

SUSSEX BANCORP  
Form 10-Q  
November 14, 2011

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 September 30, 2011

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  
(State or other jurisdiction of  
incorporation or organization)

22-3475473

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

200 Munsonhurst Rd., Franklin, NJ  
(Address of principal executive offices)

07416  
(Zip Code)

(973) 827-2914

(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 and 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 SD-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

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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 November 1, 2011 there were 3,372,688 shares of common stock, no par value, outstanding.

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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 to interest rates, the ability to control costs and expenses;

§ our ability to integrate new technology into our operations;

§ general economic conditions;

§ the success of our efforts to diversify its revenue base by developing additional sources of non-interest income while continuing to manage its existing fee based business;

§ the impact on us of the changing statutory and regulatory requirements; and

§ the risks inherent in commencing operations in new markets.

Any or all of our forward-looking statements in this Report on Form 10-Q, and in any other public statements we make may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Consequently, no forward-looking statements can be guaranteed. We disclaim any obligation to subsequently revise any forward-looking statements to reflect events or circumstances after the date of such statements, or to reflect the occurrence of anticipated or unanticipated events.

## PART I – FINANCIAL INFORMATION

## Item 1 - Financial Statements

SUSSEX BANCORP  
CONSOLIDATED BALANCE SHEETS  
(Unaudited)

| (Dollars in thousands)  | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Cash and due from banks   | \$5,280               | \$4,672              |
| Interest-bearing deposits with other banks  | 43,117                | 10,077               |
| Federal funds sold  | -                     | 3,000                |
| Cash and cash equivalents   | 48,397                | 17,749               |
| Interest bearing time deposits with other banks   | 100                   | 600                  |
| Securities available-for-sale, at estimated fair value  | 78,613                | 89,380               |
| Securities held-to-maturity, at cost (estimated fair value of \$3,424 at September 30, 2011 and \$1,007 at December 31, 2010) | 3,287                 | 1,000                |
| Federal Home Loan Bank Stock, at cost   | 1,837                 | 2,235                |
| Loans receivable, net of unearned income  | 337,794               | 338,234              |
| Less: allowance for loan losses   | 7,401                 | 6,397                |
| Net loans receivable  | 330,393               | 331,837              |
| Foreclosed real estate  | 4,545                 | 2,397                |
| Premises and equipment, net   | 6,422                 | 6,749                |
| Accrued interest receivable   | 1,602                 | 1,916                |
| Goodwill  | 2,820                 | 2,820                |
| Bank-owned life insurance   | 11,037                | 10,173               |
| Other assets  | 6,831                 | 7,168                |
| <b>Total Assets</b>   | <b>\$495,884</b>      | <b>\$474,024</b>     |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                       |                      |
| <b>Liabilities:</b>   |                       |                      |
| Deposits:   |                       |                      |
| Non-interest bearing  | \$39,613              | \$35,362             |
| Interest bearing  | 375,437               | 350,605              |
| Total deposits  | 415,050               | 385,967              |
| Short term borrowings   | -                     | 10,000               |
| Long term borrowings  | 26,000                | 26,000               |
| Accrued interest payable and other liabilities  | 2,559                 | 2,504                |
| Junior subordinated debentures  | 12,887                | 12,887               |
| <b>Total Liabilities</b>  | <b>456,496</b>        | <b>437,358</b>       |

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Stockholders' Equity:

|   |                  |                  |
|---|------------------|------------------|
| Preferred stock, no par value, 1,000,000 shares authorized; none issued   | -                | -                |
| Common stock, no par value, 10,000,000 shares authorized;<br>issued shares 3,373,468 in 2011 and 3,352,346 in 2010;<br>outstanding shares 3,372,688 in 2011 and 3,351,566 in 2010 | 27,943           | 27,870           |
| Treasury stock, at cost; 780 shares in 2011 and 780 shares in 2010  | (4)              | (4)              |
| Retained earnings   | 10,708           | 8,753            |
| Accumulated other comprehensive income  | 741              | 47               |
| <b>Total Stockholders' Equity</b>   | <b>39,388</b>    | <b>36,666</b>    |
| <b>Total Liabilities and Stockholders' Equity</b>   | <b>\$495,884</b> | <b>\$474,024</b> |

See Notes to Unaudited Consolidated Financial Statements

## SUSSEX BANCORP

CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

| (Dollars In Thousands Except Per Share Data)          | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|---------|------------------------------------|----------|
|   | 2011                                | 2010    | 2011                               | 2010     |
| <b>INTEREST INCOME</b>                                |                                     |         |                                    |          |
| Loans receivable, including fees                      | \$4,687                             | \$4,765 | \$14,210                           | \$14,194 |
| Securities:   |                                     |         |                                    |          |
| Taxable   | 313                                 | 412     | 989                                | 1,378    |
| Tax-exempt  | 296                                 | 292     | 879                                | 820      |
| Federal funds sold                                    | -                                   | 3       | 3                                  | 20       |
| Interest bearing deposits                             | 20                                  | 20      | 32                                 | 30       |
| Total Interest Income                                 | 5,316                               | 5,492   | 16,113                             | 16,442   |
| <b>INTEREST EXPENSE</b>                               |                                     |         |                                    |          |
| Deposits  | 806                                 | 943     | 2,342                              | 3,158    |
| Borrowings  | 268                                 | 358     | 797                                | 1,065    |
| Junior subordinated debentures                        | 55                                  | 62      | 164                                | 170      |
| Total Interest Expense                                | 1,129                               | 1,363   | 3,303                              | 4,393    |
| Net Interest Income                                   | 4,187                               | 4,129   | 12,810                             | 12,049   |
| PROVISION FOR LOAN LOSSES                             | 737                                 | 662     | 2,688                              | 2,364    |
| Net Interest Income after Provision for Loan Losses   | 3,450                               | 3,467   | 10,122                             | 9,685    |
| <b>OTHER INCOME</b>                                   |                                     |         |                                    |          |
| Service fees on deposit accounts                      | 324                                 | 375     | 968                                | 1,049    |
| ATM and debit card fees                               | 140                                 | 128     | 400                                | 370      |
| Bank-owned life insurance                             | 105                                 | 100     | 314                                | 209      |
| Insurance commissions and fees                        | 545                                 | 485     | 1,724                              | 1,622    |
| Investment brokerage fees                             | 33                                  | 24      | 103                                | 133      |
| Realized holding gains on trading securities          | -                                   | -       | -                                  | 7        |
| Gain (loss) on sale of securities, available-for-sale | (1                                  | )       | (2                                 | )        |
|   | 268                                 |         | 52                                 |          |
| Gain on sale of premises and equipment                | -                                   | 2       | -                                  | 2        |
| Gain (loss) on sale of foreclosed real estate         | 2                                   | 12      | (2                                 | )        |
|   |                                     |         | 17                                 |          |
| Impairment write-downs on equity securities           | -                                   | -       | -                                  | (171     |
|   |                                     |         |                                    | )        |
| Other   | 58                                  | 52      | 177                                | 200      |
| Total Other Income                                    | 1,206                               | 1,176   | 3,952                              | 3,490    |
| <b>OTHER EXPENSES</b>                                 |                                     |         |                                    |          |
| Salaries and employee benefits                        | 2,219                               | 1,885   | 6,212                              | 5,865    |
| Occupancy, net  | 338                                 | 336     | 1,055                              | 1,011    |
| Furniture, equipment and data processing              | 283                                 | 325     | 871                                | 919      |
| Advertising and promotion                             | 52                                  | 36      | 141                                | 138      |
| Professional fees                                     | 163                                 | 130     | 439                                | 398      |

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|                                       |        |        |         |         |
|---------------------------------------|--------|--------|---------|---------|
| Director fees                         | 5      | 65     | 144     | 183     |
| FDIC assessment                       | 153    | 232    | 535     | 681     |
| Insurance                             | 53     | 56     | 163     | 167     |
| Stationary and supplies               | 39     | 53     | 122     | 147     |
| Loan collection costs                 | 314    | 144    | 606     | 307     |
| Write-down on foreclosed assets       | -      | 182    | 145     | 209     |
| Expenses related to foreclosed assets | 74     | 82     | 177     | 222     |
| Amortization of intangible assets     | 3      | 3      | 8       | 11      |
| Other                                 | 329    | 315    | 966     | 950     |
| Total Other Expenses                  | 4,025  | 3,844  | 11,584  | 11,208  |
| Income before Income Taxes            | 631    | 799    | 2,490   | 1,967   |
| <b>PROVISION FOR INCOME TAXES</b>     | 97     | 168    | 535     | 388     |
| Net Income                            | \$534  | \$631  | \$1,955 | \$1,579 |
| <b>EARNINGS PER SHARE</b>             |        |        |         |         |
| Basic                                 | \$0.16 | \$0.19 | \$0.60  | \$0.49  |
| Diluted                               | \$0.16 | \$0.19 | \$0.59  | \$0.48  |

See Notes to Unaudited Consolidated Financial Statements



SUSSEX BANCORP  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
Nine Months Ended September 30, 2011 and 2010  
(Unaudited)

| (Dollars in thousand)  | Number of<br>Shares<br>Outstanding | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Treasury<br>Stock | Total<br>Stockholders'<br>Equity |
|--|------------------------------------|-----------------|----------------------|---|-------------------|----------------------------------|
| Balance December 31, 2009  | 3,259,786                          | \$ 27,805       | \$ 6,577             | \$ 145  | \$ -              | \$ 34,527                        |
| Comprehensive income:  |                                    |                 |                      |   |                   |                                  |
| Net income   | -                                  | -               | 1,579                | -   | -                 | 1,579                            |
| Change in unrealized gains on securities available-for-sale, net of tax  | -                                  | -               | -                    | 806   | -                 | 806                              |
| Total Comprehensive Income   |                                    |                 |                      |   |                   | 2,385                            |
| Restricted stock granted   | 95,303                             | -               | -                    | -   | -                 | -                                |
| Restricted stock forfeited   | (2,743 )                           | -               | -                    | -   | -                 | -                                |
| Compensation expense related to stock option and restricted stock grants | -                                  | 47              | -                    | -   | -                 | 47                               |
| Balance September 30, 2010   | 3,352,346                          | \$ 27,852       | \$ 8,156             | \$ 951  | \$ -              | \$ 36,959                        |
| Balance December 31, 2010  | 3,351,566                          | \$ 27,870       | \$ 8,753             | \$ 47   | \$ (4 )           | \$ 36,666                        |
| Comprehensive income:  |                                    |                 |                      |   |                   |                                  |
| Net income   | -                                  | -               | 1,955                | -   | -                 | 1,955                            |
| Change in unrealized gains on securities available-for-sale, net of tax  | -                                  | -               | -                    | 694   | -                 | 694                              |
| Total Comprehensive Income   |                                    |                 |                      |   |                   | 2,649                            |
| Restricted stock granted   | 22,805                             | -               | -                    | -   | -                 | -                                |
| Restricted stock forfeited   | (1,683 )                           | -               | -                    | -   | -                 | -                                |
| Compensation expense related to stock option and restricted stock grants | -                                  | 73              | -                    | -   | -                 | 73                               |
| Balance September 30, 2011   | 3,372,688                          | \$ 27,943       | \$ 10,708            | \$ 741  | \$ (4 )           | \$ 39,388                        |

