

SUSSEX BANCORP
Form 10-Q
May 15, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

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

For the transition period from _____ to _____

Commission File Number 0-29030

SUSSEX BANCORP

(Exact name of registrant as specified in its charter)

New Jersey

22-3475473

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

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 SD-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No

As of May 4, 2012 there were 3,399,106 shares of common stock, no par value, outstanding.

SUSSEX BANCORP

FORM 10-Q

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FORWARD-LOOKING STATEMENTS

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

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

§ our ability to integrate new technology into our operations;

§ general economic conditions;

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

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

§ the risks inherent in commencing operations in new markets.

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

PART I – FINANCIAL INFORMATIONItem 1 - Financial Statements**SUSSEX BANCORP****CONSOLIDATED BALANCE SHEETS***(Unaudited)*

| (Dollars in thousands) | March 31, 2012 | December 31, 2011 |
|---|-------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 6,240 | \$ 3,903 |
| Interest-bearing deposits with other banks | 37,844 | 33,597 |
| Cash and cash equivalents | 44,084 | 37,500 |
| Interest bearing time deposits with other banks | 100 | 100 |
| Securities available-for-sale, at estimated fair value | 100,917 | 96,361 |
| Securities held-to-maturity, at cost (estimated fair value of \$4,811 At March 31, 2012 and \$4,345 at December 31, 2011) | 4,728 | 4,220 |
| Federal Home Loan Bank Stock, at cost | 1,837 | 1,837 |
| Loans receivable, net of unearned income | 335,434 | 339,705 |
| Less: allowance for loan losses | 7,617 | 7,210 |
| Net loans receivable | 327,817 | 332,495 |
| Foreclosed real estate | 5,001 | 5,509 |
| Premises and equipment, net | 6,910 | 6,778 |
| Accrued interest receivable | 1,784 | 1,735 |
| Goodwill | 2,820 | 2,820 |
| Bank-owned life insurance | 11,245 | 11,142 |
| Other assets | 5,941 | 6,456 |
| Total Assets | \$ 513,184 | \$ 506,953 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Deposits: | | |
| Non-interest bearing | \$ 44,640 | \$ 44,762 |
| Interest bearing | 387,434 | 380,614 |

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| | | |
|---|-------------------|-------------------|
| Total deposits | 432,074 | 425,376 |
| Long term borrowings | 26,000 | 26,000 |
| Accrued interest payable and other liabilities | 2,320 | 2,788 |
| Junior subordinated debentures | 12,887 | 12,887 |
| Total Liabilities | 473,281 | 467,051 |
| Stockholders' Equity: | | |
| Preferred stock, no par value, 1,000,000 shares authorized; none issued | - | - |
| Common stock, no par value, 10,000,000 shares authorized; issued shares 3,404,289 in 2012 and 3,373,793 in 2011; outstanding shares 3,393,106 in 2012 and 3,372,949 in 2011 | 28,000 | 27,964 |
| Treasury stock, at cost; 11,183 shares in 2012 and 844 shares in 2011 | (59 |) (4 |
| Retained earnings | 11,028 | 11,223 |
| Accumulated other comprehensive income | 934 | 719 |
| Total Stockholders' Equity | 39,903 | 39,902 |
| Total Liabilities and Stockholders' Equity | \$ 513,184 | \$ 506,953 |

See Notes to Unaudited Consolidated Financial Statements

SUSSEX BANCORP**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME***(Unaudited)*

| (Dollars in thousands except per share data) | Three Months Ended March 31, | |
|---|------------------------------|----------|
| | 2012 | 2011 |
| INTEREST INCOME | | |
| Loans receivable, including fees | \$ 4,450 | \$ 4,784 |
| Securities: | | |
| Taxable | 320 | 365 |
| Tax-exempt | 245 | 292 |
| Federal funds sold | - | 1 |
| Interest bearing deposits | 17 | 3 |
| Total Interest Income | 5,032 | 5,445 |
| INTEREST EXPENSE | | |
| Deposits | 719 | 769 |
| Borrowings | 265 | 265 |
| Junior subordinated debentures | 62 | 54 |
| Total Interest Expense | 1,046 | 1,088 |
| Net Interest Income | 3,986 | 4,357 |
| PROVISION FOR LOAN LOSSES | 860 | 839 |
| Net Interest Income after Provision for Loan Losses | 3,126 | 3,518 |
| OTHER INCOME | | |
| Service fees on deposit accounts | 275 | 316 |
| ATM and debit card fees | 137 | 122 |
| Bank-owned life insurance | 103 | 104 |
| Insurance commissions and fees | 599 | 615 |
| Investment brokerage fees | 36 | 31 |
| Gain on sale of loans, held for sale | 47 | - |
| Gain on sale of securities, available-for-sale | 59 | - |
| Gain on sale of premises and equipment | 1 | - |
| Gain (loss) on sale of foreclosed real estate | 2 | (11) |
| Other | 65 | 68 |
| Total Other Income | 1,324 | 1,245 |
| OTHER EXPENSES | | |
| Salaries and employee benefits | 2,424 | 2,007 |
| Occupancy, net | 362 | 381 |
| Furniture, equipment and data processing | 354 | 300 |
| Advertising and promotion | 71 | 43 |

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| | | | |
|---|----------|---|---------|
| Professional fees | 158 | | 127 |
| Director fees | 106 | | 67 |
| FDIC assessment | 167 | | 256 |
| Insurance | 53 | | 56 |
| Stationary and supplies | 45 | | 43 |
| Loan collection costs | 134 | | 115 |
| Write-down on foreclosed assets | 615 | | 145 |
| Expenses related to foreclosed assets | 93 | | 24 |
| Amortization of intangible assets | 2 | | 3 |
| Other | 326 | | 293 |
| Total Other Expenses | 4,910 | | 3,860 |
| Income (Loss) before Income Taxes | (460 |) | 903 |
| PROVISION (BENEFIT) FOR INCOME TAXES | (265 |) | 209 |
| Net Income (Loss) | (195 |) | 694 |
| OTHER COMPREHENSIVE INCOME: | | | |
| Net unrealized gains on available for sale securities arising during the period | 417 | | 217 |
| Reclassification adjustment for gain on sales included in net income (loss) | (59 |) | - |
| Income tax expense related to other comprehensive income | (143 |) | (87 |
| Other comprehensive income, net of income taxes | 215 | | 130 |
| Comprehensive income | \$ 20 | | \$ 824 |
| EARNINGS (LOSS) PER SHARE | | | |
| Net Income (loss): | | | |
| Basic | \$ (0.06 |) | \$ 0.21 |
| Diluted | \$ (0.06 |) | \$ 0.21 |

See Notes to Unaudited Consolidated Financial Statements

SUSSEX BANCORP**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY****Three Months Ended March 31, 2012 and 2011***(Unaudited)*

| (Dollars in thousand) | Number of Shares Outstanding | Common Stock | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total Stockholders' Equity |
|--|------------------------------------|-----------------|----------------------|---|-------------------|----------------------------------|
| Balance December 31, 2010 | 3,351,566 | \$27,870 | \$8,753 | \$ 47 | \$ (4) | \$ 36,666 |
| Net income | - | - | 694 | - | - | 694 |
| Other comprehensive income | - | - | - | 130 | - | 130 |
| Restricted stock granted | 11,850 | - | - | - | - | - |
| Restricted stock forfeited | (1,041) | - | - | - | - | - |
| Compensation expense related to stock option and restricted stock grants | - | 21 | - | - | - | 21 |
| Balance March 31, 2011 | 3,362,375 | \$27,891 | \$9,447 | \$ 177 | \$ (4) | \$ 37,511 |
| Balance December 31, 2011 | 3,372,949 | \$27,964 | \$11,223 | \$ 719 | \$ (4) | \$ 39,902 |
| Net loss | - | - | (195) | - | - | (195) |
| Other comprehensive income | - | - | - | 215 | - | 215 |
| Treasury stock purchased | (10,339) | - | - | - | (55) | (55) |
| Restricted stock granted | 30,496 | - | - | - | - | - |
| Compensation expense related to stock option and restricted stock grants | - | 36 | - | - | - | 36 |
| Balance March 31, 2012 | 3,393,106 | \$28,000 | \$11,028 | \$ 934 | \$ (59) | \$ 39,903 |

