December 31, 2015. The increase in total assets was largely driven by growth in loans receivable of \$36.6 million, or 6.7%, which was partially offset by a decline in the securities portfolio of \$7.3 million, or 7.2%.

Cash and Cash Equivalents – Our cash and cash equivalents increased by \$2.9 million to \$9.0 million at March 31, 2016, or 1.3% of total assets, from \$6.1 million, or 0.9%, of total assets, at December 31, 2015.

Securities Portfolio – At March 31, 2016, the securities portfolio, which includes available for sale and held to maturity securities, was \$93.3 million, compared to \$100.6 million at December 31, 2015. Available for sale securities were \$86.5 million at March 31, 2016, compared to \$93.8 million at December 31, 2015. The available for sale securities are held primarily for liquidity, interest rate risk management and profitability. Accordingly, our investment policy is to invest in securities with low credit risk, such as U.S. government agency obligations, state and political obligations and mortgage-backed securities. Held to maturity securities were \$6.8 million at March 31, 2016 and December 31, 2015.

Net unrealized gains in the available for sale securities portfolio were \$961 thousand at March 31, 2016. Net unrealized gains in the available for sale securities portfolio were \$144 thousand at December 31, 2015.

We conduct a regular assessment of our investment securities to determine whether any securities are OTTI. Further detail of the composition of the securities portfolio and discussion of the results of the most recent OTTI assessment are in Note 2 – Securities to our unaudited consolidated financial statements.

The unrealized losses in our securities portfolio are mostly driven by changes in spreads and market interest rates. All of our securities in an unrealized loss position have been evaluated for other-than-temporary impairment as of March 31, 2016 and we do not consider any security OTTI. We evaluated the prospects of the issuers in relation to the severity and the duration of the unrealized losses. In addition, we do not intend to sell, and it is more likely than not that we will not have to sell any of our securities before recovery of their cost basis.

Other investments totaled \$3.8 million at March 31, 2016, as compared to \$5.2 million at December 31, 2015, which consisted primarily of FHLB stock. We also held \$100 thousand in time deposits with other financial institutions at March 31, 2016 and December 31, 2015.

Loans – The loan portfolio comprises our largest class of earning assets. Total loans receivable, net of unearned income, increased \$36.6 million, or 6.7%, to \$580.1 million at March 31, 2016, as compared to \$543.4 million at December 31, 2015. During the three months ended March 31, 2016, the Company had \$50.6 million in commercial loan production, which was partly offset by \$2.4 million in commercial loan payoffs.

The following table summarizes the composition of our gross loan portfolio by type:

| (Dollars in thousands)          | March 31,<br>2016 | December<br>31, 2015 |
|---------------------------------|-------------------|----------------------|
| Commercial and industrial loans | \$ 24,278         | \$ 20,023            |
| Construction                    | 15,827            | 13,348               |
| Commercial real estate          | 409,358           | 382,262              |
| Residential real estate         | 130,189           | 127,204              |
| Consumer and other              | 1,172             | 1,253                |
| Total gross loans               | \$ 580,824        | \$ 544,090           |

Loan and Asset Quality – The ratio of NPAs, which include non-accrual loans, loans 90 days past due and still accruing, troubled debt restructured loans currently performing in accordance with renegotiated terms and foreclosed real estate, to total assets improved to 1.39% at March 31, 2016 from 1.49% at December 31, 2015. NPAs decreased \$270 thousand, or 2.6%, to \$9.9 million at March 31, 2016, as compared to \$10.2 million at December 31, 2015. Non-accrual loans increased \$41 thousand, or 0.8%, to \$5.4 million at March 31, 2016, as compared to \$5.3 million at December 31, 2015. The top five non-accrual loan relationships total \$3.4 million, which equates to 63.1% of total nonaccrual loans and 33.9% of total NPAs at March 31, 2016. The remaining non-accrual loans at March 31, 2016 have an average loan balance of \$94 thousand. Loans past due 30 to 89 days increased \$2.0 million, or 71.5%, to approximately \$4.8 million at March 31, 2016, as compared to \$2.8 million at December 31, 2015. The increase was largely due to four loans. Loans that make up approximately half of the balance increase have made payments to bring their status current in April.