See Notes to Unaudited Consolidated Financial Statements

SUSSEX BANCORP  
CONSOLIDATED STATEMENTS OF CASH FLOWS

| (Dollars in thousands)  | Nine Months Ended<br>September 30, |                  |
|---|------------------------------------|------------------|
|   | 2011                               | 2010             |
| <b>Cash Flows from Operating Activities</b>                                       |                                    |                  |
| Net income  | \$1,955                            | \$1,579          |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |                  |
| Provision for loan losses   | 2,688                              | 2,364            |
| Provision for depreciation and amortization                                       | 458                                | 510              |
| Net change in trading securities  | -                                  | 714              |
| Net amortization of securities premiums and discounts                             | 646                                | 203              |
| Net realized gain on sale of securities   | (268 )                             | (52 )            |
| Impairment charge on equity securities  | -                                  | 171              |
| Net realized gain on the sale of premises and equipment                           | -                                  | (2 )             |
| Net realized loss (gain) on sale of foreclosed real estate                        | 2                                  | (17 )            |
| Provision for foreclosed assets   | 145                                | 209              |
| Earnings on bank-owned life insurance   | (314 )                             | (209 )           |
| Compensation expense for stock options and stock awards                           | 73                                 | 47               |
| (Increase) decrease in assets:  |                                    |                  |
| Accrued interest receivable   | 314                                | 18               |
| Other assets  | (133 )                             | (581 )           |
| Increase in accrued interest payable and other liabilities                        | 55                                 | 304              |
| <b>Net Cash Provided by Operating Activities</b>                                  | <b>5,621</b>                       | <b>5,258</b>     |
| <b>Cash Flows from Investing Activities</b>                                       |                                    |                  |
| Securities available-for-sale:  |                                    |                  |
| Purchases   | (18,431 )                          | (33,784 )        |
| Sales   | 6,252                              | 1,077            |
| Maturities, calls and principal repayments  | 23,727                             | 21,608           |
| Securities held-to-maturity:  |                                    |                  |
| Purchases   | (2,289 )                           | -                |
| Net increase in loans   | (3,944 )                           | (3,347 )         |
| Proceeds from the sale of foreclosed assets                                       | 405                                | 2,492            |
| Net maturities (purchases) of interest bearing time deposits                      | 500                                | (500 )           |
| Purchases of bank premises and equipment  | (124 )                             | (302 )           |
| Proceeds from the sale of premises and equipment                                  | -                                  | 2                |
| Purchases of bank-owned life insurance  | (550 )                             | (6,500 )         |
| Decrease (increase) in FHLB stock   | 398                                | (57 )            |
| <b>Net Cash Provided by (Used in) Investing Activities</b>                        | <b>5,944</b>                       | <b>(19,311 )</b> |
| <b>Cash Flows from Financing Activities</b>                                       |                                    |                  |
| Net increase in deposits  | 29,083                             | 26,662           |
| Repayments of borrowings  | (10,000 )                          | (44 )            |
| <b>Net Cash Provided by Financing Activities</b>                                  | <b>19,083</b>                      | <b>26,618</b>    |

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|   |          |          |
|---|----------|----------|
| Net Increase in Cash and Cash Equivalents                                   | 30,648   | 12,565   |
| Cash and Cash Equivalents - Beginning                                       | 17,749   | 23,079   |
| Cash and Cash Equivalents - Ending  | \$48,397 | \$35,644 |
| <b>Supplementary Cash Flows Information</b>                                 |          |          |
| Interest paid   | \$3,286  | \$4,411  |
| Income taxes paid   | \$1,069  | \$617    |
| <b>Supplementary Schedule of Noncash Investing and Financing Activities</b> |          |          |
| Foreclosed real estate acquired in settlement of loans                      | \$2,700  | \$936    |
| Trading securities transferred to available-for-sale securities             | \$-      | \$2,241  |

See Notes to Unaudited Consolidated Financial Statements

## Note 1 - Summary of Significant Accounting Policies

### Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of Sussex Bancorp (“we,” “us” or “our”) and its 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. 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 ten banking offices, eight located in Sussex County, New Jersey and two in Orange County, New York.

The Company is 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 Federal Deposit Insurance Corporation (“FDIC”) up to applicable limits. The operations of the Company and the Bank are subject to the supervision and regulation of the FRB, 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 and nine month periods ended September 30, 2011, are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. 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, 2010.

We have evaluated events and transactions occurring subsequent to the balance sheet date of September 30, 2011 for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through the date these financial statements were issued.

### Reclassifications

Certain amounts in the prior period financial statements have been reclassified to conform to the current year presentation. These reclassifications had no effect on previously reported net income.

### New Accounting Standards

In April 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2011-02, A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring. This issuance clarifies guidance on a creditor’s evaluation of whether or not a concession has been granted, with an emphasis on evaluating all aspects of the modification rather than a focus on specific criteria, such as the effective interest rate test, to determine a concession. The ASU goes on to provide guidance on specific types of modifications such as changes in the interest rate of the borrowing, and insignificant delays in payments, as well as guidance on the creditor’s evaluation of whether or not a debtor is experiencing financial difficulties. For public entities, the amendments in ASU 2011-02 are effective for the first interim or annual periods beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The entity should also disclose information required by ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for

Credit Losses, which had previously been deferred by ASU 2011-01, Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in ASU 2010-20, for interim and annual periods beginning on or after June 15, 2011. We completed our evaluation on ASU 2011-02 and it did not have a material effect on our consolidated financial statements.

In April 2011, FASB issued ASU 2011-03, Reconsideration of Effective Control for Repurchase Agreements. This issuance clarifies the accounting principles applied to repurchase agreements, as set forth by FASB ASC Topic 860, Transfers and Servicing. This ASU amends one of three criteria used to determine whether or not a transfer of assets may be treated as a sale by the transferor. Under Topic 860, the transferor may not maintain effective control over the transferred assets in order to qualify as a sale. This ASU eliminates the criteria under which the transferor must retain collateral sufficient to repurchase or redeem the collateral on substantially agreed upon terms as a method of maintaining effective control. This ASU is effective for both public and nonpublic entities for interim and annual reporting periods beginning on or after December 31, 2011, and requires prospective application to transactions or modifications of transactions which occur on or after the effective date and early adoption is not permitted. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

In May 2011, FASB issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. This ASU amends FASB ASC Topic 820, Fair Value Measurements, to bring U.S. GAAP for fair value measurements in line with International Accounting Standards. The ASU clarifies existing guidance for items such as: the application of the highest and best use concept to non-financial assets and liabilities; the application of fair value measurement to financial instruments classified in a reporting entity's stockholder's equity; and disclosure requirements regarding quantitative information about unobservable inputs used in the fair value measurements of level 3 assets. The ASU also creates an exception to Topic 820 for entities which carry financial instruments within a portfolio or group, under which the entity is now permitted to base the price used for fair valuation upon a price that would be received to sell the net asset position or transfer a net liability position in an orderly transaction. The ASU also allows for the application of premiums and discounts in a fair value measurement if the financial instrument is categorized in level 2 or 3 of the fair value hierarchy. Lastly, the ASU contains new disclosure requirements regarding fair value amounts categorized as level 3 in the fair value hierarchy such as: disclosure of the valuation process used; effects of and relationships between unobservable inputs; usage of nonfinancial assets for purposes other than their highest and best use when that is the basis of the disclosed fair value; and categorization by level of items disclosed at fair value, but not measured at fair value for financial statement purposes. This ASU is effective for interim and annual periods beginning after December 15, 2011. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

In June 2011, FASB issued ASU 2011-05, Presentation of Comprehensive Income. The provisions of this ASU amend FASB ASC Topic 220, Comprehensive Income, to facilitate the continued alignment of U.S. GAAP with International Accounting Standards. The ASU prohibits the presentation of the components of comprehensive income in the statement of stockholder's equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate, but consecutive, statements of net income and other comprehensive income. Under previous GAAP, all 3 presentations were acceptable. Regardless of the presentation selected, the Reporting Entity is required to present all reclassifications between other comprehensive and net income on the face of the new statement or statements. The provisions of this ASU are effective for fiscal years and interim periods beginning after December 31, 2011 for public entities. For nonpublic entities, the provisions are effective for fiscal years ending after December 31, 2012, and for interim and annual periods thereafter. As the two remaining options for presentation existed prior to the issuance of this ASU, early adoption is permitted. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

In September 2011, the FASB issued ASU 2011-08, Testing Goodwill for Impairment. The purpose of this ASU is to simplify how entities test goodwill for impairment by adding a new first step to the preexisting goodwill impairment test under ASC Topic 350, Intangibles – Goodwill and other. This amendment gives the entity the option to first assess a variety of qualitative factors such as economic conditions, cash flows, and competition to determine whether it was more likely than not that the fair value of goodwill has fallen below its carrying value. If the entity determines that it is not likely that the fair value has fallen below its carrying value, then the entity will not have to complete the original two-step test under Topic 350. The amendments in this ASU are effective for impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. We are evaluating the impact of this ASU on our consolidated financial statements.

## Note 2 – Securities

The amortized cost and approximate fair value of securities available-for-sale and held-to-maturity as of September 30, 2011 and December 31, 2010 are summarized as follows:

| (Dollars in thousands)                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value   |
|---|-------------------|------------------------------|-------------------------------|-----------------|
| <b>September 30, 2011</b>                               |                   |                              |                               |                 |
| <b>Available-for-Sale</b>                               |                   |                              |                               |                 |
| U.S. government agencies                                | \$4,000           | \$4                          | \$-                           | \$4,004         |
| State and political subdivisions                        | 26,953            | 943                          | (55 )                         | 27,841          |
| <b>Mortgage-backed securities:</b>                      |                   |                              |                               |                 |
| U.S. government-sponsored enterprises                   | 41,759            | 704                          | (74 )                         | 42,389          |
| Private mortgage-backed securities                      | 3,020             | 67                           | -                             | 3,087           |
| Equity securities-financial services industry and other | 1,646             | 3                            | (357 )                        | 1,292           |
|   | 77,378            | 1,721                        | (486 )                        | 78,613          |
| <b>Held-to-Maturity Securities</b>                      |                   |                              |                               |                 |
| State and political subdivisions                        | 3,287             | 137                          | -                             | 3,424           |
| <b>Total Securities</b>                                 | <b>\$80,665</b>   | <b>\$1,858</b>               | <b>\$(486 )</b>               | <b>\$82,037</b> |
| <b>December 31, 2010</b>                                |                   |                              |                               |                 |
| <b>Available-for-Sale</b>                               |                   |                              |                               |                 |
| U.S. government agencies                                | \$21,158          | \$78                         | \$(47 )                       | \$21,189        |
| State and political subdivisions                        | 29,353            | 97                           | (715 )                        | 28,735          |
| <b>Mortgage-backed securities:</b>                      |                   |                              |                               |                 |
| U.S. government-sponsored enterprises                   | 32,560            | 747                          | (21 )                         | 33,286          |
| Private mortgage-backed securities                      | 4,592             | 215                          | -                             | 4,807           |
| Equity securities-financial services industry and other | 1,638             | 9                            | (284 )                        | 1,363           |
|   | 89,301            | 1,146                        | (1,067 )                      | 89,380          |
| <b>Held-to-Maturity Securities</b>                      |                   |                              |                               |                 |
| State and political subdivisions                        | 1,000             | 7                            | -                             | 1,007           |
| <b>Total Securities</b>                                 | <b>\$90,301</b>   | <b>\$1,153</b>               | <b>\$(1,067 )</b>             | <b>\$90,387</b> |

The amortized cost and fair value of securities at September 30, 2011 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)                 | Available-for-Sale |               | Held-to-Maturity  |               |
|--|--------------------|---------------|-------------------|---------------|
|  | Amortized<br>Cost  | Fair<br>Value | Amortized<br>Cost | Fair<br>Value |
| Due in one year or less                | \$2,581            | \$2,585       | \$1,219           | \$1,224       |
| Due after one year through five years  | 3,000              | 3,002         | -                 | -             |
| Due after five years through ten years | 197                | 200           | 1,068             | 1,088         |
| Due after ten years                    | 25,175             | 26,058        | 1,000             | 1,112         |

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|   |          |          |         |         |
|---|----------|----------|---------|---------|
| Total bonds and obligations                             | 30,953   | 31,845   | 3,287   | 3,424   |
| Mortgage-backed securities:                             |          |          |         |         |
| U.S. government-sponsored enterprises                   | 41,759   | 42,389   | -       | -       |
| Private mortgage-backed securities                      | 3,020    | 3,087    | -       | -       |
| Equity securities-financial services industry and other | 1,646    | 1,292    | -       | -       |
| Total securities  | \$77,378 | \$78,613 | \$3,287 | \$3,424 |

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## Temporarily Impaired Securities and Other-Than-Temporary Impairment

The following table shows the gross unrealized losses and fair value for securities in our portfolio that are not deemed to be other than temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2011 and December 31, 2010.

