

SUSSEX BANCORP  
Form 10-Q  
November 13, 2013

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, 2013

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

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

Commission File Number 0-29030

SUSSEX BANCORP

(Exact name of registrant as specified in its charter)

New Jersey 22-3475473

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

200 Munsonhurst Rd., Franklin, NJ 07416  
(Address of principal executive offices) (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 S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

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As of November 7, 2013 there were 4,629,113 shares of common stock, no par value, outstanding.

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SUSSEX BANCORP

FORM 10-Q

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## FORWARD-LOOKING STATEMENTS

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

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

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



## PART I – FINANCIAL INFORMATION

## Item 1 – Financial Statements

SUSSEX BANCORP  
CONSOLIDATED BALANCE SHEETS

| (Dollars In Thousands)   | September 30,<br>2013<br>(Unaudited) | December<br>31, 2012 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Cash and due from banks  | \$ 7,784                             | \$ 6,268             |
| Interest-bearing deposits with other banks   | 3,256                                | 5,400                |
| Cash and cash equivalents  | 11,040                               | 11,668               |
| Interest bearing time deposits with other banks  | 100                                  | 100                  |
| Securities available for sale, at fair value   | 95,378                               | 118,881              |
| Securities held to maturity, at cost (fair value of \$5,856 and \$5,472 at September 30, 2013 and December 31, 2012, respectively) | 5,824                                | 5,221                |
| Federal Home Loan Bank Stock, at cost  | 2,480                                | 1,980                |
| Loans receivable, net of unearned income   | 392,300                              | 347,736              |
| Less: allowance for loan losses  | 5,655                                | 4,976                |
| Net loans receivable   | 386,645                              | 342,760              |
| Foreclosed real estate   | 3,077                                | 5,066                |
| Premises and equipment, net  | 6,556                                | 6,476                |
| Accrued interest receivable  | 1,695                                | 1,741                |
| Goodwill   | 2,820                                | 2,820                |
| Bank-owned life insurance  | 11,803                               | 11,536               |
| Other assets   | 7,468                                | 6,485                |
| Total Assets   | \$ 534,886                           | \$ 514,734           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                      |                      |
| Liabilities:   |                                      |                      |
| Deposits:  |                                      |                      |
| Non-interest bearing   | \$ 59,438                            | \$ 48,375            |
| Interest bearing   | 377,536                              | 384,061              |
| Total Deposits   | 436,974                              | 432,436              |
| Long-term borrowings   | 36,000                               | 26,000               |
| Accrued interest payable and other liabilities   | 3,012                                | 3,039                |

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|  |            |            |
|--|------------|------------|
| Junior subordinated debentures   | 12,887     | 12,887     |
| Total Liabilities  | 488,873    | 474,362    |
| 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>4,640,296 and 3,409,056 shares issued and 4,629,113 and 3,397,873 shares<br>outstanding at September 30, 2013 and December 31, 2012, respectively | 35,187     | 28,117     |
| Treasury stock, at cost; 11,183 shares   | (59)       | (59)       |
| Retained earnings  | 12,765     | 11,958     |
| Accumulated other comprehensive (loss) income  | (1,880)    | 356        |
| Total Stockholders' Equity   | 46,013     | 40,372     |
| Total Liabilities and Stockholders' Equity   | \$ 534,886 | \$ 514,734 |

See Notes to Unaudited Consolidated Financial Statements



SUSSEX BANCORP  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (LOSS)  
(Unaudited)

| (Dollars in thousands except per share data)                   | Three Months             |          | Nine Months Ended  |           |
|--|--------------------------|----------|--------------------|-----------|
|  | Ended September 30, 2013 | 2012     | September 30, 2013 | 2012      |
| <b>INTEREST INCOME</b>   |                          |          |                    |           |
| Loans receivable, including fees                               | \$ 4,599                 | \$ 4,467 | \$ 13,360          | \$ 13,292 |
| Securities:  |                          |          |                    |           |
| Taxable  | 130                      | 241      | 410                | 994       |
| Tax-exempt   | 254                      | 292      | 762                | 827       |
| Interest bearing deposits                                      | 2                        | 4        | 9                  | 30        |
| Total Interest Income  | 4,985                    | 5,004    | 14,541             | 15,143    |
| <b>INTEREST EXPENSE</b>  |                          |          |                    |           |
| Deposits   | 419                      | 587      | 1,410              | 1,938     |
| Borrowings   | 293                      | 268      | 828                | 797       |
| Junior subordinated debentures                                 | 54                       | 60       | 163                | 183       |
| Total Interest Expense   | 766                      | 915      | 2,401              | 2,918     |
| Net Interest Income  | 4,219                    | 4,089    | 12,140             | 12,225    |
| <b>PROVISION FOR LOAN LOSSES</b>                               | 500                      | 1,104    | 2,342              | 2,922     |
| Net Interest Income after Provision for Loan Losses            | 3,719                    | 2,985    | 9,798              | 9,303     |
| <b>OTHER INCOME</b>  |                          |          |                    |           |
| Service fees on deposit accounts                               | 283                      | 292      | 840                | 842       |
| ATM and debit card fees  | 181                      | 165      | 519                | 453       |
| Bank-owned life insurance                                      | 85                       | 96       | 267                | 300       |
| Insurance commissions and fees                                 | 756                      | 684      | 2,245              | 1,892     |
| Investment brokerage fees                                      | 37                       | 46       | 136                | 118       |
| Net gain on sale of loans held for sale                        | -                        | -        | -                  | 47        |
| Net gain on securities transactions                            | -                        | 569      | 399                | 763       |
| Net loss on sale of premises and equipment                     | -                        | -        | -                  | (6)       |
| Other  | 92                       | 108      | 276                | 291       |
| Total Other Income   | 1,434                    | 1,960    | 4,682              | 4,700     |
| <b>OTHER EXPENSES</b>  |                          |          |                    |           |
| Salaries and employee benefits                                 | 2,387                    | 2,196    | 6,943              | 6,744     |
| Occupancy, net   | 342                      | 355      | 1,083              | 1,071     |
| Furniture, equipment and data processing                       | 326                      | 326      | 983                | 1,014     |
| Advertising and promotion                                      | 63                       | 63       | 198                | 222       |
| Professional fees  | 153                      | 175      | 536                | 478       |
| Director fees  | 106                      | 56       | 299                | 236       |
| FDIC assessment  | 176                      | 177      | 523                | 516       |
| Insurance  | 65                       | 68       | 204                | 179       |
| Stationary and supplies  | 43                       | 44       | 143                | 128       |
| Loan collection costs  | 37                       | 204      | 251                | 539       |
| Net expenses and write-downs related to foreclosed real estate | 317                      | 232      | 1,325              | 1,039     |
| Amortization of intangible assets                              | -                        | 1        | 1                  | 4         |
| Other  | 420                      | 396      | 1,213              | 1,095     |
| Total Other Expenses   | 4,435                    | 4,293    | 13,702             | 13,265    |
| Income before Income Taxes                                     | 718                      | 652      | 778                | 738       |
| <b>EXPENSE (BENEFIT) FOR INCOME TAXES</b>                      | 143                      | 106      | (29)               | (94)      |

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|  |         |         |            |          |
|--|---------|---------|------------|----------|
| Net Income   | 575     | 546     | 807        | 832      |
| <b>OTHER COMPREHENSIVE INCOME (LOSS):</b>  |         |         |            |          |
| Unrealized gains (losses) on available for sale securities arising during the period       | 430     | 693     | (3,327)    | 1,413    |
| Reclassification adjustment for net gain on securities transactions included in net income | -       | (569)   | (399)      | (763)    |
| Income tax (benefit) expense related to items of other comprehensive income (loss)         | (173)   | (49)    | 1,490      | (259)    |
| Other comprehensive income (loss), net of income taxes                                     | 257     | 75      | (2,236)    | 391      |
| Comprehensive income (loss)  | \$ 832  | \$ 621  | \$ (1,429) | \$ 1,223 |
| <b>EARNINGS PER SHARE</b>  |         |         |            |          |
| Basic  | \$ 0.14 | \$ 0.17 | \$ 0.23    | \$ 0.26  |
| Diluted  | \$ 0.14 | \$ 0.17 | \$ 0.23    | \$ 0.25  |
| See Notes to Unaudited Consolidated Financial Statements                                   |         |         |            |          |

SUSSEX BANCORP  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
Nine Months Ended September 30, 2013 and 2012  
(Unaudited)

| (Dollars In Thousands)  | Number of<br>Shares<br>Outstanding | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Treasury<br>Stock | Total<br>Stockholders'<br>Equity |
|---|------------------------------------|-----------------|----------------------|--|-------------------|----------------------------------|
| Balance December 31,<br>2011  | 3,372,949                          | \$ 27,964       | \$ 11,223            | \$ 719   | \$ (4)            | \$ 39,902                        |
| Net income  | -                                  | -               | 832                  | -  | -                 | 832                              |
| Other comprehensive<br>income   | -                                  | -               | -                    | 391  | -                 | 391                              |
| Treasury shares<br>purchased  | (10,339)                           | -               | -                    | -  | (55)              | (55)                             |
| Restricted stock<br>granted   | 37,496                             | -               | -                    | -  | -                 | -                                |
| Restricted stock<br>forfeited   | (2,233)                            | -               | -                    | -  | -                 | -                                |
| Compensation expense<br>related to stock<br>option and restricted<br>stock grants | -                                  | 112             | -                    | -  | -                 | 112                              |
| Balance September 30,<br>2012   | 3,397,873                          | \$ 28,076       | \$ 12,055            | \$ 1,110   | \$ (59)           | \$ 41,182                        |
| Balance December 31,<br>2012  | 3,397,873                          | \$ 28,117       | \$ 11,958            | \$ 356   | \$ (59)           | \$ 40,372                        |
| Net income  | -                                  | -               | 807                  | -  | -                 | 807                              |
| Other comprehensive<br>loss   | -                                  | -               | -                    | (2,236)  | -                 | (2,236)                          |
| Restricted stock<br>granted   | 32,940                             | -               | -                    | -  | -                 | -                                |
| Stock issued in rights<br>offering  | 1,198,300                          | 6,896           | -                    | -  | -                 | 6,896                            |
| Compensation expense<br>related to stock  | -                                  | 174             | -                    | -  | -                 | 174                              |

option and restricted  
stock grants

|                               |           |           |           |            |         |           |
|-------------------------------|-----------|-----------|-----------|------------|---------|-----------|
| Balance September 30,<br>2013 | 4,629,113 | \$ 35,187 | \$ 12,765 | \$ (1,880) | \$ (59) | \$ 46,013 |
|-------------------------------|-----------|-----------|-----------|------------|---------|-----------|

See Notes to Unaudited Consolidated Financial Statements

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SUSSEX BANCORP  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

| (Dollars in thousands)  | Nine Months Ended September 30,<br>2013 | 2012   |
|---|---|--------|
| Cash Flows from Operating Activities  |   |        |
| Net income  | \$ 807                                  | \$ 832 |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |        |
| Provision for loan losses   | 2,342                                   | 2,922  |
| Depreciation and amortization   | 510                                     | 509    |
| Net amortization of securities premiums and discounts                             | 2,496                                   | 1,991  |
| Net realized gain on sale of securities   | (399)                                   | (763)  |
| Net realized gain on sale of loans held for sale                                  | -                                       | (47)   |
| Proceeds from the sale of loans held for sale                                     | -                                       | 638    |
| Net realized loss on sale of premises and equipment                               | -                                       | 6      |
| Net realized gain on sale of foreclosed real estate                               | (50)                                    | (5)    |
| Write-downs of and provisions for foreclosed real estate                          | 995                                     | 871    |
| Deferred income taxes   | 648                                     | (509)  |
| Earnings on bank owned life insurance   | (267)                                   | (300)  |
| Compensation expense for stock options and stock awards                           | 174                                     | 112    |
| (Increase) decrease in assets:  |   |        |
| Accrued interest receivable   | 46                                      | (126)  |
| Other assets  | (142)                                   | 1,060  |
| Decrease in accrued interest payable and other liabilities                        | (27)                                    | 4,096  |
| Net Cash Provided by Operating Activities   | 7,133                                   | 11,287 |

