SUSSEX BANCORP
Form 10-Q
November 14, 2007

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D. C. 20549**

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# FORM 10-Q

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

For the quarterly period ended September 30, 2007
Or

**¨ 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<br>(State of other jurisdiction of incorporation or organization) | 22-3475473<br>(I. R. S. Employer Identification No.) |
|---|---|
| 200 Munsonhurst Road, Franklin, New Jersey<br>(Address of principal executive offices) | 07416<br><br>(Zip Code) |

Issuer's telephone number, including area code) (973) 827-2914

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(Former name, former address and former fiscal year, if changed since last report)

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 ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12-b-2 of the Exchange Act. (Check one):

Large accelerated filer: ¨ Accelerated filer: ¨ Non-accelerated filer: ý

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

As of November 5, 2007 there were 3,145,350 shares of common stock, no par value, outstanding.

**SUSSEX BANCORP**
**FORM 10-Q**

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**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**SUSSEX BANCORP**
**CONSOLIDATED BALANCE SHEETS**
*(Dollars In Thousands)*
*(Unaudited)*

| **ASSETS** | **September 30, 2007** | **December 31, 2006** |
|---|---|---|
| | | |
| Cash and due from banks | $ 10,056 | $ 10,170 |
| Federal funds sold | 11,255 | 11,995 |
| Cash and cash equivalents | 21,311 | 22,165 |
| | | |
| Interest bearing time deposits with other banks | 100 | 100 |
| Trading securities | 11,865 | - |
| Securities available for sale | 46,248 | 54,635 |
| Federal Home Loan Bank Stock, at cost | 1,358 | 1,188 |
| | | |
| Loans receivable, net of unearned income | 293,906 | 262,276 |
| Less: allowance for loan losses | 4,098 | 3,340 |
| Net loans receivable | 289,808 | 258,936 |
| | | |
| Premises and equipment, net | 8,897 | 7,794 |
| Accrued interest receivable | 2,046 | 1,910 |
| Goodwill | 2,820 | 2,820 |
| Other assets | 7,481 | 6,749 |
| | | |
| **Total Assets** | $ 391,934 | $ 356,297 |
| | | |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| | | |
| Liabilities: | | |
| Deposits: | | |
| Non-interest bearing | $ 38,315 | $ 40,083 |
| Interest bearing | 282,116 | 255,687 |
| Total Deposits | 320,431 | 295,770 |
| | | |
| Borrowings | 20,213 | 18,251 |
| Accrued interest payable and other liabilities | 3,158 | 2,529 |
| Junior subordinated debentures | 12,887 | 5,155 |
| | | |
| **Total Liabilities** | 356,689 | 321,705 |
| | | |
| Stockholders' Equity: | | |

| | | | | |
|---|---|---|---|---|
| Common stock, no par value, authorized 5,000,000 shares; | | | | |
| issued shares 3,156,025 in 2007 and 3,158,399 in 2006; | | | | |
| outstanding shares 3,145,350 in 2007 and 3,152,374 in 2006 | | 27,252 | | 27,306 |
| Retained earnings | | 8,037 | | 7,415 |
| Accumulated other comprehensive loss | | (44) | | (129) |
| **Total Stockholders' Equity** | | 35,245 | | 34,592 |
| **Total Liabilities and Stockholders' Equity** | $ | 391,934 | $ | 356,297 |

See Notes to Consolidated Financial Statements

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**SUSSEX BANCORP**
**CONSOLIDATED STATEMENTS OF INCOME**
*(Dollars In Thousands Except Per Share Data)*
*(Unaudited)*

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| **INTEREST INCOME** | | | | |
| Loans receivable, including fees | $ 5,038 | $ 4,374 | $ 14,572 | $ 12,404 |
| Securities: | | | | |
| Taxable | 439 | 365 | 1,239 | 1,067 |
| Tax-exempt | 255 | 263 | 762 | 783 |
| Federal funds sold | 193 | 120 | 354 | 315 |
| Interest bearing deposits | 1 | 1 | 4 | 11 |
| **Total Interest Income** | 5,926 | 5,123 | 16,931 | 14,580 |
| | | | | |
| **INTEREST EXPENSE** | | | | |
| Deposits | 2,548 | 1,987 | 7,111 | 4,907 |
| Borrowings | 241 | 167 | 706 | 526 |
| Junior subordinated debentures | 226 | 117 | 460 | 329 |
| **Total Interest Expense** | 3,015 | 2,271 | 8,277 | 5,762 |
| | | | | |
| **Net Interest Income** | 2,911 | 2,852 | 8,654 | 8,818 |
| **PROVISION FOR LOAN LOSSES** | 324 | 117 | 868 | 562 |
| **Net Interest Income after Provision for Loan Losses** | 2,587 | 2,735 | 7,786 | 8,256 |
| | | | | |
| **OTHER INCOME** | | | | |
| Service fees on deposit accounts | 362 | 349 | 1,016 | 1,017 |
| ATM and debit card fees | 109 | 97 | 300 | 276 |
| Insurance commissions and fees | 618 | 600 | 2,136 | 2,021 |
| Investment brokerage fees | 26 | 74 | 239 | 214 |
| Holding gains on trading securities | 194 | - | 192 | - |
| Gain on sale of securities, available for sale | 10 | - | 10 | - |
| Other | 149 | 179 | 396 | 431 |
| **Total Other Income** | 1,468 | 1,299 | 4,289 | 3,959 |
| | | | | |
| **OTHER EXPENSES** | | | | |
| Salaries and employee benefits | 1,792 | 1,759 | 5,403 | 5,154 |
| Occupancy, net | 319 | 280 | 932 | 810 |
| Furniture, equipment and data processing | 372 | 300 | 1,066 | 875 |
| Stationary and supplies | 46 | 47 | 138 | 143 |
| Professional fees | 120 | 153 | 424 | 498 |
| Advertising and promotion | 174 | 110 | 415 | 440 |
| Insurance | 41 | 47 | 135 | 151 |
| Postage and freight | 36 | 52 | 124 | 164 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Amortization of intangible assets | | 15 | | 40 | | 78 | | 113 |
| Other | | 369 | | 402 | | 1,145 | | 1,200 |
| **Total Other Expenses** | | 3,284 | | 3,190 | | 9,860 | | 9,548 |
| | | | | | | | | |
| **Income before Income Taxes** | | 771 | | 844 | | 2,215 | | 2,667 |
| **PROVISION FOR INCOME TAXES** | | 238 | | 266 | | 664 | | 841 |
| **Net Income** | $ | 533 | $ | 578 | $ | 1,551 | $ | 1,826 |
| | | | | | | | | |
| **EARNINGS PER SHARE** | | | | | | | | |
| Basic | $ | 0.17 | $ | 0.18 | $ | 0.49 | $ | 0.58 |
| Diluted | $ | 0.17 | $ | 0.18 | $ | 0.49 | $ | 0.57 |