| (Dollars in thousands)                                  | Less Than Twelve Months |                         | Twelve Months or More |                         | Total      |                         |
|---|-------------------------|-------------------------|-----------------------|-------------------------|------------|-------------------------|
|   | Fair Value              | Gross Unrealized Losses | Fair Value            | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| September 30, 2011                                      |                         |                         |                       |                         |            |                         |
| Available-for-sale securities:                          |                         |                         |                       |                         |            |                         |
| U.S. government agencies                                | \$ -                    | \$ -                    | \$ -                  | \$ -                    | \$ -       | \$ -                    |
| State and political subdivisions                        | -                       | -                       | 897                   | (55 )                   | 897        | (55 )                   |
| Mortgage-backed securities:                             |                         |                         |                       |                         |            |                         |
| U.S. government-sponsored enterprises                   | 12,469                  | (74 )                   | -                     | -                       | 12,469     | (74 )                   |
| Equity securities-financial services industry and other | 888                     | (19 )                   | 488                   | (338 )                  | 1,376      | (357 )                  |
| Total Temporarily Impaired Securities                   | \$ 13,357               | \$ (93 )                | \$ 1,385              | \$ (393 )               | \$ 14,742  | \$ (486 )               |
| December 31, 2010                                       |                         |                         |                       |                         |            |                         |
| Available-for-sale securities:                          |                         |                         |                       |                         |            |                         |
| U.S. government agencies                                | \$ 6,962                | \$ (47 )                | \$ -                  | \$ -                    | \$ 6,962   | \$ (47 )                |
| State and political subdivisions                        | 18,006                  | (578 )                  | 1,071                 | (137 )                  | 19,077     | (715 )                  |
| Mortgage-backed securities:                             |                         |                         |                       |                         |            |                         |
| U.S. government-sponsored enterprises                   | 4,536                   | (21 )                   | -                     | -                       | 4,536      | (21 )                   |
| Equity securities-financial services industry and other | 820                     | (50 )                   | 445                   | (234 )                  | 1,265      | (284 )                  |
| Total Temporarily Impaired Securities                   | \$ 30,324               | \$ (696 )               | \$ 1,516              | \$ (371 )               | \$ 31,840  | \$ (1,067 )             |

As of September 30, 2011, we reviewed our investment portfolio for indications of impairment. This review included 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 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 (including but not limited to those whose fair value is less than their amortized cost basis), an extensive, regular review is conducted to determine if an other-than-temporary impairment has occurred.

At September 30, 2011, the market value of and the unrealized losses for our state and political subdivisions investment portfolio were caused by changes in interest rates and spreads and were not the result of credit quality. At September 30, 2011, there were 3 securities that had an unrealized loss, compared to 44 securities at December 31,

2010. These securities typically have maturity dates greater than ten years and the fair values are more sensitive to changes in market interest rates. As of September 30, 2011, 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 September 30, 2011 were deemed to be other than temporarily impaired.

At September 30, 2011, the decline in market value and the unrealized losses for our mortgaged-backed securities that are backed by U.S. government-sponsored enterprises were caused by changes in interest rates and spreads and were not the result of credit quality. At both September 30, 2011 and December 31, 2010, there were 2 securities that had an unrealized loss. The decline in market value and the unrealized losses were primarily due to changes in spreads and market conditions and not credit quality. As of September 30, 2011, 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 mortgaged-backed securities at September 30, 2011 were deemed to be other than temporarily impaired. At September 30, 2011, our private mortgage-backed securities portfolio all had unrealized gains and was rated investment grade.

Our investments in marketable equity securities consist primarily of a mutual fund, one equity portfolio fund and common stock of entities in the financial services and insurance industries. These securities, other than the mutual fund, which had a fair value of \$850 thousand and an unrealized loss of \$7 thousand at September 30, 2011, have been adversely impacted by the effects of the current economic environment on the financial services and insurance industries. We evaluated each of the underlying banks for credit impairment based on its financial condition and performance. Based on our evaluation and our ability and intent to hold those investments for a reasonable period of time sufficient for a forecasted recovery of amortized cost, we do not consider these investments to be other-than-temporarily impaired at September 30, 2011. At September 30, 2011, there were 14 of 20 securities that had an unrealized loss, including an equity portfolio fund with a market value of \$111 thousand and an unrealized loss of \$139 thousand. We continue to closely monitor the performance of the securities we own as well as the impact from any further deterioration in the economy or in the banking industry that may adversely affect these securities. We will continue to evaluate them for other-than-temporary impairment, which could result in a future non-cash charge to earnings.

During the second quarter of 2010, we recognized \$171 thousand pre-tax (\$113 thousand after-tax, or \$0.03 per share) non-cash other-than-temporarily impaired charge related to an equity portfolio fund that had an amortized cost of \$250 thousand and a termination date of October 2010. The impairment was recognized because the market value of this security was below our amortized cost for an extended period of time along with credit deterioration in some of the underlying collateral and it was not believed the market value of this security would recover to our amortized cost before its termination date. The fund was comprised of common stocks of bank holding companies. During the third quarter of 2010, management decided to execute a redemption in kind provision for this investment prior to the termination date of October 22, 2010. We received its pro-rata share of the underlying bank securities. We received seventeen different equity securities totaling \$76 thousand. In October of 2010 the securities which then were recorded at market value resulted in an additional \$3 thousand pre-tax charge related to the exchange. As of September 30, 2011, we held 16 equity securities and their current market value was \$63 thousand with a net unrealized loss of \$9 thousand.

Note 3 – Loans

The composition of net loans receivable at September 30, 2011 and December 31, 2010:

| (Dollars in thousands)             | September 30,<br>2011 | December 31,<br>2010 |
|------------------------------------|-----------------------|----------------------|
| Commercial and industrial loans    | \$ 13,589             | \$ 15,045            |
| Construction                       | 17,447                | 20,862               |
| Commercial real estate             | 204,279               | 204,407              |
| Residential real estate            | 101,386               | 96,659               |
| Consumer and other                 | 1,272                 | 1,395                |
|                                    | 337,973               | 338,368              |
| Unearned net loan origination fees | (179 )                | (134 )               |
| Allowance for loan losses          | (7,401 )              | (6,397 )             |
| Net Loans Receivable               | \$ 330,393            | \$ 331,837           |

An age analysis of loans receivable which are past due as of September 30, 2011 and December 31, 2010 is as follows:

| (Dollars in thousands)    | 30-59<br>Days<br>Past Due | 60-89 days<br>Past Due | Greater<br>Than<br>90 Days (a) | Total Past<br>Due | Current   | Total<br>Financing<br>Receivables | Recorded<br>Investment<br>> 90 Days<br>and<br>Accruing |
|---------------------------|---------------------------|------------------------|--------------------------------|-------------------|-----------|-----------------------------------|--|
| September 30, 2011        |                           |                        |                                |                   |           |                                   |  |
| Commercial and industrial | \$ 383                    | \$ 643                 | \$ 85                          | \$ 1,111          | \$ 12,478 | \$ 13,589                         | \$ -   |
| Construction              | -                         | 785                    | 5,489                          | 6,274             | 11,173    | 17,447                            | 563  |
| Commercial real estate    | 2,859                     | 3,214                  | 20,603                         | 26,676            | 177,603   | 204,279                           | 425  |
| Residential real estate   | 798                       | 520                    | 2,304                          | 3,622             | 97,764    | 101,386                           | -  |

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|                           |          |          |           |           |            |            |        |
|---------------------------|----------|----------|-----------|-----------|------------|------------|--------|
| Consumer and other        | 8        | 12       | 10        | 30        | 1,242      | 1,272      | 10     |
| Total                     | \$ 4,048 | \$ 5,174 | \$ 28,491 | \$ 37,713 | \$ 300,260 | \$ 337,973 | \$ 998 |
| December 31, 2010         |          |          |           |           |            |            |        |
| Commercial and industrial | \$ 182   | \$ 229   | \$ 98     | \$ 509    | \$ 14,536  | \$ 15,045  | \$ 20  |
| Construction              | -        | -        | 6,430     | 6,430     | 14,432     | 20,862     | -      |
| Commercial real estate    | 2,316    | 3,946    | 14,959    | 21,221    | 183,186    | 204,407    | 29     |
| Residential real estate   | 3,029    | -        | 1,244     | 4,273     | 92,386     | 96,659     | -      |
| Consumer and other        | 3        | 16       | -         | 19        | 1,376      | 1,395      | -      |
| Total                     | \$ 5,530 | \$ 4,191 | \$ 22,731 | \$ 32,452 | \$ 305,916 | \$ 338,368 | \$ 49  |

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

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Loans which the accrual of interest has been discontinued at September 30, 2011 and December 31, 2010 were:

| (Dollars in thousands)    | September 30,<br>2011 | December 31,<br>2010 |
|---------------------------|-----------------------|----------------------|
| Commercial and industrial | \$ 85                 | \$ 78                |
| Construction              | 4,926                 | 6,430                |
| Commercial real estate    | 20,178                | 14,930               |
| Residential real estate   | 2,304                 | 1,244                |
| Consumer and other        | -                     | -                    |
| Total                     | \$ 27,493             | \$ 22,682            |

The following table presents changes in the allowance for loan losses for the three and nine months ended September 30, 2011:

| (Dollars in thousands)                    | Commercial<br>and<br>Industrial | Construction | Commercial<br>Real Estate | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---|---------------------------------|--------------|---------------------------|----------------------------|----------|-------------|----------|
| Three Months Ended:<br>September 30, 2011 |                                 |              |                           |                            |          |             |          |
| Beginning balance                         | \$ 428                          | \$ 969       | \$ 4,773                  | \$ 945                     | \$ 45    | \$ 376      | \$ 7,536 |
| Charge-offs                               | -                               | -            | (868 )                    | -                          | (10 )    | -           | (878 )   |
| Recoveries                                | 1                               | -            | 1                         | -                          | 4        | -           | 6        |
| Provision                                 | 58                              | 435          | 327                       | 58                         | (1 )     | (140 )      | 737      |
| Ending balance                            | \$ 487                          | \$ 1,404     | \$ 4,233                  | \$ 1,003                   | \$ 38    | \$ 236      | \$ 7,401 |
| Nine Months Ended:<br>September 30, 2011  |                                 |              |                           |                            |          |             |          |
| Beginning balance                         | \$ 436                          | \$ 1,183     | \$ 3,760                  | \$ 798                     | \$ 56    | \$ 164      | \$ 6,397 |
| Charge-offs                               | (13 )                           | (909 )       | (1,263 )                  | (12 )                      | (33 )    | -           | (2,230 ) |
| Recoveries                                | 4                               | 516          | 9                         | -                          | 17       | -           | 546      |
| Provision                                 | 60                              | 614          | 1,727                     | 217                        | (2 )     | 72          | 2,688    |
| Ending balance                            | \$ 487                          | \$ 1,404     | \$ 4,233                  | \$ 1,003                   | \$ 38    | \$ 236      | \$ 7,401 |

The following table presents the balance in the allowance of loan losses at September 30, 2011 and December 31, 2010 disaggregated on the basis of our impairment method by class of loans receivable along with the balance of loans receivable by class 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 |
| September 30, 2011        |                           |  |  |                  |  |  |
| Commercial and industrial | \$487                     | \$80   | \$407  | \$13,589         | \$85   | \$13,504                                       |

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|                          |         |         |         |           |          |           |
|--------------------------|---------|---------|---------|-----------|----------|-----------|
| Construction             | 1,404   | 897     | 507     | 17,447    | 4,926    | 12,521    |
| Commercial real estate   | 4,233   | 1,297   | 2,936   | 204,279   | 23,001   | 181,278   |
| Residential real estate  | 1,003   | 249     | 754     | 101,386   | 2,304    | 99,082    |
| Consumer and other loans | 38      | -       | 38      | 1,272     | -        | 1,272     |
| Unallocated              | 236     | -       | -       | -         | -        | -         |
| Total                    | \$7,401 | \$2,523 | \$4,642 | \$337,973 | \$30,316 | \$307,657 |

December 31, 2010

|                           |         |         |         |           |          |           |
|---------------------------|---------|---------|---------|-----------|----------|-----------|
| Commercial and industrial | \$436   | \$54    | \$382   | \$15,045  | \$78     | \$14,967  |
| Construction              | 1,183   | 610     | 573     | 20,862    | 6,636    | 14,226    |
| Commercial real estate    | 3,760   | 493     | 3,267   | 204,407   | 15,514   | 188,893   |
| Residential real estate   | 798     | 233     | 565     | 96,659    | 1,244    | 95,415    |
| Consumer and other loans  | 56      | -       | 56      | 1,395     | -        | 1,395     |
| Unallocated               | 164     | -       | -       | -         | -        | -         |
| Total                     | \$6,397 | \$1,390 | \$4,843 | \$338,368 | \$23,472 | \$314,896 |

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, payment status and other information; 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 as defined below is consistent with the system used by regulatory agencies and consistent with industry practices. Loans rated Substandard, Doubtful or Loss is consistent with the regulatory definitions of classified assets.

