

SUSSEX BANCORP
Form 10-Q
November 14, 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 September 30, 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

(State or other jurisdiction of incorporation or organization) **22-3475473** (I.R.S. Employer Identification No.)

200 Munsonhurst Rd., Franklin, NJ 07416
(Address of principal executive offices) (Zip Code)

(973) 827-2914

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Yes No

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

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

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

Yes No

As of November 2, 2012 there were 3,397,873 shares of common stock, no par value, outstanding.

SUSSEX BANCORP

FORM 10-Q

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FORWARD-LOOKING STATEMENTS

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

§ changes in the interest rate environment that reduce margins;

§ changes in the regulatory environment;

§ the highly competitive industry and market area in which we operate;

§ general economic conditions, either nationally or regionally, resulting in, among other things, a deterioration in credit quality;

§ changes in business conditions and inflation;

§ changes in credit market conditions;

§ changes in the securities markets which affect investment management revenues;

§ increases in Federal Deposit Insurance Corporation (“FDIC”) deposit insurance premiums and assessments could adversely affect our financial condition;

§ changes in technology used in the banking business;

§ the soundness of other financial services institutions which may adversely affect our credit risk;

§ our controls and procedures may fail or be circumvented;

§ new line of business or new products and services which may subject us to additional risks;

§ changes in key management personnel which may adversely impact our operations;

§ the effect on our operations of recent legislative and regulatory initiatives that were or may be enacted in response to the ongoing financial crisis;

§ severe weather, natural disasters, acts of war or terrorism and other external events which could significantly impact our business;

§ other factors detailed from time to time in our filings with the SEC.

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

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements**SUSSEX BANCORP****CONSOLIDATED BALANCE SHEETS***(Unaudited)*

| (Dollars In Thousands) | September 30, 2012 | December 31, 2011 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 6,513 | \$ 3,903 |
| Interest-bearing deposits with other banks | 3,917 | 33,597 |
| Cash and cash equivalents | 10,430 | 37,500 |
| Interest bearing time deposits with other banks | 100 | 100 |
| Securities available for sale, at estimated fair value | 119,002 | 96,361 |
| Securities held to maturity, at cost (estimated fair value of \$5,802 at September 30, 2012 and \$4,345 at December 31, 2011) | 5,593 | 4,220 |
| Federal Home Loan Bank Stock, at cost | 1,943 | 1,837 |
| Loans receivable, net of unearned income | 340,395 | 339,705 |
| Less: allowance for loan losses | 6,721 | 7,210 |
| Net loans receivable | 333,674 | 332,495 |
| Foreclosed real estate | 5,158 | 5,509 |
| Premises and equipment, net | 6,630 | 6,778 |
| Accrued interest receivable | 1,861 | 1,735 |
| Goodwill | 2,820 | 2,820 |
| Bank-owned life insurance | 11,442 | 11,142 |
| Other assets | 5,641 | 6,456 |
| Total Assets | \$ 504,294 | \$ 506,953 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Deposits: | | |
| Non-interest bearing | \$ 46,813 | \$ 44,762 |
| Interest bearing | 370,528 | 380,614 |

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| | | |
|---|------------|------------|
| Total Deposits | 417,341 | 425,376 |
| Long-term borrowings | 26,000 | 26,000 |
| Accrued interest payable and other liabilities | 6,884 | 2,788 |
| Junior subordinated debentures | 12,887 | 12,887 |
| Total Liabilities | 463,112 | 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 3,409,056 in 2012 and 3,373,793 in 2011; outstanding shares 3,397,873 in 2012 and 3,372,949 in 2011 | 28,076 | 27,964 |
| Treasury stock, at cost; 11,183 shares in 2012 and 844 shares in 2011 | (59 |) (4 |
| Retained earnings | 12,055 | 11,223 |
| Accumulated other comprehensive income | 1,110 | 719 |
| Total Stockholders' Equity | 41,182 | 39,902 |
| Total Liabilities and Stockholders' Equity | \$ 504,294 | \$ 506,953 |

See Notes to Unaudited Consolidated Financial Statements

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

| (Dollars in thousands except per share data) | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|--------------|-----------------------|---------------|
| | September 30, 2012 | 2011 | September 30, 2012 | 2011 |
| INTEREST INCOME | | | | |
| Loans receivable, including fees | \$ 4,467 | \$ 4,687 | \$ 13,292 | \$ 14,210 |
| Securities: | | | | |
| Taxable | 241 | 313 | 994 | 989 |
| Tax-exempt | 292 | 296 | 827 | 879 |
| Federal funds sold | - | - | - | 3 |
| Interest bearing deposits | 4 | 20 | 30 | 32 |
| Total Interest Income | 5,004 | 5,316 | 15,143 | 16,113 |
| INTEREST EXPENSE | | | | |
| Deposits | 587 | 806 | 1,938 | 2,342 |
| Borrowings | 268 | 268 | 797 | 797 |
| Junior subordinated debentures | 60 | 55 | 183 | 164 |
| Total Interest Expense | 915 | 1,129 | 2,918 | 3,303 |
| Net Interest Income | 4,089 | 4,187 | 12,225 | 12,810 |
| PROVISION FOR LOAN LOSSES | 1,104 | 737 | 2,922 | 2,688 |
| Net Interest Income after Provision for Loan Losses | 2,985 | 3,450 | 9,303 | 10,122 |
| OTHER INCOME | | | | |
| Service fees on deposit accounts | 292 | 324 | 842 | 968 |
| ATM and debit card fees | 165 | 140 | 453 | 400 |
| Bank-owned life insurance | 96 | 105 | 300 | 314 |
| Insurance commissions and fees | 684 | 545 | 1,892 | 1,724 |
| Investment brokerage fees | 46 | 33 | 118 | 103 |
| Net gain on sale of loans, held for sale | - | - | 47 | - |
| Net gain (loss) on securities transactions | 569 | (1) | 763 | 268 |
| Net loss on sale of premises and equipment | - | - | (6) | - |
| Net gain (loss) on sale of foreclosed real estate | 2 | 2 | 5 | (2) |
| Other | 108 | 58 | 291 | 177 |
| Total Other Income | 1,962 | 1,206 | 4,705 | 3,952 |
| OTHER EXPENSES | | | | |
| Salaries and employee benefits | 2,196 | 2,219 | 6,744 | 6,212 |
| Occupancy, net | 355 | 338 | 1,071 | 1,055 |
| Furniture, equipment and data processing | 326 | 283 | 1,014 | 871 |
| Advertising and promotion | 63 | 52 | 222 | 141 |
| Professional fees | 175 | 163 | 478 | 439 |
| Director fees | 56 | 5 | 236 | 144 |
| FDIC assessment | 177 | 153 | 516 | 535 |
| Insurance | 68 | 53 | 179 | 163 |

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| | | | | |
|---|---------|---------|----------|----------|
| Stationary and supplies | 44 | 39 | 128 | 122 |
| Loan collection costs | 204 | 314 | 539 | 606 |
| Expenses and write-downs related to foreclosed real estate | 234 | 74 | 1,044 | 322 |
| Amortization of intangible assets | 1 | 3 | 4 | 8 |
| Other | 396 | 329 | 1,095 | 966 |
| Total Other Expenses | 4,295 | 4,025 | 13,270 | 11,584 |
| Income before Income Taxes | 652 | 631 | 738 | 2,490 |
| PROVISION (BENEFIT) FOR INCOME TAXES | 106 | 97 | (94) |) 535 |
| Net Income | \$ 546 | \$ 534 | \$ 832 | \$ 1,955 |
| OTHER COMPREHENSIVE INCOME: | | | | |
| Net unrealized gains on available for sale securities arising during the period | 693 | 353 | 1,413 | 1,425 |
| Reclassification adjustment for (gain) loss on sales included in net income | (569) |) 1 | (763) |) (268) |
| Income tax expense related to items of other comprehensive income | (49) |) (142) |) (259) |) (463) |
| Other comprehensive income, net of income taxes | 75 | 212 | 391 | 694 |
| Comprehensive income | \$ 621 | \$ 746 | \$ 1,223 | \$ 2,649 |
| EARNINGS PER SHARE | | | | |
| Basic | \$ 0.17 | \$ 0.16 | \$ 0.26 | \$ 0.60 |
| Diluted | \$ 0.17 | \$ 0.16 | \$ 0.25 | \$ 0.59 |

See Notes to Unaudited Consolidated Financial Statements

SUSSEX BANCORP**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY****Nine Months Ended September 30, 2012 and 2011***(Unaudited)*

| (Dollars In Thousands) | 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 | - | - | 1,955 | - | - | 1,955 |
| Other comprehensive income | - | - | - | 694 | - | 694 |
| Restricted stock granted | 22,805 | - | - | - | - | - |
| Restricted stock forfeited | (1,683) | - | - | - | - | - |
| Compensation expense related to stock option and restricted stock grants | - | 73 | - | - | - | 73 |
| Balance September 30, 2011 | 3,372,688 | \$27,943 | \$10,708 | \$ 741 | \$ (4) | \$ 39,388 |
| Balance December 31, 2011 | 3,372,949 | \$27,964 | \$11,223 | \$ 719 | \$ (4) | \$ 39,902 |
| Net income | - | - | 832 | - | - | 832 |
| Other comprehensive income | - | - | - | 391 | - | 391 |
| Treasury shares purchased | (10,339) | - | - | - | (55) | (55) |
| Restricted stock granted | 37,496 | - | - | - | - | - |
| Restricted stock forfeited | (2,233) | - | - | - | - | - |
| Compensation expense related to stock option and restricted stock grants | - | 112 | - | - | - | 112 |
| Balance September 30, 2012 | 3,397,873 | \$28,076 | \$12,055 | \$ 1,110 | \$ (59) | \$ 41,182 |