See Notes to Consolidated Financial Statements

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**SUSSEX BANCORP**
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**
**Nine Months Ended September 30, 2007 and 2006**
*(Dollars In Thousands, Except Per Share Amounts)*
*(Unaudited)*

| | Number of Shares Outstanding | Common Stock | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total Stockholders' Equity |
|---|---|---|---|---|---|---|
| **Balance January 1, 2006** | 3,153,004 | $ 27,300 | $ 5,842 | $ (218) | $ - | $ 32,924 |
| Comprehensive income: | | | | | | |
| Net income | - | - | 1,826 | - | - | 1,826 |
| Change in unrealized gains (losses) on securities available for sale, net of tax | - | - | - | 154 | - | 154 |
| **Total Comprehensive Income** | | | | | | 1,980 |
| | | | | | | |
| Treasury shares purchased | (23,458) | - | - | - | (336) | (336) |
| Treasury shares retired | - | (336) | - | - | 336 | - |
| Exercise of stock options | 6,154 | 56 | - | - | - | 56 |
| Income tax benefit of stock options exercised | - | 7 | - | - | - | 7 |
| Issuance of 6,450 unvested shares of restricted common stock, net of related unearned compensation | - | - | - | - | - | - |
| Compensation expense related to stock option and restricted stock grants | - | 41 | - | - | - | 41 |
| Compensation expense related to stock awards | 1,000 | 15 | - | - | - | 15 |
| Shares issued through dividend reinvestment plan | 6,481 | 93 | - | - | - | 93 |
| Dividends on common stock ($.21 per share) | - | - | (665) | - | - | (665) |
| | | | | | | |
| **Balance September 30, 2006** | 3,143,181 | $ 27,176 | $ 7,003 | $ (64) | $ - | $ 34,115 |
| | | | | | | |
| **Balance January 1, 2007** | 3,152,374 | $ 27,306 | $ 7,415 | $ (129) | $ - | $ 34,592 |
| | - | - | (262) | 262 | - | - |

| | | | | | | |
|---|---|---|---|---|---|---|
| Adjustment to opening balance, net of tax, for the adoption of SFAS No. 159 (see Note 8) | | | | | | |
| Adjusted opening balance, January 1, 2007 | 3,152,374 | 27,306 | 7,153 | 133 | - | 34,592 |
| | | | | | | |
| Comprehensive income: | | | | | | |
| Net income | - | - | 1,551 | - | - | 1,551 |
| Change in unrealized gains (losses) on securities available for sale, net of tax | - | - | - | (177) | - | (177) |
| **Total Comprehensive Income** | | | | | | 1,374 |
| | | | | | | |
| Treasury shares purchased | (30,800) | - | - | - | (397) | (397) |
| Treasury shares retired | - | (397) | - | - | 397 | - |
| Exercise of stock options | 20,851 | 256 | - | - | - | 256 |
| Income tax benefit of stock options exercised | - | 18 | - | - | - | 18 |
| Issuance of 6,875 unvested shares of restricted common stock, net of related unearned compensation | - | - | - | - | - | - |
| Forfeit of 300 unvested shares of restricted common shares | - | - | - | - | - | - |
| Restricted stock vested during the period | 1,925 | - | - | - | - | - |
| Compensation expense related to stock option and restricted stock grants | - | 54 | - | - | - | 54 |
| Compensation expense related to stock awards | 1,000 | 15 | - | - | - | 15 |
| Dividends on common stock ($.21 per share) | - | - | (667) | - | - | (667) |
| | | | | | | |
| **Balance September 30, 2007** | 3,145,350 | $ 27,252 | $ 8,037 | $ (44) | $ - | $ 35,245 |

See Notes to Consolidated Financial Statements

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**SUSSEX BANCORP**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
*(Dollars in Thousands)*
*(Unaudited)*

| | Nine Months Ended September 30, | |
|---|---|---|
| | **2007** | **2006** |
| **Cash Flows from Operating Activities** | | |
| Net income | $ 1,551 | $ 1,826 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 868 | 562 |
| Provision for depreciation and amortization | 770 | 671 |
| Net change in value of trading securities | (192) | - |
| Net amortization of securities premiums and discounts | 5 | 90 |
| Net realized gain on sale of securities, available for sale | (10) | - |
| Earnings on investment in life insurance | (79) | (74) |
| Compensation expense for stock options and stock awards | 69 | 56 |
| (Increase) decrease in assets: | | |
| Accrued interest receivable | (136) | 140 |
| Other assets | (615) | (638) |
| Increase in accrued interest payable and other liabilities | 647 | 473 |
| | | |
| **Net Cash Provided by Operating Activities** | 2,878 | 3,106 |
| | | |
| **Cash Flows from Investing Activities** | | |
| Securities available for sale: | | |
| Purchases | (15,475) | (7,541) |
| Proceeds from sale of securities | 2,335 | - |
| Maturities, calls and principal repayments | 6,886 | 9,255 |
| Trading securities: | | |
| Purchases | (1,240) | - |
| Proceeds from sale of securities | 905 | - |
| Maturities, calls and principal repayments | 3,015 | - |
| Net increase in loans | (31,740) | (39,451) |
| Purchases of bank premises and equipment | (1,795) | (1,423) |
| Decrease (increase) in FHLB stock | (170) | 61 |
| Net decrease in interest bearing time deposits with other banks | - | 400 |
| Net cash received for branch acquisition | - | 2,354 |
| | | |
| **Net Cash Used in Investing Activities** | (37,279) | (36,345) |
| | | |
| **Cash Flows from Financing Activities** | | |
| Net increase in deposits | 24,661 | 28,415 |
| Proceeds from borrowings | 8,000 | - |
| Repayments of borrowings | (6,038) | (3,036) |
| Proceeds from junior subordinated debentures | 12,887 | - |

| | | | | |
|---|---|---|---|---|
| Repayments of junior subordinated debentures | | (5,155) | | - |
| Proceeds from the exercise of stock options | | 256 | | 56 |
| Purchase of treasury stock | | (397) | | (336) |
| Dividends paid, net of reinvestments | | (667) | | (572) |
| | | | | |
| **Net Cash Provided by Financing Activities** | | 33,547 | | 24,527 |
| | | | | |
| **Net Decrease in Cash and Cash Equivalents** | | (854) | | (8,712) |
| | | | | |
| **Cash and Cash Equivalents - Beginning** | | 22,165 | | 24,780 |
| **Cash and Cash Equivalents - Ending** | $ | 21,311 | $ | 16,068 |
| | | | | |
| **Supplementary Cash Flows Information** | | | | |
| Interest paid | $ | 7,920 | $ | 5,655 |
| Income taxes paid | $ | 1,227 | $ | 926 |

See Notes to Consolidated Financial Statements

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**Sussex Bancorp**
**Notes to Consolidated Financial Statements (Unaudited)**

1. Basis of Presentation

The consolidated financial statements include the accounts of Sussex Bancorp (the "Company") and its wholly-owned subsidiary Sussex Bank (the "Bank"). The Bank's wholly-owned subsidiaries are SCB Investment Company, Inc., and Tri-State Insurance Agency, Inc., ("Tri-State") a full service insurance agency located in Sussex County, New Jersey. All inter-company transactions and balances have been eliminated in consolidation. Sussex Bank is also a 49% partner of SussexMortgage.com LLC, an Indiana limited liability company and mortgage banking joint venture with National City Mortgage, Inc. SussexMortgage.com commenced operations in the third quarter of 2005. The Bank operates ten banking offices, eight located in Sussex County, New Jersey and two in Orange County, New York. The Company has received regulatory approval for a branch location in Pike County, Pennsylvania. It is anticipated that the branch will open in late 2008.