See Notes to Unaudited Consolidated Financial Statements

SUSSEX BANCORP**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| (Dollars in thousands) | Three Months Ended March 31, | |
|--|------------------------------|----------------|
| | 2012 | 2011 |
| Cash Flows from Operating Activities | | |
| Net income (loss) | \$ (195 |) \$ 694 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Provision for loan losses | 860 | 839 |
| Provision for depreciation and amortization | 165 | 153 |
| Net amortization of securities premiums and discounts | 574 | 222 |
| Net realized gain on sale of securities | (59 |) - |
| Net realized gain on sale of loans, held for sale | (47 |) - |
| Proceeds from the sale of loans held for sale | 638 | - |
| Net realized gain on sale of premises and equipment | (1 |) - |
| Net realized (gain) loss on sale of foreclosed real estate | (2 |) 11 |
| Provision for foreclosed real estate | 615 | 145 |
| Earnings on bank owned life insurance | (103 |) (104 |
| Compensation expense for stock options and stock awards | 36 | 21 |
| (Increase) decrease in assets: | | |
| Accrued interest receivable | (49 |) 80 |
| Other assets | 370 | 701 |
| Decrease in accrued interest payable and other liabilities | (468 |) (241 |
| | |) |
| Net Cash Provided by Operating Activities | 2,334 | 2,521 |
| Cash Flows from Investing Activities | | |
| Securities available for sale: | | |
| Purchases | (14,882 |) (3 |
| Sales | 4,919 | - |
| Maturities, calls and principal repayments | 5,258 | 8,992 |
| Securities held to maturity: | | |
| Purchases | (849 |) (333 |
| Maturities, calls and principal repayments | 333 | - |
| Net (increase) decrease in loans | 3,120 | (5,250 |
| Proceeds from the sale of foreclosed real estate | 2 | 161 |
| Purchases of bank premises and equipment | (306 |) (30 |
| Proceeds from the sale of premises and equipment | 12 | - |
| Net decrease in FHLB stock | - | 450 |
| Net Cash (Used in) Provided by Investing Activities | (2,393 |) 3,987 |
| Cash Flows from Financing Activities | | |
| Net increase in deposits | 6,698 | 4,264 |

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| | | |
|--|-----------|-----------|
| Repayments of borrowings | - | (10,000) |
| Purchase of treasury stock | (55) | - |
| Net Cash Provided by (Used in) Financing Activities | 6,643 | (5,736) |
| Net Increase in Cash and Cash Equivalents | 6,584 | 772 |
| Cash and Cash Equivalents - Beginning | 37,500 | 17,749 |
| Cash and Cash Equivalents - Ending | \$ 44,084 | \$ 18,521 |
| Supplementary Cash Flows Information | | |
| Interest paid | \$ 1,065 | \$ 1,107 |
| Income taxes paid | \$ - | \$ 7 |
| Supplementary Schedule of Noncash Investing and Financing Activities | | |
| Foreclosed real estate acquired in settlement of loans | \$ 107 | \$ - |
| 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 its wholly-owned subsidiary Sussex Bank (the “Bank”). The Bank’s wholly-owned subsidiaries are SCB Investment Company, Inc., SCBNY Company, Inc., ClassicLake Enterprises, LLC, Wheatsworth Properties Corp., PPD Holding Company, LLC, and Tri-State Insurance Agency, Inc. (“Tri-State”), a full service insurance agency located in Sussex County, New Jersey. Tri-State’s operations are considered a separate segment for financial disclosure purposes. All inter-company transactions and balances have been eliminated in consolidation. The Bank operates ten banking offices, eight located in Sussex County, New Jersey and two in Orange County, New York. In 2011 we opened a loan production and insurance agency satellite office in Rochelle Park, New Jersey.

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 month period ended March 31, 2012, are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. 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, 2011.

We have evaluated events and transactions occurring subsequent to the balance sheet date of March 31, 2012 for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through the date these financial statements were issued.

Reclassifications

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

New Accounting Standards

In December, 2011, FASB issued ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, in an effort to improve comparability between U.S. GAAP and IFRS financial statements with regard to the presentation of offsetting assets and liabilities on the statement of financial position arising from financial and derivative instruments, and repurchase agreements. The ASU establishes additional disclosures presenting the gross amounts of recognized assets and liabilities, offsetting amounts, and the net balance reflected in the statement of financial position. Descriptive information regarding the nature and rights of the offset must also be disclosed. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

NOTE 2 – SECURITIES*Available for Sale*

The amortized cost and approximate fair value of securities available for sale as of March 31, 2012 and December 31, 2011 are summarized as follows:

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2012 | | | | |
| State and political subdivisions | \$ 24,101 | \$ 897 | \$ (42) | \$24,956 |
| Mortgage-backed securities: | | | | |
| U.S. government-sponsored enterprises | 73,912 | 905 | (207) | 74,610 |
| Equity securities-financial services industry and other | 1,348 | 18 | (15) | 1,351 |
| | \$ 99,361 | \$ 1,820 | \$ (264) | \$100,917 |
| December 31, 2011 | | | | |
| State and political subdivisions | \$ 19,706 | \$ 883 | \$ (19) | \$20,570 |
| Mortgage-backed securities: | | | | |
| U.S. government-sponsored enterprises | 71,684 | 786 | (472) | 71,998 |
| Private mortgage-backed securities | 2,423 | 58 | (4) | 2,477 |
| Equity securities-financial services industry and other | 1,349 | 1 | (34) | 1,316 |
| | \$ 95,162 | \$ 1,728 | \$ (529) | \$96,361 |

Securities with a carrying value of approximately \$29.4 million and \$21.5 million at March 31, 2012 and December 31, 2011, 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 March 31, 2012 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 Cost | Fair Value |
|------------------------|-------------------|---------------|
|------------------------|-------------------|---------------|

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| | | |
|---|-----------|-----------|
| Due in one year or less | \$ - | \$- |
| Due after one year through five years | - | - |
| Due after five years through ten years | 1,073 | 1,115 |
| Due after ten years | 23,028 | 23,841 |
| Total bonds and obligations | 24,101 | 24,956 |
| Mortgage-backed securities: | | |
| U.S. government-sponsored enterprises | 73,912 | 74,610 |
| Equity securities-financial services industry and other | 1,348 | 1,351 |
| Total available for sale securities | \$ 99,361 | \$100,917 |

Gross gains on sales of securities available for sale were \$79 thousand and gross losses were \$20 thousand for the three months ended March 31, 2012. There were no sales of securities during the first three months of 2011.

Temporarily Impaired Securities

The following table shows our investments' gross unrealized losses and fair value with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by investment category and length of time that individual available for sale securities have been in a continuous unrealized loss position, at March 31, 2012 and December 31, 2011.

| (Dollars in thousands) | Less Than Twelve | Twelve Months or | | Total | | |
|---|------------------|-------------------------------|---------------|-------------------------------|---------------|-------------------------------|
| | Months | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| March 31, 2012 | | | | | | |
| State and political subdivisions | \$ 700 | \$ (29) | \$ 128 | \$ (13) | \$ 828 | \$ (42) |
| Mortgage-backed securities: | | | | | | |
| U.S. government-sponsored enterprises | 26,907 | (207) | - | - | 26,907 | (207) |
| Equity securities-financial services industry and other | 104 | (2) | 199 | (13) | 303 | (15) |
| Total temporarily impaired securities | \$ 27,711 | \$ (238) | \$ 327 | \$ (26) | \$ 28,038 | \$ (264) |
| December 31, 2011 | | | | | | |
| State and political subdivisions | \$ 115 | \$ (2) | \$ 124 | \$ (17) | \$ 239 | \$ (19) |
| Mortgage-backed securities: | | | | | | |
| U.S. government-sponsored enterprises | 34,576 | (472) | - | - | 34,576 | (472) |
| Private mortgage-backed securities | 518 | (4) | - | - | 518 | (4) |
| Equity securities-financial services industry and other | - | - | 1,025 | (34) | 1,025 | (34) |
| Total temporarily impaired securities | \$ 35,209 | \$ (478) | \$ 1,149 | \$ (51) | \$ 36,358 | \$ (529) |

As of March 31, 2012, we reviewed our available for sale investment 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 March 31, 2012, the decline in fair value and the unrealized losses for our state and political subdivisions portfolio were caused by changes in interest rates and spreads and were not the result of credit quality. At March 31, 2012, there

were three securities with a fair value of \$828 thousand that had an unrealized loss that amounted to \$42 thousand. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates. As of March 31, 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 March 31, 2012 were deemed to be other than temporarily impaired.