See Notes to Unaudited Consolidated Financial Statements

SUSSEX BANCORP**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| (Dollars in thousands) | Nine Months Ended September 30, | |
|---|---------------------------------|-----------|
| | 2012 | 2011 |
| Cash Flows from Operating Activities | | |
| Net income | \$ 832 | \$ 1,955 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 2,922 | 2,688 |
| Provision for depreciation and amortization | 509 | 458 |
| Net amortization of securities premiums and discounts | 1,991 | 646 |
| Net realized gain on sale of securities | (763) | (268) |
| Net realized gain on sale of loans, held for sale | (47) | - |
| Proceeds from the sale of loans held for sale | 638 | - |
| Net realized loss on sale of premises and equipment | 6 | - |
| Net realized (gain) loss on sale of foreclosed real estate | (5) | 2 |
| Provision for foreclosed real estate | 871 | 145 |
| Deferred income taxes | (509) | - |
| Earnings on bank owned life insurance | (300) | (314) |
| Compensation expense for stock options and stock awards | 112 | 73 |
| (Increase) decrease in assets: | | |
| Accrued interest receivable | (126) | 314 |
| Other assets | 1,060 | (133) |
| Increase in accrued interest payable and other liabilities | 4,096 | 55 |
| Net Cash Provided by Operating Activities | 11,287 | 5,621 |
| Cash Flows from Investing Activities | | |
| Securities available for sale: | | |
| Purchases | (71,850) | (18,431) |
| Sales | 24,187 | 6,252 |
| Maturities, calls and principal repayments | 24,475 | 23,727 |
| Securities held to maturity: | | |
| Purchases | (2,623) | (2,289) |
| Maturities, calls and principal repayments | 1,220 | - |
| Net increase in loans | (5,632) | (3,944) |
| Net maturities of interest bearing time deposits | - | 500 |
| Proceeds from the sale of foreclosed real estate | 425 | 405 |
| Purchases of bank premises and equipment | (375) | (124) |
| Proceeds from the sale of premises and equipment | 12 | - |
| Purchases of bank owned life insurance | - | (550) |
| (Increase) decrease in FHLB stock | (106) | 398 |
| Net Cash (Used in) Provided by Investing Activities | (30,267) | 5,944 |

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| | | | |
|--|-----------|---|-----------|
| Cash Flows from Financing Activities | | | |
| Net (decrease) increase in deposits | (8,035 |) | 29,083 |
| Repayments of borrowings | - | | (10,000) |
| Purchase of treasury stock | (55 |) | - |
| Net Cash (Used in) Provided by Financing Activities | (8,090 |) | 19,083 |
| Net (Decrease) Increase in Cash and Cash Equivalents | (27,070 |) | 30,648 |
| Cash and Cash Equivalents - Beginning | 37,500 | | 17,749 |
| Cash and Cash Equivalents - Ending | \$ 10,430 | | \$ 48,397 |
| Supplementary Cash Flows Information | | | |
| Interest paid | \$ 2,952 | | \$ 3,286 |
| Income taxes paid | \$ 212 | | \$ 1,069 |
| Supplementary Schedule of Noncash Investing and Financing Activities | | | |
| Foreclosed real estate acquired in settlement of loans | \$ 940 | | \$ 2,700 |
| Loans transferred to held for sale | \$ 591 | | \$ - |

See Notes to Unaudited Consolidated Financial Statements

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of Sussex Bancorp (“we,” “us” or “our”) and our wholly-owned subsidiary Sussex Bank (the “Bank”). The Bank’s wholly-owned subsidiaries are SCB Investment Company, Inc., SCBNY Company, Inc., ClassicLake Enterprises, LLC, Wheatsworth Properties Corp., PPD Holding Company, LLC, and Tri-State Insurance Agency, Inc. (“Tri-State”), a full service insurance agency located in Sussex County, New Jersey. 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 nine month period ended September 30, 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 September 30, 2012, for items that should potentially be recognized or disclosed in these unaudited consolidated financial statements. The evaluation was conducted through the date these unaudited consolidated financial statements were issued.

Reclassifications

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

New Accounting Standards

In December, 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2011-11, *Disclosures about Offsetting Assets and Liabilities*, in an effort to improve comparability between U.S. GAAP and International Financial Reporting Standards (“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. The new standards are effective for annual periods beginning January 1, 2013, and interim periods within those annual periods. Retrospective application is required. 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 fair value of securities available for sale as of September 30, 2012, and December 31, 2011 are summarized as follows:

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2012 | | | | |
| State and political subdivisions | \$ 29,098 | \$ 1,530 | \$ (18) | \$ 30,610 |
| Mortgage-backed securities: | | | | |
| U.S. government-sponsored enterprises | 87,560 | 688 | (338) | 87,910 |
| Equity securities-financial services industry and other | 495 | 15 | (28) | 482 |
| | \$ 117,153 | \$ 2,233 | \$ (384) | \$ 119,002 |
| 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 \$17.8 million and \$21.5 million at September 30, 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 September 30, 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 | 1,097 | 1,147 |
| Due after ten years | 28,001 | 29,463 |
| Total bonds and obligations | 29,098 | 30,610 |
| Mortgage-backed securities: | | |
| U.S. government-sponsored enterprises | 87,560 | 87,910 |
| Equity securities-financial services industry and other | 495 | 482 |
| Total available for sale securities | \$ 117,153 | \$ 119,002 |

Gross realized gains on sales of securities available for sale were \$775 thousand and \$269 thousand for the nine months ended September 30, 2012 and 2011, respectively, and gross realized losses were \$20 thousand and \$1 thousand for the nine months ended September 30, 2012 and 2011, respectively. In addition, we realized gross gains of \$8 thousand on debt securities that were called during the nine months ended September 30, 2012.

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 September 30, 2012, and December 31, 2011.

| (Dollars in thousands) | Less Than Twelve Months | | Twelve Months or More | | Total | |
|---|-------------------------|-------------------------|-----------------------|-------------------------|------------|-------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| September 30, 2012 | | | | | | |
| State and political subdivisions | \$ 1,650 | \$ (18) | \$ - | \$ - | \$ 1,650 | \$ (18) |
| Mortgage-backed securities: | | | | | | |
| U.S. government-sponsored enterprises | 30,270 | (338) | - | - | 30,270 | (338) |
| Equity securities-financial services industry and other | 116 | (27) | 116 | (1) | 232 | (28) |
| Total temporarily impaired securities | \$ 32,036 | \$ (383) | \$ 116 | \$ (1) | \$ 32,152 | \$ (384) |
| 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 September 30, 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 September 30, 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 September 30, 2012, there were three securities with a fair value of \$1.7 million that had an unrealized loss that amounted to \$18 thousand. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates. As of September 30, 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 September 30, 2012 were deemed to be other-than-temporarily-impaired.

Mortgage-Backed Securities

At September 30, 2012, the decline in fair value and the unrealized losses for our mortgaged-backed securities backed by U.S. government-sponsored enterprises were primarily due to changes in spreads and market conditions and not credit quality. At September 30, 2012, there were 15 securities with a fair value of \$30.3 million that had an unrealized loss that amounted to \$338 thousand. As of September 30, 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 September 30, 2012, were deemed to be other-than-temporarily impaired.

Equity Securities

Our investments in marketable equity securities consist primarily of one equity portfolio fund and common stock of entities in the financial services industry. At September 30, 2012, there were two securities with a fair value of \$232 thousand that had an unrealized loss of \$28 thousand. These securities have been adversely impacted by the effects of the current economic environment on the financial services industry. We evaluated each of the underlying banks for credit impairment based on its financial condition and performance. Based on our evaluation and our ability and intent to hold those investments for a reasonable period of time sufficient for a forecasted recovery of amortized cost, we do not consider these investments to be other-than-temporarily impaired at September 30, 2012. We continue to closely monitor the performance of the securities we own as well as the impact from any further deterioration in the economy or in the banking industry that may adversely affect these securities. We will continue to evaluate them for other-than-temporary impairment, which could result in a future non-cash charge to earnings.