The Company is subject to the supervision and regulation of the Board of Governors of the Federal Reserve System (the "FRB"). The Bank's deposits are insured by the Deposit Insurance Fund ("DIF") of the Federal Deposit Insurance Corporation ("FDIC") up to applicable limits. The operations of the Company and the Bank are subject to the supervision and regulation of the FRB, FDIC and the New Jersey Department of Banking and Insurance (the "Department") and the operations of Tri-State are subject to supervision and regulation by the Department.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles 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, 2007, are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto that are included in the Company's Annual Report on Form 10-K for the fiscal period ended December 31, 2006.

2. 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 reflects additional common shares that would have been outstanding if dilutive potential common shares (nonvested restricted stock grants and stock options) had been issued, as well as any adjustment to income that would result from the assumed issuance of potential common shares that may be issued by the Company. Potential common shares related to stock options are determined using the treasury stock method.

The following table sets forth the computations of basic and diluted earnings per share.

| | Three Months Ended September 30, 2007 | | | Three Months Ended September 30, 2006 | | |
|---|---|---|---|---|---|---|
| | Income | Shares | Per Share | Income | Shares | Per Share |
| *(In thousands, except per share data)* | (Numerator) | (Denominator) | Amount | (Numerator) | (Denominator) | Amount |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Basic earnings per share: | | | | | | | | | |
| Net income applicable to common stockholders | $ | 533 | 3,158 | $ | 0.17 | $ | 578 | 3,151 | $ | 0.18 |
| Effect of dilutive securities: | | | | | | | | | |
| Stock options | | - | 23 | | | | - | 33 | | |
| Diluted earnings per share: | | | | | | | | | |
| Net income applicable to common stockholders and assumed conversions | $ | 533 | 3,181 | $ | 0.17 | $ | 578 | 3,184 | $ | 0.18 |

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| *(In thousands, except per share data)* | Nine Months Ended September 30, 2007 Income (Numerator) | Shares (Denominator) | Per Share Amount | Nine Months Ended September 30, 2006 Income (Numerator) | Shares (Denominator) | Per Share Amount |
|---|---|---|---|---|---|---|
| Basic earnings per share: | | | | | | |
| Net income applicable to common stockholders | $ 1,551 | 3,161 | $ 0.49 | $ 1,826 | 3,156 | $ 0.58 |
| Effect of dilutive securities: | | | | | | |
| Stock options | - | 31 | | - | 33 | |
| Diluted earnings per share: | | | | | | |
| Net income applicable to common stockholders and assumed conversions | $ 1,551 | 3,192 | $ 0.49 | $ 1,826 | 3,189 | $ 0.57 |

3. Comprehensive Income

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

| *(Dollars in thousands)* | Three Months Ended September 30, 2007 | 2006 | Nine Months Ended September 30, 2007 | 2006 |
|---|---|---|---|---|
| Unrealized holding gain (loss) on available for sale securities | $ 382 | $ 920 | $ (283) | $ 256 |
| Reclassification adjustments for gains included in net income | (10) | - | (10) | - |
| Net unrealized gain (loss) | 372 | 920 | (293) | 256 |
| Tax effect | (150) | (368) | 116 | (102) |
| Other comprehensive income gain (loss), net of tax | $ 222 | $ 552 | $ (177) | $ 154 |

4. Segment Information

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

| *(Dollars in thousands)* | Three Months Ended September 30, 2007 Banking and | Insurance Services | Total | Three Months Ended September 30, 2006 Banking and | Insurance Services | Total |
|---|---|---|---|---|---|---|

| | Financial Services | | | Financial Services | | |
|---|---|---|---|---|---|---|
| Net interest income from external sources | $ 2,911 | $ - | $ 2,911 | $ 2,852 | $ - | $ 2,852 |
| Other income from external sources | 850 | 618 | 1,468 | 699 | 600 | 1,299 |
| Depreciation and amortization | 247 | 10 | 257 | 221 | 12 | 233 |
| Income before income taxes | 756 | 15 | 771 | 822 | 22 | 844 |
| Income tax expense (1) | 232 | 6 | 238 | 257 | 9 | 266 |
| Total assets | 388,650 | 3,284 | 391,934 | 343,166 | 3,345 | 346,511 |

| | Nine Months Ended September 30, 2007 | | | Nine Months Ended September 30, 2006 | | |
|---|---|---|---|---|---|---|
| | Banking and Financial Services | Insurance Services | Total | Banking and Financial Services | Insurance Services | Total |
| Net interest income from external sources | $ 8,654 | $ - | $ 8,654 | $ 8,818 | $ - | $ 8,818 |
| Other income from external sources | 2,153 | 2,136 | 4,289 | 1,938 | 2,021 | 3,959 |
| Depreciation and amortization | 740 | 30 | 770 | 636 | 35 | 671 |
| Income before income taxes | 1,922 | 293 | 2,215 | 2,433 | 234 | 2,667 |
| Income tax expense (1) | 547 | 117 | 664 | 747 | 94 | 841 |
| Total assets | 388,650 | 3,284 | 391,934 | 343,166 | 3,345 | 346,511 |

(1) Calculated at statutory tax rate of 40%.

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5. Stock-Based Compensation

The Company currently has stock-based compensation plans in place for directors, officers, employees, consultants and advisors of the Company. Under the terms of these plans the Company may grant restricted shares and stock options for the purchase of the Company's common stock. The stock-based compensation is granted under terms determined by the Compensation Committee of the Board of Directors. Stock options granted 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 five years.

Effective January 1, 2006, the Company adopted SFAS 123(R) using the modified prospective transition method to account for share-based payments. No stock options have been granted in 2007. During the first nine months of 2007, the Company expensed $54 thousand in stock-based compensation under stock option plans and restricted stock awards, including $15 thousand related to stock option plans. At September 30, 2007, the unrecognized compensation expense for stock option plans was $17 thousand and will be recognized through July of 2008.