Mortgage-Backed Securities

At March 31, 2012, the decline in fair value and the unrealized losses for our mortgaged-backed securities were backed by U.S. government-sponsored enterprises. At March 31, 2012, there were twelve securities with a fair value of \$26.9 million that had an unrealized loss. The decline in fair value and the unrealized losses were primarily due to changes in spreads and market conditions and not credit quality. As of March 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 March 31, 2012 were deemed to be other than temporarily impaired.

Equity Securities

Our investments in marketable equity securities consist primarily of a mutual fund, one equity portfolio fund and common stock of entities in the financial services industry. At March 31, 2012, there were three securities with a fair value of \$303 thousand that had an unrealized loss. 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 our ability and intent to hold those investments for a reasonable period of time sufficient for a forecasted recovery of amortized cost, we do not consider these investments to be other-than-temporarily impaired at March 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 approximate fair value of securities held to maturity as of March 31, 2012 and December 31, 2011 are summarized as follows:

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|----------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2012 | | | | |
| State and political subdivisions | \$ 4,728 | \$ 123 | \$ (40) | \$4,811 |
| December 31, 2011 | | | | |
| State and political subdivisions | \$ 4,220 | \$ 125 | \$ - | \$4,345 |

The amortized cost and carrying value of securities held to maturity at March 31, 2012 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 Cost | Fair Value |
|--|-------------------|---------------|
| Due in one year or less | \$ 1,248 | \$1,251 |
| Due after one year through five years | - | - |
| Due after five years through ten years | 1,057 | 1,083 |
| Due after ten years | 2,423 | 2,477 |
| Total held to maturity securities | \$ 4,728 | \$4,811 |

Temporarily Impaired Securities

The following table shows our held to maturity investments' gross unrealized losses and fair value with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by investment category and length of time that individual held to maturity securities have been in a continuous unrealized loss position, at March 31, 2012. There were no securities with unrealized losses on December 31, 2011.

| | Less Than Twelve Months | Twelve Months or More | Total |
|------|-------------------------|-----------------------|-----------------------------|
| Fair | Gross Unrealized | Fair | Gross Unrealized Fair |

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| (Dollars in thousands) | Value | Losses | Value | Losses | Value | Losses |
|----------------------------------|--------|----------|-------|--------|-------|----------|
| March 31, 2012 | | | | | | |
| State and political subdivisions | \$ 808 | \$ (40) | \$ - | \$ - | \$808 | \$ (40) |

As of March 31, 2012, we reviewed our held to maturity investment 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 March 31, 2012, the decline in fair value and the unrealized losses for our state and political subdivisions portfolio were caused by changes in interest rates and spreads and were not the result of credit quality. At March 31, 2012, there were two securities with a fair value of \$808 thousand that had an unrealized loss that amounted to \$40 thousand. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates. As of March 31, 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 March 31, 2012 were deemed to be other-than-temporarily impaired.

NOTE 3 – LOANS

The composition of net loans receivable at March 31, 2012 and December 31, 2011 is as follows:

| (Dollars in thousands) | March 31, 2012 | December 31, 2011 |
|------------------------------------|----------------|-------------------|
| Commercial and industrial loans | \$ 13,401 | \$ 13,711 |
| Construction | 8,293 | 8,520 |
| Commercial real estate | 214,678 | 216,191 |
| Residential real estate | 97,829 | 100,175 |
| Consumer and other | 1,467 | 1,336 |
| | 335,668 | 339,933 |
| Unearned net loan origination fees | (234) | (228) |
| Allowance for loan losses | (7,617) | (7,210) |
| Net loans receivable | \$ 327,817 | \$ 332,495 |

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 \$841 thousand and \$852 thousand at March 31, 2012 and December 31, 2011, 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 months ended March 31, 2012 and 2011:

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| (Dollars in thousands) | Commercial and Industrial | Construction | Commercial Real Estate | Residential Real Estate | Consumer and Other | Unallocated | Total |
|------------------------|------------------------------|--------------|---------------------------|----------------------------|-----------------------|-------------|---------|
| March 31, 2012: | | | | | | | |
| Beginning balance | \$ 304 | \$ 294 | \$ 4,833 | \$ 987 | \$ 9 | \$ 783 | \$7,210 |
| Charge-offs | - | - | (295) | (157) | (16) | - | (468) |
| Recoveries | 1 | - | 11 | - | 3 | - | 15 |
| Provision | - | 288 | 637 | 146 | 35 | (246) | 860 |
| Ending balance | \$ 305 | \$ 582 | \$ 5,186 | \$ 976 | \$ 31 | \$ 537 | \$7,617 |
| March 31, 2011: | | | | | | | |
| Beginning balance | \$ 436 | \$ 1,183 | \$ 3,760 | \$ 798 | \$ 56 | \$ 164 | \$6,397 |
| Charge-offs | - | - | (1) | (12) | (12) | - | (25) |
| Recoveries | 1 | - | 7 | - | 7 | - | 15 |
| Provision | 11 | 164 | 187 | 46 | 3 | 428 | 839 |
| Ending balance | \$ 448 | \$ 1,347 | \$ 3,953 | \$ 832 | \$ 54 | \$ 592 | \$7,226 |

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The following table presents the balance in the allowance of loan losses at March 31, 2012 and December 31, 2011 disaggregated on the basis of our impairment method by class of loans receivable along with the balance of loans receivable by class disaggregated on the basis of our impairment methodology:

| (Dollars in thousands) | Allowance for Loan Losses | | | Loans Receivable | | |
|---------------------------|---------------------------|---|---|------------------|--|--|
| | Balance | Balance Related to Loans Individually Evaluated | Balance Related to Loans Collectively Evaluated | Balance | Individually Evaluated for Impairment | Collectively Evaluated for Impairment |
| March 31, 2012: | | | | | | |
| Commercial and industrial | \$ 305 | \$ 15 | \$ 290 | \$ 13,401 | \$ 31 | \$ 13,370 |
| Construction | 582 | 486 | 96 | 8,293 | 3,462 | 4,831 |
| Commercial real estate | 5,186 | 2,290 | 2,896 | 214,678 | 23,881 | 190,797 |
| Residential real estate | 976 | 195 | 781 | 97,829 | 1,993 | 95,836 |
| Consumer and other | 31 | - | 31 | 1,467 | - | 1,467 |
| Unallocated | 537 | - | - | - | - | - |
| Total | \$ 7,617 | \$ 2,986 | \$ 4,094 | \$ 335,668 | \$ 29,367 | \$ 306,301 |
| December 31, 2011: | | | | | | |
| Commercial and industrial | \$ 304 | \$ 16 | \$ 288 | \$ 13,711 | \$ 32 | \$ 13,679 |
| Construction | 294 | 50 | 244 | 8,520 | 2,458 | 6,062 |
| Commercial real estate | 4,833 | 1,572 | 3,261 | 216,191 | 22,722 | 193,469 |
| Residential real estate | 987 | 319 | 668 | 100,175 | 2,482 | 97,693 |
| Consumer and other | 9 | - | 9 | 1,336 | - | 1,336 |
| Unallocated | 783 | - | - | - | - | - |
| Total | \$ 7,210 | \$ 1,957 | \$ 4,470 | \$ 339,933 | \$ 27,694 | \$ 312,239 |

An age analysis of loans receivable which were past due as of March 31, 2012 and December 31, 2011 is as follows:

| (Dollars in thousands) | 30-59 Days Past Due | 60-89 days Past Due | Greater Than 90 Days (a) | Total Past Due | Current | Total Financing Receivables | Recorded |
|---------------------------|------------------------|------------------------|--------------------------------|-------------------|----------|-----------------------------------|--|
| | | | | | | | Investment > 90 Days and Accruing |
| March 31, 2012: | | | | | | | |
| Commercial and industrial | \$ 279 | \$ 175 | \$ 31 | \$ 485 | \$12,916 | \$ 13,401 | \$ - |
| Construction | 268 | - | 4,247 | 4,515 | 3,778 | 8,293 | 785 |
| Commercial real estate | 4,600 | 1,480 | 21,988 | 28,068 | 186,610 | 214,678 | 191 |
| Residential real estate | 1,503 | 447 | 1,894 | 3,844 | 93,985 | 97,829 | - |