Held to Maturity Securities

The amortized cost and fair value of securities held to maturity as of September 30, 2012, and December 31, 2011 are summarized as follows:

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|----------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2012 | | | | |
| State and political subdivisions | \$ 5,593 | \$ 218 | \$ (9) | \$5,802 |
| December 31, 2011 | | | | |
| State and political subdivisions | \$ 4,220 | \$ 125 | \$ - | \$4,345 |

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The amortized cost and carrying value of securities held to maturity at September 30, 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 | \$ 1,583 | \$1,583 |
| Due after one year through five years | - | - |
| Due after five years through ten years | 1,313 | 1,345 |
| Due after ten years | 2,697 | 2,874 |
| Total held to maturity securities | \$ 5,593 | \$5,802 |

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 September 30, 2012. There were no held to maturity securities with unrealized losses at December 31, 2011.

| (Dollars in thousands) | Less Than Twelve Months | | Twelve Months or More | | Total | |
|----------------------------------|-------------------------|-------------------------|-----------------------|-------------------------|------------|-------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| September 30, 2012 | | | | | | |
| State and political subdivisions | \$ 832 | \$ (9) | \$ - | \$ - | \$832 | \$ (9) |

As of September 30, 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 September 30, 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 September 30, 2012, there were two securities with a fair value of \$832 thousand that had an unrealized loss that amounted to \$9 thousand. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates. As of September 30, 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 September 30, 2012, were deemed to be other-than-temporarily impaired.

NOTE 3 – LOANS

The composition of net loans receivable at September 30, 2012, and December 31, 2011 is as follows:

| (Dollars in thousands) | September 30, 2012 | December 31, 2011 |
|---------------------------------|--------------------|-------------------|
| Commercial and industrial loans | \$ 13,244 | \$ 13,711 |
| Construction | 6,679 | 8,520 |
| Commercial real estate | 222,525 | 216,191 |
| Residential real estate | 96,916 | 100,175 |

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| | | | | |
|------------------------------------|------------|---|------------|---|
| Consumer and other | 1,347 | | 1,336 | |
| | 340,711 | | 339,933 | |
| Unearned net loan origination fees | (316 |) | (228 |) |
| Allowance for loan losses | (6,721 |) | (7,210 |) |
| Net loans receivable | \$ 333,674 | | \$ 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 \$708 thousand and \$852 thousand at September 30, 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 and nine months ended September 30, 2012 and 2011:

| (Dollars in thousands) | Commercial and Industrial | Construction | Commercial Real Estate | Residential Real Estate | Consumer and Other | Unallocated | Total |
|------------------------|---------------------------------|--------------|------------------------------|-------------------------------|--------------------------|-------------|---------|
| Three Months Ended: | | | | | | | |
| September 30, 2012 | | | | | | | |
| Beginning balance | \$ 430 | \$ 170 | \$ 4,547 | \$ 1,055 | \$ 11 | \$ 47 | \$6,260 |
| Charge-offs | - | (122 |) (264 |) (266 |) (8 |) - | (660) |
| Recoveries | - | - | 2 | - | 15 | - | 17 |
| Provision | 183 | 131 | 153 | 393 | (10 |) 254 | 1,104 |
| Ending balance | \$ 613 | 179 | 4,438 | 1,182 | 8 | 301 | 6,721 |
| September 30, 2011 | | | | | | | |
| Beginning balance | \$ 428 | \$ 969 | \$ 4,773 | \$ 945 | \$ 45 | \$ 376 | \$7,536 |
| Charge-offs | - | - | (868 |) - | (10 |) - | (878) |
| Recoveries | 1 | - | 1 | - | 4 | - | 6 |
| Provision | 58 | 435 | 327 | 58 | (1 |) (140 |) 737 |
| Ending balance | \$ 487 | \$ 1,404 | \$ 4,233 | \$ 1,003 | \$ 38 | \$ 236 | \$7,401 |

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| (Dollars in thousands) | Commercial and Industrial | Construction | Commercial Real Estate | Residential Real Estate | Consumer and Other | Unallocated | Total |
|------------------------|---------------------------------|--------------|------------------------------|-------------------------------|--------------------------|-------------|---------|
| Nine Months Ended: | | | | | | | |
| September 30, 2012 | | | | | | | |
| Beginning balance | \$ 304 | 294 | 4,833 | 987 | 9 | 783 | \$7,210 |
| Charge-offs | - | (830) | (2,081) | (546) | (53) | - | (3,510) |
| Recoveries | 2 | - | 71 | - | 26 | - | 99 |
| Provision | 307 | 715 | 1,615 | 741 | 26 | (482) | 2,922 |
| Ending balance | \$ 613 | \$ 179 | \$ 4,438 | \$ 1,182 | \$ 8 | \$ 301 | \$6,721 |
| September 30, 2011 | | | | | | | |
| Beginning balance | \$ 436 | \$ 1,183 | \$ 3,760 | \$ 798 | \$ 56 | \$ 164 | \$6,397 |
| Charge-offs | (13) | (909) | (1,263) | (12) | (33) | - | (2,230) |
| Recoveries | 4 | 516 | 9 | - | 17 | - | 546 |
| Provision | 60 | 614 | 1,727 | 217 | (2) | 72 | 2,688 |
| Ending balance | \$ 487 | \$ 1,404 | \$ 4,233 | \$ 1,003 | \$ 38 | \$ 236 | \$7,401 |

The following table presents the balance in the allowance of loan losses at September 30, 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 for Impairment | Balance Related to Loans Collectively Evaluated for Impairment | Balance | Individually Evaluated for Impairment | Collectively Evaluated for Impairment |
| September 30, 2012 | | | | | | |
| Commercial and industrial | \$ 613 | \$ 382 | \$ 231 | \$13,244 | \$ 396 | \$ 12,848 |
| Construction | 179 | 133 | 46 | 6,679 | 4,507 | 2,172 |
| Commercial real estate | 4,438 | 1,399 | 3,039 | 222,525 | 17,219 | 205,306 |
| Residential real estate | 1,182 | 363 | 819 | 96,916 | 2,988 | 93,928 |
| Consumer and other | 8 | - | 8 | 1,347 | - | 1,347 |
| Unallocated | 301 | - | - | - | - | - |
| Total | \$ 6,721 | \$ 2,277 | \$ 4,143 | \$340,711 | \$ 25,110 | \$ 315,601 |
| 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 |

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| | | | | | | |
|--------------------|----------|----------|----------|------------|-----------|------------|
| Consumer and other | 9 | - | 9 | 1,336 | - | 1,336 |
| Unallocated | 783 | - | - | - | - | - |
| Total | \$ 7,210 | \$ 1,957 | \$ 4,470 | \$ 339,933 | \$ 27,694 | \$ 312,239 |

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An age analysis of loans receivable which were past due as of September 30, 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 |
|---------------------------|------------------------|------------------------|--------------------------------|-------------------|-----------|-----------------------------------|--|
| September 30, 2012 | | | | | | | |
| Commercial and industrial | \$ - | \$ - | \$ 396 | \$ 396 | \$12,848 | \$ 13,244 | \$ 2 |
| Construction | - | - | 4,507 | 4,507 | 2,172 | 6,679 | - |
| Commercial real estate | 4,617 | 1,306 | 16,164 | 22,087 | 200,438 | 222,525 | 57 |
| Residential real estate | 665 | 445 | 2,984 | 4,094 | 92,822 | 96,916 | - |
| Consumer and other | 5 | 2 | 1 | 8 | 1,339 | 1,347 | - |
| Total | \$ 5,287 | \$ 1,753 | \$ 24,052 | \$ 31,092 | \$309,619 | \$ 340,711 | \$ 59 |
| 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 for which the accrual of interest has been discontinued at September 30, 2012, and December 31, 2011 were:

| (Dollars in thousands) | September 30, 2012 | December 31, 2011 |
|---------------------------|--------------------|-------------------|
| Commercial and industrial | \$ 394 | \$ 32 |
| Construction | 4,507 | 2,458 |
| Commercial real estate | 16,107 | 19,311 |
| Residential real estate | 2,984 | 2,482 |
| Consumer and other | 1 | - |
| Total | \$ 23,993 | \$ 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.

The following tables illustrate our corporate credit risk profile by creditworthiness category as of September 30, 2012, and December 31, 2011:

| (Dollars in thousands) | Pass | Special Mention | Substandard | Doubtful | Total |
|---------------------------|-----------|--------------------|-------------|----------|-----------|
| September 30, 2012 | | | | | |
| Commercial and industrial | \$12,644 | \$ 204 | \$ 24 | \$ 372 | \$13,244 |
| Construction | 2,172 | - | 4,507 | - | 6,679 |
| Commercial real estate | 195,004 | 5,844 | 21,104 | 573 | 222,525 |
| Residential real estate | 92,241 | 454 | 3,897 | 324 | 96,916 |
| Consumer and other | 1,347 | - | - | - | 1,347 |
| | \$303,408 | \$ 6,502 | \$ 29,532 | \$ 1,269 | \$340,711 |
| December 31, 2011 | | | | | |
| Commercial and industrial | \$13,103 | \$ 398 | \$ 202 | \$ 8 | \$13,711 |
| Construction | 5,057 | - | 3,463 | - | 8,520 |

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| | | | | | |
|-------------------------|-----------|----------|-----------|--------|-----------|
| 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 |

In accordance with FASB ASC 310-10-35-16, a loan is considered impaired 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 September 30, 2012, and December 31, 2011:

| (Dollars in thousands) | September 30, 2012 | | | December 31, 2011 | | |
|--|--|----------|----------------------|--|----------|----------------------|
| | Unpaid Recorded Principal Investment | Balance | Related Allowance | Unpaid Recorded Principal Investment | Balance | Related Allowance |
| | (1) | (2) | | (1) | (2) | |
| With no related allowance recorded: | | | | | | |
| Construction | \$2,802 | \$3,779 | \$ - | \$2,062 | \$2,331 | \$ - |
| Commercial real estate | 3,777 | 4,542 | - | 10,362 | 12,932 | - |
| Residential real estate | 2,081 | 2,081 | - | 1,758 | 1,757 | - |
| Total impaired loans without a related allowance | 8,660 | 10,402 | - | 14,182 | 17,020 | - |
| With an allowance recorded: | | | | | | |
| Commercial and industrial | 396 | 396 | 382 | 32 | 32 | 16 |
| Construction | 1,705 | 1,827 | 133 | 396 | 396 | 50 |
| Commercial real estate | 13,442 | 15,827 | 1,399 | 12,404 | 12,399 | 1,572 |
| Residential real estate | 907 | 1,058 | 363 | 732 | 724 | 319 |
| Total impaired loans with an allowance | 16,450 | 19,108 | 2,277 | 13,564 | 13,551 | 1,957 |
| Total impaired loans | \$25,110 | \$29,510 | \$ 2,277 | \$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.