We continue to actively market our foreclosed real estate properties, which decreased \$26 thousand to \$3.3 million at March 31, 2016, as compared to \$3.4 million at December 31, 2015. The decrease was primarily due to the sale of \$26



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thousand in foreclosed real estate properties. At March 31, 2016, the Company's foreclosed real estate properties had an average carrying value of approximately \$303 thousand per property.

The allowance for loan losses increased by \$222 thousand, or 4.0%, to \$5.8 million, or 1.00% of total loans, at March 31, 2016, compared to \$5.6 million, or 1.03% of total loans, at December 31, 2015. The Company recorded \$211 thousand in provision for loan losses for the quarter ended March 31, 2016. Additionally, the Company recorded net recoveries of \$11 thousand for the quarter ended March 31, 2016, as compared to \$183 thousand in net charge-offs for the quarter ended March 31, 2015. The allowance for loan losses as a percentage of non-accrual loans increased to 108.6% at March 31, 2016 from 105.2% at December 31, 2015.

Management continues to monitor our asset quality and believes that the NPAs are adequately collateralized and anticipated material losses have been adequately reserved for in the allowance for loan losses. However, given the uncertainty of the current real estate market, additional provisions for losses may be deemed necessary in future periods. The following table provides information regarding risk elements in the loan portfolio at each of the periods presented:

| (Dollars in thousands)                                | March 31,<br>2016 | December<br>31, 2015 |
|---|-------------------|----------------------|
| Non-accrual loans                                     | \$ 5,353          | \$ 5,312             |
| Non-accrual loans to total loans                      | 0.92%             | 0.98%                |
| Non-performing assets                                 | \$ 9,949          | \$ 10,219            |
| Non-performing assets to total assets                 | 1.39%             | 1.49%                |
| Allowance for loan losses as a % of non-accrual loans | 108.57%           | 105.23%              |
| Allowance for loan losses to total loans              | 1.00%             | 1.03%                |

A loan is considered impaired, in accordance with the impairment accounting guidance, when based on current information and events, it is probable that we will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Total impaired loans at March 31, 2016 were \$6.6 million and at December 31, 2015 were \$6.9 million. Impaired loans measured at fair value on a non-recurring basis increased to \$1.1 million on March 31, 2016 from \$801 thousand at December 31, 2015. These balances consist of loans that were written down or required additional reserves during the periods ended March 31, 2016 and December 31, 2015, respectively. Impaired loans include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection. Not all impaired loans and restructured loans are on non-accrual, and therefore not all are considered non-performing loans. Restructured loans still accruing totaled \$1.3 million and \$1.6 million at March 31, 2016 and December 31, 2015, respectively.

We also continue to monitor our portfolio for potential problem loans. Potential problem loans are defined as loans which cause management to have serious concerns as to the ability of such borrowers to comply with the present loan repayment terms and which may cause the loan to be placed on non-accrual status. As of March 31, 2016, we had

six loan relationships totaling \$1.4 million that we deemed potential problem loans. Management is actively monitoring these loans.

Further detail of the credit quality of the loan portfolio is included in Note 4 – Allowance for Loan Losses and Credit Quality of Financing Receivables to our unaudited consolidated financial statements.

Allowance for Loan Losses – The allowance for loan losses consists of general, allocated and unallocated components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical charge-off experience and expected losses derived from our internal risk rating process. The unallocated component covers the potential for other adjustments that may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

Management regularly assesses the appropriateness and adequacy of the loan loss reserve in relation to credit exposure associated with individual borrowers, overall trends in the loan portfolio and other relevant factors, and believes the reserve is reasonable and adequate for each of the periods presented.