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| | | | | | | | |
|---------------------------|----------|----------|-----------|-----------|-----------|------------|--------|
| Consumer and other | 19 | - | 7 | 26 | 1,441 | 1,467 | 7 |
| Total | \$ 6,669 | \$ 2,102 | \$ 28,167 | \$ 36,938 | \$298,730 | \$ 335,668 | \$ 983 |
| December 31, 2011: | | | | | | | |
| Commercial and industrial | \$ 428 | \$ - | \$ 32 | \$ 460 | \$13,251 | \$ 13,711 | \$ - |
| Construction | 558 | - | 3,243 | 3,801 | 4,719 | 8,520 | 785 |
| Commercial real estate | 5,238 | 137 | 19,311 | 24,686 | 191,505 | 216,191 | - |
| Residential real estate | 940 | - | 2,482 | 3,422 | 96,753 | 100,175 | - |
| Consumer and other | 17 | 1 | 18 | 36 | 1,300 | 1,336 | 18 |
| Total | \$ 7,181 | \$ 138 | \$ 25,086 | \$ 32,405 | \$307,528 | \$ 339,933 | \$ 803 |

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

Loans which the accrual of interest has been discontinued at March 31, 2012 and December 31, 2011 were:

| (Dollars in thousands) | March 31, 2012 | December 31, 2011 |
|---------------------------|----------------|-------------------|
| Commercial and industrial | \$ 31 | \$ 32 |
| Construction | 3,462 | 2,458 |
| Commercial real estate | 21,797 | 19,311 |
| Residential real estate | 1,894 | 2,482 |
| Total | \$ 27,184 | \$ 24,283 |

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

Our risk-rating system as defined below is consistent with the system used by regulatory agencies and consistent with industry practices. Loans rated Substandard, Doubtful or Loss is consistent with the regulatory definitions of classified assets.

Pass: This category represents loans performing to contractual terms and conditions and the primary source of repayment is adequate to meet the obligation. We have five categories within the Pass classification depending on strength of repayment sources, collateral values and financial condition of the borrower.

Special Mention: This category represents loans performing to contractual terms and conditions; however the primary source of repayment or the borrower is exhibiting some deterioration or weaknesses in financial condition that could potentially threaten the borrowers' future ability to repay our loan principal and interest or fees due.

Substandard: This category represents loans 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 a 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 little value that their continuance as active assets is not warranted. Such loans are fully charged off.

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The following tables illustrate our corporate credit risk profile by creditworthiness category as of March 31, 2012 and December 31, 2011:

| (Dollars in thousands) | Pass | Special Mention | Substandard | Doubtful | Total |
|---------------------------|-----------|--------------------|-------------|----------|-----------|
| March 31, 2012: | | | | | |
| Commercial and industrial | \$12,830 | \$ 365 | \$ 198 | \$ 8 | \$13,401 |
| Construction | 4,831 | - | 3,462 | - | 8,293 |
| Commercial real estate | 177,771 | 8,995 | 27,339 | 573 | 214,678 |
| Residential real estate | 93,616 | 490 | 3,723 | - | 97,829 |
| Consumer and other | 1,320 | - | 147 | - | 1,467 |
| | \$290,368 | \$ 9,850 | \$ 34,869 | \$ 581 | \$335,668 |

| | | | | | |
|---------------------------|-----------|----------|-----------|--------|-----------|
| December 31, 2011: | | | | | |
| Commercial and industrial | \$13,103 | \$ 398 | \$ 202 | \$ 8 | \$13,711 |
| Construction | 5,057 | - | 3,463 | - | 8,520 |
| Commercial real estate | 180,862 | 6,987 | 27,769 | 573 | 216,191 |
| Residential real estate | 95,491 | 494 | 4,190 | - | 100,175 |
| Consumer and other | 1,336 | - | - | - | 1,336 |
| | \$295,849 | \$ 7,879 | \$ 35,624 | \$ 581 | \$339,933 |

A loan is considered impaired, in accordance FASB ASC 310-10-35-16, when based on current information and events, it is probable that we will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. 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 average recorded investment in impaired loans is calculated using the average of impaired loans over the past five quarter-end periods. We recognize income on impaired loans under the cash basis when the collateral on the loan is sufficient to cover the outstanding obligation to us. If these factors do not exist, we will record all payments as a reduction of principal on such loans.

The following table reflects our impaired loans by class as of March 31, 2012 and December 31, 2011:

| (Dollars in thousands) | March 31, 2012 | | | December 31, 2011 | | |
|-------------------------------------|-------------------------|------------------------------|-------------------|-------------------------|------------------------------|-------------------|
| | Recorded Investment (1) | Unpaid Principal Balance (2) | Related Allowance | Recorded Investment (1) | Unpaid Principal Balance (2) | Related Allowance |
| With no related allowance recorded: | | | | | | |
| Commercial and industrial | \$- | \$ - | \$ - | \$- | \$ - | \$ - |

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| | | | | | | |
|--|----------|-----------|----------|----------|-----------|----------|
| Construction | 73 | 73 | - | 2,062 | 2,331 | - |
| Commercial real estate | 7,708 | 8,692 | - | 10,362 | 12,932 | - |
| Residential real estate | 1,460 | 1,457 | - | 1,758 | 1,757 | - |
| Consumer and other | - | - | - | - | - | - |
| Total impaired loans without a related allowance | 9,466 | 10,447 | - | 14,182 | 17,020 | - |
| With an allowance recorded: | | | | | | |
| Commercial and industrial | 31 | 31 | 15 | 32 | 32 | 16 |
| Construction | 3,389 | 3,658 | 486 | 396 | 396 | 50 |
| Commercial real estate | 16,200 | 17,754 | 2,290 | 12,404 | 12,399 | 1,572 |
| Residential real estate | 536 | 536 | 195 | 732 | 724 | 319 |
| Consumer and other | - | - | - | - | - | - |
| Total impaired loans with an allowance | 19,931 | 21,754 | 2,986 | 13,564 | 13,551 | 1,957 |
| Total impaired loans | \$29,397 | \$ 32,201 | \$ 2,986 | \$27,746 | \$ 30,571 | \$ 1,957 |

(1) The recorded investment of impaired loans includes the outstanding principal balance and any unpaid interest and escrow balances due

(2) Unpaid principal balance includes the present recorded principal balance plus any amounts that have been previously charged-off.

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The average recorded investment and income recognized is presented for the three month periods ended March 31, 2012 and 2011:

| (Dollars in thousands) | For the Three Months Ended March 31, 2012 | | For the Three Months Ended March 31, 2011 | |
|--|--|----------------------------------|--|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded: | | | | |
| Commercial and industrial | \$ - | \$ - | \$ 20 | \$ - |
| Construction | 2,662 | - | 3,367 | 1 |
| Commercial real estate | 9,235 | 25 | 8,792 | 36 |
| Residential real estate | 1,490 | 33 | 719 | 5 |
| Consumer and other | - | - | 16 | - |
| Total impaired loans without a related allowance | 13,614 | 58 | 12,914 | 42 |
| With an allowance recorded: | | | | |
| Commercial and industrial | 62 | - | 74 | - |
| Construction | 1,408 | - | 2,411 | - |
| Commercial real estate | 13,102 | 6 | 9,874 | 43 |
| Residential real estate | 571 | 1 | 530 | - |
| Consumer and other | - | - | - | - |
| Total impaired loans with an allowance | 14,916 | 7 | 12,889 | 43 |
| Total impaired loans | \$ 28,530 | \$ 65 | \$ 25,803 | \$ 85 |

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 following table presents the recorded investment in troubled debt restructured loans as of March 31, 2012 based on payment performance status:

| (Dollars in thousands) | Commercial Real Estate | Commercial & Industrial | Total |
|------------------------|---------------------------|----------------------------|---------|
| Performing | \$ 5,018 | \$ 8 | \$5,026 |
| Non-performing | 1,889 | - | 1,889 |
| Total | \$ 6,907 | \$ 8 | \$6,915 |

Troubled debt restructured loans are considered impaired and are included in the previous impaired loans disclosures in this footnote. As of March 31, 2012, we have not committed to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

Troubled debt restructured loans can include one or a combination of the following: an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; temporary reduction in the interest rate; change in scheduled payment amount; or permanent reduction of the principal or interest of the loan.

During the first three months of 2012, we have not restructured any troubled debt or required an allocation of the allowance for credit losses. There were no payment defaults of loans during the three months ended March 31, 2012 which were modified in a troubled debt restructuring within the previous twelve months.

A troubled debt restructured loan is considered to be in payment default once it is greater than 30 days contractually past due under the modified terms. The troubled debt restructurings that subsequently defaulted resulted in a net allocation of the allowance for credit losses of \$446 thousand at March 31, 2012. There were no charge-offs on defaulted troubled debt restructurings during the three month period ended March 31, 2012.