**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.

**Substandard:** This category represents loans where 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 our 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 is continuously monitored. Once these factors are questionable the loan will be considered for a downgrade and a 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.

The following tables illustrate our credit risk profile by creditworthiness category as of September 30, 2011 and December 31, 2010:

| (Dollars in thousands)    | September 30, 2011 |                    |             |          |           |
|---------------------------|--------------------|--------------------|-------------|----------|-----------|
|                           | Pass               | Special<br>Mention | Substandard | Doubtful | Total     |
| Commercial and industrial | \$12,859           | \$291              | \$430       | \$9      | \$13,589  |
| Construction              | 10,949             | 563                | 5,935       | -        | 17,447    |
| Commercial real estate    | 169,469            | 6,509              | 28,301      | -        | 204,279   |
| Residential real estate   | 96,862             | 513                | 4,011       | -        | 101,386   |
| Consumer and other        | 1,262              | -                  | 10          | -        | 1,272     |
|                           | \$291,401          | \$7,876            | \$38,687    | \$9      | \$337,973 |

| (Dollars in thousands)    | December 31, 2010 |                    |             |          |          |
|---------------------------|-------------------|--------------------|-------------|----------|----------|
|                           | Pass              | Special<br>Mention | Substandard | Doubtful | Total    |
| Commercial and industrial | \$14,268          | \$679              | \$75        | \$23     | \$15,045 |
| Construction              | 10,669            | 2,753              | 7,440       | -        | 20,862   |
| Commercial real estate    | 162,147           | 19,880             | 21,920      | 460      | 204,407  |

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|                         |           |          |           |       |           |
|-------------------------|-----------|----------|-----------|-------|-----------|
| Residential real estate | 93,884    | 1,083    | 1,681     | 11    | 96,659    |
| Consumer and other      | 1,382     | -        | 13        | -     | 1,395     |
|                         | \$282,350 | \$24,395 | \$ 31,129 | \$494 | \$338,368 |

A loan is considered impaired, in accordance with the impairment accounting guidance (FASB ASC 310-10-35-16), 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. The average recorded investment in impaired loans is calculated using the average of impaired loans over the past five quarter-end periods. We recognize income on impaired loans under the cash basis when the collateral on the loan is sufficient to cover the outstanding obligation to the Company. If these factors do not exist, we will record all payments as a reduction of principal on such loans.



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The following table reflects our impaired loans as of September 30, 2011 and December 31, 2010:

| (Dollars in thousands)                     | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|--|---------------------|--------------------------|-------------------|-----------------------------|----------------------------|
| <b>September 30, 2011</b>                  |                     |                          |                   |                             |                            |
| <b>With no related allowance recorded:</b> |                     |                          |                   |                             |                            |
| Commercial and industrial                  | \$-                 | \$-                      | \$-               | \$10                        | \$1                        |
| Construction                               | 2,604               | 2,908                    | -                 | 3,454                       | -                          |
| Commercial real estate                     | 9,356               | 10,521                   | -                 | 8,608                       | 142                        |
| Residential real estate                    | 1,675               | 1,675                    | -                 | 954                         | 27                         |
| Consumer and other                         | -                   | -                        | -                 | -                           | -                          |
| <b>With an allowance recorded:</b>         |                     |                          |                   |                             |                            |
| Commercial and industrial                  | 85                  | 85                       | 80                | 81                          | -                          |
| Construction                               | 2,322               | 2,322                    | 897               | 1,980                       | -                          |
| Commercial real estate                     | 13,676              | 14,435                   | 1,297             | 10,899                      | 144                        |
| Residential real estate                    | 636                 | 630                      | 249               | 637                         | 1                          |
| Consumer and other                         | -                   | -                        | -                 | -                           | -                          |
| <b>Total:</b>                              |                     |                          |                   |                             |                            |
| Commercial and industrial                  | \$85                | \$85                     | \$80              | \$91                        | \$1                        |
| Construction                               | 4,926               | 5,231                    | 897               | 5,434                       | -                          |
| Commercial real estate                     | 23,032              | 24,955                   | 1,297             | 19,507                      | 286                        |
| Residential real estate                    | 2,311               | 2,304                    | 249               | 1,591                       | 28                         |
| Consumer and other                         | -                   | -                        | -                 | -                           | -                          |
|  | \$30,354            | \$32,575                 | \$2,523           | \$26,623                    | \$315                      |
| <b>December 31, 2010</b>                   |                     |                          |                   |                             |                            |
| <b>With no related allowance recorded:</b> |                     |                          |                   |                             |                            |
| Commercial and industrial                  | \$-                 | \$-                      | \$-               | \$188                       | \$-                        |
| Construction                               | 3,230               | 3,535                    | -                 | 2,885                       | 38                         |
| Commercial real estate                     | 4,863               | 5,284                    | -                 | 8,122                       | 118                        |
| Residential real estate                    | 560                 | 560                      | -                 | 849                         | 7                          |
| Consumer and other                         | -                   | -                        | -                 | 9                           | -                          |
| <b>With an allowance recorded:</b>         |                     |                          |                   |                             |                            |
| Commercial and industrial                  | 78                  | 78                       | 54                | 71                          | -                          |
| Construction                               | 3,406               | 5,481                    | 610               | 2,568                       | -                          |
| Commercial real estate                     | 10,651              | 11,453                   | 493               | 10,379                      | 299                        |
| Residential real estate                    | 684                 | 684                      | 233               | 449                         | 1                          |
| Consumer and other                         | -                   | -                        | -                 | -                           | -                          |
| <b>Total:</b>                              |                     |                          |                   |                             |                            |
| Commercial and industrial                  | \$78                | \$78                     | \$54              | \$259                       | \$-                        |
| Construction                               | 6,636               | 9,016                    | 610               | 5,453                       | 38                         |
| Commercial real estate                     | 15,514              | 16,737                   | 493               | 18,501                      | 417                        |
| Residential real estate                    | 1,244               | 1,244                    | 233               | 1,298                       | 8                          |

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|                    |          |          |         |          |       |
|--------------------|----------|----------|---------|----------|-------|
| Consumer and other | -        | -        | -       | 9        | -     |
|                    | \$23,472 | \$27,075 | \$1,390 | \$25,520 | \$463 |

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.

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The following table presents the recorded investment in troubled debt restructured loans as of September 30, 2011 based on payment performance status (in thousands):

|                | Commercial<br>Real Estate | Commercial<br>& Industrial | Total    |
|----------------|---------------------------|----------------------------|----------|
| Performing     | \$ 1,509                  | \$ 9                       | \$ 1,518 |
| Non-performing | 6,282                     | -                          | 6,282    |
| Total          | \$ 7,791                  | \$ 9                       | \$ 7,800 |

Troubled debt restructured loans are considered impaired and are included in the previous impaired loans disclosures in this footnote. As of September 30, 2011, we have not committed to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the three and nine month periods ending September 30, 2011, one loan modification was executed which constituted a troubled debt restructuring. The modification included one or a combination of the following: an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; temporary reduction in the interest rate; change in scheduled payment amount; or permanent reduction of the principal or interest of the loan or an extension of additional credit for payment of delinquent real estate taxes.

The following tables summarize troubled debt restructurings that occurred during the periods indicated (in thousands):

|                        | For the three months ending<br>September 30, 2011 |   |  |
|------------------------|---|---|--|
|                        | Number<br>of Loans                                | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Commercial Real Estate | -   | \$ -  | \$ -   |

|                        | For the nine months ending<br>September 30, 2011 |   |  |
|------------------------|--|---|--|
|                        | Number<br>of Loans                               | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Commercial Real Estate | 1  | \$ 1,535  | \$ 1,535   |

The troubled debt restructuring described above did not require a net allocation of the allowance for credit losses for the three and nine month periods ending September 30, 2011. No charge-offs were recorded during the three and nine month periods ending September 30, 2011.

The following table summarizes the troubled debt restructurings for which there was a payment default within twelve months following the date of the restructuring for the periods indicated (in thousands):

|  | For the three months<br>ending | For the nine months<br>ending |
|--|--------------------------------|-------------------------------|
|--|--------------------------------|-------------------------------|

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|                        | September 30, 2011 |                        | September 30, 2011 |                        |
|------------------------|--------------------|------------------------|--------------------|------------------------|
|                        | Number of<br>Loans | Recorded<br>Investment | Number of<br>Loans | Recorded<br>Investment |
| Commercial real estate | -                  | \$-                    | 2                  | \$1,414                |

Loans are considered to be in payment default once it is greater than 30 days contractually past due under the modified terms. The troubled debt restructurings described above that subsequently defaulted resulted in a net allocation of the allowance for credit losses of \$7 thousand for the three and nine month period ending September 30, 2011. There were no charge-offs on these defaulted troubled debt restructurings during the three and nine month periods ending September 30, 2011.

Note 4 – 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 (nonvested 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.

|  | Three Months Ended September 30, 2011 |               |           | Three Months Ended September 30, 2010 |               |           |
|--|---------------------------------------|---------------|-----------|---------------------------------------|---------------|-----------|
|  | Income                                | Shares        | Per Share | Income                                | Shares        | Per Share |
| (In thousands, except per share data)                                | (Numerator)                           | (Denominator) | Amount    | (Numerator)                           | (Denominator) | Amount    |
| Basic earnings per share:  |                                       |               |           |                                       |               |           |
| Net income applicable to common stockholders                         | \$534                                 | 3,257         | \$0.16    | \$631                                 | 3,250         | \$0.19    |
| Effect of dilutive securities:                                       |                                       |               |           |                                       |               |           |
| Stock options  | -                                     | 75            |           | -                                     | 59            |           |
| Diluted earnings per share:  |                                       |               |           |                                       |               |           |
| Net income applicable to common stockholders and assumed conversions | \$534                                 | 3,332         | \$0.16    | \$631                                 | 3,309         | \$0.19    |
|  |                                       |               |           |                                       |               |           |
|  | Nine Months Ended September 30, 2011  |               |           | Nine Months Ended September 30, 2010  |               |           |
|  | Income                                | Shares        | Per Share | Income                                | Shares        | Per Share |
| (In thousands, except per share data)                                | (Numerator)                           | (Denominator) | Amount    | (Numerator)                           | (Denominator) | Amount    |
| Basic earnings per share:  |                                       |               |           |                                       |               |           |
| Net income applicable to common stockholders                         | \$1,955                               | 3,256         | \$0.60    | \$1,579                               | 3,250         | \$0.49    |
| Effect of dilutive securities:                                       |                                       |               |           |                                       |               |           |
| Stock options  | -                                     | 70            |           | -                                     | 44            |           |
| Diluted earnings per share:  |                                       |               |           |                                       |               |           |
| Net income applicable to common stockholders and assumed conversions | \$1,955                               | 3,326         | \$0.59    | \$1,579                               | 3,294         | \$0.48    |

Note 5 – Comprehensive Income

The components of other comprehensive income and related tax effects are as follows:

| (Dollars in thousands) | Three Months Ended |                    | Nine Months Ended  |                    |
|------------------------|--------------------|--------------------|--------------------|--------------------|
|                        | September 30, 2011 | September 30, 2010 | September 30, 2011 | September 30, 2010 |
|                        |                    |                    |                    |                    |