At March 31, 2016, the total allowance for loan losses increased by \$222 thousand, or 4.0%, to \$5.8 million, or 1.00% of total loans as compared to \$5.6 million, or 1.03% of total loans, at December 31, 2015. The Company recorded \$211 thousand in provision for loan losses for the quarter ended March 31, 2016. Additionally, the Company recorded net recoveries of \$11 thousand for the quarter ended March 31, 2016, as compared to \$183 thousand in net charge-offs for

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the quarter ended March 31, 2015. The allowance for loan losses as a percentage of non-accrual loans increased to 108.6% at March 31, 2016 from 105.3% at December 31, 2015. The provision also reflects the continued weakness in current real estate values in our market area and reduced cash flows to support the repayment of loans.

The table below presents information regarding our provision and allowance for loan losses for the three months ended March 31, 2016 and 2015:

| (Dollars in thousands)       | March<br>31, 2016 | March<br>31, 2015 |
|------------------------------|-------------------|-------------------|
| Balance, beginning of period | \$ 5,590          | \$ 5,641          |
| Provision                    | 211               | 305               |
| Charge-offs                  | (28)              | (214)             |
| Recoveries                   | 39                | 31                |
| Balance, end of period       | \$ 5,812          | \$ 5,763          |

The table below presents details concerning the allocation of the allowance for loan losses to the various categories for each of the periods presented. The allocation is made for analytical purposes and it is not necessarily indicative of the categories in which future credit losses may occur. The total allowance is available to absorb losses from any category of loans.

| (Dollars in thousands)    | March 31, 2016 |  | December 31, 2015 |  |
|---------------------------|----------------|--|-------------------|--|
|                           | Amount         | Percentage of<br>Loans In Each<br>Category To<br>Gross Loans | Amount            | Percentage of<br>Loans In Each<br>Category To<br>Gross Loans |
| Commercial and industrial | \$ 98          | 4.2%   | \$ 85             | 3.7%   |
| Construction              | 267            | 2.7%   | 220               | 2.5%   |
| Commercial real estate    | 3,847          | 70.5%  | 3,646             | 70.2%  |
| Residential real estate   | 908            | 22.4%  | 784               | 23.4%  |
| Consumer and other loans  | 121            | 0.2%   | 87                | 0.2%   |
| Unallocated               | 571            | 0.0%   | 768               | -  |
| Total                     | \$ 5,812       | 100.0%   | \$ 5,590          | 100.0%   |

Bank-Owned Life Insurance (“BOLI”) – Our BOLI carrying value amounted to \$12.6 million at March 31, 2016 and \$12.5 million at December 31, 2015.

Goodwill and Other Intangibles – Goodwill represents the excess of the purchase price over the fair market value of net assets acquired. At March 31, 2016 and December 31, 2015, we had recorded goodwill totaling \$2.8 million, primarily as a result of the acquisition of Tri-State in 2001. Our recorded goodwill total also includes \$486 thousand related to the 2006 acquisition of \$6.3 million in deposits in our Port Jervis branch. As of March 31, 2016 deposits in that branch were \$19 million. During the quarter ended March 31, 2016 we announced the closing of this branch, as a result we will monitor the outflow of these deposits and evaluate the related goodwill for impairment. In accordance with U.S. GAAP, goodwill is not amortized, but evaluated at least annually for impairment. Any impairment of goodwill results in a charge to income. We periodically assess whether events and changes in circumstances indicate that the carrying amounts of goodwill and intangible assets may be impaired. The estimated fair value of the reporting segment exceeded its book value; therefore, no write-down of goodwill was required. The goodwill related to the insurance agency is not deductible for tax purposes.

Deposits – Our total deposits increased \$57.4 million, or 11.1%, to \$575.3 million at March 31, 2016, from \$517.9 million at December 31, 2015. The increase in deposits was due to increases in both interest bearing deposits of \$35.5 million, or 8.2%, and non-interest bearing deposits of \$21.9 million, or 25.2%, at March 31, 2016, as compared to December 31, 2015. Included in total deposits at March 31, 2016, were \$35.9 million in deposit balances with an average cost of 0.56% attributed to our newest branch in Oradell, New Jersey, which opened in the beginning of March 2016, and \$51.8 million in deposit balances with an average cost of 0.47% attributed to our branch in Astoria, New York, which opened in Mid-March of 2015.