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 per share amounts) | Income (Numerator) | Shares (Denominator) | Per Share Amount |
|--|-----------------------|-------------------------|------------------------|
| Three months ended March 31, 2012: | | | |
| Basic earnings per share: | | | |
| Net loss applicable to common shareholders | \$ (195) | 3,256 | \$ (0.06) |
| Effect of dilutive securities: | | | |
| Non-vested stock awards | - | - | |
| Diluted earnings per share: | | | |
| Net loss applicable to common shareholders and assumed conversions | \$ (195) | 3,256 | \$ (0.06) |
| Three months ended March 31, 2011: | | | |
| Basic earnings per share: | | | |
| Net income applicable to common shareholders | \$ 694 | 3,254 | \$ 0.21 |
| Effect of dilutive securities: | | | |
| Non-vested stock awards | - | 64 | |
| Diluted earnings per share: | | | |
| Net income applicable to common shareholders and assumed conversions | \$ 694 | 3,318 | \$ 0.21 |

Options to purchase 97,434 and 116,075 shares of common stock were outstanding at March 31, 2012 and 2011, 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 INCOME

The components of other comprehensive income and related tax effects for the three months ended March 31, 2012 and 2011 are as follows:

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| (Dollars in thousands) | Three Months Ended March 31, | |
|---|------------------------------|--------|
| | 2012 | 2011 |
| Net unrealized gains on available for sale securities arising during the period | \$ 417 | \$ 217 |
| Less: reclassification adjustments for net gains included in net income (loss) | 59 | - |
| | 358 | 217 |
| Tax effect | (143) | (87) |
| | \$ 215 | \$ 130 |

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.

| (Dollars in thousands) | Banking and Financial Services | Insurance Services | Total |
|---|-----------------------------------|-----------------------|---------|
| Three months ended March 31, 2012: | | | |
| Net interest income from external sources | \$ 3,986 | \$ - | \$3,986 |
| Other income from external sources | 725 | 599 | 1,324 |
| Depreciation and amortization | 162 | 3 | 165 |
| (Loss) income before income taxes | (499) | 39) | (460) |
| Income tax (benefit) expense ⁽¹⁾ | (281) | 16) | (265) |
| Total assets | 509,943 | 3,241 | 513,184 |
| Three months ended March 31, 2011: | | | |
| Net interest income from external sources | \$ 4,357 | \$ - | \$4,357 |
| Other income from external sources | 630 | 615 | 1,245 |
| Depreciation and amortization | 150 | 3 | 153 |
| Income before income taxes | 793 | 110 | 903 |
| Income tax expense ⁽¹⁾ | 165 | 44 | 209 |
| Total assets | 466,029 | 2,863 | 468,892 |

(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 ten years, generally vest over periods ranging between one and four years, and are granted with an exercise price equal to the fair market value of the common stock on the date the options are granted. Restricted stock is valued at the market value of the common stock on the date of grant and generally vests between two and seven years. All dividends paid on restricted stock, whether vested or unvested, are granted to the shareholder.

Information regarding our stock option plans as of March 31, 2012 was as follows:

| | Number of Shares | Weighted Average Exercise Price per Share | Weighted Average Contractual Term | Aggregate Intrinsic Value |
|--------------------------------|---------------------|--|--|------------------------------|
| Outstanding, December 31, 2011 | 111,034 | \$ 12.25 | | |
| Options expired | (4,389) | 8.90 | | |
| Options forfeited | (9,211) | 11.77 | | |
| Outstanding, March 31, 2012 | 97,434 | \$ 12.45 | 1.84 | \$ - |
| Exercisable, March 31, 2012 | 97,434 | \$ 12.45 | 1.84 | \$ - |

During the first three months of 2012 and 2011, we expensed \$36 thousand and \$21 thousand, respectively, in stock-based compensation under restricted stock awards. The summary of changes in unvested restricted stock awards for the three months ended March 31, 2012 is as follows:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|--|---------------------|---|
| Unvested restricted stock, beginning of year | 115,729 | \$ 4.86 |
| Granted | 30,496 | 4.97 |
| Vested | (7,152) | 6.03 |
| Unvested restricted stock, end of period | 139,073 | \$ 4.83 |

At March 31, 2012, unrecognized compensation expense for non-vested restricted stock was \$572 thousand, which is expected to be recognized over an average period of 3.8 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. We had \$709 thousand of undrawn standby letters of credit outstanding as of March 31, 2012. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of March 31, 2012 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 ASC 820, *Fair Value Measurement and Disclosures*, there is a hierarchal disclosure framework associated with the level of pricing observability utilized in measuring assets and liabilities at fair value. The three broad levels defined by the FASB ASC 820 hierarchy are as follows:

Level I - Quoted prices are available in active markets for identical assets or liabilities as of the 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.

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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 Value Measurements | Quoted Prices in Active Markets for Identical Assets (Level I) | Significant Other Observable Inputs (Level II) | Significant Unobservable Inputs (Level III) |
|---|-------------------------------|--|--|--|
| March 31, 2012: | | | | |
| State and political subdivisions | \$ 24,956 | \$ - | \$ 24,956 | \$ - |
| Mortgage-backed securities: | | | | |
| U.S. government-sponsored enterprises | 74,610 | - | 74,610 | - |
| Equity securities-financial services industry and other | 1,351 | 1,351 | - | - |
| | \$ 100,917 | \$ 1,351 | \$ 99,566 | \$ - |
| December 31, 2011: | | | | |
| State and political subdivisions | \$ 20,570 | \$ - | \$ 20,570 | \$ - |
| Mortgage-backed securities: | | | | |
| U.S. government-sponsored enterprises | 71,998 | - | 71,998 | - |
| Private mortgage-backed securities | 2,477 | - | 2,477 | - |
| Equity securities-financial services industry and other | 1,316 | 1,316 | - | - |
| | \$ 96,361 | \$ 1,316 | \$ 95,045 | \$ - |

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 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) |
|------------------------|-------------------------|--|--|--|
| | | | | |
| March 31, 2012: | | | | |
| Impaired loans | \$ 16,945 | \$ - | \$ - | \$ 16,945 |
| Foreclosed real estate | 4,499 | - | - | 4,499 |
| December 31, 2011: | | | | |
| Impaired loans | \$ 12,087 | \$ - | \$ - | \$ 12,087 |
| Foreclosed real estate | 4,959 | - | - | 4,959 |

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) | Qualitative Information about Level 3 Fair Value Measurements | | | |
|------------------------|---|-------------------------|---|-------------------------------|
| | Fair Value Estimate | Valuation Techniques | Unobservable Input | Range (Weighted Average) |
| March 31, 2012: | | | | |
| Impaired loans | \$ 16,945 | Appraisal of collateral | Appraisal adjustments ⁽¹⁾ Selling expenses ⁽¹⁾ | 0.00% to -63.8 % (-26.6)% |
| Foreclosed real estate | 4,499 | Appraisal of | | -7.0% (-7.0)% |

collateral

Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated (1) 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 March 31, 2012 and December 31, 2011:

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.

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.

The estimated fair values of our financial instruments at March 31, 2012 and December 31, 2011 were as follows:

| (Dollars in thousands) | March 31, 2012 | | Quoted Prices in Active Markets for Identical Assets (Level I) | Significant Other Observable Inputs (Level II) | Significant Unobservable Inputs (Level III) |
|------------------------------------|--------------------|---------------|---|--|--|
| | Carrying Amount | Fair Value | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$44,084 | \$44,084 | \$44,084 | \$ - | \$ - |
| Time deposits with other banks | 100 | 100 | 100 | - | - |
| Securities available for sale | 100,917 | 100,917 | 1,351 | 99,566 | - |
| Securities held to maturity | 4,728 | 4,811 | - | 4,811 | - |
| Federal Home Loan Bank stock | 1,837 | 1,837 | 1,837 | - | - |
| Loans receivable, net of allowance | 327,817 | 329,205 | - | - | 329,205 |
| Accrued interest receivable | 1,784 | 1,784 | 1,784 | - | - |
| Financial liabilities: | | | | | |
| Deposits | 432,074 | 434,736 | 322,836 | 111,900 | - |
| Borrowings | 26,000 | 29,080 | - | 29,080 | - |
| Junior subordinated debentures | 12,887 | 6,513 | - | 6,513 | - |
| Accrued interest payable | 281 | 281 | 281 | - | - |
| December 31, 2011 | | | | | |
| (Dollars in thousands) | Carrying Amount | Fair Value | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$37,500 | \$37,500 | | | |
| Time deposits with other banks | 100 | 100 | | | |
| Securities available for sale | 96,361 | 96,361 | | | |
| Securities held to maturity | 4,220 | 4,345 | | | |
| Federal Home Loan Bank stock | 1,837 | 1,837 | | | |
| Loans receivable, net of allowance | 332,495 | 334,403 | | | |

| | | |
|--------------------------------|---------|---------|
| Accrued interest receivable | 1,735 | 1,735 |
| Financial liabilities: | | |
| Deposits | 425,376 | 428,098 |
| Borrowings | 26,000 | 29,686 |
| Junior subordinated debentures | 12,887 | 6,613 |
| Accrued interest payable | 301 | 301 |

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 the accounting principles generally accepted in the United States of America ("U.S. GAAP") and practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Actual results could differ from those estimates.