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|  |           |    |          |
|--|-----------|----|----------|
| Cash Flows from                                  |           |    |          |
| Investing Activities                             |           |    |          |
| Securities available for sale:                   |           |    |          |
| Purchases  | (28,745)  |    | (71,850) |
| Sales  | 13,029    |    | 24,187   |
| Maturities, calls and principal repayments       | 33,431    |    | 24,475   |
| Securities held to maturity:                     |           |    |          |
| Purchases  | (1,860)   |    | (2,623)  |
| Maturities, calls and principal repayments       | 1,222     |    | 1,220    |
| Net increase in loans                            | (49,080)  |    | (5,632)  |
| Proceeds from the sale of foreclosed real estate | 3,897     |    | 425      |
| Purchases of bank premises and equipment         | (589)     |    | (375)    |
| Proceeds from the sale of premises and equipment | -         |    | 12       |
| Increase in FHLB stock                           | (500)     |    | (106)    |
| Net Cash Used in Investing Activities            | (29,195)  |    | (30,267) |
| Cash Flows from Financing Activities             |           |    |          |
| Net increase (decrease) in deposits              | 4,538     |    | (8,035)  |
| Increase in borrowed funds                       | 10,000    |    | -        |
| Purchase of treasury stock                       | -         |    | (55)     |
| Net proceeds from issuance of common stock       | 6,896     |    | -        |
| Net Cash Provided by Financing Activities        | 21,434    |    | (8,090)  |
| Net Decrease in Cash and Cash Equivalents        | (628)     |    | (27,070) |
| Cash and Cash Equivalents - Beginning            | 11,668    |    | 37,500   |
| Cash and Cash Equivalents - Ending               | \$ 11,040 | \$ | 10,430   |
| Supplementary Cash Flows Information             |           |    |          |
| Interest paid                                    | \$ 2,468  | \$ | 2,952    |
| Income taxes paid                                | \$ 33     | \$ | 212      |

Supplementary Schedule of Noncash Investing

and Financing Activities

Foreclosed real estate  
acquired in settlement of  
loans

\$ 2,853

\$ 940

Loans transferred to  
held for sale

\$ -

\$ 591

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

Sussex Bancorp 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 Sussex Bancorp and Sussex 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, 2013, are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. 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, 2012.

We have evaluated events and transactions occurring subsequent to the balance sheet date of September 30, 2013, for items that should potentially be recognized or disclosed in these unaudited consolidated financial statements. The evaluation was conducted through the date these unaudited consolidated financial statements were issued.

Reclassifications

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

New Accounting Standards



In July 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists, which provides guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss (NOL) carryforward, a similar tax loss, or a tax credit carryforward exists. The FASB’s objective in issuing this ASU is to eliminate diversity in practice resulting from a lack of guidance on this topic in current U.S. GAAP. This ASU applies to all entities with unrecognized tax benefits that also have tax loss or tax credit carryforwards in the same tax jurisdiction as of the reporting date. For public entities, the guidance is effective for fiscal years beginning after December 15, 2013 and interim periods within those years. We do not expect the adoption of this guidance to have a material impact on our consolidated financial statements.

In February 2013, FASB issued ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This ASU requires entities to disclose the effect of items reclassified out of accumulated other comprehensive income (“AOCI”) on each affected net income line item. For AOCI reclassification items that are not reclassified in their entirety into net income, a cross reference to other required U.S. GAAP disclosures. This information may be provided either in the notes or parenthetically on the face of the financial statements. For public entities, the guidance is effective for annual reporting periods beginning after December 15, 2012, and interim periods within those years. The adoption of this guidance did not have a material impact on our consolidated financial statements and the required disclosures are included in Note 6 to these consolidated financial statements.

## NOTE 2 – SECURITIES

## Available for Sale

The amortized cost and fair value of securities available for sale as of September 30, 2013 and December 31, 2012 are summarized as follows:

| (Dollars in thousands)                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2013                                      |                   |                              |                               |               |
| U.S. government agencies                                | \$ 5,517          | \$ 24                        | \$ (28)                       | \$ 5,513      |
| State and political subdivisions                        | 28,772            | 3                            | (2,660)                       | 26,115        |
| Mortgage-backed securities:                             |                   |                              |                               |               |
| U.S. government-sponsored enterprises                   | 63,814            | 320                          | (830)                         | 63,304        |
| Equity securities-financial services industry and other | 408               | 55                           | (17)                          | 446           |
|   | \$ 98,511         | \$ 402                       | \$ (3,535)                    | \$ 95,378     |
| December 31, 2012                                       |                   |                              |                               |               |
| State and political subdivisions                        | \$ 27,341         | \$ 594                       | \$ (194)                      | \$ 27,741     |
| Mortgage-backed securities:                             |                   |                              |                               |               |
| U.S. government-sponsored enterprises                   | 90,487            | 671                          | (449)                         | 90,709        |
| Equity securities-financial services industry and other | 460               | 16                           | (45)                          | 431           |
|   | \$ 118,288        | \$ 1,281                     | \$ (688)                      | \$ 118,881    |

Securities with a carrying value of approximately \$39.9 million and \$26.1 million at September 30, 2013 and December 31, 2012, respectively, were pledged to secure public deposits and for other purposes required or permitted by applicable laws and regulations.

The amortized cost and fair value of securities available for sale at September 30, 2013, are shown below by contractual maturity. Actual maturities may differ from contractual maturities as issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in thousands)                                  | Amortized<br>Cost | Fair<br>Value |
|---|-------------------|---------------|
| Due in one year or less                                 | \$ -              | \$ -          |
| Due after one year through five years                   | 502               | 496           |
| Due after five years through ten years                  | 2,102             | 2,032         |
| Due after ten years                                     | 26,168            | 23,587        |
| Total bonds and obligations                             | 28,772            | 26,115        |
| U.S. government agencies                                | 5,517             | 5,513         |
| Mortgage-backed securities:                             |                   |               |
| U.S. government-sponsored enterprises                   | 63,814            | 63,304        |
| Equity securities-financial services industry and other | 408               | 446           |
| Total available for sale securities                     | \$ 98,511         | \$ 95,378     |

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There were no gross realized gains on sales of securities available for sale for the three months ended September 30, 2013. Gross realized gains on sales of securities available for sale were \$561 thousand for the three months ended September 30, 2012, and there were no gross realized losses for the three months ended September 30, 2013 and 2012. Gross realized gains on sales of securities available for sale were \$407 thousand and \$775 thousand for the nine months ended September 30, 2013 and 2012, respectively, and gross realized losses were \$8 thousand and \$20 thousand for the nine months ended September 30, 2013 and 2012, respectively. In addition, we realized gross gains of \$8 thousand on debt securities that were called during the three and nine month period ended September 30, 2012.

#### Temporarily Impaired Securities

The following table shows gross unrealized losses and fair value of securities with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by category and length of time that individual available for sale securities have been in a continuous unrealized loss position at September 30, 2013 and December 31, 2012.

| (Dollars in thousands)                                  | Less Than 12 Months |                         | 12 Months or More |                         | Total      |                         |
|---|---------------------|-------------------------|-------------------|-------------------------|------------|-------------------------|
|   | Fair Value          | Gross Unrealized Losses | Fair Value        | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| September 30, 2013                                      |                     |                         |                   |                         |            |                         |
| U.S. government agencies                                | \$ 3,303            | \$ (28)                 | \$ -              | \$ -                    | \$ 3,303   | \$ (28)                 |
| State and political subdivisions                        | 25,194              | (2,603)                 | 465               | (57)                    | 25,659     | (2,660)                 |
| Mortgage-backed securities:                             |                     |                         |                   |                         |            |                         |
| U.S. government-sponsored enterprises                   | 33,977              | (612)                   | 8,102             | (218)                   | 42,079     | (830)                   |
| Equity securities-financial services industry and other | -                   | -                       | 126               | (17)                    | 126        | (17)                    |
| Total temporarily impaired securities                   | \$ 62,474           | \$ (3,243)              | \$ 8,693          | \$ (292)                | \$ 71,167  | \$ (3,535)              |
| December 31, 2012                                       |                     |                         |                   |                         |            |                         |
| State and political subdivisions                        | \$ 9,788            | \$ (194)                | \$ -              | \$ -                    | \$ 9,788   | \$ (194)                |
| Mortgage-backed securities:                             |                     |                         |                   |                         |            |                         |
| U.S. government-sponsored enterprises                   | 31,901              | (305)                   | 4,658             | (144)                   | 36,559     | (449)                   |
| Equity securities-financial services industry and other | 106                 | (37)                    | 109               | (8)                     | 215        | (45)                    |
| Total temporarily impaired securities                   | \$ 41,795           | \$ (536)                | \$ 4,767          | \$ (152)                | \$ 46,562  | \$ (688)                |

As of September 30, 2013, we reviewed our available for sale securities portfolio for indications of impairment. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and the intent and likelihood of selling the security. The intent and likelihood of sale of debt and equity securities is evaluated based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy and interest rate risk position. For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred.

#### U.S. Government Agencies

At September 30, 2013, the decline in fair value and the unrealized losses for our U.S. government agencies securities were primarily due to changes in spreads and market conditions and not credit quality. At September 30, 2013, there were two securities with a fair value of \$3.3 million that had an unrealized loss that amounted to \$28 thousand. As of September 30, 2013, we did not intend to sell and it was not more-likely-than-not that we would be required to sell any of these securities before recovery of their amortized cost basis. Therefore, none of the U.S. government agency securities at September 30, 2013, were deemed to be other-than-temporarily impaired.

#### State and Political Subdivisions

At September 30, 2013, the decline in fair value and the unrealized losses for our state and political subdivisions securities were caused by changes in interest rates and spreads and were not the result of credit quality. At September 30, 2013, there were 51 securities with a fair value of \$25.7 million that had an unrealized loss that amounted to \$2.7 million. The average loss amounts to 9.4% of amortized cost at September 30, 2013. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates. As of September 30, 2013, we did not intend to sell and it was not more-likely-than-not that we would be required to sell any

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of these securities before recovery of their amortized cost basis. Therefore, none of our state and political subdivision securities at September 30, 2013, were deemed to be other-than-temporarily-impaired.

At December 31, 2012, the decline in fair value and the related unrealized losses for our state and political subdivisions securities were caused by changes in interest rates and spreads and were not the result of credit quality. At December 31, 2012, there were 17 securities with a fair value of \$9.8 million that had an unrealized loss that amounted to \$194 thousand. The average loss amounts to 1.9% of amortized cost at December 31, 2012. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates. As of December 31, 2012, 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 December 31, 2012, were deemed to be other-than-temporarily impaired.

#### Mortgage-Backed Securities

At September 30, 2013, the decline in fair value and the unrealized losses for our mortgaged-backed securities guaranteed by U.S. government-sponsored enterprises were primarily due to changes in spreads and market conditions and not credit quality. At September 30, 2013, there were 35 securities with a fair value of \$42.1 million that had an unrealized loss that amounted to \$830 thousand. As of September 30, 2013, 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 mortgage-backed securities at September 30, 2013, were deemed to be other-than-temporarily impaired.

At December 31, 2012, the decline in fair value and the unrealized losses for our mortgage-backed securities guaranteed by U.S. government-sponsored enterprises were primarily due to changes in spreads and market conditions and not credit quality. At December 31, 2012, there were 22 securities with a fair value of \$36.6 million that had an unrealized loss that amounted to \$449 thousand. As of December 31, 2012, 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 mortgage-backed securities at December 31, 2012, were deemed to be other-than-temporarily impaired.

#### Equity Securities

Our marketable equity securities portfolio consists primarily of one equity fund and common stock of entities in the financial services industry. At September 30, 2013, there was one security with a fair value of \$126 thousand that had an unrealized loss of \$17 thousand. These securities have been adversely impacted by the effects of the current economic environment on the financial services industry. We evaluated each of the underlying banks for credit impairment based on its financial condition and performance. Based on our evaluation and expectation that these securities will recover within a reasonable period of time, we do not consider these investments to be other-than-temporarily impaired at September 30, 2013.