Information regarding the Company's stock option plans as of September 30, 2007 was as follows:

| | Number of Shares | Weighted Average Price | Weighted Average Remaining Life | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Options outstanding, beginning of year | 245,286 | $ 12.99 | | |
| Options exercised | (20,851) | 12.28 | | |
| Options outstanding, end of quarter | 224,435 | $ 13.06 | 5.56 | $ (248,764) |
| Options exercisable, end of quarter | 213,410 | $ 13.06 | 7.29 | $ (236,662) |
| Option price range at end of quarter | $ 7.32 to $17.52 | | | |
| Option price range for exercisable shares | $ 7.32 to $17.52 | | | |

The total intrinsic value or fair market price over the exercise price, of stock options exercised was $57,000 during the first nine months of 2007.

Information regarding the Company's restricted stock activity as of September 30, 2007 was as follows:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Restricted stock, beginning of year | 6,025 | $ 14.90 |
| Granted | 6,875 | 15.22 |
| Forfeited | (300) | 15.50 |
| Vested | (1,925) | 14.84 |
| Restricted stock, end of quarter | 10,675 | $ 15.06 |

Compensation expense recognized for restricted stock was $39 thousand for the first nine months of 2007. At September 30, 2007, unrecognized compensation expense for non-vested restricted stock was $128 thousand, which is expected to be recognized over an average period of 2.8 years.

6. Guarantees

The Company does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Company 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 those that are involved in extending loan facilities to customers. The Company, generally, holds collateral and/or personal guarantees supporting these commitments. The Company had $2,454,000 of undrawn standby letters of credit outstanding as of September 30, 2007. 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 payment required under the corresponding guarantees. The amount of the liability as of September 30, 2007 for guarantees under standby letters of credit issued is not material.

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7. Branch Acquisition

On March 24, 2006, the Company completed the acquisition of the Port Jervis, New York branch of NBT Bank. The transaction was recorded as a purchase of a business and the $538,000 purchase price was allocated based on the fair value of the assets acquired and liabilities assumed. The branch purchase added approximately $6.3 million in deposits, $3.4 million in loans, $449 thousand in goodwill and $120 thousand in core deposit intangible. The core deposit intangible will be amortized over seven years on an accelerated basis.

8. Adoption of SFAS 157 and 159

The Company elected to early adopt Statement of Financial Accounting Standards ("SFAS") No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities", including an amendment of FASB Statement No. 115 and FASB Statement No. 157, "Fair Value Measurements." SFAS No. 157, issued in September 2006, defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements. SFAS No. 159, which was issued in February 2007, generally permits the measurement of selected eligible financial instruments at fair value at specified election dates, subject to the conditions set forth in the standard, one of which is a requirement to adopt all the requirements of SFAS No. 157 at the early adoption date of SFAS No. 159 or earlier.

The Company elected to early adopt SFAS No. 159 for 28, or 20.3%, of its 138 available for sale securities and reclassified them as trading securities. At December 31, 2006, it was the Company's intent to hold these investments until maturity or market price recovery and classified the securities as available for sale. In the weeks following the filing of the Company's annual report in form 10-K, the Company evaluated the impact of the adoption of each of the statements on the Company's consolidated balance sheets and consolidated statements of income. The purposes weighing most heavily in favor of adoption of SFAS No. 159 included the potential net-interest margin improvements afforded by the election and the balance sheet management flexibility which the Company has achieved.

Upon adoption of SFAS No. 159, the Company selected the fair value option for $14.4 million of its $23.2 million in mortgage-backed securities as of January 1, 2007. The Company selected these mortgage-backed securities primarily on the basis of yield. The initial fair value measurement of these securities resulted in a $262 thousand cumulative effect adjustment, net of tax, recorded as a reduction in retained earnings as of January 1, 2007 as shown in the table below:

| *(Dollars in thousands)* | Balance Sheet 1/1/2007 prior to adoption | Balance Sheet Adjustment Pretax | Balance Sheet 1/1/2007 after FVO adoption |
|---|---|---|---|
| Securities, available for sale, at amortized cost | $ 54,851 | $ (14,828) | $ 40,023 |
| Net unrealized losses on securities available for sale | (216) | 436 | 220 |
| Securities available for sale, at fair value | 54,635 | (14,392) | 40,243 |
| Trading securities | - | 14,392 | 14,392 |
| | $ 54,635 | $ - | $ 54,635 |

| | | |
|---|---|---|
| Pretax cumulative effect of adoption of the fair value option | $ | (436) |
| Increase in deferred tax assets | | 174 |
| Cumulative effect of adoption of the fair value option (charge to retained earnings) | $ | (262) |

The charge to retained earnings has no overall effect on total stockholders' equity because the fair value adjustment had previously been included as an element in accumulated other comprehensive loss account.

The Company records trading securities at fair value. Any holding gains and losses on those trading securities are reflected in the consolidated statement of income. The degree of judgment utilized in measuring the fair value of trading securities generally correlates to the level of pricing observability. Pricing observability is impacted by a number of factors, including the type of asset, whether the asset has an established market and the characteristics specific to the transaction. Trading securities with readily active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of pricing observability and a lesser degree of judgment utilized in

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measuring fair value. Conversely, assets rarely traded or not quoted will generally have less, or no, pricing observability and a higher degree of judgment utilized in measuring fair value.

Under SFAS No. 157, 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 SFAS No. 157 hierarchy are as follows:

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

Level II - Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these asset and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level III - Assets and liabilities that have little to no pricing observability as of reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

The following table summarizes the valuation of the Company's trading assets and available-for-sale securities by the above SFAS No. 157 pricing observability levels as of September 30, 2007:

| | | Fair Value Measurements at September 30, 2007 Using | | |
|---|---|---|---|---|
| *(Dollars in thousands)* | Fair Value Measurements 9/30/2007 | Quoted Prices in Active Markets for Identical Assets (Level I) | Significant Other Observable Inputs (Level II) | Significant Unobservable Inputs (Level III) |
| Trading securities | $ 11,865 | $ - | $ 11,865 | $ - |
| Available for sale securities | 46,248 | - | 46,248 | - |

There was a gain on trading securities recorded on the income statement of $194,000 for the three month period ended September 30, 2007 and $192,000 for the nine month period ended September 30, 2007.

9. New Accounting Standards

In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes." The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." Specifically, the pronouncement prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on the related derecognition, classification, interest and penalties, accounting for interim periods, disclosure and transition of uncertain tax positions. The interpretation was effective for the nine

months ended September 30, 2007. As of September 30, 2007 and January 1, 2007, the Company had an insignificant amount of unrecognized tax benefits; therefore the adoption of the interpretation did not have a material impact on our consolidated financial statements.

In March 2007, the FASB ratified EITF Issue No. 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards." EITF 06-11 requires companies to recognize the income tax benefit realized from dividends or dividend equivalents that are charged to retained earnings and paid to employees for nonvested equity-classified employee share-based payment awards as an increase to additional paid-in capital. EITF 06-11 is effective for fiscal years beginning after September 15, 2007. The Company does not expect EITF 06-11 will have a material impact on its financial position, results of operations or cash flows.