Critical accounting estimates are necessary in the application of certain accounting policies and procedures, and are particularly susceptible to significant change. Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. For additional information on our critical accounting policies, please refer to the information contained in Note 1 of the accompanying unaudited consolidated financial statements and Note 1 of the consolidated financial statements included in our 2011 Annual Report on Form 10-K.

COMPARISON OF OPERATING RESULTS FOR THREE MONTHS ENDED MARCH 31, 2012 AND 2011

Overview - We reported a net loss of \$195 thousand for the first quarter of 2012 as compared to net income of \$694 thousand for the same period in 2011. Basic and diluted loss per share for the three months ended March 31, 2012 were \$0.06 compared to the basic and diluted earnings per share of \$0.21 for the comparable period of 2011. The net loss was largely attributed to write-downs of \$615 thousand on foreclosed real estate properties recognized during the first quarter of 2012, which was a \$470 thousand increase from the same period last year. First quarter results also reflected a decrease in net interest income due to a decline in the net interest margin and an increase in non-interest expenses attributed to higher salaries and employee benefits expenses, due in part to the expansion of our commercial lending group, severance costs for a former executive and increased medical benefit expenses. Management continues to focus on strengthening our core operations as well as resolving and mitigating our credit exposures.

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 March 31, 2012 and 2011.

| (Dollars in thousands) | Three Months Ended March 31, | | | | | | | |
|--|------------------------------|-----------------|----------|-----------|-----------------|----------|--|--|
| | 2012 | | | 2011 | | | | |
| | Average | | Average | Average | | Average | | |
| | Balance | Interest (1) | Rate (2) | Balance | Interest (1) | Rate (2) | | |
| Earning Assets: | | | | | | | | |
| Securities: | | | | | | | | |
| Tax exempt (3) | \$24,686 | \$ 371 | 6.04 % | \$30,023 | \$ 441 | 5.96 % | | |
| Taxable | 77,506 | 320 | 1.66 % | 59,427 | 365 | 2.49 % | | |
| Total securities | 102,192 | 691 | 2.72 % | 89,450 | 806 | 3.66 % | | |
| Total loans receivable (4) | 335,558 | 4,450 | 5.33 % | 341,682 | 4,784 | 5.68 % | | |
| Other interest-earning assets | 33,837 | 17 | 0.20 % | 11,485 | 4 | 0.15 % | | |
| Total earning assets | 471,587 | \$ 5,158 | 4.40 % | 442,617 | \$ 5,594 | 5.13 % | | |
| Non-interest earning assets | 41,203 | | | 36,429 | | | | |
| Allowance for loan losses | (7,543) | | | (6,813) | | | | |
| Total Assets | \$505,247 | | | \$472,233 | | | | |
| Sources of Funds: | | | | | | | | |
| Interest bearing deposits: | | | | | | | | |
| NOW | \$92,293 | \$ 51 | 0.22 % | \$80,689 | \$ 114 | 0.57 % | | |
| Money market | 17,560 | 20 | 0.47 % | 13,410 | 19 | 0.56 % | | |
| Savings | 163,130 | 206 | 0.51 % | 170,601 | 297 | 0.71 % | | |
| Time | 109,950 | 442 | 1.61 % | 90,024 | 339 | 1.53 % | | |
| Total interest bearing deposits | 382,933 | 719 | 0.75 % | 354,724 | 769 | 0.88 % | | |
| Borrowed funds | 26,000 | 265 | 4.03 % | 28,604 | 265 | 3.70 % | | |
| Junior subordinated debentures | 12,887 | 62 | 1.91 % | 12,887 | 54 | 1.69 % | | |
| Total interest bearing liabilities | 421,820 | 1,046 | 1.00 % | 396,215 | 1,088 | 1.11 % | | |
| Non-interest bearing liabilities: | | | | | | | | |
| Demand deposits | 41,314 | | | 36,810 | | | | |
| Other liabilities | 2,012 | | | 2,293 | | | | |
| Total non-interest bearing liabilities | 43,326 | | | 39,103 | | | | |
| Stockholders' equity | 40,100 | | | 36,915 | | | | |
| Total Liabilities and Stockholders' Equity | \$505,246 | | | \$472,233 | | | | |
| Net Interest Income and Margin (5) | | 4,112 | 3.51 % | | 4,506 | 4.13 % | | |
| Tax-equivalent basis adjustment | | (126) | | | (149) | | | |
| Net Interest Income | | \$ 3,986 | | | \$ 4,357 | | | |

- (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, decreased \$394 thousand, or 8.7%, to \$4.1 million for the quarter ended March 31, 2012, as compared to the same period in 2011. The decrease in net interest income was largely due to a decline in the net interest margin of 62 basis points to 3.51% for the first quarter of 2012 as compared to the same period in 2011. The decline in the net interest margin was mostly due to lower yields on loans and securities and an increase in cash balances (other interest earning assets with average rate of 0.20%) resulting from deposit growth (\$28.2 million on average) and a decline in the loan portfolio (\$6.1 million on average) for the first quarter 2012 as compared to same period last year. Total average interest earning assets increased \$29.0 million, or 6.5%, for the first quarter of 2012 as compared to the same period last year.

Interest Income - Total interest income, on a fully taxable equivalent basis, decreased \$436 thousand for the quarter ended March 31, 2012 as compared to the same period last year. The decline was due to lower taxable security and loan yields, which decreased 83 basis points and 35 basis points, respectively.

Total interest income on securities, on a fully taxable equivalent basis, decreased \$115 thousand, to \$691 thousand for the quarter ended March 31, 2012 from \$806 thousand for the first quarter of 2011. This decline was largely due to a 94 basis point decrease in the yield on securities from 3.66% to 2.72% between the two first quarter periods. The decline in security yields was mostly attributed to the reinvestment of excess liquidity, cash flows from maturities, calls and prepayments into a lower market rate environment.

The interest earned on total loans receivable decreased \$334 thousand for the first quarter of 2012 as compared to the same period in 2011. The decline was mostly driven by a 35 basis point decline in average yields due to lower market rates and a \$2.1 million increase in non-accrual loans between the two first quarter periods. The average rate earned on loans for the quarter ended March 31, 2012 was 5.33% as compared to 5.68% for the same period in 2011.

Other interest-earning assets include federal funds sold and interest bearing deposits in other banks. The interest earned on total other interest-earning assets increased \$13 thousand for the first quarter of 2012 as compared to the first quarter in 2011 due to higher average balances. The average balances in other interest-earning assets increased \$22.3 million to \$33.8 million in the first quarter of 2012 from \$11.5 million during the first quarter a year earlier. The increases in the average balance in other interest-earning assets were driven by deposit growth.

Interest Expense - Our interest expense for the three months ended March 31, 2012 decreased \$42 thousand, or 3.9%, to \$1.0 million from \$1.1 million for the same period in 2011. The improvement was principally due to lower average rates paid on total interest-bearing liabilities, which declined 11 basis points from 1.11% for the three months ended March 31, 2011 to 1.00% for the same period in 2012. The improvement in interest expense was partly offset by an increase in average balances in interest-bearing liabilities, which grew \$25.6 million, or 6.5%, to \$421.8 million for the first quarter in 2012 from \$396.2 million for the same period in 2011.

Interest expense on deposits declined \$50 thousand, or 6.5%, for the quarter ended March 31, 2012, as compared to the same period last year. The decline was largely attributed to lower rates on total interest bearing deposits, which decreased 13 basis points for the first quarter 2012 as compared to the same period in 2011. The decrease in rates on deposit products reflects managements' asset/liability strategies and a lower market rate environment between the two first quarter periods. During the first quarter of 2012, there was a favorable shift in deposit mix as savings deposits, on average, with a yield of 51 basis points declined \$7.5 million, while average NOW accounts with a yield of 22 basis points increased \$11.6 million. The shift in mix had a positive effect on interest expense for the first quarter of 2012.