At December 31, 2012, there were two securities with a fair value of \$215 thousand that had an unrealized loss of \$45 thousand. These securities have been adversely impacted by the effects of the current economic environment on the financial services industry. We evaluated each of the underlying banks for credit impairment based on its financial condition and performance. Based on our evaluation and expectation that these investments will recover within a reasonable period of time, we do not consider these investments to be other-than-temporarily impaired at December 31, 2012.

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.

## Held to Maturity Securities

The amortized cost and fair value of securities held to maturity as of September 30, 2013 and December 31, 2012, are summarized as follows:

| (Dollars in thousands)           | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|----------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2013               |                   |                              |                               |               |
| State and political subdivisions | \$ 5,824          | \$ 101                       | \$ (69)                       | \$ 5,856      |
| December 31, 2012                |                   |                              |                               |               |
| State and political subdivisions | \$ 5,221          | \$ 260                       | \$ (9)                        | \$ 5,472      |

The amortized cost and carrying value of securities held to maturity at September 30, 2013, are shown below by contractual maturity. Actual maturities may differ from contractual maturities as issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in thousands)                 | Amortized<br>Cost | Fair<br>Value |
|--|-------------------|---------------|
| Due in one year or less                | \$ 1,860          | \$ 1,860      |
| Due after one year through five years  | -                 | -             |
| Due after five years through ten years | 1,290             | 1,285         |
| Due after ten years                    | 2,674             | 2,711         |
| Total held to maturity securities      | \$ 5,824          | \$ 5,856      |

## Temporarily Impaired Securities

The following table shows gross unrealized losses and fair value of held to maturity securities with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by category and length of time that individual held to maturity securities have been in a continuous unrealized loss position at September 30, 2013 and December 31, 2012:



| (Dollars in thousands)           | Less Than 12 Months |                         | 12 Months or More |                         | Total      |                         |
|----------------------------------|---------------------|-------------------------|-------------------|-------------------------|------------|-------------------------|
|                                  | Fair Value          | Gross Unrealized Losses | Fair Value        | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| September 30, 2013               |                     |                         |                   |                         |            |                         |
| State and political subdivisions | \$ 1,617            | \$ (58)                 | \$ 253            | \$ (11)                 | \$ 1,870   | \$ (69)                 |
| December 31, 2012                |                     |                         |                   |                         |            |                         |
| State and political subdivisions | \$ 830              | \$ (9)                  | \$ -              | \$ -                    | \$ 830     | \$ (9)                  |

As of September 30, 2013, we reviewed our held to maturity securities portfolio for indications of impairment. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and the intent and likelihood of selling the security. The intent and likelihood of sale of debt and equity securities is evaluated based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy and interest rate risk position. For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred.

#### State and Political Subdivisions

At September 30, 2013, the decline in fair value and the unrealized losses for our state and political subdivisions securities were caused by changes in interest rates and spreads and were not the result of credit quality. At September

30, 2013, there were four securities with a fair value of \$1.9 million that had an unrealized loss that amounted to \$69 thousand. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates. As of September 30, 2013, 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, 2013, were deemed to be other-than-temporarily impaired.

At December 31, 2012, the decline in fair value and the unrealized losses for our state and political subdivisions securities were caused by changes in interest rates and spreads and were not the result of credit quality. At December 31, 2012, there were two securities with a fair value of \$830 thousand that had an unrealized loss that amounted to \$9 thousand. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates. As of December 31, 2012, 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 December 31, 2012, were deemed to be other-than-temporarily impaired.

### NOTE 3 – LOANS

The composition of net loans receivable at September 30, 2013 and December 31, 2012 is as follows:

| (Dollars in thousands)             | September<br>30, 2013 | December<br>31, 2012 |
|------------------------------------|-----------------------|----------------------|
| Commercial and industrial          | \$ 17,999             | \$ 16,158            |
| Construction                       | 9,649                 | 7,004                |
| Commercial real estate             | 256,976               | 225,345              |
| Residential real estate            | 106,448               | 98,301               |
| Consumer and other                 | 1,615                 | 1,255                |
|                                    | 392,687               | 348,063              |
| Unearned net loan origination fees | (387)                 | (327)                |
| Allowance for loan losses          | (5,655)               | (4,976)              |
| Net loans receivable               | \$ 386,645            | \$ 342,760           |

Mortgage loans serviced for others are not included in the accompanying balance sheets. The total amount of loans serviced for the benefit of others was approximately \$553 thousand and \$695 thousand at September 30, 2013 and December 31, 2012, respectively.



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

The following table presents changes in the allowance for loan losses disaggregated by the class of loans receivable for the three and nine months ended September 30, 2013 and 2012:

| (Dollars in thousands) | Commercial and Industrial | Construction | Commercial Real Estate | Residential Real Estate | Consumer and Other | Unallocated | Total    |
|------------------------|---------------------------|--------------|------------------------|-------------------------|--------------------|-------------|----------|
| Three Months Ended:    |                           |              |                        |                         |                    |             |          |
| September 30, 2013     |                           |              |                        |                         |                    |             |          |
| Beginning balance      | \$ 249                    | \$ 400       | \$ 3,472               | \$ 990                  | \$ 15              | \$ 521      | \$ 5,647 |
| Charge-offs            | -                         | (19)         | (747)                  | (89)                    | (7)                | -           | (862)    |
| Recoveries             | -                         | -            | 343                    | 24                      | 3                  | -           | 370      |
| Provision              | (10)                      | 16           | 358                    | (58)                    | 4                  | 190         | 500      |
| Ending balance         | \$ 239                    | \$ 397       | \$ 3,426               | \$ 867                  | \$ 15              | \$ 711      | \$ 5,655 |
| September 30, 2012     |                           |              |                        |                         |                    |             |          |
| Beginning balance      | \$ 430                    | \$ 170       | \$ 4,547               | \$ 1,055                | \$ 11              | \$ 47       | \$ 6,260 |
| Charge-offs            | -                         | (122)        | (264)                  | (266)                   | (8)                | -           | (660)    |
| Recoveries             | -                         | -            | 2                      | -                       | 15                 | -           | 17       |
| Provision              | 183                       | 131          | 153                    | 393                     | (10)               | 254         | 1,104    |
| Ending balance         | \$ 613                    | \$ 179       | \$ 4,438               | \$ 1,182                | \$ 8               | \$ 301      | \$ 6,721 |
| Nine Months Ended:     |                           |              |                        |                         |                    |             |          |
| September 30, 2013     |                           |              |                        |                         |                    |             |          |
| Beginning balance      | \$ 271                    | \$ 223       | \$ 3,395               | \$ 869                  | \$ 38              | \$ 180      | \$ 4,976 |
| Charge-offs            | (6)                       | (141)        | (1,759)                | (155)                   | (22)               | -           | (2,083)  |
| Recoveries             | -                         | -            | 387                    | 24                      | 9                  | -           | 420      |
| Provision              | (26)                      | 315          | 1,403                  | 129                     | (10)               | 531         | 2,342    |
| Ending balance         | \$ 239                    | \$ 397       | \$ 3,426               | \$ 867                  | \$ 15              | \$ 711      | \$ 5,655 |
| September 30, 2012     |                           |              |                        |                         |                    |             |          |
| Beginning balance      | \$ 304                    | \$ 294       | \$ 4,833               | \$ 987                  | \$ 9               | \$ 783      | \$ 7,210 |
| Charge-offs            | -                         | (830)        | (2,081)                | (546)                   | (53)               | -           | (3,510)  |
| Recoveries             | 2                         | -            | 71                     | -                       | 26                 | -           | 99       |
| Provision              | 307                       | 715          | 1,615                  | 741                     | 26                 | (482)       | 2,922    |
| Ending balance         | \$ 613                    | \$ 179       | \$ 4,438               | \$ 1,182                | \$ 8               | \$ 301      | \$ 6,721 |



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The following table presents the balance of the allowance of loan losses and loans receivable by class at September 30, 2013 and December 31, 2012, 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, 2013        |                           |  |  |                  |  |  |
| Commercial and industrial | \$ 239                    | \$ -   | \$ 239   | \$ 17,999        | \$ -   | \$ 17,999                                      |
| Construction              | 397                       | 27   | 370  | 9,649            | 269  | 9,380  |
| Commercial real estate    | 3,426                     | 308  | 3,118  | 256,976          | 10,930   | 246,046  |
| Residential real estate   | 867                       | 99   | 768  | 106,448          | 2,819  | 103,629  |
| Consumer and other loans  | 15                        | -  | 15   | 1,615            | -  | 1,615  |
| Unallocated               | 711                       | -  | -  | -                | -  | -  |
| Total                     | \$ 5,655                  | \$ 434   | \$ 4,510   | \$ 392,687       | \$ 14,018                                      | \$ 378,669                                     |
| December 31, 2012         |                           |  |  |                  |  |  |
| Commercial and industrial | \$ 271                    | \$ 27  | \$ 244   | \$ 16,158        | \$ 27  | \$ 16,131                                      |
| Construction              | 223                       | 42   | 181  | 7,004            | 2,462  | 4,542  |
| Commercial real estate    | 3,395                     | 230  | 3,165  | 225,345          | 12,682   | 212,663  |
| Residential real estate   | 869                       | 66   | 803  | 98,301           | 3,351  | 94,950   |
| Consumer and other loans  | 38                        | -  | 38   | 1,255            | -  | 1,255  |
| Unallocated               | 180                       | -  | -  | -                | -  | -  |
| Total                     | \$ 4,976                  | \$ 365   | \$ 4,431   | \$ 348,063       | \$ 18,522                                      | \$ 329,541                                     |

An age analysis of loans receivable which were past due as of September 30, 2013 and December 31, 2012, is as follows:

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

September 30, 2013

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|                           |          |        |           |           |            |            |        |
|---------------------------|----------|--------|-----------|-----------|------------|------------|--------|
| Commercial and industrial | \$ -     | \$ -   | \$ 50     | \$ 50     | \$ 17,949  | \$ 17,999  | \$ 50  |
| Construction              | -        | -      | 269       | 269       | 9,380      | 9,649      | -      |
| Commercial real estate    | 988      | 260    | 10,319    | 11,567    | 245,409    | 256,976    | -      |
| Residential real estate   | 372      | 407    | 2,962     | 3,741     | 102,707    | 106,448    | 144    |
| Consumer and other        | 2        | 5      | 3         | 10        | 1,605      | 1,615      | 3      |
| Total                     | \$ 1,362 | \$ 672 | \$ 13,603 | \$ 15,637 | \$ 377,050 | \$ 392,687 | \$ 197 |

December 31, 2012

|                           |          |          |           |           |            |            |        |
|---------------------------|----------|----------|-----------|-----------|------------|------------|--------|
| Commercial and industrial | \$ -     | \$ -     | \$ 27     | \$ 27     | \$ 16,131  | \$ 16,158  | \$ -   |
| Construction              | -        | -        | 2,462     | 2,462     | 4,542      | 7,004      | -      |
| Commercial real estate    | 1,103    | 1,303    | 12,127    | 14,533    | 210,812    | 225,345    | 65     |
| Residential real estate   | 207      | 127      | 3,315     | 3,649     | 94,652     | 98,301     | -      |
| Consumer and other        | 12       | 3        | 144       | 159       | 1,096      | 1,255      | 143    |
| Total                     | \$ 1,322 | \$ 1,433 | \$ 18,075 | \$ 20,830 | \$ 327,233 | \$ 348,063 | \$ 208 |

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

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Loans for which the accrual of interest has been discontinued at September 30, 2013 and December 31, 2012, were:

| (Dollars in thousands)    | September<br>30, 2013 | December<br>31, 2012 |
|---------------------------|-----------------------|----------------------|
| Commercial and industrial | \$ -                  | \$ 27                |
| Construction              | 269                   | 2,462                |
| Commercial real estate    | 10,319                | 12,062               |
| Residential real estate   | 2,818                 | 3,315                |
| Consumer and other        | -                     | 1                    |
| Total                     | \$ 13,406             | \$ 17,867            |

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. Loan classifications of Substandard, Doubtful or Loss are 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 that the primary source of repayment has significantly deteriorated or weakened which has or could threaten the borrowers' ability to make scheduled payments. The weaknesses require close supervision by management and there is a distinct possibility that we could sustain some loss if the deficiencies are not corrected. Such weaknesses could jeopardize the timely and ultimate collection of our loan principal and interest or fees due. Loss may not be expected or evident, however, loan repayment is inadequately supported by current financial information or pledged collateral.