In March 2007, the FASB ratified Emerging Issues Task Force Issue No. 06-10 "Accounting for Collateral Assignment Split-Dollar Life Insurance Agreements" (EITF 06-10). EITF 06-10 provides guidance for determining a liability for the postretirement benefit obligation as well as recognition and measurement of the associated asset on the basis of the terms of the collateral assignment agreement. EITF 06-10 is effective for fiscal years beginning after December 15, 2007. The Company is currently assessing the impact of EITF 06-10 on its consolidated financial position and results of operations.

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In September 2006, the FASB's Emerging Issues Task Force (EITF) issued EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements" ("EITF 06-4"). EITF 06-4 requires the recognition of a liability related to the postretirement benefits covered by an endorsement split-dollar life insurance arrangement. The consensus highlights that the employer (who is also the policyholder) has a liability for the benefit it is providing to its employee. As such, if the policyholder has agreed to maintain the insurance policy in force for the employee's benefit during his or her retirement, then the liability recognized during the employee's active service period should be based on the future cost of insurance to be incurred during the employee's retirement. Alternatively, if the policy holder has agreed to provide the employee with a death benefit, then the liability for the future death benefit should be recognized by following the guidance in SFAS No. 106 or Accounting Principals Board (APB) Option No. 12, as appropriate. For transition, an entity can choose to apply the guidance using either of the following approaches: (a) a change in accounting principle through retrospective application to all periods presented or (b) a change in accounting principle through a cumulative-effect adjustment to the balance in retained earnings at the beginning of the year of adoption. The disclosures are required in fiscal years beginning after December 15, 2007, with early adoption permitted. We are evaluating the effect of adopting EITF 06-4 on our consolidated financial statements.

On September 7, 2006, the Task Force reached a conclusion on EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance" ("EITF 06-5"). The scope of EITF 06-5 consists of six separate issues relating to accounting for life insurance policies purchased by entities protecting against the loss of "key persons." The six issues are clarifications of previously issued guidance on FASB Technical Bulletin No. 85-4. EITF 06-5 is effective for fiscal years beginning after December 15, 2006. The adoption of EITE 06-5 did not have a significant effect on the Company's financial statements.

In April 2007, the FASB directed the FASB Staff to issue FSP No. FIN 39-1, "Amendment of FASB Interpretation No. 39 ("FSP FIN 39-1). FSP FIN 3-1 modifies FIN No. 39, "Offsetting of Amounts Related to Certain Contracts," and permits companies to offset cash collateral receivables or payables with net derivative positions under certain circumstances. FSP FIN 39-1 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. We are evaluating the effect of adopting FSP FIN 39-1 on our consolidated financial statements.

In May 2007, the FASB issued FASB Staff Position ("FSP") FIN 48-1 "Definition of Settlement in FASB Interpretation No. 48" (FSP FIN 48-1). FSP FIN 48-1 provides guidance on how to determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FSP FIN 48-1 is effective retroactively to January 1, 2007. The implementation of this standard did not have a material impact on our consolidated financial position or results of operations.

In February 2007, the FASB issued FASB Staff Position (FSP) FAS 158-1, "Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88, and No. 106 and to the Related Staff Implementation Guides." This FSP makes conforming amendments to other FASB statements and staff implementation guides and provides technical corrections to SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." The conforming amendments in this FSP shall be applied upon adoption of SFAS No. 158. We believe our adoption of FSP FAS 158-1 will not have a material impact on our consolidated financial statements or disclosures.

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

MANAGEMENT STRATEGY

The Company's goal is to serve as community-oriented financial institution serving the northwestern New Jersey, northeastern Pennsylvania and Orange County, New York marketplace. Our market presence has expanded by opening branch offices in Port Jervis and Warwick, New York. In addition, the Company has received regulatory approval to open an office in Westfall Township, Pennsylvania. This office is expected to open in late 2008. The Company completed the construction and moved its Wantage branch to its new location on June 30, 2007. While offering traditional community bank loan and deposit products and services, the Company obtains significant non-interest income through its Tri-State Insurance Agency, Inc. ("Tri-State") insurance brokerage operations and the sale of non-deposit products. We report the operations of Tri-State as a separate segment from our commercial banking operations. See Note 4 to the Consolidated Financial Statements for September 30, 2007 included herein for more financial data regarding our two segments.

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During the first quarter of 2007, the Company elected to early adopt Statement of Financial Accounting Standards ("SFAS") No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," including an amendment of FASB Statement No. 115 and No. 157 Fair Value Measurements. See Note 8 to the Consolidated Financial Statements for September 30, 2007.

The Company has continued to face strong competition for cost effective deposits in its primary trade area. This competition has caused us to rely more heavily on time deposits to fund our growing loan portfolio. Time deposits, however, generally bear higher rates of interest than do savings or transactional accounts, and our reliance on time deposits has caused our net interest margin to decline. Management is addressing the margin compression by closely monitoring rates offered on deposit products and seeking to enhance its yield on interest earning assets, primarily its loan portfolio. The Company will no longer seek to compete on rate for all potential customers, but only on its more profitable relationships. This may lead to a slowing in the rate of growth of the Company’s loan portfolio, as certain borrowers elect to obtain credit products from competing institutions. However, management believes this will benefit the Company’s net interest margin and profitability.

CRITICAL ACCOUNTING POLICIES

Our accounting policies are fundamental to understanding Management’s Discussion and Analysis of Financial Condition and Results of Operations. Disclosure of the Company’s significant accounting policies is included in Note 1 to the consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2006. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions about future events that affect the amounts reported in our consolidated financial statements and accompanying notes. Since future events and their effect cannot be determined with absolute certainty, actual results may differ from those estimates. Management makes adjustments to its assumptions and judgments when facts and circumstances dictate. The amounts currently estimated by us are subject to change if different assumptions as to the outcome of future events were made. We evaluate our estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. Management believes the critical accounting policies relating to the allowance for loan losses, stock-based compensation, goodwill and other intangible assets, and investment securities impairment evaluation, encompass the most significant judgments and estimates used in preparation of our consolidated financial statements. These estimates, judgments and policies were unchanged from the Company’s Annual Report on Form 10-K for the year ended December 31, 2006.

FORWARD LOOKING STATEMENTS

When used in this discussion the words: “believes”, “anticipates”, “contemplates”, “expects” or similar expressions are intended to identify forward looking statements. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Those risks and uncertainties include those discussed under Item 1A – “Risk Factors” included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006 as well as changes to interest rates, the ability to control costs and expenses, general economic conditions, the success of the Company’s efforts to diversify its revenue base by developing additional sources of non-interest income while continuing to manage its existing fee based business, risks associated with the quality of the Company’s assets and the ability of its borrowers to comply with repayment terms, and the risks inherent in integrating acquisitions into the Company and commencing operations in new markets. The Company undertakes no obligation to publicly release the results of any revisions to those forward looking statements that may be made to reflect events or circumstances after this date or to reflect the occurrence of unanticipated events.