The average recorded investment and income recognized is presented for the nine month periods ended September 30, 2012, and 2011:

| (Dollars in thousands) | For the Nine Months Ended September 30, 2012 | | For the Nine Months Ended September 30, 2011 | |
|-------------------------------------|---|----------------------------------|---|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded: | | | | |
| Commercial and industrial | \$ - | \$ - | \$ 10 | \$ 1 |
| Construction | 1,986 | - | 3,454 | - |
| Commercial real estate | 6,505 | 42 | 8,608 | 142 |
| Residential real estate | 1,756 | 41 | 954 | 27 |
| Consumer and other | - | - | - | - |

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| | | | | |
|--|-----------|--------|-----------|--------|
| Total impaired loans without a related allowance | 10,247 | 83 | 13,026 | 170 |
| With an allowance recorded: | | | | |
| Commercial and industrial | 189 | - | 81 | - |
| Construction | 1,405 | 3 | 1,980 | - |
| Commercial real estate | 14,610 | 59 | 10,899 | 144 |
| Residential real estate | 786 | 17 | 637 | 1 |
| Consumer and other | - | - | - | - |
| Total impaired loans with an allowance | 16,990 | 79 | 13,597 | 145 |
| Total impaired loans | \$ 27,237 | \$ 162 | \$ 26,623 | \$ 315 |

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

| (Dollars in thousands) | Commercial Real Estate | Commercial & Industrial | Total |
|------------------------|------------------------|-------------------------|---------|
| September 30, 2012 | | | |
| Performing | \$ 603 | \$ - | \$603 |
| Non-performing | 1,847 | - | 1,847 |
| Total | \$ 2,450 | \$ - | \$2,450 |
| December 31, 2011 | | | |
| Performing | \$ 5,592 | \$ 8 | \$5,600 |
| Non-performing | 2,682 | - | 2,682 |
| Total | \$ 8,274 | \$ 8 | \$8,282 |

Troubled debt restructured loans are considered impaired and are included in the previous impaired loans disclosures in this footnote. As of September 30, 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 three and nine months ended September 30, 2012, we have not restructured any troubled debt or required an allocation of the allowance for credit losses. During the three and nine months ended September 30, 2011, one commercial real estate loan modification was executed which constituted a troubled debt restructuring. The modification included one or a combination of the following: an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; temporary reduction in the interest rate; change in scheduled payment amount; or permanent reduction of the principal or interest of the loan or an extension of additional credit for payment of delinquent real estate taxes. The modification had a pre- and post-modification outstanding recorded investment of \$1.5 million dollars.

There were no payment defaults of loans during the three and nine months ended September 30, 2012 and the three months ended September 30, 2011, which were modified in a troubled debt restructuring within the previous 12 months. There were two commercial real estate loans with a recorded investment of \$1.4 million for which there was a payment default during the nine months ended September 30, 2011, which were modified in a troubled debt restructuring within the previous 12 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 \$1 thousand and \$3 thousand for the three and nine months ended September 30, 2012, respectively, and \$7 thousand for the three and nine months ended September 30, 2011. There were no charge-offs on defaulted troubled debt restructurings during the three and nine months ended September 30, 2012 and 2011.

NOTE 5 – EARNINGS PER SHARE

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

| (In thousands, except share and per share data) | Three Months Ended September 30, 2012 | | | Three Months Ended September 30, 2011 | | |
|--|---------------------------------------|----------------------|------------------|---------------------------------------|----------------------|------------------|
| | Income (Numerator) | Shares (Denominator) | Per Share Amount | Income (Numerator) | Shares (Denominator) | Per Share Amount |
| Basic earnings per share: | | | | | | |
| Net loss applicable to common shareholders | \$ 546 | 3,264,034 | \$ 0.17 | \$ 534 | 3,257,284 | \$ 0.16 |
| Effect of dilutive securities: | | | | | | |
| Nonvested stock awards | - | 24,933 | | - | 74,613 | |
| Diluted earnings per share: | | | | | | |
| Net loss applicable to common shareholders and assumed conversions | \$ 546 | 3,288,967 | \$ 0.17 | \$ 534 | 3,331,897 | \$ 0.16 |

| (In thousands, except share and per share data) | Nine Months Ended September 30, 2012 | | | Nine Months Ended September 30, 2011 | | |
|--|--------------------------------------|----------------------|------------------|--------------------------------------|----------------------|------------------|
| | Income (Numerator) | Shares (Denominator) | Per Share Amount | Income (Numerator) | Shares (Denominator) | Per Share Amount |
| Basic earnings per share: | | | | | | |
| Net income applicable to common shareholders | \$ 832 | 3,260,827 | \$ 0.26 | \$ 1,955 | 3,255,815 | \$ 0.60 |
| Effect of dilutive securities: | | | | | | |
| Nonvested stock awards | - | 21,399 | | - | 69,941 | |
| Diluted earnings per share: | | | | | | |
| Net income applicable to common shareholders and assumed conversions | \$ 832 | 3,282,226 | \$ 0.25 | \$ 1,955 | 3,325,756 | \$ 0.59 |

Options to purchase 65,036 and 112,637 shares of common stock were outstanding at September 30, 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 and nine months ended September 30, 2012 and 2011 are as follows:

| (Dollars in thousands) | Three Months Ended | | Nine Months Ended | |
|------------------------|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2012 | September 30, 2011 | September 30, 2012 | September 30, 2011 |

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| | | | | |
|---|--------|--------|----------|----------|
| Unrealized gains on available for sale securities arising during the period | \$ 693 | \$ 353 | \$ 1,413 | \$ 1,425 |
| Less: reclassification adjustments for net gains included in net income | 569 | (1) | 763 | 268 |
| | 124 | 354 | 650 | 1,157 |
| Tax effect | (49) | (142) | (259) | (463) |
| | \$ 75 | \$ 212 | \$ 391 | \$ 694 |

NOTE 7 – SEGMENT INFORMATION

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

| | Three Months Ended September 30, 2012 | | | Three Months Ended September 30, 2011 | | |
|---|--|-----------------------|----------|--|-----------------------|----------|
| | Banking and Financial Services | Insurance Services | Total | Banking and Financial Services | Insurance Services | Total |
| Net interest income from external sources | \$ 4,089 | \$ - | \$ 4,089 | \$ 4,187 | \$ - | \$ 4,187 |
| Other income from external sources | 1,278 | 684 | 1,962 | 661 | 545 | 1,206 |
| Depreciation and amortization | 170 | 3 | 173 | 148 | 3 | 151 |
| Income before income taxes | 546 | 106 | 652 | 635 | (4) | 631 |
| Income tax (benefit) expense ⁽¹⁾ | 64 | 42 | 106 | 99 | (2) | 97 |
| Total assets | 500,594 | 3,700 | 504,294 | 492,953 | 2,931 | 495,884 |

| | Nine Months Ended September 30, 2012 | | | Nine Months Ended September 30, 2011 | | |
|---|---|-----------------------|-----------|---|-----------------------|-----------|
| | Banking and Financial Services | Insurance Services | Total | Banking and Financial Services | Insurance Services | Total |
| Net interest income from external sources | \$ 12,225 | \$ - | \$ 12,225 | \$ 12,810 | \$ - | \$ 12,810 |
| Other income from external sources | 2,813 | 1,892 | 4,705 | 2,228 | 1,724 | 3,952 |
| Depreciation and amortization | 501 | 8 | 509 | 449 | 9 | 458 |
| Income (loss) before income taxes | 522 | 216 | 738 | 2,336 | 154 | 2,490 |
| Income tax expense (benefit) ⁽¹⁾ | (180) | 86 | (94) | 473 | 62 | 535 |
| Total assets | 500,594 | 3,700 | 504,294 | 492,953 | 2,931 | 495,884 |

