SUSSEX BANCORP
Form 10-Q
November 14, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

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FORM 10-Q

(Mark One)

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

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

(973) 827-2914

(Registrant's telephone number, including area code)

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

Yes x 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 x 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 S
(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 x

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

SUSSEX BANCORP

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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

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

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SUSSEX BANCORP

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands except per share data)	2012	2011	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

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

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SUSSEX BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
(Dollars in thousands)	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

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 ACOUNTING 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

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

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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.

	Less Than Twelve Months		Twelve Months or More		Total	
(Dollars in thousands)	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.

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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

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

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.

	Allowance for Loan Losses			Loans Receivable		
(Dollars in thousands)	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

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				