**Doubtful:** Loans so classified have all the inherent weaknesses of a substandard loan with the added provision that collection or liquidation in full is highly questionable and not reasonably assured. The probability of at least partial loss is high, but extraneous factors might strengthen the asset to prevent loss. The validity of the extraneous factors must be continuously monitored. Once these factors are questionable the loan should be considered for full or partial charge-off.

**Loss:** Loans so classified are considered uncollectible, and of such little value that their continuance as active assets is not warranted. Such loans are fully charged off.

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The following tables illustrate our corporate credit risk profile by creditworthiness category as of September 30, 2013 and December 31, 2012:

| (Dollars in thousands)    | Pass       | Special<br>Mention | Substandard | Doubtful | Total      |
|---------------------------|------------|--------------------|-------------|----------|------------|
| September 30, 2013        |            |                    |             |          |            |
| Commercial and industrial | \$ 17,936  | \$ 63              | \$ -        | \$ -     | \$ 17,999  |
| Construction              | 9,380      | -                  | 269         | -        | 9,649      |
| Commercial real estate    | 234,820    | 7,188              | 14,968      | -        | 256,976    |
| Residential real estate   | 102,371    | 1,045              | 3,017       | 15       | 106,448    |
| Consumer and other        | 1,474      | 141                | -           | -        | 1,615      |
|                           | \$ 365,981 | \$ 8,437           | \$ 18,254   | \$ 15    | \$ 392,687 |
| December 31, 2012         |            |                    |             |          |            |
| Commercial and industrial | \$ 15,860  | \$ 269             | \$ 23       | \$ 6     | \$ 16,158  |
| Construction              | 4,542      | -                  | 2,462       | -        | 7,004      |
| Commercial real estate    | 203,106    | 4,648              | 17,256      | 335      | 225,345    |
| Residential real estate   | 93,563     | 253                | 4,485       | -        | 98,301     |
| Consumer and other        | 1,112      | -                  | 143         | -        | 1,255      |
|                           | \$ 318,183 | \$ 5,170           | \$ 24,369   | \$ 341   | \$ 348,063 |

The following table reflects information about our impaired loans by class as of September 30, 2013 and December 31, 2012:

| (Dollars in thousands)              | September 30, 2013     |                                |                      | December 31, 2012      |                                |                      |
|-------------------------------------|------------------------|--------------------------------|----------------------|------------------------|--------------------------------|----------------------|
|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
| With no related allowance recorded: |                        |                                |                      |                        |                                |                      |
| Construction                        | \$ -                   | \$ -                           | \$ -                 | \$ 2,421               | \$ 2,743                       | \$ -                 |
| Commercial real estate              | 8,039                  | 8,398                          | -                    | 10,466                 | 13,581                         | -                    |
| Residential real estate             | 2,182                  | 2,237                          | -                    | 2,675                  | 2,768                          | -                    |
| With an allowance recorded:         |                        |                                |                      |                        |                                |                      |
| Commercial and industrial           | -                      | -                              | -                    | 27                     | 27                             | 27                   |
| Construction                        | 269                    | 391                            | 27                   | 42                     | 42                             | 42                   |
| Commercial real estate              | 2,891                  | 3,967                          | 308                  | 2,216                  | 3,135                          | 230                  |

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|                           |           |           |        |           |           |        |
|---------------------------|-----------|-----------|--------|-----------|-----------|--------|
| Residential real estate   | 637       | 730       | 99     | 675       | 675       | 66     |
| Total:                    |           |           |        |           |           |        |
| Commercial and industrial | -         | -         | -      | 27        | 27        | 27     |
| Construction              | 269       | 391       | 27     | 2,463     | 2,785     | 42     |
| Commercial real estate    | 10,930    | 12,365    | 308    | 12,682    | 16,716    | 230    |
| Residential real estate   | 2,819     | 2,967     | 99     | 3,350     | 3,443     | 66     |
|                           | \$ 14,018 | \$ 15,723 | \$ 434 | \$ 18,522 | \$ 22,971 | \$ 365 |

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The following table presents the average recorded investment and income recognized for the three and nine months ended September 30, 2013 and 2012:

|  | For the Three Months<br>Ended September 30,<br>2013 |                                  | For the Three Months<br>Ended September 30,<br>2012 |                                  |
|--|---|----------------------------------|---|----------------------------------|
|  | Average<br>Recorded<br>Investment                   | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment                   | Interest<br>Income<br>Recognized |
| (Dollars in thousands)                           |   |                                  |   |                                  |
| With no related allowance recorded:              |   |                                  |   |                                  |
| Construction                                     | \$ -  | \$ -                             | \$ 2,251  | \$ -                             |
| Commercial real estate                           | 8,386   | 11                               | 4,538   | 12                               |
| Residential real estate                          | 2,261   | 22                               | 1,964   | 9                                |
| Total impaired loans without a related allowance | 10,647  | 33                               | 8,753   | 21                               |
| With an allowance recorded:                      |   |                                  |   |                                  |
| Commercial and industrial                        | -   | -                                | 398   | -                                |
| Construction                                     | 328   | -                                | 1,765   | 3                                |
| Commercial real estate                           | 2,764   | -                                | 13,092  | 10                               |
| Residential real estate                          | 887   | -                                | 991   | 2                                |
| Total impaired loans with an allowance           | 3,979   | -                                | 16,246  | 15                               |
| Total impaired loans                             | \$ 14,626   | \$ 33                            | \$ 24,999   | \$ 36                            |

|  | For the Nine Months<br>Ended September 30,<br>2013 |                                  | For the Nine Months<br>Ended September 30,<br>2012 |                                  |
|--|--|----------------------------------|--|----------------------------------|
|  | Average<br>Recorded<br>Investment                  | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment                  | Interest<br>Income<br>Recognized |
| (Dollars in thousands)                           |  |                                  |  |                                  |
| With no related allowance recorded:              |  |                                  |  |                                  |
| Construction                                     | \$ 329   | \$ -                             | \$ 1,986   | \$ -                             |
| Commercial real estate                           | 8,334  | 51                               | 6,505  | 42                               |
| Residential real estate                          | 2,288  | 24                               | 1,756  | 41                               |
| Total impaired loans without a related allowance | 10,951   | 75                               | 10,247   | 83                               |
| With an allowance recorded:                      |  |                                  |  |                                  |
| Commercial and industrial                        | -  | -                                | 189  | -                                |
| Construction                                     | 374  | -                                | 1,405  | 3                                |
| Commercial real estate                           | 2,927  | -                                | 14,610   | 59                               |

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|  |           |       |           |        |
|--|-----------|-------|-----------|--------|
| Residential real estate                | 946       | 3     | 786       | 17     |
| Total impaired loans with an allowance | 4,247     | 3     | 16,990    | 79     |
| Total impaired loans                   | \$ 15,198 | \$ 78 | \$ 27,237 | \$ 162 |

We recognize income on impaired loans under the cash basis when the collateral on the loan is sufficient to cover the outstanding obligation to us. If these factors do not exist, we will record all payments as a reduction of principal on such loans.

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

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

| (Dollars in thousands) | Commercial Real Estate | Commercial & Industrial | Residential Real Estate | Total    |
|------------------------|------------------------|-------------------------|-------------------------|----------|
| September 30, 2013     |                        |                         |                         |          |
| Performing             | \$ 612                 | \$ -                    | \$ -                    | \$ 612   |
| Non-performing         | 4,720                  | -                       | 527                     | 5,247    |
| Total                  | \$ 5,332               | \$ -                    | \$ 527                  | \$ 5,859 |
| December 31, 2012      |                        |                         |                         |          |
| Performing             | \$ 603                 | \$ -                    | \$ 5                    | \$ 608   |
| Non-performing         | 1,829                  | 6                       | 228                     | 2,063    |
| Total                  | \$ 2,432               | \$ 6                    | \$ 233                  | \$ 2,671 |

Troubled debt restructured loans are considered impaired and are included in the previous impaired loans disclosures in this footnote. As of September 30, 2013, we have not committed to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

The following table summarizes troubled debt restructurings that occurred during the three and nine months ended September 30, 2013:

| (Dollars in thousands)                | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---------------------------------------|-----------------|--|---|
| Three months ended September 30, 2013 |                 |  |   |
| Commercial real estate                | 1               | \$ 1,201   | \$ 1,201  |
| Nine months ended September 30, 2013  |                 |  |   |
| Commercial real estate                | 3               | \$ 3,100   | \$ 3,100  |
| Residential real estate               | 1               | 302  | 302   |

The troubled debt restructurings presented in the table above resulted in an allocation of the allowance for credit losses of \$49 thousand and \$112 thousand for the three and nine months ended September 30, 2013, respectively. These specific reserves are included in the allowance for credit losses for loans individually evaluated for impairment. There were \$200 thousand in charge-offs on the troubled debt restructurings presented in the table above during the

three and nine months ended September 30, 2013.

There were no troubled debt restructurings that occurred during the three and nine months ended September 30, 2012, therefore, no allocation for the allowance for credit losses or charge-offs were required on loans modified as troubled debt restructurings during the three and nine months ended September 30, 2012.

There were no troubled debt restructurings for which there was a payment default within twelve months following the date of the restructuring for the three and nine months ended September 30, 2013 and 2012.

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## NOTE 5 – EARNINGS PER SHARE

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

| (In thousands, except share and per share data)                        | Three Months Ended September 30, 2013 |                      |                  | Three Months Ended September 30, 2012 |                      |                  |
|--|---------------------------------------|----------------------|------------------|---------------------------------------|----------------------|------------------|
|  | Income (Numerator)                    | Shares (Denominator) | Per Share Amount | Income (Numerator)                    | Shares (Denominator) | Per Share Amount |
| Basic earnings per share:  |                                       |                      |                  |                                       |                      |                  |
| Net earnings applicable to common shareholders                         | \$ 575                                | 4,031,022            | \$ 0.14          | \$ 546                                | 3,264,034            | \$ 0.17          |
| Effect of dilutive securities:   |                                       |                      |                  |                                       |                      |                  |
| Nonvested stock awards   | -                                     | 35,887               |                  | -                                     | 24,933               |                  |
| Diluted earnings per share:  |                                       |                      |                  |                                       |                      |                  |
| Net earnings applicable to common shareholders and assumed conversions | \$ 575                                | 4,066,909            | \$ 0.14          | \$ 546                                | 3,288,967            | \$ 0.17          |

| (In thousands, except share and per share data)                      | Nine Months Ended September 30, 2013 |                      |                  | Nine Months Ended September 30, 2012 |                      |                  |
|--|--------------------------------------|----------------------|------------------|--------------------------------------|----------------------|------------------|
|  | Income (Numerator)                   | Shares (Denominator) | Per Share Amount | Income (Numerator)                   | Shares (Denominator) | Per Share Amount |
| Basic earnings per share:  |                                      |                      |                  |                                      |                      |                  |
| Net income applicable to common shareholders                         | \$ 807                               | 3,538,770            | \$ 0.23          | \$ 832                               | 3,260,827            | \$ 0.26          |
| Effect of dilutive securities:                                       |                                      |                      |                  |                                      |                      |                  |
| Nonvested stock awards   | -                                    | 31,393               |                  | -                                    | 21,399               |                  |
| Diluted earnings per share:  |                                      |                      |                  |                                      |                      |                  |
| Net income applicable to common shareholders and assumed conversions | \$ 807                               | 3,570,163            | \$ 0.23          | \$ 832                               | 3,282,226            | \$ 0.25          |



Options to purchase 43,022 and 65,036 shares of common stock were outstanding at September 30, 2013 and 2012, respectively, but were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares.