(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 September 30, 2012, was as follows:

| | Number of Shares | Weighted Average Exercise Price per Share | Weighted Average Contractual Term | Aggregate Intrinsic Value |
|---|---------------------|---|--|---------------------------------|
| Options outstanding, beginning of year | 111,034 | \$ 12.25 | | |
| Options expired | (4,389 |) 8.90 | | |
| Options forfeited | (41,609 |) 12.69 | | |
| Options outstanding, end of quarter | 65,036 | \$ 12.20 | 1.39 | - |
| Options exercisable, end of quarter | 65,036 | \$ 12.20 | 1.39 | - |
| Option price range at end of quarter | \$8.86 to \$16.45 | | | |
| Option price range for exercisable shares | \$8.86 to \$16.45 | | | |

During the first nine months of 2012 and 2011, we expensed \$112 thousand and \$72 thousand, respectively, in stock-based compensation under restricted stock awards. The summary of changes in unvested restricted stock awards for the nine months ended September 30, 2012, is as follows:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|--|---------------------|---|
| Unvested restricted stock, beginning of year | 115,729 | \$ 4.86 |
| Granted | 37,496 | 4.97 |
| Forfeited | (2,233) | 5.27 |
| Vested | (17,349) | 6.05 |
| Unvested restricted stock, end of period | 133,643 | \$ 4.73 |

At September 30, 2012, unrecognized compensation expense for non-vested restricted stock was \$514 thousand, which is expected to be recognized over an average period of 3.4 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 \$754 thousand of undrawn standby letters of credit outstanding as of September 30, 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 September 30, 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.

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) | Total Fair Value Measurements | Quoted Prices in Active Markets for Identical Assets (Level I) | Significant Other Observable Inputs (Level II) | Significant Unobservable Inputs (Level III) |
|---|--|--|--|--|
| September 30, 2012: | | | | |
| State and political subdivisions | \$ 30,610 | \$ - | \$ 30,610 | \$ - |
| Mortgage-backed securities | | | | |
| U.S. government-sponsored enterprises | 87,910 | - | 87,910 | - |
| Equity securities-financial services industry and other | 482 | 373 | 109 | - |
| | \$ 119,002 | \$ 373 | \$ 118,629 | \$ - |
| 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 | 1,173 | 143 | - |
| | \$ 96,361 | \$ 1,173 | \$ 95,188 | \$ - |

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) | Total Fair Value Measurements | Quoted Prices in Active Markets for Identical Assets (Level I) | Significant Other Observable Inputs (Level II) | Significant Unobservable Inputs (Level III) |
|------------------------|--|--|--|--|
| September 30, 2012: | | | | |
| Impaired loans | \$ 23,243 | \$ - | \$ - | \$ 23,243 |
| Foreclosed real estate | 329 | - | - | 329 |

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December 31, 2011:

| | | | | |
|------------------------|-----------|------|------|-----------|
| Impaired loans | \$ 11,571 | \$ - | \$ - | \$ 11,571 |
| Foreclosed real estate | 4,959 | - | - | 4,959 |

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The following table presents additional qualitative information about assets measured at fair value on a nonrecurring basis and for which Level 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) |
| September 30, 2012: | | | | |
| Impaired loans | \$ 23,243 | Appraisal of collateral | Appraisal adjustments ⁽¹⁾ Selling expenses ⁽¹⁾ | 0% to -63.8 % (-4.1)% -7.0% (-7.0)% |
| Foreclosed real estate | \$ 329 | Appraisal of collateral | | |

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

The following methods and assumptions were used to estimate the fair value of our financial instruments at September 30, 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 September 30, 2012, and December 31, 2011 were as follows:

| | | Quoted Prices in | Significant | |
|--------------------|------|------------------|-------------|--------------|
| | | Active Markets | Other | Significant |
| | | for Identical | Observable | Unobservable |
| | | Assets | Inputs | Inputs |
| September 30, 2012 | | | | |
| Carrying | Fair | | | |

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| (Dollars in thousands) | Amount | Value | (Level I) | (Level II) | (Level III) |
|------------------------------------|----------|----------|-----------|------------|-------------|
| Financial assets: | | | | | |
| Cash and cash equivalents | \$10,430 | \$10,430 | \$ 10,430 | \$ - | \$ - |
| Time deposits with other banks | 100 | 100 | 100 | - | - |
| Securities available for sale | 119,002 | 119,002 | 373 | 118,629 | - |
| Securities held to maturity | 5,593 | 5,802 | - | 5,802 | - |
| Federal Home Loan Bank stock | 1,943 | 1,943 | 1,943 | - | - |
| Loans receivable, net of allowance | 333,674 | 345,779 | - | - | 345,779 |
| Accrued interest receivable | 1,861 | 1,861 | 1,861 | - | - |
| Financial liabilities: | | | | | |
| Deposits | 417,341 | 419,668 | 313,862 | 105,806 | - |
| Borrowings | 26,000 | 29,527 | - | 29,527 | - |
| Junior subordinated debentures | 12,887 | 6,319 | - | 6,319 | - |
| Accrued interest payable | 267 | 267 | 267 | - | - |

| (Dollars in thousands) | December 31, 2011 | | 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 | \$37,500 | \$37,500 | \$ 37,500 | \$ - | \$ - |
| Time deposits with other banks | 100 | 100 | 100 | - | - |
| Securities available for sale | 96,361 | 96,361 | 1,173 | 95,188 | - |
| Securities held to maturity | 4,220 | 4,345 | - | 4,345 | - |
| Federal Home Loan Bank stock | 1,837 | 1,837 | 1,837 | - | - |
| Loans receivable, net of allowance | 332,495 | 334,403 | - | - | 334,403 |
| Accrued interest receivable | 1,735 | 1,735 | 1,735 | - | - |
| Financial liabilities: | | | | | |
| Deposits | 425,376 | 428,098 | 314,571 | 113,527 | - |
| Borrowings | 26,000 | 29,696 | - | 29,696 | - |
| Junior subordinated debentures | 12,887 | 6,613 | - | 6,613 | - |
| Accrued interest payable | 301 | 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.

RECENT LEGISLATIVE UPDATES

In June 2012, the FRB, the Office of the Comptroller of the Currency and the FDIC issued three proposals that would amend the existing regulatory risk-based capital adequacy requirements of banks and bank holding companies. The proposed rules implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. The Basel III proposal would increase the minimum levels of required capital, narrow the definition of capital, and place much greater emphasis on common equity. The proposed rules were subject to a comment period through September 7, 2012.

The proposed rules include new risk-based capital and leverage ratios, which would be phased in from 2013 to 2019, and would refine the definition of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to us and the Bank under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The proposed rules would also establish a "capital conservation buffer" of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase by that amount each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

The proposed rules also implement revisions and clarifications consistent with Basel III regarding the various components of Tier 1 capital, including common equity, unrealized gains and losses, as well as certain instruments that will no longer qualify as Tier 1 capital, such as trust preferred securities, which would be phased out over time. Although the Dodd-Frank Act only required the phase out of such instruments for institutions with total consolidated assets of \$15 billion or more, the proposed rules would require almost all institutions to phase out instruments that will no longer qualify as Tier 1 capital, albeit on a longer time frame than for institutions with total consolidated assets of \$15 billion or more.

The federal bank regulatory agencies also proposed revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Bank, if their capital levels begin to show signs of weakness. These revisions would take effect January 1, 2015. We are still in the process of assessing the impacts of these complex proposals.

CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are prepared in accordance with U.S. GAAP and practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in 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 SEPTEMBER 30, 2012 AND 2011

Overview – We reported net income of \$546 thousand for the third quarter of 2012 as compared to net income of \$534 thousand for the same period in 2011. Basic and diluted earnings per share for the three months ended September 30, 2012 were \$0.17, compared to the basic and diluted earnings per share of \$0.16 for the comparable period of 2011. The increase in net income was largely due to improved non-interest income resulting from an increase in gains on sale of securities and insurance commissions and fees, which was largely offset by higher provision for loan losses and expenses and write-downs related to foreclosed real estate.

Net income before taxes for our Tri-State segment increased \$110 thousand, or 103.8%, resulting in a net income before taxes of \$106 thousand for the third quarter of 2012 compared to a \$4 thousand loss for the same period in 2011. This increase was due to insurance commission and fee income increasing \$139 thousand, or 25.5%, between the two periods.