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|   |        |        |         |         |
|---|--------|--------|---------|---------|
| Unrealized holding gain on available-for-sale securities  | \$353  | \$690  | \$1,425 | \$1,225 |
| Reclassification adjustments for gains (losses) and impairment write-downs included in net income | (1 )   | (2 )   | 268     | (119 )  |
| Net unrealized gain   | 354    | 692    | 1,157   | 1,344   |
| Tax effect  | (142 ) | (277 ) | (463 )  | (538 )  |
| Other comprehensive income, net of tax  | \$212  | \$415  | \$694   | \$806   |

## Note 6 – 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.

| (Dollars in thousands)                    | Three Months Ended September 30,<br>2011 |                       |         | Three Months Ended September 30,<br>2010 |                       |         |
|---|--|-----------------------|---------|--|-----------------------|---------|
|   | Banking<br>and<br>Financial<br>Services  | Insurance<br>Services | Total   | Banking<br>and<br>Financial<br>Services  | Insurance<br>Services | Total   |
| Net interest income from external sources | \$4,187                                  | \$-                   | \$4,187 | \$4,129                                  | \$-                   | \$4,129 |
| Other income from external sources        | 661                                      | 545                   | 1,206   | 691                                      | 485                   | 1,176   |
| Depreciation and amortization             | 148                                      | 3                     | 151     | 177                                      | 3                     | 180     |
| Income before income taxes                | 635                                      | (4 )                  | 631     | 845                                      | (46 )                 | 799     |
| Income tax expense (benefit)(1)           | 99                                       | (2 )                  | 97      | 186                                      | (18 )                 | 168     |
| Total assets                              | 492,953                                  | 2,931                 | 495,884 | 481,182                                  | 3,013                 | 484,195 |

  

|   | Nine Months Ended September 30, 2011    |                       |          | Nine Months Ended September 30, 2010    |                       |          |
|---|---|-----------------------|----------|---|-----------------------|----------|
|   | Banking<br>and<br>Financial<br>Services | Insurance<br>Services | Total    | Banking<br>and<br>Financial<br>Services | Insurance<br>Services | Total    |
| Net interest income from external sources | \$12,810                                | \$-                   | \$12,810 | \$12,049                                | \$-                   | \$12,049 |
| Other income from external sources        | 2,228                                   | 1,724                 | 3,952    | 1,868                                   | 1,622                 | 3,490    |
| Depreciation and amortization             | 449                                     | 9                     | 458      | 501                                     | 9                     | 510      |
| Income before income taxes                | 2,336                                   | 154                   | 2,490    | 1,971                                   | (4 )                  | 1,967    |
| Income tax expense(1)                     | 473                                     | 62                    | 535      | 390                                     | (2 )                  | 388      |
| Total assets                              | 495,884                                 | 2,931                 | 495,884  | 481,182                                 | 3,013                 | 484,195  |

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

## Note 7 - Stock-Based Compensation

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 the Compensation Committee of the Board of Directors. Our standard stock option grants have a maximum term of ten 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 the options are granted. Restricted stock is valued at the market value of the common stock on the date of grant and generally vests between two and seven years. All dividends paid on restricted stock,

whether vested or unvested, are granted to the stockholder.

Information regarding our stock option plans as of September 30, 2011 was 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    | 116,075              | \$ 12.33  |  |                                 |
| Options expired                           | -                    | -   |  |                                 |
| Options forfeited                         | (3,438 )             | 14.20   |  |                                 |
| Options outstanding, end of quarter       | 112,637              | \$ 12.27  | 2.28                                       | \$ -                            |
| Options exercisable, end of quarter       | 112,637              | \$ 12.27  | 2.28                                       | \$ -                            |
| Option price range at end of quarter      | \$8.86 to<br>\$16.45 |   |  |                                 |
| Option price range for exercisable shares | \$8.86 to<br>\$16.45 |   |  |                                 |



During the first nine months of 2011 and 2010, we expensed \$72 thousand and \$47 thousand, respectively, in stock-based compensation under restricted stock awards. Information regarding our restricted stock activity as of September 30, 2011 is as follows:

|                                     | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|-------------------------------------|---------------------|---|
| Restricted stock, beginning of year | 101,991             | \$4.71  |
| Granted                             | 22,805              | 6.25  |
| Forfeited                           | (1,683 )            | 5.85  |
| Vested                              | (7,709 )            | 6.47  |
| Restricted stock, end of quarter    | 115,404             | \$4.88  |

At September 30, 2011, unrecognized compensation expense for non-vested restricted stock was \$479 thousand, which is expected to be recognized over an average period of 4.3 years.

#### Note 8 – Guarantees

We do not issue any guarantees that would require liability recognition or disclosure, other than its 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. We, generally, hold collateral and/or personal guarantees supporting these commitments. We had \$1.7 million of undrawn standby letters of credit outstanding as of September 30, 2011. 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 September 30, 2011 for guarantees under standby letters of credit issued is not material.

#### Note 9 - Fair Value of Financial Instruments

Management uses its best judgment in estimating the fair value of our consolidated 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 estimated 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 estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period end.

Under FASB ASC 820, Fair Value Measurement and Disclosures, there is a hierarchal 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 FASB ASC 820 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 the 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 valuation of our financial assets measured on a recurring basis by the above FASB ASC 820 pricing observability levels:

| (Dollars in thousands)                                  | Fair Value Measurements | Quoted Prices In Active Markets for Identical Assets (Level I) | Significant Other Observable Inputs (Level II) | Significant Unobservable Inputs (Level III) |
|---|-------------------------|--|--|---|
| September 30, 2011:                                     |                         |  |  |   |
| U.S. government agencies                                | \$ 4,004                | \$-  | \$4,004  | \$ -  |
| State and political subdivisions                        | 27,841                  | -  | 27,841   | -   |
| Mortgage-backed securities                              |                         |  |  |   |
| U.S. government-sponsored enterprises                   | 42,389                  | -  | 42,389   | -   |
| Private mortgage-backed securities                      | 3,087                   | -  | 3,087  | -   |
| Equity securities-financial services industry and other | 1,292                   | 1,144  | 148  | -   |
| December 31, 2010:                                      |                         |  |  |   |
| U.S. government agencies                                | \$ 21,189               | \$-  | \$21,189                                       | \$ -  |
| State and political subdivisions                        | 28,735                  | -  | 28,735   | -   |
| Mortgage-backed securities                              |                         |  |  |   |
| U.S. government-sponsored enterprises                   | 33,286                  | -  | 33,286   | -   |
| Private mortgage-backed securities                      | 4,807                   | -  | 4,807  | -   |
| Equity securities-financial services industry and other | 1,363                   | 1,213  | 150  | -   |

On June 1, 2010, we transferred all trading securities, which amounted to \$2.2 million, to available-for-sale at fair value. There were holding gains on trading securities recorded on the income statement of \$7 thousand for the nine months ended September 30, 2010. 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. There were no trading securities held during 2011.

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level are as follows:

| (Dollars in thousands) | Fair Value Measurements | Quoted Prices in Active Markets for Identical Assets (Level I) | Significant Other Observable Inputs (Level II) | Significant Unobservable Inputs (Level III) |
|------------------------|-------------------------|--|--|---|
| September 30, 2011:    |                         |  |  |   |
| Impaired loans         | \$ 14,196               | \$-  | \$-  | \$ 14,196                                   |

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|                        |           |     |     |           |
|------------------------|-----------|-----|-----|-----------|
| Foreclosed real estate | 3,994     | -   | -   | 3,994     |
| December 31, 2010:     |           |     |     |           |
| Impaired loans         | \$ 13,430 | \$- | \$- | \$ 13,430 |
| Foreclosed real estate | 2,007     | -   | -   | 2,007     |

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 September 30, 2011 and December 31, 2010:

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.

Time Deposits with Other Banks (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) is determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), 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 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) were used to support fair values of certain Level 3 investments.

**Loans Receivable (Carried at Cost):** The fair values of loans are estimated using discounted cash flow analyses, using the market rates on 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 and 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 (Generally Carried at Fair Value):** Impaired loans are those that are accounted for under FASB ASC 310, Accounting by Creditors for Impairment of a Loan, in which we have measured impairment generally based on the fair value of the loan's collateral. Fair value 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 3 fair values, based upon the lowest level of input that is significant to the fair value measurements.

**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.

**Deposit Liabilities (Carried at Cost):** The fair values disclosed for demand, savings and club 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 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.

**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 their fair values.

**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.



The following information is an estimate of the fair value of 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 estimated fair values of our financial instruments at September 30, 2011 and December 31, 2010 were as follows:

| (Dollars in thousands)                    | 2011            |            | 2010            |            |
|---|-----------------|------------|-----------------|------------|
|   | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| <b>Financial assets:</b>                  |                 |            |                 |            |
| Cash and cash equivalents                 | \$48,937        | \$48,937   | \$17,749        | \$17,749   |
| Time deposits with other banks            | 100             | 100        | 600             | 600        |
| Securities available-for-sale             | 78,613          | 78,613     | 89,380          | 89,380     |
| Securities held-to-maturity               | 3,287           | 3,424      | 1,000           | 1,007      |
| Federal Home Loan Bank stock              | 1,837           | 1,837      | 2,235           | 2,235      |
| Loans receivable, net of allowance        | 330,393         | 332,925    | 331,837         | 334,762    |
| Accrued interest receivable               | 1,602           | 1,602      | 1,916           | 1,916      |
| <b>Financial liabilities:</b>             |                 |            |                 |            |
| Deposits                                  | 415,050         | 417,621    | 385,957         | 386,935    |
| Borrowings                                | 26,000          | 29,569     | 36,000          | 38,168     |
| Junior subordinated debentures            | 12,887          | 6,233      | 12,887          | 8,647      |
| Accrued interest payable                  | 286             | 286        | 269             | 269        |
| <b>Off-balance financial instruments:</b> |                 |            |                 |            |
| Commitments to extend credit              | -               | -          | -               | -          |
| Outstanding letters of credit             | -               | -          | -               | -          |

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

MANAGEMENT STRATEGY

We are a community-oriented financial institution serving the northern New Jersey, northeastern Pennsylvania and Orange County, New York marketplace. While offering traditional community bank loan and deposit products and services, we obtain non-interest income through our insurance brokerage operations, Tri-State Insurance Agency, Inc., ("Tri-State") and the sale of non-deposit products. We report the operations of Tri-State as a separate segment from our commercial banking operations.

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. The economic downturn continues to impact our level of nonperforming assets and in turn has increased our provision for loan losses. We have been focused on building for the future and strengthening our core operating results within a risk management framework.

CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are prepared in accordance with the accounting principles generally accepted in the United States of America ("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 the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. 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. For additional information on our critical accounting policies, please refer to the information contained in Note 1 of the accompanying unaudited consolidated financial statements and Note 1 of the consolidated financial statements included in our 2010 Annual Report on Form 10-K.

COMPARISON OF OPERATING RESULTS FOR THREE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010

Overview - We realized net income of \$534 thousand for the third quarter of 2011, a decrease of \$97 thousand, or 15.4%, from net income of \$631 thousand reported for the same period in 2010. Basic and diluted earnings per share for the three months ended September 30, 2011 were \$0.16 compared to the basic and diluted earnings per share of \$0.19 for the comparable period of 2010. The decrease in net income was largely due to an increase in non-interest expenses of \$181 thousand. Third quarter results reflected an increase in non-interest expenses largely attributed to higher salaries and employee benefits expenses due in part to the expansion of our commercial lending group. Management continues to focus on strengthening the Company's core operations as well as resolving and mitigating the Company's credit exposures.

Net loss before taxes for our Tri-State segment improved to \$4 thousand for the third quarter of 2011 compared to net loss before taxes of \$46 thousand in the same period in 2010. This improvement was largely the result of a \$60 thousand, or 12.4%, increase in revenues.