NOTE 6 – OTHER COMPREHENSIVE (LOSS) INCOME

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

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

|   | Three Months Ended<br>September 30, 2013 |               |        | Three Months Ended<br>September 30, 2012 |               |        |
|---|--|---------------|--------|--|---------------|--------|
|   | Before<br>Tax                            | Net of<br>Tax | Effect | Before<br>Tax                            | Net of<br>Tax | Effect |
| Other comprehensive income:   |  |               |        |  |               |        |
| Unrealized gains on available for sale securities   | \$ 430                                   | \$ 173        | \$ 257 | \$ 693                                   | \$ 277        | \$ 416 |
| Reclassification adjustment for net gains on securities transactions included in net income | -  | -             | -      | (569)                                    | (228)         | (341)  |
| Total other comprehensive income  | \$ 430                                   | \$ 173        | \$ 257 | \$ 124                                   | \$ 49         | \$ 75  |

|   | Nine Months Ended September<br>30, 2013 |               |            | Nine Months Ended<br>September 30, 2012 |               |        |
|---|---|---------------|------------|---|---------------|--------|
|   | Before<br>Tax                           | Net of<br>Tax | Effect     | Before<br>Tax                           | Net of<br>Tax | Effect |
| Other comprehensive (loss) income:  |   |               |            |   |               |        |
| Unrealized (losses) gains on available for sale securities                                  | \$ (3,327)                              | \$ (1,330)    | \$ (1,997) | \$ 1,413                                | \$ 564        | \$ 849 |
| Reclassification adjustment for net gains on securities transactions included in net income | (399)                                   | (160)         | (239)      | (763)                                   | (305)         | (458)  |
| Total other comprehensive (loss) income   | \$ (3,726)                              | \$ (1,490)    | \$ (2,236) | \$ 650                                  | \$ 259        | \$ 391 |

Reclassification adjustments for gains on securities transactions of \$399 thousand for the nine months ended September 30, 2013 and \$569 thousand and \$763 thousand for the three and nine months ended September 30, 2012, respectively, are presented in the income statement on the line item for net gain on securities transactions. There were no reclassification adjustments for gains on securities transactions for the three months ended September 30, 2013.

NOTE 7 – SEGMENT INFORMATION

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

personal coverage.

|   | Three Months Ended September 30,<br>2013 |                       |          | Three Months Ended September 30,<br>2012 |                       |          |
|---|--|-----------------------|----------|--|-----------------------|----------|
|   | 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   | \$ 4,219                                 | \$ -                  | \$ 4,219 | \$ 4,089                                 | \$ -                  | \$ 4,089 |
| Other income from external sources          | 678                                      | 756                   | 1,434    | 1,276                                    | 684                   | 1,960    |
| Depreciation and amortization               | 162                                      | 4                     | 166      | 170                                      | 3                     | 173      |
| Income (loss) before income taxes           | 588                                      | 130                   | 718      | 546                                      | 106                   | 652      |
| Income tax (benefit) expense <sup>(1)</sup> | 91                                       | 52                    | 143      | 64                                       | 42                    | 106      |
| Total assets                                | 531,730                                  | 3,156                 | 534,886  | 500,594                                  | 3,700                 | 504,294  |

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|   | Nine Months Ended September 30,<br>2013 |                       |           | Nine Months Ended September 30,<br>2012 |                       |           |
|---|---|-----------------------|-----------|---|-----------------------|-----------|
|   | 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   | \$ 12,140                               | \$ -                  | \$ 12,140 | \$ 12,225                               | \$ -                  | \$ 12,225 |
| Other income from external sources          | 2,437                                   | 2,245                 | 4,682     | 2,808                                   | 1,892                 | 4,700     |
| Depreciation and amortization               | 502                                     | 8                     | 510       | 501                                     | 8                     | 509       |
| Income (loss) before income taxes           | 389                                     | 389                   | 778       | 522                                     | 216                   | 738       |
| Income tax (benefit) expense <sup>(1)</sup> | (185)                                   | 156                   | (29)      | (180)                                   | 86                    | (94)      |
| Total assets                                | 531,730                                 | 3,156                 | 534,886   | 500,594                                 | 3,700                 | 504,294   |

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

NOTE 8 – 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 our Compensation Committee. Our standard stock option grants have a maximum term of 10 years, generally vest over periods ranging between one and four years, and are granted with an exercise price equal to the fair market value of the common stock on the date 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 shareholder.

Information regarding our stock option plans as of September 30, 2013, 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 | 55,751              | \$ 12.48  |  |                                 |
| Options expired                        | (12,729)            | 10.59   |  |                                 |
| Options outstanding, end of quarter    | 43,022              | \$ 13.04  | 0.76                                       | -                               |
| Options exercisable, end of quarter    | 43,022              | \$ 13.04  | 0.76                                       | -                               |

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|   |                   |
|---|-------------------|
| Option price range at end of quarter      | \$8.99 to \$16.45 |
| Option price range for exercisable shares | \$8.99 to \$16.45 |

During the three months ended September 30, 2013 and 2012, we expensed \$60 thousand and \$39 thousand, respectively, in stock-based compensation under restricted stock awards. During the nine months ended September 30, 2013 and 2012, we expensed \$174 thousand and \$112 thousand, respectively, in stock-based compensation under restricted stock awards. The summary of changes in unvested restricted stock awards for the nine months ended September 30, 2013, is as follows:

|  | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|--|---------------------|---|
| Unvested restricted stock, beginning of year | 123,144             | \$ 4.83   |
| Granted                                      | 32,940              | 6.06  |
| Vested                                       | (28,162)            | 5.52  |
| Unvested restricted stock, end of period     | 127,922             | \$ 4.99   |

At September 30, 2013, unrecognized compensation expense for non-vested restricted stock was \$500 thousand, which is expected to be recognized over an average period of 2.5 years.

#### NOTE 9 – GUARANTEES

We do not issue any guarantees that would require liability recognition or disclosure, other than standby letters of credit. Standby letters of credit are conditional commitments issued by us to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. We, generally, hold collateral and/or personal guarantees supporting these commitments. As of September 30, 2013, we had \$2.0 million of outstanding letters of credit. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of September 30, 2013, for guarantees under standby letters of credit issued is not material.

#### NOTE 10 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Management uses its best judgment in estimating the fair value of our 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 Accounting Standards Codification (“ASC”) 820 Fair Value Measurement and Disclosure, 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 reporting date.

Level II - Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting 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 reporting 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.

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<br>Value<br>Measurements | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level I) | Significant<br>Other<br>Observable<br>Inputs<br>(Level II) | Significant<br>Unobservable<br>Inputs<br>(Level III) |
|---|-------------------------------|---|--|--|
| September 30, 2013:                                     |                               |   |  |  |
| U.S. government agencies                                | \$ 5,513                      | \$ -  | \$ 5,513   | \$ -   |
| State and political subdivisions                        | 26,115                        | -   | 26,115   | -  |
| Mortgage-backed securities                              |                               |   |  |  |
| U.S. government-sponsored enterprises                   | 63,304                        | -   | 63,304   | -  |
| Equity securities-financial services industry and other | 446                           | 446   | -  | -  |
| December 31, 2012:                                      |                               |   |  |  |
| State and political subdivisions                        | \$ 27,741                     | \$ -  | \$ 27,741  | \$ -   |
| Mortgage-backed securities                              |                               |   |  |  |
| U.S. government-sponsored enterprises                   | 90,709                        | -   | 90,709   | -  |
| Equity securities-financial services industry and other | 431                           | 431   | -  | -  |

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

For financial assets measured at fair value on a nonrecurring basis the fair value measurements by level within the fair value hierarchy used at September 30, 2013 and December 31, 2012, 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, 2013:    |                         |  |  |   |
| Impaired loans         | \$ 4,207                | \$ -   | \$ -   | \$ 4,207                                    |
| Foreclosed real estate | 789                     | -  | -  | 789   |
| December 31, 2012:     |                         |  |  |   |
| Impaired loans         | \$ 6,239                | \$ -   | \$ -   | \$ 6,239                                    |
| Foreclosed real estate | 3,612                   | -  | -  | 3,612                                       |

The following table presents additional qualitative information about assets measured at fair value on a nonrecurring basis and for which Level 3 inputs were used to determine fair value:

| (Dollars in thousands) | Fair Value Estimate | Qualitative Information about Level 3 Fair Value Measurements Valuation Techniques | Unobservable Input | Range (Weighted Average) |
|------------------------|---------------------|--|--------------------|--------------------------|
| September 30, 2013:    |                     |  |                    |                          |
| Impaired loans         | \$ 4,207            | Appraisal of   | Appraisal          | 0% to -61.2%             |



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collateral adjustments <sup>(1)</sup> (-7.5%)

|                        |     |                         |                                 |               |
|------------------------|-----|-------------------------|---------------------------------|---------------|
| Foreclosed real estate | 789 | Appraisal of collateral | Selling expenses <sup>(1)</sup> | -7.0% (-7.0%) |
|------------------------|-----|-------------------------|---------------------------------|---------------|

December 31, 2012:

|                |          |                         |                                      |                          |
|----------------|----------|-------------------------|--------------------------------------|--------------------------|
| Impaired loans | \$ 6,239 | Appraisal of collateral | Appraisal adjustments <sup>(1)</sup> | 0% to -57.1%<br>(-21.8%) |
|----------------|----------|-------------------------|--------------------------------------|--------------------------|

|                        |       |                         |                                 |               |
|------------------------|-------|-------------------------|---------------------------------|---------------|
| Foreclosed real estate | 3,612 | Appraisal of collateral | Selling expenses <sup>(1)</sup> | -7.0% (-7.0%) |
|------------------------|-------|-------------------------|---------------------------------|---------------|

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

The following methods and assumptions were used to estimate the fair value of our financial instruments at September 30, 2013 and December 31, 2012:

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 (Carried at the Lower of Cost or 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.

**Foreclosed Real Estate (Carried at the Lower of Cost or Fair Value):** Foreclosed real estate is recorded at estimated fair value, less estimated costs to sell when the property is acquired. Fair value is generally based on independent appraisals and is considered a Level 3 fair value input. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less costs to sell.

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

**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 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. 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.

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The fair values of our financial instruments at September 30, 2013 and December 31, 2012, were as follows:

| (Dollars in thousands)             | September 30, 2013 |               | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level I) | Significant<br>Other<br>Observable<br>Inputs<br>(Level II) | Significant<br>Unobservable<br>Inputs<br>(Level III) |
|------------------------------------|--------------------|---------------|---|--|--|
|                                    | Carrying<br>Amount | Fair<br>Value |   |  |  |
| <b>Financial assets:</b>           |                    |               |   |  |  |
| Cash and cash equivalents          | \$ 11,040          | \$ 11,040     | \$ 11,040   | \$ -   | \$ -   |
| Time deposits with other banks     | 100                | 100           | 100   | -  | -  |
| Securities available for sale      | 95,378             | 95,378        | 446   | 94,932   | -  |
| Securities held to maturity        | 5,824              | 5,856         | -   | 5,856  | -  |
| Federal Home Loan Bank stock       | 2,480              | 2,480         | -   | 2,480  | -  |
| Loans receivable, net of allowance | 386,645            | 387,076       | -   | -  | 387,076  |
| Accrued interest receivable        | 1,695              | 1,695         | -   | 1,695  | -  |
| <b>Financial liabilities:</b>      |                    |               |   |  |  |
| Non-maturity deposits              | 340,503            | 325,590       | 325,590   | -  | -  |
| Time deposits                      | 96,471             | 97,616        | -   | 97,616   | -  |
| Borrowings                         | 36,000             | 38,130        | -   | 38,130   | -  |
| Junior subordinated debentures     | 12,887             | 7,581         | -   | 7,581  | -  |
| Accrued interest payable           | 206                | 206           | -   | 206  | -  |

| (Dollars in thousands)         | December 31, 2012  |               | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level I) | Significant<br>Other<br>Observable<br>Inputs<br>(Level II) | Significant<br>Unobservable<br>Inputs<br>(Level III) |
|--------------------------------|--------------------|---------------|---|--|--|
|                                | Carrying<br>Amount | Fair<br>Value |   |  |  |
| <b>Financial assets:</b>       |                    |               |   |  |  |
| Cash and cash equivalents      | \$ 11,668          | \$ 11,668     | \$ 11,668   | \$ -   | \$ -   |
| Time deposits with other banks | 100                | 100           | 100   | -  | -  |

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|                                    |         |         |         |         |         |
|------------------------------------|---------|---------|---------|---------|---------|
| Securities available for sale      | 118,881 | 118,881 | 431     | 118,450 | -       |
| Securities held to maturity        | 5,221   | 5,472   | -       | 5,472   | -       |
| Federal Home Loan Bank stock       | 1,980   | 1,980   | -       | 1,980   | -       |
| Loans receivable, net of allowance | 342,760 | 353,208 | -       | -       | 353,208 |
| Accrued interest receivable        | 1,741   | 1,741   | -       | 1,741   | -       |
| Financial liabilities:             |         |         |         |         |         |
| Non-maturity deposits              | 328,856 | 327,096 | 327,096 | -       | -       |
| Time deposits                      | 103,580 | 105,680 | -       | 105,680 | -       |
| Borrowings                         | 26,000  | 29,476  | -       | 29,476  | -       |
| Junior subordinated debentures     | 12,887  | 6,315   | -       | 6,315   | -       |
| Accrued interest payable           | 273     | 273     | -       | 273     | -       |

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

MANAGEMENT STRATEGY

We are a community-oriented financial institution serving northern New Jersey, northeastern Pennsylvania and Orange County, New York. While offering traditional community bank loan and deposit products and services, we obtain non-interest income through our insurance brokerage operations and the sale of non-deposit products.