## RESULTS OF OPERATIONS

### Three Months ended September 30, 2007 and September 30, 2006

### Overview

The Company realized net income of $533 thousand for the third quarter of 2007, a decrease of $45 thousand, or 7.9%, from the $578 thousand reported for the same period in 2006. Basic and diluted earnings per share for the three months ended September 30, 2007 were $0.17 compared to $0.18 for the comparable period of 2006. The decline in both net income and earnings per share reflects continued pressure on the Company's net interest margin, as well as an increase in the Company's provision for loan losses due to an increase in the Company's non-performing loans.

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Comparative Average Balances and Average Interest Rates

The following table presents, on a fully taxable equivalent basis, a summary of the Company's interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for the three month period ended September 30, 2007 and 2006.

| | Three Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| *(dollars in thousands)* | 2007 | | | 2006 | | |
| Earning Assets: | Average Balance | Interest (1) | Average Rate (2) | Average Balance | Interest (1) | Average Rate (2) |
| Securities: | | | | | | |
| Tax exempt (3) | $ 24,187 | $ 329 | 5.40% | $ 24,429 | $ 348 | 5.65% |
| Taxable | 36,026 | 439 | 4.83% | 35,441 | 365 | 4.09% |
| Total securities | 60,213 | 768 | 5.06% | 59,870 | 713 | 4.72% |
| Total loans receivable (4) | 288,773 | 5,038 | 6.92% | 247,473 | 4,374 | 7.01% |
| Other interest-earning assets | 14,959 | 194 | 5.16% | 9,185 | 121 | 5.24% |
| Total earning assets | 363,945 | $ 6,000 | 6.54% | 316,528 | $ 5,208 | 6.53% |
| | | | | | | |
| Non-interest earning assets | 29,053 | | | 26,698 | | |
| Allowance for loan losses | (3,878) | | | (3,118) | | |
| Total Assets | $ 389,120 | | | $ 340,108 | | |
| | | | | | | |
| Sources of Funds: | | | | | | |
| Interest bearing deposits: | | | | | | |
| NOW | $ 60,917 | $ 329 | 2.15% | $ 60,964 | $ 385 | 2.50% |
| Money market | 41,624 | 393 | 3.75% | 31,580 | 334 | 4.19% |
| Savings | 37,294 | 86 | 0.91% | 44,425 | 101 | 0.91% |
| Time | 141,317 | 1,740 | 4.88% | 104,616 | 1,167 | 4.43% |
| Total interest bearing deposits | 281,152 | 2,548 | 3.60% | 241,585 | 1,987 | 3.26% |
| Borrowed funds | 20,218 | 241 | 4.65% | 13,265 | 167 | 4.94% |
| Junior subordinated debentures | 13,335 | 226 | 6.65% | 5,155 | 117 | 8.85% |
| Total interest bearing liabilities | 314,705 | $ 3,015 | 3.80% | 260,005 | $ 2,271 | 3.47% |
| | | | | | | |
| Non-interest bearing liabilities: | | | | | | |
| Demand deposits | 37,076 | | | 44,581 | | |
| Other liabilities | 2,320 | | | 1,781 | | |
| Total non-interest bearing liabilities | 39,396 | | | 46,362 | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Stockholders' equity | 35,019 | | | 33,741 | | |
| Total Liabilities and Stockholders' Equity | $ 389,120 | | | $ 340,108 | | |
| | | | | | | |
| Net Interest Income and Margin (5) | | $ 2,985 | 3.25% | | $ 2,937 | 3.68% |

(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 taxable equivalent basis (a 39% tax rate), increased $48 thousand, or 1.6%, to $3.0 million for the three months ended September 30, 2007 from $2.9 million for the same three month period in 2006. Total average earning assets increased by $47.4 million, or 15.0%, to $363.9 million for the three months ended September 30, 2007, while total interest bearing liabilities increased $54.7 million, or 21.0%, to $314.7 million during the same three month period. The major increase in average earning assets was in the loan portfolio while the largest increase in interest bearing liabilities was in time deposits.

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The net interest margin decreased, on a fully taxable equivalent basis, by 43 basis points to 3.25% for the three months ended September 30, 2007 compared to 3.68% for the same period in 2006, as the yield on total earning assets increased 1 basis point to 6.54% and the cost of total interest bearing liabilities increased 33 basis points to 3.80% in the three month period ended September 30, 2007 from the same period a year earlier.

Interest Income

Total interest income, on a fully taxable equivalent basis, increased by $792 thousand to $6.0 million for the three months ended September 30, 2007 compared to $5.2 million in the same period in 2006. The increase in interest income primarily reflects the $47.4 million increase in average earning assets, as discussed above, as the average yield on earning assets increased 1 basis point to 6.54% for the third quarter of 2007 from 6.53% in the same period in 2006. This marginal increase in yield is the net result of a 9 basis point decline in the yield on loan receivables, offset by a 34 basis point increase in yield on investment securities. The average balance in loans receivable increased $41.3 million. The decline in yield in loans receivable reflects both continued strong competition for creditworthy loans and the impact of an increase in non-accrual loan balances and their related loss of interest income.

Total interest income on securities, on a fully taxable equivalent basis, increased $55 thousand, to $768 thousand for the quarter ended September 30, 2007 from $713 thousand for the third quarter of 2006. As the average balance of total securities increased $343 thousand, the yield on securities increased 34 basis points, from 4.72% in the third quarter of 2006 to 5.06% for the third quarter of 2007. The increase in the average balances of the securities portfolio reflects a $585 thousand increase in taxable securities and a $242 thousand decrease in tax-exempt securities, as new purchases exceeded paydowns and maturities of securities. The increase in yield was primarily accomplished by the repricing of existing mortgage backed securities and new security purchases in an increasing market rate environment.

The average balance in loans receivable increased $41.3 million, or 16.7%, to $288.8 million in the current three month period from $247.5 million in the same period of 2006, while the interest earned on total loans receivable increased $664 thousand, or 15.2% from the third quarter of 2006 to the current period. The average rate earned on loans decreased 9 basis points from 7.01% for the three months ended September 30, 2006 to 6.92% for the same period in 2007. The increase in our loan portfolio average balance reflects our continuing efforts to enhance our loan origination capacity and continue to grow our commercial portfolio, while the decrease in yield is the result of a $4.0 million increase in non-accrual loan balances between the two three month periods and market competition.

Interest Expense

The Company’s interest expense for the three months ended September 30, 2007 increased $744 thousand, or 32.8%, to $3.0 million from $2.3 million for the same period in 2006, as the balance in average interest-bearing liabilities increased $54.7 million, or 21.0% to $314.7 million from $260.0 million between the same two periods. The average rate paid on total interest-bearing liabilities has increased by 33 basis points from 3.47% for the three months ended September 30, 2006 to 3.80% for the same period in 2007. The increase in rate reflects both the competitive environment for deposits in the Company’s market area and an increased reliance on time deposits, as traditional savings deposits have declined.