Borrowings – Borrowings consist of short-term and long-term advances from the FHLB. The advances are secured under terms of a blanket collateral agreement by a pledge of qualifying mortgage loans. We had \$67.4 million and \$95.7 million in borrowings, at a weighted average interest rate of 2.57% at March 31, 2016 and 2.61% at December 31, 2015. The long-term borrowings at March 31, 2016 consisted of \$50.0 million of fixed rate advances, \$5.0 million of advances with quarterly convertible puts that allow us to put the advance back to the FHLB quarterly after one year

from issuance and \$11.0 million of advances with quarterly convertible options that allow the FHLB to change the note rate to a then current market rate. During the quarter ended March 31, 2016, the Company entered into forward starting interest rate swap agreements related to four of its FHLB borrowings. Please refer to Liquidity and Capital Resources section Off-Balance Sheet Arrangements.

Junior Subordinated Debentures – On June 28, 2007, Sussex Capital Trust II (the “Trust”), a Delaware statutory business trust and our non-consolidated wholly owned subsidiary, issued \$12.5 million of variable rate capital trust pass-through securities to investors. The Trust purchased \$12.9 million of variable rate junior subordinated deferrable interest debentures from us. The debentures are the sole asset of the Trust. The terms of the junior subordinated debentures are the same as the terms of the capital securities. We have also fully and unconditionally guaranteed the obligations of the Trust under the capital securities. The interest rate is based on the three-month LIBOR plus 144 basis points and adjusts quarterly. The rate at March 31, 2016, was 2.07%. The capital securities are currently redeemable by us at par in whole or in part. The capital securities must be redeemed upon final maturity of the subordinated debentures on September 15, 2037. The proceeds of these trust preferred securities, which have been contributed to the Bank, are included in the Bank’s capital ratio calculations and treated as Tier I capital.

During the quarter ended March 31, 2016, the Company entered into an interest rate swap agreement related to the junior subordinated debentures. Please refer to Liquidity and Capital Resources section Off-Balance Sheet Arrangements.

In accordance with FASB ASC 810, Consolidations, our wholly owned subsidiary, the Trust, is not included in our consolidated financial statements.

Equity – Stockholders’ equity, inclusive of accumulated other comprehensive income, net of income taxes, was \$55.7 million at March 31, 2016, an increase of \$1.7 million when compared to December 31, 2015. The increase was largely due to net income for the quarter ended March 31, 2016.

## LIQUIDITY AND CAPITAL RESOURCES

A fundamental component of our business strategy is to manage liquidity to ensure the availability of sufficient resources to meet all financial obligations and to finance prospective business opportunities. Liquidity management is critical to our stability. Our liquidity position over any given period of time is a product of our operating, financing and investing activities. The extent of such activities is often shaped by such external factors as competition for deposits and loan demand.

Traditionally, financing for our loans and investments is derived primarily from deposits, along with interest and principal payments on loans and investments. At March 31, 2016, total deposits amounted to \$575.3 million, an

increase of \$57.4 million, or 11.1%, from December 31, 2015. At March 31, 2016 and December 31, 2015, advances from FHLB and subordinated debentures totaled \$80.3 million and \$108.5 million, respectively, and represented 11.2% and 15.9% of total assets, respectively.

Loan production continued to be our principal investing activity. Total loans receivable, net of unearned income, at March 31, 2016, amounted to \$580.1 million, an increase of \$36.6 million, or 6.7%, compared to December 31, 2015.

Our most liquid assets are cash and due from banks and federal funds sold. At March 31, 2016, the total of such assets amounted to \$9.0 million, or 1.3%, of total assets, compared to \$6.1 million, or 0.9%, of total assets at December 31, 2015. Another significant liquidity source is our available for sale securities portfolio. At March 31, 2016, available for sale securities amounted to \$86.5 million, compared to \$93.8 million at December 31, 2015.