Comparative Average Balances and Average Interest Rates

The following table presents, on a fully taxable equivalent basis, a summary of our interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for the three month periods ended September 30, 2012 and 2011.

| (Dollars in thousands) | Three Months Ended September 30, | | | | | | |
|---------------------------------------|----------------------------------|-------------------------|--------------------------------|--------------------|-------------------------|--------------------------------|--|
| | 2012 | | | 2011 | | | |
| | Average Balance | Interest ⁽¹⁾ | Average Rate ⁽²⁾ | Average Balance | Interest ⁽¹⁾ | Average Rate ⁽²⁾ | |
| Earning Assets: | | | | | | | |
| Securities: | | | | | | | |
| Tax exempt ⁽³⁾ | \$32,199 | \$ 442 | 5.46 % | \$30,059 | \$ 448 | 5.90 % | |
| Taxable | 86,766 | 241 | 1.10 % | 48,890 | 313 | 2.54 % | |
| Total securities | 118,965 | 683 | 2.28 % | 78,949 | 761 | 3.82 % | |
| Total loans receivable ⁽⁴⁾ | 342,502 | 4,467 | 5.19 % | 338,393 | 4,687 | 5.49 % | |
| Other interest-earning assets | 10,405 | 4 | 0.15 % | 35,530 | 20 | 0.22 % | |
| Total earning assets | 471,872 | \$ 5,154 | 4.35 % | \$452,872 | \$ 5,468 | 4.79 % | |
| Non-interest earning assets | 43,319 | | | 41,159 | | | |
| Allowance for loan losses | (6,671) | | | (7,261) | | | |
| Total Assets | \$508,520 | | | 486,770 | | | |

Sources of Funds:

Interest bearing deposits:

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| | | | | | | | | |
|---|-----------|----------|------|---|-----------|----------|------|---|
| NOW | \$95,611 | \$ 36 | 0.15 | % | \$77,676 | \$ 85 | 0.44 | % |
| Money market | 14,506 | 11 | 0.30 | % | 16,564 | 23 | 0.55 | % |
| Savings | 162,762 | 133 | 0.33 | % | 168,419 | 287 | 0.68 | % |
| Time | 104,128 | 407 | 1.55 | % | 102,725 | 411 | 1.59 | % |
| Total interest bearing deposits | 377,007 | 587 | 0.62 | % | 365,384 | 806 | 0.88 | % |
| Borrowed funds | 26,196 | 268 | 4.07 | % | 26,000 | 268 | 4.09 | % |
| Junior subordinated debentures | 12,887 | 60 | 1.85 | % | 12,887 | 55 | 1.69 | % |
| Total interest bearing liabilities | 416,090 | \$ 915 | 0.87 | % | \$404,271 | \$ 1,129 | 1.11 | % |
| Non-interest bearing liabilities: | | | | | | | | |
| Demand deposits | 48,702 | | | | 41,012 | | | |
| Other liabilities | 2,676 | | | | 2,613 | | | |
| Total non-interest bearing liabilities | 51,378 | | | | 43,625 | | | |
| Stockholders' equity | 41,052 | | | | 38,874 | | | |
| Total Liabilities and Stockholders' Equity | \$508,520 | | | | \$486,770 | | | |
| Net Interest Income and Margin ⁽⁵⁾ | | 4,239 | 3.57 | % | | 4,339 | 3.80 | % |
| Tax-equivalent basis adjustment | | (150) | | | | (152) | | |
| Net Interest Income | | \$ 4,089 | | | | \$ 4,187 | | |

- (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, declined \$100 thousand, or 2.3%, to \$4.2 million for the third quarter of 2012 as compared to \$4.3 million for same period in 2011. The decrease in net interest income was largely due to the Company's net interest margin declining 23 basis points to 3.57% for the third quarter of 2012 compared to the same period last year. The decline in the net interest margin was mostly due to a 30 basis point decline in the average rate earned on loans. This decline in net interest income was partially offset by a decrease in the average rate paid on total interest bearing liabilities, which decreased 24 basis points to 0.87% for the third quarter of 2012 from 1.11% for the same period in 2011. The decline was in part offset by a \$19.0 million, or 4.2%, increase in average interest earning assets, principally securities.

Interest Income - Our total interest income, on a fully taxable equivalent basis, decreased \$314 thousand, or 5.8%, to \$5.2 million for the quarter ended September 30, 2012, as compared to the same period last year. The decline was due to lower earning asset yields, which decreased 45 basis points to 4.35% for the quarter ended September 30, 2012 as compared to the same period in 2011.

Our total interest income earned on loans receivable decreased \$220 thousand, or 4.7%, to \$4.5 million for the third quarter of 2012 as compared to the same period in 2011. The decline was driven by a 30 basis point decline in average yields to 5.19% for the quarter end September 30, 2012, as compared to the same period in 2011.

Our total interest income earned on securities, on a fully taxable equivalent basis, decreased \$79 thousand, to \$683 thousand for the quarter ended September 30, 2012, from \$761 thousand for the same period in 2011. This decrease was largely due to a decline in the average rate earned on securities, which declined 155 basis points for the quarter ended September 30, 2012, as compared to the same period last year. The lower yields on securities reflect investment

in securities in a low market rate environment. The decrease in interest income on securities was offset by a \$40.0 million, or 50.7%, increase in average balance of securities for the three months ended September 30, 2012 as compared to same period last year. The increase resulted from investing excess liquidity generated from deposit growth outpacing loan growth.

Other interest-earning assets include federal funds sold and interest bearing deposits in other banks. Our interest earned on total other interest-earning assets decreased \$16 thousand for the third quarter of 2012 as compared to the same period in 2011 due to a decline in average balances. The average balances in other interest-earning assets decreased \$25.1 million to \$10.4 million in the third quarter of 2012 from \$35.5 million during the third quarter a year earlier.

Interest Expense - Our interest expense for the three months ended September 30, 2012 decreased \$214 thousand, or 19.0%, to \$915 thousand 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 24 basis points from 1.11% for the three months ended September 30, 2011, to 0.87% 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 \$11.8 million, or 2.9%, to \$416.1 million for the third quarter in 2012 from \$404.3 million for the same period in 2011.

Our interest expense on deposits declined \$219 thousand, or 27.2%, for the quarter ended September 30, 2012, as compared to the same period last year. The decline was largely attributed to lower rates on total interest bearing deposits, which decreased 26 basis points to 0.62% for the third 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 third quarter periods. The aforementioned benefit from the decline in rates paid on deposits was partly offset by \$11.6 million, or 3.2%, increase in interest bearing deposits.

Provision for Loan Losses - The loan loss provision for the third quarter of 2012 increased \$367 thousand, or 49.8%, to \$1.1 million compared to a provision of \$737 thousand in the third 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 \$756 thousand, or 62.7%, to \$2.0 million for the quarter ended September 30, 2012, as compared to the same period last year. The increase in non-interest income was largely due to a \$570 thousand increase in gain on the sale of securities and a \$139 thousand, or 25.5%, growth in insurance commissions and fees.

Non-Interest Expense - Our non-interest expenses increased \$270 thousand, or 6.7%, to \$4.3 million for the quarter ended September 30, 2012 as compared to the same period last year. The increase for the third quarter of 2012 versus the same period in 2011 was largely due to an increase in expenses related to foreclosed real estate and other expenses, which increased \$160 thousand and \$67 thousand, respectively.

Income Taxes - Our income tax expense, which includes both federal and state taxes, was \$106 thousand for the three months ended September 30, 2012, representing a 16.3% effective tax rate, compared to income tax expense of \$97 thousand for the third quarter of 2011, representing a 15.4% effective tax rate. The effective tax rate benefited from tax exempt income from securities and bank-owned life insurance policies.

COMPARISON OF OPERATING RESULTS FOR NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011

Overview - We reported net income of \$832 thousand for the nine months ended September 30, 2012, as compared to net income of \$2.0 million for the same period in 2011. Basic and diluted earnings per share for the nine months ended September 30, 2012 were \$0.26 and \$0.25, respectively, compared to the basic and diluted earnings per share of \$0.60 and \$0.59, respectively, for the comparable period of 2011. The decline in net income was largely attributed to expenses and write-downs related to the prospective sales of several foreclosed real estate properties. In addition, expenses related to additional commercial lending staff, technology upgrades, increased advertising and promotion and FDIC assessment costs (due to deposit growth) also added to the decrease in net income. The aforementioned declines were partly offset by improved non-interest income resulting from increases in gains on sale of securities and insurance commissions and fees.

Net income before taxes for our Tri-State segment increased \$62 thousand, or 40.6%, resulting in a net income before taxes of \$216 thousand for the first nine months of 2012 compared to \$154 thousand for the same period in 2011. This increase was due to insurance commission and fee income increasing \$168 thousand, or 9.74%, between the two periods.

Comparative Average Balances and Average Interest Rates

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The following table presents, on a fully taxable equivalent basis, a summary of our interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for the nine month periods ended September 30, 2012 and 2011.