## Comparative Average Balances and Average Interest Rates

The following table presents, on a fully taxable 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 period ended September 30, 2011 and 2010.

| (Dollars in thousands)                     | Three Months Ended September 30, |                  |                 |                 |                  |        | Average Rate(2) |
|--|----------------------------------|------------------|-----------------|-----------------|------------------|--------|-----------------|
|  | Average Balance                  | 2011 Interest(1) | Average Rate(2) | Average Balance | 2010 Interest(1) |        |                 |
| <b>Earning Assets:</b>                     |                                  |                  |                 |                 |                  |        |                 |
| <b>Securities:</b>                         |                                  |                  |                 |                 |                  |        |                 |
| Tax exempt(3)                              | \$30,059                         | \$449            | 5.92 %          | \$30,669        | \$436            | 5.64 % |                 |
| Taxable                                    | 48,890                           | 313              | 2.54 %          | 49,501          | 412              | 3.30 % |                 |
| Total securities                           | 78,949                           | 762              | 3.83 %          | 80,170          | 848              | 4.20 % |                 |
| Total loans receivable(4)                  | 338,393                          | 4,687            | 5.49 %          | 329,294         | 4,765            | 5.74 % |                 |
| Other interest-earning assets              | 35,530                           | 20               | 0.22 %          | 39,071          | 23               | 0.23 % |                 |
| Total earning assets                       | 452,872                          | \$5,468          | 4.79 %          | 448,535         | \$5,636          | 4.99 % |                 |
| Non-interest earning assets                | 41,159                           |                  |                 | 39,847          |                  |        |                 |
| Allowance for loan losses                  | (7,261 )                         |                  |                 | (5,809 )        |                  |        |                 |
| Total assets                               | \$486,770                        |                  |                 | \$482,573       |                  |        |                 |
| <b>Sources of Funds:</b>                   |                                  |                  |                 |                 |                  |        |                 |
| <b>Interest bearing deposits:</b>          |                                  |                  |                 |                 |                  |        |                 |
| NOW  | \$77,676                         | \$85             | 0.44 %          | \$67,306        | \$109            | 0.64 % |                 |
| Money market                               | 16,564                           | 23               | 0.54 %          | 13,735          | 25               | 0.72 % |                 |
| Savings                                    | 168,419                          | 287              | 0.68 %          | 178,833         | 398              | 0.88 % |                 |
| Time                                       | 102,725                          | 411              | 1.59 %          | 100,517         | 411              | 1.62 % |                 |
| Total interest bearing deposits            | 365,384                          | 806              | 0.88 %          | 360,391         | 943              | 1.04 % |                 |
| Borrowed funds                             | 26,000                           | 268              | 4.03 %          | 33,051          | 358              | 4.24 % |                 |
| Junior subordinated debentures             | 12,887                           | 55               | 1.65 %          | 12,887          | 62               | 1.88 % |                 |
| Total interest bearing liabilities         | 404,271                          | \$1,129          | 1.11 %          | 406,329         | \$1,363          | 1.33 % |                 |
| <b>Non-interest bearing liabilities:</b>   |                                  |                  |                 |                 |                  |        |                 |
| Demand deposits                            | 41,012                           |                  |                 | 38,721          |                  |        |                 |
| Other liabilities                          | 2,613                            |                  |                 | 1,266           |                  |        |                 |
| Total non-interest bearing liabilities     | 43,625                           |                  |                 | 39,987          |                  |        |                 |
| Stockholders' equity                       | 38,874                           |                  |                 | 36,257          |                  |        |                 |
| Total liabilities and stockholders' equity | \$486,770                        |                  |                 | \$482,573       |                  |        |                 |
| Net interest income and margin(5)          |                                  | \$4,339          | 3.80 %          |                 | \$4,273          | 3.78 % |                 |

(1) Includes loan fee income

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

(3) Fully taxable 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 \$66 thousand, or 1.5%, to \$4.3 million for the quarter ended September 30, 2011, as compared to the same period in 2010. The increase in net interest income was largely due to our net interest margin improving 2 basis points to 3.80% for the third quarter of 2011 compared to the same period in 2010. The improvement was driven by a 22 basis point decrease in the average rate paid on interest bearing liabilities, offset by a decline in the average rate earned on total earning assets, which decreased 20 basis points to 4.79% for the third quarter of 2011 from 4.99% for the same period in 2010. Total earning assets increased \$4.3 million while total interest bearing liabilities declined \$2.1 million between the two third quarter periods ended September 30, 2011 and 2010.

Interest Income - Total interest income, on a fully taxable equivalent basis, decreased \$168 thousand for the quarter ended September 30, 2011 as compared to the same period last year. The decline was due to lower taxable security yields and loan yields, which decreased 76 basis points and 25 basis points, respectively.

Total interest income on securities, on a fully taxable equivalent basis, decreased \$86 thousand, to \$762 thousand for the quarter ended September 30, 2011 from \$848 thousand for the third quarter of 2010. This decline was largely due to a 37 basis point decrease in the yield on securities from 4.20% to 3.83% between the two third quarter periods. The decline in security yields was mostly attributed to the reinvestment of cash flows from maturities, calls and prepayments into lower market rate environment.

The interest earned on total loans receivable decreased \$78 thousand for the third quarter of 2011 as compared to the third quarter in 2010. The decline was mostly driven by a 25 basis point decline in average yields due to lower market rates and a \$5.0 million increase in non-accrual loans between the two third quarter periods. The average rate earned on loans for the quarter ended September 30, 2011 was 5.49% as compared to 5.74% for the same period in 2010.

Other interest-earning assets include federal funds sold and interest bearing deposits in other banks. The interest earned on total other interest-earning assets decreased \$3 thousand for the third quarter of 2011 as compared to the third quarter in 2010 due to lower average balances. The average balances in other interest-earning assets decreased \$3.5 million, or 9.1%, to \$35.5 million in the third quarter of 2011 from \$39.1 million during the third quarter a year earlier. The decreases in the average balance in interest bearing deposits were used to fund the growth in the loan portfolio.

Interest Expense - Our interest expense for the three months ended September 30, 2011 decreased \$234 thousand, or 17.2%, to \$1.1 million from \$1.4 million for the same period in 2010. The improvement was principally due to lower average rates paid on total interest-bearing liabilities, which declined 22 basis points from 1.33% for the three months ended September 30, 2010 to 1.11% for the same period in 2011. The improvement in interest expense was partly due to a decline in average balances in interest-bearing liabilities, which decreased \$2.1 million, or 0.5%, to \$404.3 million for the third quarter in 2011 from \$406.3 million for the same period in 2010.

Interest expense on deposits declined \$137 thousand, or 14.5%, for the quarter ended September 30, 2011, as compared to the same period last year. The decline was largely attributed to lower rates on total interest bearing deposits, which decreased 16 basis points for the third quarter 2011 as compared to the same period in 2010. The decrease in rates on deposit products reflects managements' asset/liability strategies and a lower market rate environment between the two third quarter periods. During the third quarter of 2011, there was a favorable shift in deposit mix as savings deposits, on average, with a yield of 68 basis points declined \$10.4 million, while NOW accounts, on average, with a yield of 44 basis points increased \$10.4 million. The shift in mix had a positive effect on interest expense for the third quarter of 2011.

Interest expense on borrowings declined \$90 thousand, or 25.1%, for the quarter ended September 30, 2011, as compared to the same period last year. The decrease was largely due to a decline in our average borrowed funds by \$7.1 million to \$26.0 million for the quarter ended September 30, 2011 as compared to the same period last year. The decline in interest expense on borrowings also benefited from lower average rates paid on borrowed funds, which declined 21 basis points to 4.03% for the quarter ended September 30, 2011 as compared to 4.24% for the same period last year.

We had an average balance of \$12.9 million in junior subordinated debentures outstanding during the third quarters of 2011 and 2010. The \$12.9 million junior subordinated debentures, issued on June 28, 2007 bear a floating rate of interest tied to the three month LIBOR. The average rate paid on the debentures declined 23 basis points to 1.65% for the third quarter for 2011 compared to 1.88% in the third quarter of 2010.

Provision for Loan Losses - The loan loss provision for the third quarter of 2011 increased \$75 thousand, or 11.3%, to \$737 thousand compared to a provision of \$662 thousand in the third quarter of 2010. 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 \$30 thousand, or 2.5%, to \$1.2 million for the three months ended September 30, 2011 compared to the same period in 2010. The increase in non-interest income was largely due to a \$60 thousand, or 12.4%, growth in insurance commissions and fees and a \$12 thousand, or 9.4%, improvement in ATM and debit card fees for the third quarter of 2011 as compared to the same period in 2010. The aforementioned increases were partly offset by a \$51 thousand, 13.6%, decline in service fees on deposits.

Non-Interest Expense – Total non-interest expense increased \$181 thousand, or 4.7%, to \$4.0 million for the quarter ended September 30, 2011. The increase for the third quarter of 2011 versus the same period in 2010 was largely due to a \$334 thousand increase in salaries and employee benefits and higher loan collection costs of \$170 thousand. The increase in salaries and employee benefits was mostly attributed to an increase in commercial lenders, an adjustment in 2010 to reduce incentive compensation and higher medical premium expenses for the third quarter of 2011 as compared to the same quarter in 2010. The aforementioned increase was partly offset by declines in write-downs on foreclosed real estate and FDIC assessments of \$182 thousand and \$79 thousand, respectively. Director fees declined \$60 thousand in the third quarter of 2011 to \$5 thousand, largely due to fluctuations in our stock price and its effect on the value of the Director's deferred stock compensation plan.

Income Taxes - our income tax expense, which includes both federal and state taxes, was \$97 thousand for the three months ended September 30, 2011 compared to \$168 thousand for the third quarter of 2010. The decrease of \$71 thousand in income taxes in the third quarter of 2011, as compared to the same period in 2010, was largely the result of a decrease in pre-tax income. The 15.4% effective tax rate for the three months ended September 30, 2011 and 21.0% in the prior year period was due to the benefit from tax exempt income from securities and bank-owned life insurance policies.

#### COMPARISON OF OPERATING RESULTS FOR NINE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010

Overview - For the nine months ended September 30, 2011, net income was \$2.0 million, an increase of \$376 thousand, or 23.8%, from \$1.6 million reported for the same period in 2010. Diluted earnings per share were \$0.59 for the nine month period ended September 30, 2011 and \$0.48 for the same period last year. The increase in net income reflects a \$761 thousand growth in net interest income and a \$462 thousand improvement in non-interest income, which was partially offset by a \$324 thousand increase in the provision for loan losses.

Net income before taxes for our Tri-State segment increased \$158 thousand resulting in a net income before taxes of \$154 thousand for the first nine months of 2011 compared to net loss before taxes of \$4 thousand for the same period in 2010. This increase was the combination of insurance commission and fee income increasing \$102 thousand and other expenses decreasing \$56 thousand between the two periods.