In addition to the aforementioned sources of liquidity, we have available various other sources of liquidity, including federal funds purchased from other banks and the FRB discount window. The Bank also has the capacity to borrow an additional \$49.5 million through its membership in the FHLB and \$10.0 million at Atlantic Community Bankers Bank at March 31, 2016. Management believes that our sources of funds are sufficient to meet our present funding requirements.

In July 2013, the FRB, the Office of the Comptroller of the Currency (the "OCC") and the FDIC approved final rules (the "Capital Rules") that established a new capital framework for U.S. banking organizations. The Capital Rules generally implement the Basel Committee on Banking Supervision's (the "Basel Committee") December 2010 final capital framework referred to as "Basel III" for strengthening international capital standards. In addition, the Capital Rules implement certain provisions of the Dodd-Frank Act, including the requirements of Section 939A to remove references to credit ratings from the federal banking agencies' rules.

At March 31, 2016, the Bank's Tier I, Tier II and Common Equity Tier I capital ratios were 11.29%, 12.31% and 11.29%, respectively. In addition to the risk-based guidelines, the Bank's regulators require that banks which meet the regulators' highest performance and operational standards maintain a minimum leverage ratio (Tier I capital as a percentage of tangible assets) of 4.0%. As of March 31, 2016, the Bank had a leverage ratio of 9.18%. The Bank's risk based and leverage ratios are in excess of those required to be considered "well-capitalized" under FDIC regulations.

The Capital Rules also requires a "capital conservation buffer," composed entirely of CET1, on top of these minimum risk-weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity and other capital instrument repurchases and compensation based on the amount of the shortfall. Beginning January 1, 2016, the capital standards applicable to the Company will include an additional capital conservation buffer of 0.625%, increasing 0.625% each year thereafter. When fully phased-in on January 1, 2019, the Company will include an additional capital conservation buffer of 2.5% of CET1, effectively resulting in minimum ratios inclusive of the capital conservation buffer of (i) CET1 to risk-weighted assets of at least 7%, (ii) Tier 1 capital to risk-weighted assets of at least 8.5%, and (iii) Total capital to risk-weighted assets of at least 10.5%. As of March 31, 2016, the Bank had a capital conservation buffer of 4.32%.

The Capital Rules substantially revised the risk-based capital requirements applicable to bank holding companies and their depository institution subsidiaries. The risk-based capital guidelines are designed to make regulatory capital requirements sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance sheet exposures and to minimize disincentives for holding liquid, low-risk assets. The capital guidelines apply on a consolidated basis to bank holding companies with consolidated assets of \$1 billion or more, and to certain bank holding companies with less than \$1 billion in assets if they are engaged in substantial non-banking activity or meet certain other criteria. Under FRB reporting requirements, a bank holding company that reaches \$1 billion or more in total consolidated assets as of June 30 of the preceding year must begin reporting its consolidated capital beginning in March of the following year. The threshold for capital consolidation was raised from \$500 million to \$1 billion effective May 15, 2015. As a result, the Company is no longer required to report its consolidated capital. The Bank, however, must continue to meet minimum capital requirements under the Capital Rules.

We have no investment or financial relationship with any unconsolidated entities that are reasonably likely to have a material effect on liquidity or the availability of capital resources, except for the trust preferred securities of the Trust. We are not aware of any known trends or any known demands, commitments, events or uncertainties, which would result in any material increase or decrease in liquidity. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

Off-Balance Sheet Arrangements – Our consolidated financial statements do not reflect off-balance sheet arrangements that are made in the normal course of business. These off-balance sheet arrangements consist of unfunded loans and letters of credit made under the same standards as on-balance sheet instruments. These unused commitments, at March 31, 2016, totaled \$113.6 million and consisted of \$53.4 million in commitments to grant commercial real estate, construction and land development loans, \$22.6 million in home equity lines of credit, \$36.9 million in other unused commitments and \$729 thousand in letters of credit. These instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk to us. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