The major component of the Company’s increased interest expense in the third quarter of 2007 was the increase in time deposit interest expense of $573 thousand to $1.7 million as average time deposits increased by $36.7 million to $141.3 million for the three month period ended September 30, 2007 compared to $104.6 million for the same period in 2006. The increase reflects the Company’s advertising efforts on time deposit product offerings. The average rate paid on time deposits increased 45 basis points from 4.43% for the three months ended September 30, 2006 to 4.88% for the same period in 2007.

The average balance in money market accounts increased $10.0 million, or 31.8%, to $41.6 million for the three months ended September 30, 2007 from $31.6 million for the same period in 2006, as the Company's tiered money market products continue to attract balances. The average rate paid on money market deposits has decreased 44 basis points, from 4.19% to 3.75% between the third quarter of 2006 to the same period of 2007 due to declining current market rates.

Offsetting these deposit balance increases, average balances in NOW accounts have decreased $47 thousand from $61.0 million during the third quarter of 2006 to $60.9 million during the same period in 2007. The average rate paid on NOW accounts has decreased 35 basis points from 2.50% to 2.15% during the same two third quarter periods. In addition savings deposit balances have decreased $7.1 million, or 16.1%, to $37.3 million during the third quarter of 2007 from $44.4 million for the same period a year earlier. Depositors have continued to transfer balances from lower yielding savings accounts into higher yielding products, such as the money market accounts or time deposits.

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For the quarter ended September 30, 2007, the Company's average borrowed funds increased $6.9 million to $20.2 million compared to average borrowed funds of $13.3 million during the third quarter of 2006. The balance at September 30, 2007 consisted of three convertible notes, one repurchase agreement and one amortizing advance from the Federal Home Loan Bank. The average rate paid on total borrowed funds decreased 29 basis points from the third quarter of 2006 to the same period in 2007, as $6.0 million in convertible notes were called and $11.0 million in lower yielding convertible advances and one $2.0 million repurchase agreement were purchased.

The Company had an average balance of $13.3 million in junior subordinated debentures outstanding during the third quarter of 2007 compared to $5.2 million during the same period in 2006. One $5.2 million debenture which bore a floating rate of interest averaging 8.85% during the three months ended September 30, 2007 was called and repaid on July 9, 2007 and replaced with a second $12.5 million junior subordinated debenture, issued on June 28, 2007 which also bears a floating rate of interest tied to the three month LIBOR. The rate on this debenture averaged 6.65% for the three months ended September 30, 2007. The restructuring of the junior subordinated debentures increased the average balance of these instruments by $8.2 million while lowering the Company's cost 220 basis points.

Provision for Loan Losses

The loan loss provision for the third quarter of 2007 was $324 thousand compared to a provision of $117 thousand in the third quarter of 2006. The increase is related both to the continued growth in the Company's loan portfolio and an increase in past due and non-performing loan balances. Due to current market conditions, two larger loans dependent upon residential unit sales have not kept pace with the expected loan amortization schedules. Considering the underlying collateral value and the continuing economic environment, management determined that additional provisions were prudent at this time. See "Loan and Asset Quality."

Non-Interest Income

The Company's non-interest income is primarily generated through insurance commissions earned through the operation of Tri-State and service fees on deposit accounts. The Company's non-interest income increased by $169 thousand, or 13.0%, to $1.5 million for the three months ended September 30, 2007 from $1.3 million for the same period in 2006. Insurance commission income from Tri-State has increased $18 thousand, or 3.0%, in the third quarter of 2007 over the same period in 2006. Service fees on deposit accounts have increased by $13 thousand, or 3.7%, to $362 thousand in the third quarter of 2007 from $349 thousand during the same period in 2006. ATM and debit card fees increased $12 thousand, or 12.4%, from $97 thousand in the third quarter of 2006 to $109 thousand in the three month period ended September 30, 2007, as the Company has increased its interchange pricing.

We recognized a gain on trading securities of $194 thousand in the third quarter of 2007, following the early adoption of SFAS No. 159, the Fair Value Option for Financial Assets and Liabilities in the first quarter of 2007. The trading securities gain reflects the mark to market adjustment at September 30, 2007 to the investment securities for which the Company has elected the fair value option.

Investment brokerage fees have decreased $48 thousand, or 64.9%, to $26 thousand in the third quarter of 2007 compared to $74 thousand during the same period in 2006, due to lower volume in investment product sales between the two third quarter periods. Other non-interest income decreased $29 thousand, or 16.2%, in the third quarter of 2007 to $150 thousand from $179 thousand during the same period a year earlier. The majority of the decrease in other income in the third quarter of 2007 was a $22 thousand decrease in the Company's 49% share of joint venture income from SussexMortgage.com. The decrease was based upon the Company's accrued income from anticipated September closings. However, in October of 2007, due to a greater actual volume of closed loans than accrued for in the month of September, an additional $18 thousand was received from the third party, National City Mortgage

Corporation.

Non-Interest Expense

Total non-interest expense increased $94 thousand, or 3.0%, from $3.2 million in the third quarter of 2006 to $3.3 million in the third quarter of 2007. Salaries and employee benefits increased $33 thousand, or 1.9%, occupancy expenses increased $39 thousand, or 13.9%, and furniture, equipment and data processing expenses rose $72 thousand, or 24.0%, between the two three month periods due to branch expansion and upgrades to the Company's data processing capabilities. Advertising and promotion expenses increased $64 thousand, or 58.2%, in the third quarter of 2007 from the same period in 2006 as the Company increased its newspaper advertising for time deposits and debit card usage promotion.

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Professional fees have decreased $33 thousand, or 21.6%, to $120 thousand in the third quarter of 2007 due to non-recurring audit fees incurred during 2006 in preparation for compliance with Sarbanes-Oxley Act Section 404 and SEC regulations thereunder. Certain amortization expenses on intangible assets have expired, reducing these expenses $25 thousand in the third quarter of 2007. Postage expenses have decreased by $16 thousand in the third quarter of 2007 from the same period one year ago, as the effect of document imaging is being realized. The $33 thousand decrease in other non-interest expenses in third quarter 2007 over 2006 was mostly attributable to non-recurring ATM losses in 2006.

Income Taxes

The Company's income tax provision, which includes both federal and state taxes, was $238 thousand and $266 thousand for the three months ended September 30, 2007 and 2006, respectively. This $28 thousand decrease in income taxes resulted from a decrease in income before taxes of $73 thousand, or 8.7% for the three months ended September 30, 2007 as compared to the same period in 2006 and a benefit from tax-exempt interest on securities. The Company's effective tax rate of 31% and 32% for the three months ended September 30, 2007 and 2006, respectively, is below the statutory tax rate due to tax-exempt interest on securities and earnings on the investment in life insurance.

## Nine Months ended September 30, 2007 and September 30, 2006

Overview

For the nine months ended September 30, 2007, net income was $1.6 million, a decrease of $275 thousand, or 15.1%, from the $1.8 million reported for the same period in 2006. Basic earnings per share were $0.49 for the nine months ended September 30, 2007 compared to $0.58 for the nine-month period ended September 30, 2006. Diluted earnings per share were $0.49 for the nine months ended September 30, 2007, a decrease from $0.57 during the first nine months of 2006.