We continue to focus on strengthening our core operating performance by improving our net interest income and margin by closely monitoring our yield on earning assets and adjusting the rates offered on deposit products. 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 U.S. GAAP and practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in our consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Actual results could differ from those estimates.

Critical accounting estimates are necessary in the application of certain accounting policies and procedures, and are particularly susceptible to significant change. Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. There have been no material changes to our critical accounting policies during the nine months ended September 30, 2013. 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 2012 Annual Report on Form 10-K.

## COMPARISON OF OPERATING RESULTS FOR THREE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012

Overview - For the quarter ended September 30, 2013, we reported net income of \$575 thousand, or \$0.14 per basic and diluted share, as compared to net income of \$546 thousand, or \$0.17 per basic and diluted share, for the same period last year. The increase in net income for the quarter ended September 30, 2013 was largely due to decreases in credit quality costs (provision for loan losses, loan collection costs and expenses and write-downs related to foreclosed real estate), which decreased \$686 thousand or 44.5%, which was partially offset by a decrease in gain on securities transactions of \$569 thousand.

## 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 periods ended September 30, 2013 and 2012:

| (Dollars in thousands)                | Three Months Ended September 30,<br>2013 |                         |                                | 2012               |                         |                                |
|---------------------------------------|--|-------------------------|--------------------------------|--------------------|-------------------------|--------------------------------|
|                                       | Average<br>Balance                       | Interest <sup>(1)</sup> | Average<br>Rate <sup>(2)</sup> | Average<br>Balance | Interest <sup>(1)</sup> | Average<br>Rate <sup>(2)</sup> |
| <b>Earning Assets:</b>                |  |                         |                                |                    |                         |                                |
| <b>Securities:</b>                    |  |                         |                                |                    |                         |                                |
| Tax exempt <sup>(3)</sup>             | \$ 30,413                                | \$ 382                  | 4.98%                          | \$ 32,199          | \$ 442                  | 5.46%                          |
| Taxable                               | 81,765                                   | 130                     | 0.63%                          | 86,766             | 241                     | 1.10%                          |
| Total securities                      | 112,178                                  | 512                     | 1.81%                          | 118,965            | 683                     | 2.28%                          |
| Total loans receivable <sup>(4)</sup> | 383,690                                  | 4,599                   | 4.76%                          | 342,502            | 4,467                   | 5.19%                          |
| Other interest-earning assets         | 5,807                                    | 2                       | 0.14%                          | 10,405             | 4                       | 0.15%                          |
| Total earning assets                  | 501,675                                  | \$ 5,113                | 4.04%                          | \$ 471,872         | \$ 5,154                | 4.35%                          |
| <b>Non-interest earning assets</b>    | 35,011                                   |                         |                                | 43,319             |                         |                                |
| Allowance for loan losses             | (6,019)                                  |                         |                                | (6,671)            |                         |                                |
| Total Assets                          | \$ 530,667                               |                         |                                | 508,520            |                         |                                |
| <b>Sources of Funds:</b>              |  |                         |                                |                    |                         |                                |
| <b>Interest bearing deposits:</b>     |  |                         |                                |                    |                         |                                |
| NOW                                   | \$ 114,972                               | \$ 38                   | 0.13%                          | \$ 95,611          | \$ 36                   | 0.15%                          |
| Money market                          | 15,044                                   | 8                       | 0.21%                          | 14,506             | 11                      | 0.30%                          |
| Savings                               | 152,168                                  | 80                      | 0.21%                          | 162,762            | 133                     | 0.33%                          |
| Time                                  | 96,396                                   | 293                     | 1.21%                          | 104,128            | 407                     | 1.55%                          |
| Total interest bearing deposits       | 378,580                                  | 419                     | 0.44%                          | 377,007            | 587                     | 0.62%                          |
| Borrowed funds                        | 36,598                                   | 293                     | 3.18%                          | 26,196             | 268                     | 4.07%                          |
| Junior subordinated debentures        | 12,887                                   | 54                      | 1.66%                          | 12,887             | 60                      | 1.85%                          |
| Total interest bearing liabilities    | 428,065                                  | \$ 766                  | 0.71%                          | \$ 416,090         | \$ 915                  | 0.87%                          |

|   |            |          |       |            |          |
|---|------------|----------|-------|------------|----------|
| Non-interest bearing liabilities:             |            |          |       |            |          |
| Demand deposits                               | 58,591     |          |       | 48,702     |          |
| Other liabilities                             | 1,405      |          |       | 2,676      |          |
| Total non-interest bearing liabilities        | 59,996     |          |       | 51,378     |          |
| Stockholders' equity                          | 42,606     |          |       | 41,052     |          |
| Total Liabilities and Stockholders' Equity    | \$ 530,667 |          |       | \$ 508,520 |          |
| Net Interest Income and Margin <sup>(5)</sup> |            | 4,347    | 3.44% |            | 4,239    |
| Tax-equivalent basis adjustment               |            | (128)    |       |            | (150)    |
| Net Interest Income                           |            | \$ 4,219 |       |            | \$ 4,089 |

(1) Includes loan fee income

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

(3) Full 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 \$108 thousand, or 2.5%, to \$4.3 million for the third quarter of 2013 as compared to \$4.2 million for same period in 2012. The increase in net interest income was largely due to a \$29.8 million, or 6.3%, increase in average interest earning assets, principally loans receivable. The aforementioned increase was partly offset by a 13 basis point decline in the net interest margin to 3.44% for the third quarter of 2013 as compared to the same period last year. The decline in the net interest margin was mostly due to a 31 basis point decline in the average rate earned on interest earning assets. This decline was partially offset by a decrease in the average rate paid on total interest bearing liabilities, which decreased 16 basis points to 0.71% for the third quarter of 2013 from 0.87% for the same period in 2012.

Interest Income – Our total interest income, on a fully tax equivalent basis, decreased \$41 thousand, or 0.8%, to \$5.1 million for the quarter ended September 30, 2013, as compared to the same period last year. The decline was due to lower earning asset yields, which decreased 31 basis points to 4.04% for the quarter ended September 30, 2013, as compared to the same period in 2012.

Our total interest income earned on loans receivable increased \$132 thousand, or 3.0%, to \$4.6 million for the third quarter of 2013 as compared to the same period in 2012. The increase was driven by an increase in average balance of loans receivable of \$41.2 million, or 12.0%, for the three months ended September 30, 2013, as compared to same period last year. The increase in interest income earned on loans receivable was partly offset by a 43 basis point decline in average yields to 4.76% for the quarter ended September 30, 2013, as compared to the same period in 2012.

Our total interest income earned on securities, on a fully taxable equivalent basis, decreased \$171 thousand, to \$512 thousand for the quarter ended September 30, 2013, from \$683 thousand for the same period in 2012. This decrease was largely due to a decline in the average rate earned on securities, which declined 47 basis points for the quarter ended September 30, 2013, as compared to the same period last year. The decrease in yields on securities was largely due to an increase in premium amortization relating to the government sponsored mortgage backed securities portion of our securities portfolio and the investment in securities in a low market rate environment. Premium amortization has increased as a result of faster prepayment speeds stemming from the historical low mortgage rate environment and government sponsored programs facilitating the consumer refinancing process. The decrease in interest income on securities was also affected by a \$6.8 million, or 5.7%, decrease in average balance of securities for the three months ended September 30, 2013, as compared to same period last year. This decrease resulted primarily from principal pay-downs and amortization of securities as well as sales of securities during the quarter. The proceeds from securities sales were primarily reinvested in the securities portfolio with the remaining difference used to fund loan growth.

Other interest-earning assets include federal funds sold and interest bearing deposits in other banks. Our interest earned on total other interest-earning assets decreased \$2 thousand for the third quarter of 2013 as compared to the same period in 2012 due to a decline in average balances. The average balances in other interest-earning assets decreased \$4.6 million to \$5.8 million in the third quarter of 2013 from \$10.4 million during the third quarter a year earlier.

Interest Expense – Our interest expense for the three months ended September 30, 2013 decreased \$149 thousand, or 16.3%, to \$766 thousand from \$915 thousand for the same period in 2012. The improvement was principally due to lower average rates paid on total interest-bearing liabilities, which declined 16 basis points from 0.87% for the three months ended September 30, 2012, to 0.71% for the same period in 2013 and a increase in average balances in interest-bearing liabilities, which increased \$12.0 million, or 2.9%, to \$428.1 million for the second quarter of 2013 from \$416.1 million for the same period in 2012.

Our interest expense on deposits declined \$168 thousand, or 28.6%, for the quarter ended September 30, 2013, as compared to the same period last year. The decline was largely attributed to lower rates on total interest bearing deposits, which decreased 18 basis points to 0.44% for the second quarter 2013 as compared to the same period in 2012. The decrease in rates on deposit products reflects management's asset/liability strategies and a lower market rate environment between the two periods.

Provision for Loan Losses – Provision for loan losses decreased \$604 thousand to \$500 thousand for the third quarter of 2013, as compared to \$1.1 million for the same period in 2012. 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 – We reported a decrease in non-interest income of \$526 thousand, or 26.8%, to \$1.4 million for the third quarter of 2013 as compared to the same period last year. The decrease in non-interest income was largely due

to a decrease in gains on securities transactions of \$569 thousand, which was partially offset by an increase in insurance commissions and fees of \$72 thousand, or 10.5%.

Non-Interest Expense – Our non-interest expenses increased \$142 thousand, or 3.3%, to \$4.4 million for the third quarter of 2013 as compared to the same period last year. The increase for the third quarter of 2013 versus the same period in 2012 was largely due to increases in salaries and employee benefits expense and expenses related to foreclosed real estate, which increased \$191 thousand and \$85 thousand, respectively. The aforementioned increases were partly offset by decreases in loan collection costs and professional fees of \$167 thousand and \$22 thousand, respectively.

Income Taxes – Our income tax expense, which includes both federal and state tax expenses, was \$143 thousand for the three months ended September 30, 2013, compared to income tax expense of \$106 thousand for the three months ended September 30, 2012.

## COMPARISON OF OPERATING RESULTS FOR NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012

Overview - For the nine months ended September 30, 2013, we reported net income of \$807 thousand, or \$0.23 per basic and diluted share, as compared to net income of \$832 thousand, or \$0.26 per basic and \$0.25 per diluted share, for the same period last year. The decline in net income for the nine months ended September 30, 2013 was primarily attributed to an increase in non-interest expenses of \$437 thousand, or 3.3%, which was partially offset by a decrease in the provision for loan losses of \$580 thousand, or 19.8%.