During the first quarter of 2016, the Company entered into interest rate swap agreements with notional amounts totaling \$38.5 million, of which all are designated as cash flow hedges. The Company entered into \$26.0 million in forward starting interest rate swap agreements to coincide with the maturity of five FHLB Advances over the next 21 months that have an average rate of 4.03%. The forward interest rate swaps have a term of 10 years at an average fixed rate of 1.97% and will hedge short term wholesale funding. Additionally, the Company entered into a \$12.5 million interest rate swap agreement to coincide with a junior subordinated debt issued by Sussex Capital Trust II, for a term of 10 years at a fixed rate of 3.10%.

### Item 3 - Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

### Item 4 - Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

Management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were



effective to ensure that information required to be disclosed in the reports we file and submit under the Exchange Act is (i) recorded, processed, summarized and reported as and when required and (ii) accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely discussion regarding required disclosure.

#### Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting identified in connection with the evaluation that occurred during our last fiscal quarter that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

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## PART II – OTHER INFORMATION

## Item 1 - Legal Proceedings

We are not involved in any legal proceedings other than routine legal proceedings occurring in the ordinary course of business. Management believes that such proceedings are, in the aggregate, immaterial to our financial condition and results of operations.

## Item 1A - Risk Factors

For a summary of risk factors relevant to our operations, see Part 1, Item 1A, “Risk Factors” in our 2015 Annual Report on Form 10-K. There are no material changes in the risk factors relevant to our operations.

## Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information with respect to any purchase of shares of our common stock made by or on behalf of us or any “affiliated purchaser,” as defined in Rule 10b-18(a)(3) under the Exchange Act, during the three months ended March 31, 2016:

| Period                                     | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Maximum Number of Shares that May Yet Be Purchased Under the Program(1) |
|--|----------------------------------|------------------------------|--|---|
| January 1, 2016 through January 31, 2016   | -                                | \$ -                         | -  | 185,073   |
| February 1, 2016 through February 29, 2016 | -                                | -                            | -  | 185,073   |
| March 1, 2016 through March 31, 2016       | -                                | -                            | -  | 185,073   |
| Total                                      | -                                | \$ -                         | -  |   |

(1) On February 26, 2016, the Board of Directors authorized a continuation of the stock repurchase program, under which we may repurchase up to 184,000 shares. The stock repurchase program expires on February 25, 2017, unless completed sooner or otherwise extended.

There were no sales by us of unregistered securities during the three months ended March 31, 2016.

Item 3 - Defaults Upon Senior Securities

Not applicable.

Item 4 - Mine Safety Disclosures

Not applicable.

Item 5 - Other Information

Not applicable.

Item 6 - Exhibits

The exhibits required to be filed as part of this Quarterly Report on Form 10-Q are listed in the Exhibit Index attached hereto and are incorporated herein by reference.

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, as amended, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 13, 2016      SUSSEX BANCORP

By: /s/ Steven M. Fusco  
Steven M. Fusco  
Chief Financial Officer and Senior Executive Vice President  
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

Exhibit

Number Description

|       |   |
|-------|---|
| *     |   |
| 3.1   | Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to the Quarterly Report on 10-Q filed with the SEC on August 15, 2011).   |
| 3.2   | Amended and Restated By-laws (incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed with the SEC on June 3, 2014).   |
| 4.1   | Specimen common stock certificate (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the Registration Statement on Form S-1 filed with the SEC on June 3, 2013).   |
| 31.1  | Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer.  |
| 31.2  | Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer.  |
| 32.1* | Section 1350 Certifications of the Chief Executive Officer and Chief Financial Officer.   |
| 101   | Financial statements from the Quarterly Report on Form 10-Q of Sussex Bancorp for the quarter ended March 31, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income and Comprehensive Income; (iii) the Consolidated Statements of Stockholders' Equity; (iv) the Consolidated Statements of Cash Flows and (v) Notes to Unaudited Consolidated Financial Statements. |

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\* Furnished herewith and not deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act.