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| (Dollars in thousands) | Nine Months September 30, | | | | | | | |
|---|---------------------------|-------------------------|---------------------|---|--------------------|-------------------------|---------------------|---|
| | 2012 | | Average | | 2011 | | Average | |
| | Average Balance | Interest ⁽¹⁾ | Rate ⁽²⁾ | | Average Balance | Interest ⁽¹⁾ | Rate ⁽²⁾ | |
| Earning Assets: | | | | | | | | |
| Securities: | | | | | | | | |
| Tax exempt ⁽³⁾ | \$29,444 | \$ 1,253 | 5.68 | % | \$29,962 | \$ 1,332 | 5.94 | % |
| Taxable | 84,774 | 994 | 1.57 | % | 52,398 | 989 | 2.52 | % |
| Total securities | 114,218 | 2,247 | 2.63 | % | 82,360 | 2,321 | 3.77 | % |
| Total loans receivable ⁽⁴⁾ | 339,839 | 13,292 | 5.22 | % | 341,123 | 14,210 | 5.57 | % |
| Other interest-earning assets | 21,095 | 30 | 0.19 | % | 23,319 | 35 | 0.20 | % |
| Total earning assets | 475,152 | \$ 15,569 | 4.38 | % | 446,802 | \$ 16,566 | 4.96 | % |
| Non-interest earning assets | 42,076 | | | | 38,020 | | | |
| Allowance for loan losses | (7,335) | | | | (7,227) | | | |
| Total Assets | \$509,893 | | | | \$477,595 | | | |
| Sources of Funds: | | | | | | | | |
| Interest bearing deposits: | | | | | | | | |
| NOW | \$94,578 | \$ 129 | 0.18 | % | \$78,923 | \$ 305 | 0.52 | % |
| Money market | 16,962 | 47 | 0.37 | % | 14,838 | 61 | 0.55 | % |
| Savings | 163,331 | 492 | 0.40 | % | 169,360 | 881 | 0.70 | % |
| Time | 107,389 | 1,270 | 1.58 | % | 94,898 | 1,095 | 1.54 | % |
| Total interest bearing deposits | 382,260 | 1,938 | 0.68 | % | 358,019 | 2,342 | 0.87 | % |
| Borrowed funds | 26,066 | 797 | 4.08 | % | 26,859 | 797 | 3.97 | % |
| Junior subordinated debentures | 12,887 | 183 | 1.90 | % | 12,887 | 164 | 1.70 | % |
| Total interest bearing liabilities | 421,213 | \$ 2,918 | 0.93 | % | 397,765 | \$ 3,303 | 1.11 | % |
| Non-interest bearing liabilities: | | | | | | | | |
| Demand deposits | 45,949 | | | | 39,423 | | | |
| Other liabilities | 2,209 | | | | 2,427 | | | |
| Total non-interest bearing liabilities | 48,158 | | | | 41,850 | | | |
| Stockholders' equity | 40,522 | | | | 37,980 | | | |
| Total Liabilities and Stockholders' Equity | \$509,893 | | | | \$477,595 | | | |
| Net Interest Income and Margin ⁽⁵⁾ | | \$ 12,651 | 3.56 | % | | \$ 13,263 | 3.97 | % |
| Tax-equivalent basis adjustment | | (426) | | | | (453) | | |
| Net Interest Income | | \$ 12,225 | | | | \$ 12,810 | | |

(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, on a fully taxable equivalent basis, decreased \$612 thousand, or 4.6%, to \$12.7 million for the nine months ended September 30, 2012, as compared to \$13.3 million for same period in 2011. Our net interest margin declined 41 basis points to 3.56% for the nine months ended September 30, 2012, compared to 3.97% for the same period last year. The decline was mostly attributed to a 35 basis point decline in the average rate earned on loans to 5.22%, which was partly offset by a 18 basis point decrease in the average rate paid on interest bearing liabilities to 0.93% for the nine month period ended September 30, 2012, as compared to the same period last year. The decline was in part offset by a \$28.3 million, or 6.3%, increase in average interest earning assets, principally securities.

Interest Income – Our total interest income, on a fully taxable equivalent basis, decreased \$997 thousand, or 6.0%, to \$15.6 million for the nine months ended September 30, 2012, as compared to the same period last year. The decline was due to lower earning asset yields, which decreased 58 basis points to 4.38% for the nine months ended September 30, 2012, as compared to the same period in 2011.

Our total interest income earned on loans receivable decreased \$918 thousand, or 6.5%, to \$13.3 million for the nine months ended September 30, 2012, as compared to the same period in 2011. The decline was driven by a 35 basis point decline in average yields to 5.22% for the nine months ended September 30, 2012, as compared to the same period in 2011. The decline in interest income earned on loans receivable was also impacted by a \$1.3 million decline in average balances on loans receivable to \$339.8 million for the nine months ended September 30, 2012, as compared to the same period in 2011.

Our total interest income earned on securities, on a fully taxable equivalent basis, decreased \$74 thousand, or 3.2%, to \$2.2 million for the nine months ended September 30, 2012, as compared to the same period in 2011. This decrease was largely due to a decrease in the average rate earned on securities, which declined 114 basis points for the nine months ended September 30, 2012, as compared to the same period last year. The lower yields on securities reflect investment in securities in a low market rate environment. The decrease in interest income on securities was offset by a \$31.9 million, or 38.7%, increase in average balance of securities for the nine months ended September 30, 2012 as compared to same period last year. The increase resulted from investing excess liquidity generated from deposit growth outpacing loan growth.

Other interest-earning assets include federal funds sold and interest bearing deposits in other banks. Our interest earned on total other interest-earning assets decreased \$5 thousand for the nine months ended September 30, 2012, as compared to the same period in 2011 due to a \$2.2 million decrease in average balances.

Interest Expense – Our interest expense for the nine months ended September 30, 2012 decreased \$385 thousand, or 11.7%, to \$2.9 million from \$3.3 million for the same period in 2011. The improvement was principally due to lower average rates paid on total interest-bearing liabilities, which declined 18 basis points from 1.11% for the nine months ended September 30, 2011, to 0.93% 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 \$23.4 million, or 5.9%, to \$421.2 million for the nine months ended September 30, 2012, from \$397.8 million for the same period in 2011.

Our interest expense on deposits declined \$404 thousand, or 17.3%, for the nine months ended September 30, 2012, as compared to the same period last year. The decline was largely attributed to lower rates on total interest bearing deposits, which decreased 19 basis points for the nine months ended 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 periods. The aforementioned benefit from the decline in rates paid on deposits was partly offset by \$24.2 million, or 6.8%, increase in interest bearing deposits.

Provision for Loan Losses – The loan loss provision for the first nine months of 2012 increased \$234 thousand, or 8.7%, to \$2.9 million compared to a provision of \$2.7 million for the same period in 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 \$753 thousand, or 19.1%, to \$4.7 million for the nine months ended September 30, 2012, as compared to the same period last year. The increase in non-interest income was largely due to increases in gain on sale of securities, insurance commissions and fees and other income, which increased \$495 thousand, \$168 thousand and \$114 thousand, respectively.

Non-Interest Expense – Our non-interest expenses increased \$1.7 million, or 14.6%, to \$13.3 million for the nine months ended September 30, 2012, as compared to the same period last year. The increase during the first nine months of 2012 compared to the same period in 2011 was largely due to increases in expenses and write-downs related to foreclosed real estate and salaries and benefits of \$722 thousand and \$532 thousand, respectively. The increase in expenses and write-downs related to foreclosed real estate was principally due to the prospective sales of foreclosed real estate properties. The increase in salaries and employee benefits was mostly attributed to costs 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.

Income Taxes – Our income tax expense, which includes both federal and state taxes, was a tax benefit of \$94 thousand for the nine months ended September 30, 2012, representing a 12.7% effective tax benefit rate, compared to a tax expense of \$535 thousand for the same period in 2011, representing a 21.5% effective tax rate. The effective tax rate benefited from tax exempt income from securities and bank-owned life insurance policies.

COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2012 TO DECEMBER 31, 2011

At September 30, 2012, our total assets were \$504.3 million, a decrease of \$2.7 million, or 0.5%, as compared to total assets of \$507.0 million at December 31, 2011.

Cash and Cash Equivalents – Our cash and cash equivalents decreased by \$27.1 million to \$10.4 million at September 30, 2012, or 2.1% of total assets, from \$37.5 million, or 7.4% of total assets, at December 31, 2011. The decrease was largely due to the investment of excess liquidity into securities.

Securities Portfolio – At September 30, 2012, total investment securities, which include available for sale and held to maturity securities, were \$124.6 million compared to \$100.6 million at December 31, 2011. Available for sale securities were \$119.0 million at September 30, 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. Held to maturity securities were \$5.6 million at September 30, 2012, compared to \$4.2 million at December 31, 2011.

Other investments totaled \$1.9 million at September 30, 2012, and December 31, 2011 and consisted primarily of FHLB stock. We also held \$100 thousand in time deposits with other financial institutions at September 30, 2012, and at December 31, 2011.

Net unrealized gains were \$2.1 million and \$1.3 million at September 30, 2012 and December 31, 2011, respectively. The improvement in the fair value of the investment securities is driven by state and political subdivisions. Gross unrealized gains improved by \$598 thousand to \$2.5 million at September 30, 2012, as compared to \$1.9 million at December 31, 2011. The improvement in gross unrealized losses of \$136 thousand to \$393 thousand at September 30, 2012, as compared to December 31, 2011, 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 September 30, 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 do not intend to sell and it is more likely than not that we will not have to sell any of our securities before recovery of their cost basis.

Our equity portfolio, which amounted to a fair value of \$482 thousand, is comprised primarily of investments in other banks and an equity 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 impairment 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 September 30, 2012, or December 31, 2011.