Provision for Loan Losses - The loan loss provision for the first quarter of 2012 increased \$21 thousand, or 2.5%, to \$860 thousand compared to a provision of \$839 thousand in the first quarter of 2011. The provision for loan losses reflects management's judgment concerning the risks inherent in our existing loan portfolio and the size of the allowance necessary to absorb the risks, as well as the activity in the allowance during the periods. Management reviews the adequacy of its allowance on an ongoing basis and will provide additional provisions, as management may deem necessary.

Non-Interest Income - Our non-interest income increased \$79 thousand, or 6.3%, to \$1.3 million for the three months ended March 31, 2012 compared to the same period in 2011. The increase in non-interest income was largely due to \$59 thousand in gain on sale of securities and a \$47 thousand gain on sale of loans held for sale. The security gains recognized in the first quarter of 2012 was largely driven by the execution of two security strategies. We sold \$1.9 million in private label collateralized mortgage obligations with deteriorating credit profiles for a net gain of \$8 thousand and \$2.9 million in adjustable rate mortgage backed securities with an average balance of \$122 thousand for a net gain of \$49 thousand. The aforementioned increases were partly offset by a \$41 thousand decrease in service charges on deposit accounts for the quarter ended March 31, 2012 as compared to the same period last year.

Non-Interest Expense – Total non-interest expense increased \$1.1 million, or 27.2%, to \$4.9 million for the quarter ended March 31, 2012. The increase for the first quarter of 2012 versus the same period in 2011 was largely due to a \$539 thousand increase in write-downs and expenses related to foreclosed real estate and a \$417 thousand increase in salaries and employee benefits. The increase in write-downs and expenses related to foreclosed real estate was principally due to the potential sale of our largest foreclosed asset scheduled for disposition during the second quarter. The increase in salaries and employee benefits was mostly attributed to costs of \$160 thousand related to the hiring of additional commercial lenders and support staff, higher medical benefit costs and severance costs of \$110 thousand for a former executive during the first quarter of 2012 as compared to the same quarter in 2011. The aforementioned increases were in part offset by a decline in FDIC assessments of \$89 thousand.

Income Taxes - our income tax benefit, which includes both federal and state taxes, was \$265 thousand for the three months ended March 31, 2012 compared to income tax expense of \$209 thousand for the first quarter of 2011.

COMPARISON OF FINANCIAL CONDITION AT MARCH 31, 2012 TO DECEMBER 31, 2011

At March 31, 2012, our total assets were \$513.2 million, an increase of \$6.2 million, or 1.2%, as compared to total assets of \$507.0 million at December 31, 2011.

Cash and Cash Equivalents - Our cash and cash equivalents increased by \$6.6 million at March 31, 2012 to \$44.1 million, or 8.6% of total assets, from \$37.5 million, or 7.4% of total assets, at December 31, 2011. The increase was largely due to an increase of \$6.7 million in deposits.

Securities Portfolio - At March 31, 2012, total investment securities, which include available-for-sale and held-to-maturity securities, were \$105.6 million compared to \$100.6 million at December 31, 2011. Available-for-sale securities were \$100.9 million at March 31, 2012 compared to \$96.4 million at December 31, 2011. 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.

Other investments totaled \$1.8 million at March 31, 2012 and December 31, 2011 and consisted primarily of FHLB stock. We also held \$100 thousand in time deposits with other financial institutions at March 31, 2012 and at December 31, 2011.

Net unrealized gains were \$1.6 million and \$1.2 million at March 31, 2012 and December 31, 2011, respectively. The improvement in the fair value of the investment securities is driven by mortgage backed securities. Gross unrealized gains improved by \$92 thousand to \$1.8 million at March 31, 2012, as compared to \$1.7 million at December 31, 2011. The improvement in gross unrealized losses was largely attributed to higher fair values of state and political subdivisions.

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 March 31, 2012 and we do not consider any security OTTI. We evaluated the prospects of the issuers in relation to the severity and the duration of the unrealized losses. Based on that evaluation, we did not intend to the sell and it is more likely than not that we will not have to sell any of our securities before recovery of their cost basis.

Our equity portfolio, which amounted to a fair value of \$1.4 million, is comprised primarily of investments in other banks, an equity fund and a tax exempt mutual fund. During the fourth quarter of 2011, we recognized a \$231 thousand pre-tax (\$183 thousand after-tax, or \$0.06 per share) non-cash other-than-temporarily impaired charge related to an equity portfolio fund and common stock. We recognized a \$144 thousand charge on the equity portfolio fund comprised of common stocks of bank holding companies that had an amortized cost of \$250 thousand and a termination date of December 2012. The additional \$87 thousand impairment charge was recognized on a common stock that had an amortized cost of \$230 thousand. The impairment was recognized because the market value of this security was below our amortized cost for an extended period of time along with credit deterioration in some of the underlying collateral and it was not believed the market value of this security would recover to our amortized cost. We continue to closely monitor the performance of our equity securities that we own, as well as the impact from any further deterioration in the economy or in the banking industry that may adversely affect these securities. We will continue to evaluate them for OTTI, which could result in a future non-cash charge to earnings. We held no high-risk securities or derivatives at March 31, 2012 or December 31, 2011.

Loans - The loan portfolio comprises our largest class of earning assets. Total loans receivable, net of unearned income, at March 31, 2012 decreased \$4.3 million to \$335.4 million from \$339.7 million at year-end 2011, as new loan originations were less than payments, charge-offs and maturities. The decline was largely in residential real estate loans, which declined \$2.3 million to \$97.8 million, and commercial real estate, which declined \$1.5 million to \$214.7 million, at March 31, 2012 as compared to December 31, 2011. Approximately 96% of our loan portfolio is secured by real estate and less than 5% of the loan portfolio is commercial and industrial based loans. We do not originate sub-prime or unconventional one to four family real estate loans.

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

| (Dollars in thousands) | March 31, 2012 | December 31, 2011 |
|---------------------------------|-------------------|----------------------|
| Commercial and industrial loans | \$13,401 | \$13,711 |
| Construction | 8,293 | 8,520 |
| Commercial real estate | 214,678 | 216,191 |
| Residential real estate | 97,829 | 100,175 |
| Consumer and other | 1,467 | 1,336 |
| Total gross loans | \$335,668 | \$339,933 |

Loan and Asset Quality - Total non-performing assets, which include non-accrual loans, performing troubled debt restructured loans and foreclosed real estate, increased by \$1.1 million to \$34.3 million at March 31, 2012 from \$33.2 million at year-end 2011. The increase was largely due to one borrowing relationship that totaled \$3.8 million that was previously classified and became non-accrual during the first quarter of 2012. The increase was partly offset by a \$1.3 million reduction in trouble debt restructured loans and non-performing loans that returned to performing status or were paid off during the period. Our non-accrual loans increased \$2.9 million to \$27.2 million at March 31, 2012 from \$24.3 million at December 31, 2011. Troubled debt restructured loans that were not on non-accrual were \$2.1 million at March 31, 2012 and \$3.4 million at December 31, 2011. Non-accrual loans at March 31, 2012 primarily consist of loans which are collateralized by real estate. During the first three months of 2012, foreclosed real estate decreased by a net of \$500 thousand, principally due the partial write-down on one foreclosed asset. We held 16 foreclosed real estate properties as of March 31, 2012 totaling \$5.0 million. Foreclosed real estate properties were recorded at the lower of its carrying value or fair value less costs to sell and are currently being marketed for sale.

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

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| (Dollars in thousands) | March 31, 2012 | | December 31, 2011 | |
|--|----------------------|---|----------------------|---|
| Non-accrual loans | \$27,184 | | \$ 24,283 | |
| Non-accrual loans to total loans | 8.10 | % | 7.15 | % |
| Non-performing assets | \$29,268 | | \$ 27,694 | |
| Non-performing assets to total assets | 6.68 | % | 6.55 | % |
| Allowance for loan losses as a % of non-performing loans | 26.03 | % | 26.03 | % |
| Allowance for loan losses to total loans | 2.27 | % | 2.12 | % |

Loan balances past due 90 days or more and still accruing interest, but which management expects will eventually be paid in full are not included in total non-performing loans. These loans are principally past due 90 days because of maturity but are currently paying and are well secured. At March 31, 2012, we had \$983 thousand in this category as compared to \$803 thousand at December 31, 2011.