## 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 periods ended September 30, 2013 and 2012:

| (Dollars in thousands)             | Nine Months Ended September 30,<br>2013 |                         |                     | 2012               |                            |                     |
|------------------------------------|---|-------------------------|---------------------|--------------------|----------------------------|---------------------|
|                                    | Average<br>Balance                      | Average<br>Interest (1) | Average<br>Rate (2) | Average<br>Balance | Average<br>Interest<br>(1) | Average<br>Rate (2) |
| <b>Earning Assets:</b>             |   |                         |                     |                    |                            |                     |
| <b>Securities:</b>                 |   |                         |                     |                    |                            |                     |
| Tax exempt (3)                     | \$ 30,723                               | \$ 1,148                | 5.00%               | \$ 29,444          | \$ 1,253                   | 5.68%               |
| Taxable                            | 91,750                                  | 410                     | 0.60%               | 84,774             | 994                        | 1.57%               |
| Total securities                   | 122,473                                 | 1,558                   | 1.70%               | 114,218            | 2,247                      | 2.63%               |
| Total loans receivable (4)         | 365,847                                 | 13,360                  | 4.88%               | 339,839            | 13,292                     | 5.22%               |
| Other interest-earning assets      | 5,294                                   | 9                       | 0.23%               | 21,095             | 30                         | 0.19%               |
| Total earning assets               | 493,614                                 | \$ 14,927               | 4.04%               | 475,152            | \$ 15,569                  | 4.38%               |
| Non-interest earning assets        | 38,274                                  |                         |                     | 42,076             |                            |                     |
| Allowance for loan losses          | (5,702)                                 |                         |                     | (7,335)            |                            |                     |
| Total Assets                       | \$ 526,186                              |                         |                     | \$ 509,893         |                            |                     |
| <b>Sources of Funds:</b>           |   |                         |                     |                    |                            |                     |
| <b>Interest bearing deposits:</b>  |   |                         |                     |                    |                            |                     |
| NOW                                | \$ 111,947                              | \$ 109                  | 0.13%               | \$ 94,578          | \$ 129                     | 0.18%               |
| Money market                       | 14,633                                  | 23                      | 0.21%               | 16,962             | 47                         | 0.37%               |
| Savings                            | 155,056                                 | 274                     | 0.24%               | 163,331            | 492                        | 0.40%               |
| Time                               | 99,426                                  | 1,004                   | 1.35%               | 107,389            | 1,270                      | 1.58%               |
| Total interest bearing deposits    | 381,062                                 | 1,410                   | 0.49%               | 382,260            | 1,938                      | 0.68%               |
| Borrowed funds                     | 32,619                                  | 828                     | 3.39%               | 26,066             | 797                        | 4.08%               |
| Junior subordinated debentures     | 12,887                                  | 163                     | 1.69%               | 12,887             | 183                        | 1.90%               |
| Total interest bearing liabilities | 426,568                                 | \$ 2,401                | 0.75%               | 421,213            | \$ 2,918                   | 0.93%               |
| Non-interest bearing liabilities:  |   |                         |                     |                    |                            |                     |
| Demand deposits                    | 55,652                                  |                         |                     | 45,949             |                            |                     |
| Other liabilities                  | 2,992                                   |                         |                     | 2,209              |                            |                     |

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|  |            |            |
|--|------------|------------|
| Total non-interest bearing liabilities     | 58,644     | 48,158     |
| Stockholders' equity                       | 40,974     | 40,522     |
| Total Liabilities and Stockholders' Equity | \$ 526,186 | \$ 509,893 |

|   |           |       |           |       |
|---|-----------|-------|-----------|-------|
| Net Interest Income and Margin <sup>(5)</sup> | \$ 12,526 | 3.39% | \$ 12,651 | 3.56% |
| Tax-equivalent basis adjustment               | (386)     |       | (426)     |       |
| Net Interest Income                           | \$ 12,140 |       | \$ 12,225 |       |

(1) Includes loan fee income

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

(3) Full 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.

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Net interest income on a fully tax equivalent basis declined \$125 thousand, or 1.0%, to \$12.5 million for the first nine months of 2013 as compared to \$12.7 million for same period in 2012. The decrease in net interest income was largely due to the Company's net interest margin declining 17 basis points to 3.39% for the first nine months of 2013 compared to the same period last year. The decline in the net interest margin was mostly due to a 34 basis point decline in the average rate earned on interest earning assets. This decline was partially offset by a decrease in the average rate paid on total interest bearing liabilities, which decreased 18 basis points to 0.75% for the first nine months of 2013 from 0.93% for the same period in 2012, and a \$18.5 million, or 3.9%, increase in average interest earning assets, principally loans receivable and securities.

Interest Income – Our total interest income, on a fully tax equivalent basis, decreased \$642 thousand, or 4.1%, to \$14.9 million for the nine months ended September 30, 2013, as compared to the same period last year. The decline was due to lower earning asset yields, which decreased 34 basis points to 4.04% for the nine months ended September 30, 2013, as compared to the same period in 2012.

Our total interest income earned on loans receivable increased \$68 thousand, or 0.5%, to \$13.4 million for the first nine months of 2013 as compared to the same period in 2012. The increase was driven by an increase in average balance of loans receivable of \$26.0 million, or 7.7%, for the nine months ended September 30, 2013, as compared to same period last year. The increase in interest income earned on loans receivable was partly offset by a 34 basis point decline in average yields to 4.88% for the year ended September 30, 2013, as compared to the same period in 2012.

Our total interest income earned on securities, on a fully taxable equivalent basis, decreased \$689 thousand, to \$1.6 million for the nine months ended September 30, 2013, from \$2.2 million for the same period in 2012. This decrease was largely due to a decline in the average rate earned on securities, which declined 93 basis points for the nine months ended September 30, 2013, as compared to the same period last year. The decrease in yields on securities was largely due to an increase in premium amortization relating to the government sponsored mortgage backed securities portion of our securities portfolio. Premium amortization has increased as a result of faster prepayment speeds stemming from the historical low mortgage rate environment and government sponsored programs facilitating the consumer refinancing process. To a lesser extent, the lower yields on the securities portfolio reflect the investment in securities in a low market rate environment. The decrease in interest income on securities was offset by a \$8.3 million, or 7.2%, increase in average balance of securities for the nine months ended September 30, 2013, as compared to same period last year. The increase resulted from investing excess liquidity generated from deposit growth outpacing loan growth.

Other interest-earning assets include federal funds sold and interest bearing deposits in other banks. Our interest earned on total other interest-earning assets decreased \$21 thousand for the first nine months of 2013 as compared to the same period in 2012 due to a decline in average balances. The average balances in other interest-earning assets decreased \$15.8 million to \$5.3 million in the first nine months of 2013 from \$21.1 million during the first six months a year earlier.

Interest Expense – Our interest expense for the nine months ended September 30, 2013 decreased \$517 thousand, or 17.7%, to \$2.4 million from \$2.9 million for the same period in 2012. The improvement was principally due to lower

average rates paid on total interest-bearing liabilities, which declined 18 basis points from 0.93% for the nine months ended September 30, 2012, to 0.75% for the same period in 2013. The improvement in interest expense was partly offset by an increase in average balances in interest-bearing liabilities, which grew \$5.4 million, or 1.3%, to \$426.6 million for the first nine months of 2013 from \$421.2 million for the same period in 2012.

Our interest expense on deposits declined \$528 thousand, or 27.2%, for the nine months ended September 30, 2013, as compared to the same period last year. The decline was largely attributed to lower rates on total interest bearing deposits, which decreased 19 basis points to 0.49% for the first nine months 2013 as compared to the same period in 2012. The decrease in rates on deposit products reflects management's asset/liability strategies and a lower market rate environment between the two periods.

Provision for Loan Losses – Provision for loan losses decreased \$580 thousand to \$2.3 million for the first nine months of 2013, as compared to \$2.9 million for the same period in 2012. 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 – We reported a decrease in non-interest income of \$18 thousand, or 0.4%, to \$4.7 million for the first nine months of 2013 as compared to the same period last year. The decrease in non-interest income was primarily due to a decrease in gains on securities transactions of \$364 thousand, which was partially offset by an increase in insurance commissions and fees of \$353 thousand, or 18.7%.

Non-Interest Expense – Our non-interest expenses increased \$437 thousand, or 3.3%, to \$13.7 million for the first nine months of 2013 as compared to the same period last year. The increase for the first nine months of 2013 versus the

same period in 2012 was primarily due to increases in expenses related to foreclosed real estate, salaries and employee benefits expense and other expenses of \$286 thousand, \$199 thousand and \$118 thousand, respectively, which was partially offset by decreases in loan collection costs of \$288 thousand.

Income Taxes – Our income tax benefit, which includes both federal and state tax expense, was a benefit of \$29 thousand for the nine months ended September 30, 2013, compared to income tax benefit of \$94 thousand for the nine months ended September 30, 2012.

#### COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2013 TO DECEMBER 31, 2012

At September 30, 2013, our total assets were \$534.9 million, an increase of \$20.2 million, or 3.9%, as compared to total assets of \$514.7 million at December 31, 2012. The increase in total assets was largely driven by net loans receivable growth of \$43.9 million, or 12.8%, which was partially offset by a decline in the securities portfolio of \$22.9 million, or 18.5%.

Cash and Cash Equivalents – Our cash and cash equivalents decreased by \$628 thousand to \$11.0 million at September 30, 2013, or 2.1% of total assets, from \$11.7 million, or 2.3% of total assets, at December 31, 2012. The decrease was largely due to the investment of excess liquidity into loans.

Securities Portfolio – At September 30, 2013, the securities portfolio, which includes available for sale and held to maturity securities, was \$101.2 million compared to \$124.1 million at December 31, 2012. Available for sale securities were \$95.4 million at September 30, 2013, compared to \$118.9 million at December 31, 2012. The available for sale securities are held primarily for liquidity, interest rate risk management and profitability. Accordingly, our investment policy is to invest in securities with low credit risk, such as U.S. government agency obligations, state and political obligations and mortgage-backed securities. Held to maturity securities were \$5.8 million at September 30, 2013 compared to \$5.2 million at December 31, 2012.

Net unrealized (losses) gains in the securities portfolio were (\$3.1) million and \$844 thousand at September 30, 2013 and December 31, 2012, respectively. The decrease in the fair value of the investment securities was driven by state and political subdivisions and mortgage-backed securities. Gross unrealized gains decreased by \$1.0 million to \$503 thousand at September 30, 2013, as compared to \$1.5 million at December 31, 2012. The increase in gross unrealized losses of \$2.9 million to \$3.6 million at September 30, 2013, as compared to December 31, 2012, was largely attributed to lower fair values of state and political subdivisions due to an increase in spreads and an 86 basis point rate increase in the 10 year U.S. Treasury.

We conduct a regular assessment of our 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, 2013 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 do not intend to sell and it is more likely than not that we will not have to sell any of our securities before recovery of their cost basis.

Other investments totaled \$2.5 million and \$2.0 million at September 30, 2013 and December 31, 2012, respectively, and consisted primarily of FHLB stock. We also held \$100 thousand in time deposits with other financial institutions at September 30, 2013 and December 31, 2012.

Loans – The loan portfolio comprises our largest class of earning assets. Total loans receivable, net of unearned income, increased \$44.6 million, or 12.8%, to \$392.3 million at September 30, 2013, from \$347.7 million at year-end 2012.

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

| (Dollars in thousands)          | September<br>30, 2013 | December<br>31, 2012 |
|---------------------------------|-----------------------|----------------------|
| Commercial and industrial loans | \$ 17,999             | \$ 16,158            |
| Construction                    | 9,649                 | 7,004                |
| Commercial real estate          | 256,976               | 225,345              |
| Residential real estate         | 106,448               | 98,301               |
| Consumer and other              | 1,615                 | 1,255                |
| Total gross loans               | \$ 392,687            | \$ 348,063           |

Loan and Asset Quality – Our overall credit quality of the Company continued to improve through September 30, 2013, as our total problem assets, which is comprised of foreclosed real estate, criticized assets and classified assets, declined \$5.2 million, or 14.8%, to \$29.8 million at September 30, 2013, from \$34.9 million at December 31, 2012. Our total problem assets declined 52.8% from a historical high of \$62.8 million at March 31, 2010, as compared to September 30, 2013.