Loans – The loan portfolio comprises our largest class of earning assets. Total loans receivable, net of unearned income, at September 30, 2012, increased \$690 thousand to \$340.4 million from \$339.7 million at year-end 2011. The increase was largely in commercial real estate loans, which grew by \$6.3 million, or 1.9%, to \$222.5 million at September 30, 2012 as compared to December 31, 2011. Approximately 94% 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) | September 30, 2012 | December 31, 2011 |
|---------------------------------|--------------------|-------------------|
| Commercial and industrial loans | \$ 13,244 | \$ 13,711 |
| Construction | 6,679 | 8,520 |
| Commercial real estate | 222,525 | 216,191 |
| Residential real estate | 96,916 | 100,175 |
| Consumer and other | 1,347 | 1,336 |
| Total gross loans | \$ 340,711 | \$ 339,933 |

Loan and Asset Quality – Our overall asset quality continues to show signs of improvement as our classified/criticized/foreclosed assets declined \$7.1 million, or 14.4% for September 30, 2012 as compared to December 31, 2011. Our classified/criticized/foreclosed assets totaled \$42.5 million at September 30, 2012, as compared to \$49.6 million at December 31, 2011 and have declined 33.3% from a historical high of \$62.8 million at March 31, 2010. Loans internally rated “Substandard,” “Doubtful” or “Loss” are considered classified assets, while loans rated as “Special Mention” are considered criticized. Such risk ratings are consistent with the classification system used by regulatory agencies and are consistent with industry practices.

Non-performing assets, which include non-accrual loans, 90 days past due and still accruing, performing troubled debt restructured loans and foreclosed assets, decreased \$4.2 million, or 12.3%, to \$29.8 million at September 30, 2012, as compared to \$34.0 million at December 31, 2011. The decrease was largely due to the pay-off of our second largest non-performing asset (\$2.9 million), net charge-offs of \$3.5 million and a \$2.8 million reduction in trouble debt restructured loans. The decrease was partly offset by one borrowing relationship that totaled \$3.8 million that was previously classified that became non-accrual during the first quarter of 2012. The ratio of non-performing assets to total assets for September 30, 2012 and December 31, 2011 were 5.9% and 6.7%, respectively. The allowance for loan losses was \$6.7 million, or 2.0% of total loans, at September 30, 2012, compared to \$7.2 million, or 2.1% of total loans, at December 31, 2011. Non-accrual loans at September 30, 2012, primarily consist of loans which are collateralized by real estate. At September 30, 2012, we held 16 foreclosed real estate properties totaling \$5.2 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:

| (Dollars in thousands) | September 30, 2012 | December 31, 2011 |
|------------------------|--------------------|-------------------|
|------------------------|--------------------|-------------------|

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| | | | |
|--|-----------|-----------|---|
| Non-accrual loans | \$ 23,993 | \$ 24,283 | |
| Non-accrual loans to total loans | 7.05 | % 7.15 | % |
| Non-performing assets | \$ 29,754 | \$ 34,006 | |
| Non-performing assets to total assets | 5.90 | % 6.71 | % |
| Allowance for loan losses as a % of non-performing loans | 27.33 | % 26.03 | % |
| Allowance for loan losses to total loans | 1.97 | % 2.12 | % |

A loan is considered impaired, in accordance with the impairment accounting guidance (FASB ASC 310-10-35-16), when based on current information and events, it is probable that we will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Total impaired loans at September 30, 2012 were \$25.1 million and at December 31, 2011 were \$27.7 million. Impaired loans measured at fair value on a non-recurring basis increased to \$23.2 million on September 30, 2012 from \$11.6 million at December 31, 2011. The principal balances on loans measured at fair value were \$16.5 million and \$13.6 million, net of valuation allowance of \$2.3 million at September 30, 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 \$603 thousand at September 30, 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 September 30, 2012, we had eight loan relationships totaling \$2.4 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, allocated and unallocated components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical charge-off experience and expected losses derived from our internal risk rating process. The unallocated component covers the potential for other adjustments that may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

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

At September 30, 2012, the total allowance for loan losses decreased \$489 thousand, or 6.8%, to \$6.7 million, as compared to \$7.2 million at December 31, 2011. The components of this decrease were a provision for loan losses of \$2.9 million and net charge-offs totaling \$3.5 million in the first nine months of 2012. The provision also reflects the continued weakness in current real estate values in our market area and reduced cash flows to support the repayment of loans. The allowance for loan losses as a percentage of total loans was 2.0% at September 30, 2012, and 2.1% at December 31, 2011.

The table below presents information regarding our provision and allowance for loan losses at September 30, 2012 and 2011:

| (Dollars in thousands) | September 30, 2012 | September 30, 2011 |
|------------------------------|--------------------|--------------------|
| Balance, beginning of period | \$ 7,210 | \$ 6,397 |
| Provision | 2,922 | 2,688 |

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| | | | | |
|------------------------|----------|---|----------|---|
| Charge-offs | (3,510 |) | (2,230 |) |
| Recoveries | 99 | | 546 | |
| Balance, end of period | \$ 6,721 | | \$ 7,401 | |

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

| (Dollars in thousands) | September 30, 2012 | | December 31, 2011 | | |
|---------------------------|--------------------|---|-------------------|---|---|
| | Amount | Percent of Loans In Each Category To Gross Loans | Amount | Percent of Loans In Each Category To Gross Loans | |
| Commercial and industrial | \$ 613 | 3.9 | % \$ 304 | 4.0 | % |
| Construction | 179 | 2.0 | % 294 | 3.1 | % |
| Commercial real estate | 4,438 | 65.3 | % 4,833 | 63.2 | % |
| Residential real estate | 1,182 | 28.4 | % 987 | 29.3 | % |
| Consumer and other loans | 8 | 0.4 | % 9 | 0.4 | % |
| Unallocated | 301 | - | 783 | - | |
| Total | \$ 6,721 | 100.0 | % \$ 7,210 | 100.0 | % |

Bank-Owned Life Insurance (BOLI) – Our BOLI carrying value amounted to \$11.4 million at September 30, 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 September 30, 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 decreased \$8.0 million, or 1.9%, to \$417.3 million at September 30, 2012 from \$425.4 million at December 31, 2011. The decrease was largely in interest bearing deposits, which decreased \$10.1 million to \$370.5 million at September 30, 2012, from \$380.6 million at December 31, 2011. The decrease in interest bearing deposits was partially offset by an increase in non-interest bearing deposits, which increased \$2.1 million to \$46.8 million at September 30, 2012, from \$44.8 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 4.08% at September 30, 2012 and at December 31, 2011. The borrowings at September 30, 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 September 30, 2012, was 1.83%. 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 September 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 \$41.2 million at September 30, 2012, and \$39.9 million at year-end 2011. In order to preserve capital, our Board of Directors elected not to declare any cash dividends in the first nine 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 Shareholders, shareholders approved an increase in the number of authorized shares of common stock from 5 million to 10 million shares.

LIQUIDITY AND CAPITAL RESOURCES

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

Traditionally, financing for our loans and investments is derived primarily from deposits, along with interest and principal payments on loans and investments. At September 30, 2012, total deposits amounted to \$417.3 million, a decrease of \$8.0 million, or 1.9%, from December 31, 2011. At September 30, 2012 and December 31, 2011, advances from FHLB and subordinated debentures totaled \$38.9 million and represented 7.7% of total assets.

Loan production continued to be our principal investing activity. Total loans receivable at September 30, 2012, amounted to \$340.4 million, an increase of \$690 thousand, or 0.2%, compared to December 31, 2011.

Our most liquid assets are cash and due from banks and federal funds sold. At September 30, 2012, the total of such assets amounted to \$10.4 million, or 2.1%, 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 September 30, 2012, available for sale securities amounted to \$119.0 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 \$27.9 million through its membership in the FHLB and \$4.0 million at Atlantic Central Bankers Bank at September 30, 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 September 30, 2012, the Bank's Tier I and Tier II capital ratios were 13.22% and 14.48%, respectively. In addition to the risk-based guidelines, the Bank's regulators require that banks which meet the regulators' highest performance and operational standards maintain a minimum leverage ratio (Tier I capital as a percent of tangible assets) of 4.0%. As of September 30, 2012, the Bank had a leverage ratio of 9.36%. 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 September 30, 2012, Sussex Bancorp's total assets exceeded \$500 million.

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

Off-Balance Sheet Arrangements – Our consolidated financial statements do not reflect off-balance sheet arrangements that are made in the normal course of business. These off-balance sheet arrangements consist of unfunded loans and letters of credit made under the same standards as on-balance sheet instruments. These unused commitments, at September 30, 2012, totaled \$62.8 million and consisted of \$28.3 million in commitments to grant commercial real estate, construction and land development loans, \$13.2 million in home equity lines of credit, \$18.8 million in other unused commitments and \$1.8 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 not involved in any legal proceedings other than routine legal proceedings occurring in the ordinary course of business. Management believes that such proceedings are, in the aggregate, immaterial to our financial condition and results of operations.

Item 1A - Risk Factors

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

None.

Item 3 - Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosures

Not applicable.

Item 5 - Other Information

Not applicable.

Item 6 - Exhibits

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

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SIGNATURES

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

SUSSEX BANCORP

By: /s/ Steven M. Fusco
STEVEN M. FUSCO
Senior Vice President and
Chief Financial Officer
(Principle Financial and Accounting Officer)
Date: November 14, 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 September 30, 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.