A loan is considered impaired, in accordance with the impairment accounting guidance (FASB ASC 310-10-35-16), when based on current information and events, it is probable that we will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Total impaired loans at March 31, 2012 were \$29.4 million and at December 31, 2011 were \$27.7 million. Impaired loans measured at fair value increased to \$15.3 million on March 31, 2012 from \$11.6 million at December 31, 2011. The principal balances on loans measured at fair value were \$18.3 million and \$13.6 million, net of valuation allowance of \$3.0 million at March 31, 2012 and \$2.0 million at December 31, 2011. Impaired loans include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection. Not all impaired loans and restructured loans are on non-accrual, and therefore not all are considered non-performing loans. Impaired and restructured loans still accruing totaled \$2.1 million at March 31, 2012 and \$3.4 million at December 31, 2011.

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 March 31, 2012, we had eight loan relationships totaling \$3.8 million that it deemed potential problem loans. Management is actively monitoring these loans.

Further detail of the credit quality of the loan portfolio is in Note 3 - Loans 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 and allocated components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical charge-off experience and expected losses derived from our internal risk rating process. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

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

At March 31, 2012, the total allowance for loan losses increased \$407 thousand, or 5.6%, to \$7.6 million, as compared to \$7.2 million at December 31, 2011. The components of this increase were a provision for loan losses of \$860 thousand and net charge-offs totaling \$453 thousand in the first three months of 2012. The provision also reflects the continued decline in current real estate values in our market area and reduced cash flows to support the repayment of

loans. The allowance for loan losses as a percentage of total loans was 2.27% at March 31, 2012 and 2.12% at December 31, 2011.

The table below presents information regarding our provision and allowance for loan losses at March 31, 2012 and 2011:

| (Dollars in thousands) | March 31, 2012 | March 31, 2011 |
|------------------------------|----------------------|----------------------|
| Balance, beginning of period | \$7,210 | \$6,397 |
| Provision | 860 | 839 |
| Charge-offs | (468) | (25) |
| Recoveries | 15 | 15 |
| Balance, end of period | \$7,617 | \$7,226 |

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.

| | March 31, 2012 | | | December 31, 2011 | | |
|---------------------------|----------------|--|---|-------------------|--|---|
| | Amount | Percent of Loans In Each Category To Gross Loans | | Amount | Percent of Loans In Each Category To Gross Loans | |
| (Dollars in thousands) | | | | | | |
| Commercial and industrial | \$ 305 | 4.0 | % | \$ 304 | 4.0 | % |
| Construction | 582 | 2.5 | % | 294 | 2.5 | % |
| Commercial real estate | 5,187 | 64.0 | % | 4,833 | 63.6 | % |
| Residential real estate | 976 | 29.1 | % | 987 | 29.5 | % |
| Consumer and other loans | 31 | 0.4 | % | 9 | 0.4 | % |
| Unallocated | 537 | | | 783 | | |
| Total | \$7,617 | 100.0 | % | \$7,210 | 100.0 | % |

Bank-Owned Life Insurance (BOLI) - Our BOLI carrying value amounted to \$11.2 million at March 31, 2012 and \$11.1 million at December 31, 2011.

Goodwill and Other Intangibles - Goodwill represents the excess of the purchase price over the fair market value of net assets acquired. At March 31, 2012 and December 31, 2011, 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 - Total deposits increased \$6.7 million, or 1.6%, to \$432.1 million at March 31, 2012 from \$425.4 million at December 31, 2011. The increase was largely in total interest bearing deposits, which increased \$6.8 million to \$387.4 million at March 31, 2012 from \$380.6 million at December 31, 2011.

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 \$26.0 million in borrowings, at a weighted average interest rate of 4.03%, at March 31, 2012 and at December 31, 2011. The borrowings at March 31, 2012 consisted 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 March 31, 2012 was 1.91%. The capital securities are redeemable by us during the first five years at a redemption price of 103.5% of par for the first year and thereafter on a sliding scale down to 100% of par on or after June 15, 2012 in whole or in part or earlier if the regulatory capital or tax treatment of the securities is substantially changed. The proceeds of these trust preferred securities, which have been contributed to the Bank, are included in the Bank's capital ratio calculations and treated as Tier I capital.

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

Equity – Stockholders' equity, inclusive of accumulated other comprehensive income, net of income taxes, was \$39.9 million at March 31, 2012 and at year-end 2011. In order to preserve capital, our Board of Directors elected not to declare any cash dividends in the first three months of 2012 or 2011. The Board will review our dividend policy based on a number of factors, including current economic and regulatory conditions, our earnings and asset quality and capital needs. On April 27, 2011, at our Annual Meeting of Stockholders, stockholders approved an increase in the number of authorized shares of common stock from 5 million to 10 million shares.

LIQUIDITY AND CAPITAL RESOURCES

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

Traditionally, financing for our loans and investments is derived primarily from deposits, along with interest and principal payments on loans and investments. At March 31, 2012, total deposits amounted to \$432.1 million, an increase of \$6.7 million, or 1.6%, from December 31, 2011. At March 31, 2012, advances from FHLB and subordinated debentures totaled \$38.9 million and represented 7.6% of total assets as compared to \$38.9 million and 7.7% of total assets at December 31, 2011.

Loan production continued to be our principal investing activity. Net loans at March 31, 2012 amounted to \$335.4 million, a decrease of \$4.3 million, or 1.3%, compared to December 31, 2011.

Our most liquid assets are cash and due from banks and federal funds sold. At March 31, 2012, the total of such assets amounted to \$44.1 million, or 8.6%, of total assets, compared to \$37.5 million, or 7.4%, of total assets at year-end 2011. Another significant liquidity source is our available-for-sale securities portfolio. At March 31, 2012, available-for-sale securities amounted to \$100.9 million compared to \$96.4 million at year-end 2011.

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 \$27.8 million through its membership in the FHLB and \$4.0 million at Atlantic Central Bankers Bank at March 31, 2012. 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 March 31, 2012, the Bank's Tier I and Tier II capital ratios were 13.18% and 14.45%, 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 March 31, 2012, the Bank had a leverage ratio of 9.19%. 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. As of June 30, 2011, Sussex Bancorp's total assets remained below \$500 million, but exceeded \$500 million as of March 31, 2012.

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 March 31, 2012 totaled \$43.6 million and consisted of \$19.1 million in commitments to grant commercial real estate, construction and land development loans, \$12.1 million in home equity lines of credit, \$10.6 million in other unused commitments and \$1.7 million in letters of credit. These instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk to us. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

Item 3 - Quantitative and Qualitative Disclosures about Market Risk

Not applicable

Item 4 - Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities and Exchange Act of 1934, as amended (the “Exchange Act”)), as of the end of the period covered by this report. Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective, to ensure that information required to be disclosed in the reports we file and submit under the Exchange Act is (i) recorded, processed, summarized and reported as and when required and (ii) accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely discussion regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting identified in connection with the evaluation that occurred during our last fiscal quarter that have materially 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 periodically involved in various legal proceedings as a normal incident to their businesses. In the opinion of management no material loss is expected from any such pending lawsuit.

Item 1A - Risk Factors

For a summary of risk factors relevant to our operations, see Part 1, Item 1A, “Risk Factors” in our 2011 Annual Report on Form 10-K. There are no material changes in the risk factors relevant to our operations.

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

On April 16, 1999, we announced a stock repurchase plan whereby we may purchase up to 50,000 shares of outstanding stock. There is no expiration date to this plan. The plan has been amended several times to increase the number of shares which may be repurchased, and we currently have the authority to repurchase up to 400,000 shares of our common stock.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Announced or Programs | Maximum Number of Shares that May Yet Be Purchased Under the or Plans or Programs |
|--|---|---------------------------------------|---|---|
| January 1, 2012 through January 31, 2012 | - | \$ - | - | - |

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| | | | | |
|--|--------|---------|---------|---------|
| February 1, 2012 through February 29, 2012 | - | - | - | - |
| March 1, 2012 through March 31, 2012 | 10,339 | 5.30 | 257,745 | 142,255 |
| Total | 10,339 | \$ 5.30 | 257,745 | 142,255 |

Item 3 - Defaults Upon Senior Securities

Not applicable

Item 4 – Mine Safety Disclosures

Not applicable

Item 5 - Other Information

Not applicable

Item 6 - Exhibits

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

SIGNATURES

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

SUSSEX BANCORP

By: /s/ Steven M. Fusco
STEVEN M. FUSCO
Senior Vice President
and
Chief Financial Officer
Date: May 15, 2012

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 March 31, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Stockholders' Equity, (iv) the Consolidated Statements of Cash Flows and (v) Notes to Consolidated Financial Statements. |

*

Filed herewith

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