Non-performing assets (“NPAs”), which include non-accrual loans, loans 90 days past due and still accruing, troubled debt restructured loans currently performing in accordance with renegotiated terms and foreclosed real estate, decreased \$6.5 million, or 27.2%, to \$17.3 million at September 30, 2013, as compared to \$23.8 million at December 31, 2012. The ratios of NPAs to total assets for September 30, 2013 and December 31, 2012 were 3.2% and 4.6%, respectively. Non-accrual loans decreased \$4.5 million, or 25.0%, to \$13.4 million at September 30, 2013, as compared to \$17.9 million at December 31, 2012, and declined 44.1% since September 30, 2012. Non-accrual loans to total assets fell to 2.51% at September 30, 2013, which is the lowest level since 2007.

We continue to actively market our foreclosed real estate properties, which decreased \$2.0 million to \$3.1 million at September 30, 2013, as compared to \$5.1 million at December 31, 2012. The decrease was primarily due to the sale of foreclosed real estate properties and write-downs on foreclosed real estate of \$3.9 million and \$995 thousand, respectively, which was partially offset by the addition of \$2.9 million in new foreclosed real estate properties during the first nine months of 2013. At September 30, 2013, our foreclosed real estate properties had an average value of approximately \$220 thousand per property.

The allowance for loan losses was \$5.7 million, or 1.4% of total loans, at September 30, 2013, compared to \$5.0 million, or 1.4% of total loans, at December 31, 2012. The increase in the allowance for loan losses was largely attributed to \$2.3 million in provision for loan losses, which was in partly offset by \$1.7 million in net charge-offs for the first nine months of 2013.

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<br>30, 2013 | December<br>31, 2012 |
|--|-----------------------|----------------------|
| Non-accrual loans  | \$ 13,406             | \$ 17,867            |
| Non-accrual loans to total loans                         | 3.42%                 | 5.14%                |
| Non-performing assets                                    | \$ 17,292             | \$ 23,750            |
| Non-performing assets to total assets                    | 3.23%                 | 4.61%                |
| Allowance for loan losses as a % of non-performing loans | 39.78%                | 26.63%               |
| Allowance for loan losses to total loans                 | 1.44%                 | 1.43%                |

A loan is considered impaired, in accordance with the impairment accounting guidance, when based on current information and events, it is probable that we will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Total impaired loans at September 30, 2013 were \$14.0 million and at December 31, 2012 were \$18.5 million. Impaired loans measured at fair value on a non-recurring basis decreased to \$4.2 million on September 30, 2013 from \$6.2 million at December 31, 2012. The principal balances on loans measured at fair value were \$4.6 million and \$6.6 million, net of valuation allowance of \$434 thousand at September 30, 2013 and \$365 thousand at December 31, 2012. Impaired loans include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a

reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection. Not all impaired loans and restructured loans are on non-accrual, and therefore not all are considered non-performing loans. Restructured loans still accruing totaled \$612 thousand at September 30, 2013 and \$608 thousand at December 31, 2012.

We also 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, 2013, we had 5 loan relationships totaling \$2.2 million that we 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 and Note 4 – Allowance for Loan Losses and Credit Quality of Financing Receivables to the unaudited consolidated financial statements.

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

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

At September 30, 2013, the total allowance for loan losses increased \$679 thousand, or 13.6%, to \$5.7 million, as compared to \$5.0 million at December 31, 2012. The components of this increase were a provision for loan losses of \$2.3 million and net charge-offs totaling \$1.7 million in the first nine months of 2013. The provision also reflects the continued weakness in current real estate values in our market area and reduced cash flows to support the repayment of loans. The allowance for loan losses as a percentage of total loans was 1.4% at September 30, 2013 and December 31, 2012.

The table below presents information regarding our provision and allowance for loan losses at September 30, 2013 and 2012:

| (Dollars in thousands)       | September<br>30, 2013 | September<br>30, 2012 |
|------------------------------|-----------------------|-----------------------|
| Balance, beginning of period | \$ 4,976              | \$ 7,210              |
| Provision                    | 2,342                 | 2,922                 |
| Charge-offs                  | (2,083)               | (3,510)               |
| Recoveries                   | 420                   | 99                    |
| Balance, end of period       | \$ 5,655              | \$ 6,721              |

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)    | September 30, 2013 |   | December 31, 2012 |   |
|---------------------------|--------------------|---|-------------------|---|
|                           | Amount             | Percent of<br>Loans In Each<br>Category To<br>Gross Loans | Amount            | Percent of<br>Loans In Each<br>Category To<br>Gross Loans |
| Commercial and industrial | \$ 239             | 4.6%  | \$ 271            | 4.6%  |
| Construction              | 397                | 2.5%  | 223               | 2.0%  |
| Commercial real estate    | 3,426              | 65.4%   | 3,395             | 64.7%   |
| Residential real estate   | 867                | 27.1%   | 869               | 28.3%   |
| Consumer and other loans  | 15                 | 0.4%  | 38                | 0.4%  |
| Unallocated               | 711                | -   | 180               | -   |
| Total                     | \$ 5,655           | 100.0%  | \$ 4,976          | 100.0%  |

Bank-Owned Life Insurance (BOLI) – Our BOLI carrying value amounted to \$11.8 million at September 30, 2013 and \$11.5 million at December 31, 2012.

Goodwill and Other Intangibles – Goodwill represents the excess of the purchase price over the fair market value of net assets acquired. At September 30, 2013 and December 31, 2012, we had recorded goodwill totaling \$2.8 million, primarily as a result of the acquisition of Tri-State 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 assess whether events and changes in circumstances indicate that the carrying amounts of goodwill and intangible assets may be impaired. The estimated fair value of the reporting segment exceeded its book value; therefore, no write-down of goodwill was required. The goodwill related to the insurance agency is not deductible for tax purposes.

Deposits – Our total deposits increased \$4.5 million, or 1.0%, to \$437.0 million at September 30, 2013, from \$432.4 million at December 31, 2012. The increase in deposits was due to an increase in non-interest bearing deposits of \$11.1 million, or 22.9%, partially offset by a decrease in interest bearing deposits of \$6.5 million, or 1.7%, for September 30, 2013, as compared to December 31, 2012. Our funding mix continues to improve as low cost deposits grow.

Borrowings – Borrowings consist of long term advances from the FHLB. The advances are secured under terms of a blanket collateral agreement by a pledge of qualifying mortgage loans. We had \$36.0 million and \$26.0 million in borrowings, at a weighted average interest rate of 3.39% at September 30, 2013 and 4.03% at December 31, 2012. The borrowings at September 30, 2013 consisted of \$25.0 million of fixed rate advances and \$11.0 million of advances with quarterly convertible options that allow the FHLB to change the note rate to a then current market rate.

Junior Subordinated Debentures – On June 28, 2007, we raised \$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, 2013, was 1.69%. The capital securities are currently redeemable by us at a redemption price of 100% of par, in whole or in part. These trust preferred securities must be redeemed upon final maturity on September 15, 2037. The proceeds of these trust preferred securities, which have been contributed to the Bank, are included in the Bank's capital ratio calculations and treated as Tier I capital.

In accordance with FASB 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 \$46.0 million at September 30, 2013 and \$40.4 million at December 31, 2012. The increase was largely due to an increase in capital due to a successful capital raise that was completed in the third quarter of 2013, which resulted in gross proceeds of \$7.2 million. This increase was partially offset by a \$2.2 million decline in accumulated other comprehensive income relating to net unrealized losses on available for sale securities. In order to preserve capital, our Board of Directors elected not to declare any cash dividends in the first nine months of 2013 or 2012. 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.

## 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, 2013, total deposits amounted to \$437.0 million, a increase of \$4.5 million, or 1.0%, from December 31, 2012. At September 30, 2013 and December 31, 2012, advances from FHLB and subordinated debentures totaled \$48.9 million and \$38.9 million, respectively, and represented 9.1% and 7.6% of total assets, respectively.

Loan production continued to be our principal investing activity. Net loans receivable at September 30, 2013, amounted to \$386.6 million, an increase of \$43.9 million, or 12.8%, compared to December 31, 2012.

Our most liquid assets are cash and due from banks and federal funds sold. At September 30, 2013, the total of such assets amounted to \$11.0 million, or 2.1%, of total assets, compared to \$11.7 million, or 2.3%, of total assets at December 31, 2012. Another significant liquidity source is our available for sale securities portfolio. At September 30, 2013, available for sale securities amounted to \$95.4 million compared to \$118.9 million at December 31, 2012.

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 \$26.2 million through its membership in the FHLB and \$7.0 million at Atlantic Central Bankers Bank at September 30, 2013. Management believes that our sources of funds are sufficient to meet our present funding requirements.

The Bank's regulators have implemented risk based guidelines that 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, 2013, the Bank's Tier I and Tier II capital ratios were 13.78% and 15.04%, 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, 2013, the Bank had a leverage ratio of 10.39%. 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. Under Federal Reserve reporting requirements, a bank holding company that reaches \$500 million or more in total consolidated assets as of June 30 of the preceding year must begin reporting its consolidated capital beginning in March of the following year. The Bank began reporting its consolidated capital beginning in March of 2013.

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, 2013, totaled \$71.4 million and consisted of \$33.0 million in commitments to grant commercial real estate, construction and land development loans, \$18.8 million in home equity lines of credit, \$18.9 million in other unused commitments and \$646 thousand in letters of credit. These instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk to us. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.



## REGULATORY UPDATES

On July 2, 2013, the Federal Reserve Board issued final rules, and on July 9, 2013, the Office of the Comptroller of the Currency issued interim final rules that revise the existing regulatory capital requirements to incorporate certain revisions to the Basel capital framework, including Basel III, and to implement certain provisions of the Dodd Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank Act”). The final and interim final rules seek to strengthen the components of regulatory capital, increase risk-based capital requirements, and make selected changes to the calculation of risk-weighted assets. The final and interim final rules, among other things:

- revise minimum capital requirements and adjust prompt corrective action thresholds;
- revise the components of regulatory capital, add a new minimum common equity Tier 1 capital ratio of 4.5% of risk-weighted assets, increase the minimum Tier 1 capital ratio requirement from 4% to 6%;
- retain the existing risk-based capital treatment for 1-4 family residential mortgage exposures;
- permit most banking organizations, including us, to retain, through a one-time permanent election, the existing capital treatment for accumulated other comprehensive income;
- implement a new capital conservation buffer of common equity Tier 1 capital equal to 2.5% of risk-weighted assets, which will be in addition to the 4.5% common equity Tier 1 capital ratio and be phased in over a three year period beginning January 1, 2016 which buffer is generally required to make capital distributions and pay executive bonuses;
- increase capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term loan commitments;
- require the deduction of mortgage servicing assets and deferred tax assets that exceed 10% of common equity Tier 1 capital in each category and 15% of common equity Tier 1 capital in the aggregate; and

- remove references to credit ratings consistent with the Dodd-Frank Act and establish due diligence requirements for securitization exposures.

Under the final and interim rules, compliance is required beginning January 1, 2015, for most banking organizations, subject to a transition period for several aspects of the rule, including the new minimum capital ratio requirements, the capital conservation buffer, and the regulatory capital adjustments and deductions. We are still in the process of assessing the impacts of these complex final and interim final rules, however, we believe we will continue to exceed all estimated well-capitalized regulatory requirements on a fully phased-in basis.

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 effected, or that are reasonably likely to materially effect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1 - Legal Proceedings

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

Item 1A - Risk Factors

For a summary of risk factors relevant to our operations, see Part 1, Item 1A, “Risk Factors” in our 2012 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

None.

Item 3 - Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosures

Not applicable.

Item 5 - Other Information

Not applicable.

Item 6 - Exhibits

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

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SIGNATURES

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

SUSSEX BANCORP

By: /s/ Steven M. Fusco .

STEVEN M. FUSCO

Senior Vice President and

Chief Financial Officer

(Principle Financial and Accounting Officer)

Date: November 13, 2013

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).   |
| 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, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income and Comprehensive (Loss) 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