## Comparative Average Balances and Average Interest Rates

The following table presents, on a fully taxable equivalent basis, a summary of our interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for the nine month period ended September 30, 2011 and 2010.

| (Dollars in thousands)                        | Average<br>Balance | Nine Months Ended September 30, |                        | Average<br>Rate(2) | Average<br>Balance | 2010                   |                    | Average<br>Rate(2) |
|---|--------------------|---------------------------------|------------------------|--------------------|--------------------|------------------------|--------------------|--------------------|
|   |                    | 2011                            | Average<br>Interest(1) |                    |                    | Average<br>Interest(1) | Average<br>Rate(2) |                    |
| <b>Earning Assets:</b>                        |                    |                                 |                        |                    |                    |                        |                    |                    |
| <b>Securities:</b>                            |                    |                                 |                        |                    |                    |                        |                    |                    |
| Tax exempt(3)                                 | \$29,962           | \$1,332                         | 5.94                   | %                  | \$28,432           | \$1,228                | 5.77               | %                  |
| Taxable                                       | 52,398             | 989                             | 2.52                   | %                  | 49,820             | 1,378                  | 3.70               | %                  |
| Total securities                              | 82,360             | 2,321                           | 3.77                   | %                  | 78,252             | 2,606                  | 4.45               | %                  |
| Total loans receivable(4)                     | 341,123            | 14,210                          | 5.57                   | %                  | 330,340            | 14,194                 | 5.74               | %                  |
| Other interest-earning assets                 | 23,318             | 35                              | 0.20                   | %                  | 34,914             | 50                     | 0.19               | %                  |
| Total earning assets                          | 446,802            | 16,566                          | 4.96                   | %                  | 443,506            | \$16,850               | 5.08               | %                  |
| Non-interest earning assets                   | 38,020             |                                 |                        |                    | 38,058             |                        |                    |                    |
| Allowance for loan losses                     | (7,227 )           |                                 |                        |                    | (5,991 )           |                        |                    |                    |
| Total assets                                  | \$477,595          |                                 |                        |                    | \$475,573          |                        |                    |                    |
| <b>Sources of Funds:</b>                      |                    |                                 |                        |                    |                    |                        |                    |                    |
| <b>Interest bearing deposits:</b>             |                    |                                 |                        |                    |                    |                        |                    |                    |
| NOW   | \$78,923           | \$305                           | 0.52                   | %                  | \$64,342           | \$386                  | 0.80               | %                  |
| Money market                                  | 14,838             | 61                              | 0.55                   | %                  | 12,857             | 74                     | 0.77               | %                  |
| Savings                                       | 169,360            | 881                             | 0.70                   | %                  | 174,285            | 1,398                  | 1.07               | %                  |
| Time  | 94,898             | 1,095                           | 1.54                   | %                  | 102,586            | 1,300                  | 1.69               | %                  |
| Total interest bearing deposits               | 358,019            | 2,342                           | 0.87                   | %                  | 354,070            | 3,158                  | 1.19               | %                  |
| Borrowed funds                                | 26,859             | 797                             | 3.91                   | %                  | 33,065             | 1,065                  | 4.25               | %                  |
| Junior subordinated<br>debentures             | 12,887             | 164                             | 1.68                   | %                  | 12,887             | 170                    | 1.74               | %                  |
| Total interest bearing liabilities            | 397,765            | 3,303                           | 1.11                   | %                  | 400,022            | \$4,393                | 1.47               | %                  |
| <b>Non-interest bearing liabilities:</b>      |                    |                                 |                        |                    |                    |                        |                    |                    |
| Demand deposits                               | 39,423             |                                 |                        |                    | 38,474             |                        |                    |                    |
| Other liabilities                             | 2,427              |                                 |                        |                    | 1,436              |                        |                    |                    |
| Total non-interest bearing<br>liabilities     | 41,850             |                                 |                        |                    | 39,910             |                        |                    |                    |
| Stockholders' equity                          | 37,980             |                                 |                        |                    | 35,641             |                        |                    |                    |
| Total liabilities and<br>stockholders' equity | \$477,595          |                                 |                        |                    | \$475,573          |                        |                    |                    |
| Net interest income and<br>margin(5)          |                    | \$13,263                        | 3.97                   | %                  |                    | \$12,457               | 3.76               | %                  |

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- (1) Includes loan fee income
- (2) Average rates on securities are calculated on amortized costs
- (3) Fully taxable 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, on a fully taxable equivalent basis, increased \$806 thousand, or 6.5%, to \$13.3 million for the nine months ended September 30, 2011, as compared to \$12.5 million for same period in 2010. Our net interest margin improved 21 basis points to 3.97% for the first nine months of 2011, compared to 3.76% for the same period last year. The improvement was mostly attributed to a 36 basis point decline in the average rate paid on interest bearing liabilities to 1.11%, which was partly offset by an 12 basis point decrease in the average rate on earning assets to 4.96% for the nine month period ended September 30, 2011 as compared to the same period last year. The average balance of earning assets grew \$3.3 million and as the balance sheet mix shifted to higher yielding loans and securities from lower yielding other interest-earning assets.

Interest Income - Total interest income, on a fully taxable equivalent basis, decreased \$284 thousand for the nine months ended September 30, 2011 as compared to the same period last year. The decline was principally due to lower security yields, which decreased 68 basis points.

Total interest income on securities, on a fully taxable equivalent basis, decreased \$285 thousand, to \$2.3 million for the nine months ended September 30, 2011 from \$2.6 million for the same period last year. This decline was driven by a 68 basis point decrease in the yield on securities from 4.45% for the nine months ended September 30, 2010 to 3.77% for the nine months ended September 30, 2011. The decline in interest income on securities was partly offset by a \$4.1 million increase in average balances of total securities between the two periods. The decline in security yields was mostly attributed to the reinvestment of cash flows from maturities, calls and prepayments into a lower market rate environment.



The interest earned on total loans receivable increased \$16 thousand for the first nine months of 2011 as compared to the same period in 2010, which was mostly driven by a \$10.8 million growth in loans, on average. The increase in interest income was partly offset by a 17 basis point decline in average yields. The average rate earned on loans for the nine months ended September 30, 2011 was 5.57% as compared to 5.74% for the same period in 2010.

**Interest Expense** - Our interest expense for the nine months ended September 30, 2011 decreased \$1.1 million, or 24.8%, to \$3.3 million from \$4.4 million for the same period in 2010. The improvement was principally due to lower average rates paid on total interest-bearing liabilities, which declined 36 basis points from 1.47% for the nine months ended September 30, 2010 to 1.11% for the same period in 2011.

Interest expense on deposits declined \$816 thousand, or 25.8%, for the nine months ended September 30, 2011, as compared to the same period last year. The decline was largely attributed to lower rates on total interest bearing deposits, which decreased 32 basis points for the first nine months of 2011 as compared to the same period in 2010. The decrease in rates on deposit products reflects managements' asset/liability strategies and a lower market rate environment between the two periods. During the nine months of 2011, there was a favorable shift in deposit mix as time deposits, on average, declined \$7.7 million, while NOW accounts, on average, increased \$14.6 million. The shift in mix had a positive effect on interest expense for the first nine months of 2011.

Interest expense on borrowings declined \$268 thousand, or 25.2%, for the nine months ended September 30, 2011, as compared to the same period last year. The decrease was largely due to a decline in our average borrowed funds by \$6.2 million to \$26.9 million for the nine months ended September 30, 2011 as compared to the same period last year. The decline in interest expense on borrowings also benefited from lower average rates paid on borrowed funds, which declined 34 basis points to 3.91% for the nine months ended September 30, 2011 as compared to 4.25% for the same period last year.

We had an average balance of \$12.9 million in junior subordinated debentures outstanding during the first nine months of 2011 and 2010. The \$12.9 million junior subordinated debentures, issued on June 28, 2007 bear a floating rate of interest tied to the three month LIBOR. The average rate paid on the debentures decreased 6 basis points to 1.68% for the nine months ended September 30, 2011 from 1.74% for the same period in 2010.

**Provision for Loan Losses** - The loan loss provision for the first nine months of 2011 increased \$324 thousand, or 13.7%, to \$2.7 million compared to a provision of \$2.4 million for the same period in 2010. 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 income of \$462 thousand, or 13.2%, to \$4.0 million for the nine months ended September 30, 2011. The increase in non-interest income was largely due to a \$216 thousand gain on sale of securities and a decrease in an impairment write-down on equity securities originally recorded in 2010. Contributing to the growth in non-interest income were increases in bank-owned life insurance income of \$105 thousand, or 50.2%, and higher insurance commissions and fees of \$102 thousand, or 6.3%, from Tri-State as compared to the same period last year.

**Non-Interest Expense** - Our non-interest expenses increased \$376 thousand, or 3.4%, to \$11.6 million for the nine months ended September 30, 2011. The increase for the first nine months of 2011 compared to the same period in 2010 was largely due to an increase in salaries and benefits and loan collection costs of \$347 thousand, or 5.9%, and \$299 thousand, or 97.4%, respectively. The increase was partly offset by a \$146 thousand decline in FDIC assessment costs. The increase in salary and benefits expenses was largely due to higher medical benefits expenses

and 401k costs. Total salary expense, excluding benefits, increased 1.8% for the first nine months of 2011 compared to the same period in 2010.

Income Taxes – Our income tax expense, which includes both federal and state taxes, was \$535 thousand for the nine months ended September 30, 2011 compared to \$388 thousand for the same period in 2010. Our effective tax rate increased from 19.7% for the nine months period ended September 30, 2010 to 21.5% for the first nine months of 2011 and is below the statutory tax rate due to tax-exempt interest on securities and earnings on the investment in bank-owned life insurance.

COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2011 TO DECEMBER 31, 2010

At September 30, 2011, our total assets were \$495.9 million, an increase of \$21.9 million, or 4.6%, as compared to total assets of \$474.0 million at December 31, 2010.

Cash and Cash Equivalents - Our cash and cash equivalents increased by \$30.6 million at September 30, 2011 to \$48.4 million, or 9.8% of total assets, from \$17.7 million, or 3.7% of total assets, at December 31, 2010. The increase was largely due to an increase of \$29.1 million in deposits.

Securities Portfolio - At September 30, 2011, total investment securities, which include available-for-sale and held-to-maturity securities, were \$81.9 million compared to \$90.4 million at December 31, 2010. Available-for-sale securities were \$78.6 million at September 30, 2011 compared to \$89.4 million at December 31, 2010. The available-for-sale securities are held primarily for liquidity, interest rate risk management and long-term yield enhancement. 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. The decrease for the first nine months of 2011 in available-for-sale securities compared with the year ended December 31, 2010 is due to the maturities, calls and principal repayments of \$23.7 million of securities in the first nine months of 2011. Held-to-maturity securities totaled \$3.3 million at September 30, 2011 compared to \$1.0 million at December 31, 2010 and consist principally of securities issued by state and political subdivisions.

Other investments totaled \$1.8 million at September 30, 2011, compared to \$2.2 million at December 31, 2010 and consisted primarily of FHLB stock. The decrease of \$398 thousand, or 17.8%, from September 30, 2011 to December 31, 2010 was a result of the FHLB stock redemptions due to reductions in borrowings between the two periods. We also held \$100 thousand in time deposits with other financial institutions at September 30, 2011 and \$600 thousand at December 31, 2010.

Net unrealized gains were \$1.4 million and \$86 thousand at September 30, 2011 and December 31, 2010, respectively. The improvement in the fair value of the investment securities is driven by state and political subdivisions. Gross unrealized losses improved by \$581 thousand to \$486 thousand at September 30, 2011, as compared to \$1.1 million at December 31, 2010. The improvement in gross unrealized losses was largely attributed to higher fair values of state and political subdivisions.

We conduct a regular assessment of its investment securities to determine whether any securities are other-than-temporarily impaired ("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 the unaudited consolidated financial statements. Our securities in unrealized loss positions are mostly driven by changes in spreads and market interest rates. All of our debt and equity securities have been evaluated for other-than-temporary impairment as of September 30, 2011 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. Based on that evaluation, we did 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.

Our equity portfolio, which amounted to a fair value of \$1.3 million, is comprised primarily of investments in other banks, an equity fund and a tax exempt mutual fund. During the second quarter of 2010, we recognized \$171 thousand pre-tax non-cash OTTI charge related to an equity portfolio fund of common stocks in bank holding companies that had an amortized cost of \$250 thousand. We continue to closely monitor the performance of our equity securities that we own, as well as the impact from any further deterioration in the economy or in the banking industry that may adversely affect these securities. We will continue to evaluate them for OTTI, which could result in a future non-cash charge to earnings. We held no high-risk securities or derivatives at September 30, 2011 or December 31, 2010.

Loans - The loan portfolio comprises our largest class of earning assets. Total loans receivable, net of unearned income, at September 30, 2011 decreased \$440 thousand to \$337.8 million from \$338.2 million at year-end 2010, as new loan originations were less than payments, charge-offs and maturities. The declines was largely in construction loans and commercial and industrial loans, which decreased \$3.4 million and \$1.5 million, respectively. The aforementioned decreases were mostly offset by an increase in residential real estate loans, which increased \$4.7 million to \$101.4 million at September 30, 2011 as compared to December 31, 2010. Approximately 95% of our loan portfolio is secured by real estate and less than 5% of the loan portfolio is commercial and industrial based loans. We do not originate sub-prime or unconventional one to four family real estate loans.

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

| (Dollars in thousands)    | September 30,<br>2011 | December 31,<br>2010 |
|---------------------------|-----------------------|----------------------|
| Commercial and industrial | \$ 13,589             | \$ 15,045            |
| Construction              | 17,447                | 20,862               |
| Commercial real estate    | 204,279               | 204,407              |
| Residential real estate   | 101,386               | 96,659               |
| Consumer and other loans  | 1,272                 | 1,395                |
| Total gross loans         | \$ 337,973            | \$ 338,368           |

Loan and Asset Quality - Total non-performing assets, which include non-accrual loans, performing troubled debt restructured loans and foreclosed real estate, increased by \$7.0 million to \$33.4 million at September 30, 2011 from \$26.4 million at year end 2010. Our non-accrual loans increased \$4.8 million to \$27.5 million at September 30, 2011 from \$22.7 million at December 31, 2010. Troubled debt restructured loans that were not on non-accrual were \$1.3 million at September 30, 2011 and at December 31, 2010. Non-accrual loans at September 30, 2011 primarily consist of loans which are collateralized by real estate. During the first nine months of 2011, foreclosed real estate increased by a net of \$2.1 million. We held 12 foreclosed real estate properties as of September 30, 2011 totaling \$4.5 million. Six of the properties, which consist of three residential homes, a three lot residential subdivision, a single residential lot and a commercial property, had an average book balance of approximately \$276 thousand for each property. The largest loan taken into inventory amounted to approximately \$1.0 million and consisted of land and some partially completed condominiums. All foreclosed real estate properties were recorded at fair value less selling costs and are currently being marketed for sale.

Management continues to monitor our asset quality and believes that the non-performing assets 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)                                   | September 30,<br>2011 | December 31,<br>2010 |
|--|-----------------------|----------------------|
| Non-accrual loans  | \$ 27,493             | \$ 22,682            |
| Non-accrual loans to total loans                         | 8.14                  | 6.71                 |
| Non-performing assets                                    | \$ 33,351             | \$ 26,397            |
| Non-performing assets to total assets                    | 6.73                  | 5.57                 |
| Allowance for loan losses as a % of non-performing loans | 25.69                 | 26.65                |
| Allowance for loan losses to total loans                 | 2.19                  | 1.89                 |

Loan balances past due 90 days or more and still accruing interest, but which management expects will eventually be paid in full are not included in total non-performing loans, were principally due to maturity and are current in payments and are well secured.. At September 30, 2011, we had \$1.0 million in this category as compared to \$49 thousand at December 31, 2010.

A loan is considered impaired, in accordance with the impairment accounting guidance (FASB ASC 310-10-35-16), 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 September 30, 2011 were

\$30.4 million and at December 31, 2010 were \$23.5 million. Impaired loans measured at fair value increased to \$14.2 million on September 30, 2011 from \$13.4 million at December 31, 2010. The principal balances on loans measured at fair value were \$16.7 million and \$14.8 million, net of valuation allowance of \$2.5 million at September 30, 2011 and \$1.4 million at December 31, 2010. 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. Impaired and restructured loans that were still accruing totaled \$1.3 million at September 30, 2011 and December 31, 2010.

In addition to non-performing loans we continue to monitor our portfolio for potential problem loans. Potential problem loans are defined as loans which causes 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 September 30, 2011, we had 6 loan relationships totaling \$1.7 million that it deemed potential problem loans. Management is actively monitoring these loans.

Further detail of the credit quality of the loan portfolio is in Note 3 - Loans to the unaudited consolidated financial statements.

Allowance for Loan Losses - The allowance consists of general and allocated 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-classified loans and is based on historical charge-off experience and expected losses derived from our internal risk rating process. Other adjustments 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 September 30, 2011, the total allowance for loan losses increased \$1.0 million, or 15.7%, to \$7.4 million, as compared to \$6.4 million at December 31, 2010. The components of this increase were a provision for loan losses of \$2.7 million, charge-offs totaling \$2.2 million and recoveries of \$546 thousand in the first nine months of 2011. The provision also reflects the continued decline in current real estate values in our market area and reduced cash flows to support the repayment of loans. The allowance for loan losses as a percentage of total loans was 2.19% at September 30, 2011 and 1.89% at December 31, 2010.

The table below presents information regarding our provision and allowance for loan losses at September 30, 2011 and September 30, 2010:

| (Dollars in thousands)       | September 30,<br>2011 | September 30,<br>2010 |
|------------------------------|-----------------------|-----------------------|
| Balance, beginning of period | \$ 6,397              | \$ 5,496              |
| Charge-offs                  | (2,230 )              | (1,804 )              |
| Recoveries                   | 546                   | 41                    |
| Provision                    | 2,688                 | 2,364                 |
| Balance, end of period       | \$ 7,401              | \$ 6,097              |

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)    | Allowance for Loans Losses at September 30, |  |   |        |        |
|---------------------------|---|--|---|--------|--------|
|                           | 2011  | Percent of<br>Loans In<br>Each<br>Category<br>To<br>Gross<br>Loans |   | 2010   |        |
| Commercial and industrial | Amount                                      | Amount   | % | Amount | %      |
|                           | \$487                                       | 4.01   | % | \$394  | 4.73 % |

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|                          |         |        |   |         |        |   |
|--------------------------|---------|--------|---|---------|--------|---|
| Construction             | 1,404   | 5.16   | % | 1,410   | 5.42   | % |
| Commercial real estate   | 4,233   | 60.44  | % | 3,268   | 60.90  | % |
| Residential real estate  | 1,003   | 30.01  | % | 608     | 28.58  | % |
| Consumer and other loans | 38      | 0.38   | % | 50      | 0.36   | % |
| Unallocated              | 236     | -      |   | 367     | -      |   |
| Total                    | \$7,401 | 100.00 | % | \$6,097 | 100.00 | % |

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Bank-Owned Life Insurance (BOLI) - Our BOLI carrying value amounted to \$11.0 million at September 30, 2011 and \$10.2 million at December 31, 2010.

Goodwill and Other Intangibles - Goodwill represents the excess of the purchase price over the fair market value of net assets acquired. At September 30, 2011 and December 31, 2010, we had recorded goodwill totaling \$2.8 million, primarily as a result of the acquisition of an insurance agency in 2001. 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 accesses 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 - Total deposits increased \$29.1 million, or 7.5%, to \$415.1 million at September 30, 2011 from \$386.0 million at December 31, 2010. The increase was largely in total interest bearing deposits, which increased \$24.8 million to \$375.4 million at September 30, 2011 from \$350.6 million at December 31, 2010. In addition, non-interest-bearing deposits increased \$4.3 million, or 12.0% to \$39.6 million at September 30, 2011 from \$35.4 million at December 31, 2010.

Borrowings - Borrowings consist of long term advances from the Federal Home Loan Bank of New York ("FHLBNY"). The advances are secured under terms of a blanket collateral agreement by a pledge of qualifying mortgage loans. We had \$26.0 million in borrowings, at a weighted average interest rate of 4.03%, at September 30, 2011 and \$36.0 million in borrowings, at a weighted average interest rate of 4.25%, at December 31, 2010. The borrowings at September 30, 2011 consisted of advances with quarterly convertible options that allow the FHLBNY to change the note rate to a then current market rate.

Junior Subordinated Debentures - On June 28, 2007, we raised an additional \$12.5 million in capital through the issuance of junior subordinated debentures to a non-consolidated statutory trust subsidiary. The subsidiary in turn issued \$12.5 million in variable rate capital trust pass through securities to investors in a private placement. The interest rate is based on the three-month LIBOR plus 144 basis points and adjusts quarterly. The rate at September 30, 2011 was 1.79%. The capital securities are redeemable by us during the first five years at a redemption price of 103.5% of par for the first year and thereafter on a sliding scale down to 100% of par on or after June 15, 2012 in whole or in part or earlier if the regulatory capital or tax treatment of the securities is substantially changed. 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.

In accordance with FASB issued ASC 810, Consolidations, our wholly-owned subsidiary, Sussex Capital Trust II, is not included in our consolidated financial statements.

Equity – Stockholders' equity, inclusive of accumulated other comprehensive income, net of income taxes, was \$39.4 million at September 30, 2011 and \$36.7 million at year-end 2010. In order to preserve capital, the Board of Directors elected not to declare any cash dividends in the first nine months of 2011. The Board will review our dividend policy based on a number of factors, including current economic and regulatory conditions, our earnings and asset quality and capital needs. On April 27, 2011, at our Annual Meeting of Stockholders, stockholders approved an increase in the number of authorized shares of common stock from 5 million to 10 million shares.

## 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 September 30, 2011, total deposits amounted to \$415.1 million, an increase of \$29.1 million, or 7.5%, from December 31, 2010. At September 30, 2011, advances from FHLBNY and subordinated debentures totaled \$38.9 million and represented 7.8% of total assets as compared to \$48.9 million and 10.3% of total assets at December 31, 2010.

Loan production continued to be our principal investing activity. Net loans at September 30, 2011 amounted to \$330.4 million, a decrease of \$1.4 million, or 0.4%, compared to December 31, 2010.

Our most liquid assets are cash and due from banks and federal funds sold. At September 30, 2011, the total of such assets amounted to \$48.4 million, or 9.0%, of total assets, compared to \$17.7 million, or 3.7%, of total assets at year-end 2010. Another significant liquidity source is our available-for-sale securities portfolio. At September 30, 2011, available-for-sale securities amounted to \$78.6 million compared to \$89.4 million at year-end 2010.

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 Federal Reserve Bank discount window. The Bank also has the capacity to borrow an additional \$30.4 million through its membership in the FHLBNY and \$4.0 million at Atlantic Central Bankers Bank at September 30, 2011. Management believes that our sources of funds are sufficient to meet our present funding requirements.

The Bank's regulators have implemented risk based guidelines which require banks to maintain Tier I capital as a percent of risk-adjusted assets of 4.0% and Tier II capital as a percentage of risk-adjusted assets of 8.0% at a minimum. At September 30, 2011, the Bank's Tier I and Tier II capital ratios were 13.11% and 14.37%, 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 percent of tangible assets) of 4.0%. As of September 30, 2011, the Bank had a leverage ratio of 9.42%. The Bank's risk based and leverage ratios are in excess of those required to be considered "well-capitalized" under FDIC regulations.

The Board of Governors of the Federal Reserve System also imposes similar capital requirements on bank holding companies with consolidated assets of \$500 million or more. Since we do not currently have \$500 million or more in consolidated assets, we are not currently subject to these requirements.

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 Sussex Capital Trust II. 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 September 30, 2011 totaled \$43.6 million and consisted of \$19.1 million in commitments to grant commercial real estate, construction and land development loans, \$12.1 million in home equity lines of credit, \$10.6 million in other unused commitments and \$1.7 million 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.

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 and 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.

## PART II – OTHER INFORMATION

### Item 1 - Legal Proceedings

We are periodically involved in various legal proceedings as a normal incident to their businesses. In the opinion of management no material loss is expected from any such pending lawsuit.

### Item 1A - Risk Factors

For a summary of risk factors relevant to our operations, see Part 1, Item 1A, “Risk Factors” in our 2010 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

On April 16, 1999, we announced a stock repurchase plan whereby we may purchase up to 50,000 shares of outstanding stock. There is no expiration date to this plan. The plan has been amended several times to increase the number of shares which may be repurchased, and we currently have the authority to repurchase up to 400,000 shares of our common stock. As of September 30, 2011, 247,342 shares had been purchased as part of the plan and 152,658 shares were left to be purchased under the plan. No shares were purchased during the first nine months of 2011.

### Item 3 - Defaults Upon Senior Securities

Not applicable

### Item 4 - [Removed and Reserved]

### 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 Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SUSSEX BANCORP

By: /s/ Steven M. Fusco  
STEVEN M. FUSCO  
Senior Vice President and  
Chief Financial Officer

Date: November 14, 2011

EXHIBIT INDEX

| 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.II to the Current Report on Form 8-K filed with the SEC on April 28, 2010.)   |
| 10.1   | Supplemental Executive Retirement Agreement, dated July 20, 2011, by and between Sussex Bancorp and Anthony J. Labozzetta (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed with the SEC on July 26, 2011.)   |
| 31.1*  | Certification of Anthony Labozzetta pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2*  | Certification of Steven M. Fusco pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1*  | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 101**  | Financial statements from the quarterly report on Form 10-Q of Sussex Bancorp for the quarter ended September 30, 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Stockholders' Equity, (iv) the Consolidated Statements of Cash Flows and (v) Notes to Consolidated Financial Statements. |

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\* Filed herewith

\*\*Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.