As described above, the decline in net income and earnings per share reflects continued pressure on the Company's net interest margin, as well as an increase in the Company's provision for loan losses. The Company's net interest income decreased $164 thousand, or 1.9%, in the first nine months of 2007 compared to the prior year, and the Company's provision for loan losses increased $306 thousand, or 54.5%, during the same nine month period. Net income before taxes decreased 17.0% as the Company's tax provision declined 21.1% in the first nine months of 2007 over the same period a year earlier.

Comparative Average Balances and Average Interest Rates

The following table presents, on a fully taxable equivalent basis, a summary of the Company's interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for the nine month period ended September 30, 2007 and 2006.

| | Nine Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| *(Dollars in thousands)* | 2007 | | | 2006 | | |
| Earning Assets: | Average Balance | Interest (1) | Average Rate (2) | Average Balance | Interest (1) | Average Rate (2) |
| Securities: | | | | | | |
| Tax exempt (3) | $ 24,083 | $ 992 | 5.51% | $ 24,258 | $ 1,056 | 5.82% |
| Taxable | 34,773 | 1,239 | 4.76% | 35,647 | 1,067 | 4.00% |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total securities | 58,856 | 2,231 | 5.07% | 59,905 | 2,123 | 4.74% |
| Total loans receivable (4) | 278,102 | 14,572 | 7.01% | 234,212 | 12,404 | 7.08% |
| Other interest-earning assets | 9,283 | 358 | 5.16% | 9,118 | 326 | 4.78% |
| Total earning assets | 346,241 | $ 17,161 | 6.63% | 303,235 | $ 14,853 | 6.55% |
| | | | | | | |
| Non-interest earning assets | 28,420 | | | 25,713 | | |
| Allowance for loan losses | (3,626) | | | (2,910) | | |
| Total Assets | $ 371,035 | | | $ 326,038 | | |
| | | | | | | |
| Sources of Funds: | | | | | | |
| Interest bearing deposits: | | | | | | |
| NOW | $ 59,130 | $ 971 | 2.20% | $ 55,333 | $ 885 | 2.14% |
| Money market | 38,379 | 1,097 | 3.82% | 29,122 | 845 | 3.88% |
| Savings | 38,860 | 264 | 0.91% | 47,571 | 307 | 0.86% |
| Time | 132,081 | 4,779 | 4.84% | 95,957 | 2,870 | 4.00% |
| Total interest bearing deposits | 268,450 | 7,111 | 3.54% | 227,983 | 4,907 | 2.88% |
| Borrowed funds | 19,785 | 706 | 4.70% | 14,274 | 526 | 4.86% |
| Junior subordinated debentures | 8,052 | 460 | 7.54% | 5,155 | 329 | 8.42% |
| Total interest bearing liabilities | 296,287 | $ 8,277 | 3.74% | 247,412 | $ 5,762 | 3.11% |
| | | | | | | |
| Non-interest bearing liabilities: | | | | | | |
| Demand deposits | 37,454 | | | 43,242 | | |
| Other liabilities | 2,252 | | | 1,902 | | |
| Total non-interest bearing liabilities | 39,706 | | | 45,144 | | |
| Stockholders' equity | 35,042 | | | 33,482 | | |
| Total Liabilities and Stockholders' Equity | $ 371,035 | | | $ 326,038 | | |
| | | | | | | |
| Net Interest Income and Margin (5) | | $ 8,884 | 3.43% | | $ 9,091 | 4.01% |

(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

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Net Interest Income

Net interest income, on a fully taxable equivalent basis (a 39% tax rate), decreased $207 thousand, or 2.3%, to $8.9 million for the nine months ended September 30, 2007 compared to $9.1 million for the same nine month period in 2006. The net interest margin decreased, on a fully taxable equivalent basis, 58 basis points to 3.43% for the nine months ended September 30, 2007 compared to 4.01% for the same period in 2006.

Interest Income

Total interest income, on a fully taxable equivalent basis, increased by $2.3 million, or 15.5%, to $17.2 million for the nine months ended September 30, 2007 compared to $14.9 million in the first nine months of 2006. Total average earning assets increased by $43.0 million to $346.2 million in the current nine month period from $303.2 million for the nine months ended September 30, 2006. The increasing market rate of interest on taxable securities and other interest earning assets combined with the $43.9 million average balance increase in loan receivable average balances have increased the average rate earned on earning assets 8 basis points to 6.63% for the first nine months of 2007 from 6.55% in the same period in 2006.

Total interest income on securities, on a fully taxable equivalent basis, increased $108 thousand, or 5.1%, from the nine months ended September 30, 2006 to the same period in 2007. As the average balance of total securities decreased $1.0 million and the average rate earned increased 33 basis points, from 4.74% in the first nine months of 2006 to 5.07% for the same period in 2007. The decrease in average total securities balances was due to the use of funds received from maturities, sales and paydowns primarily to fund the Company's loan growth. The increase in yield was accomplished by the increased repricing rate on mortgage backed securities and higher rates earned on new securities purchased in an increasing market rate environment.

The average balance in the loan portfolio for the nine months ended September 30, 2007 increased $43.9 million, or 18.7%, from the first nine months of 2006. The interest earned on total loans increased $2.2 million, or 17.5% as the average rate earned on loans decreased 7 basis points from 7.08% for the nine months ended September 30, 2006 to 7.01% for the same period in 2007. The decline in yield reflects the Company's decision, since reversed, to compete for loan business on the basis of rate as well as the impact of the increase in non-accrual loan balances between the two nine month periods..

Interest Expense

Interest expense increased $2.5 million to $8.3 million for the nine months ended September 30, 2007 from $5.8 million for the nine months ended September 30, 2006. The increase reflects an increase in the average balance of interest bearing liabilities of $48.9 million, to $296.3 million for the first nine months of 2007 from $247.4 million in the same period in 2006. The average rate paid on interest bearing liabilities increased 63 basis points to 3.74% for the first nine months of 2007 from 3.11% for the nine months ended September 30, 2006. The increase in volume and rate mostly reflects an increase in rates of interest on time deposits due to product promotions.

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The Company's interest expense on deposit liabilities for the nine months ended September 30, 2007 increased $2.2 million, or 44.9%, to $7.1 million from $4.9 million for the same period in 2006, as the balance in average interest-bearing liabilities increased $40.5 million, or 17.8% to $268.5 million from $228.0 million between the same two periods. The average rate paid on total interest-bearing deposits has increased by 66 basis points from 2.88% for the nine months ended September 30, 2006 to 3.54% for the same period in 2007. The increase in rate reflects both the competitive market for deposits in the Company's market area and a shift in the deposit portfolio to time deposits and away from traditional savings accounts. Time deposit average balances increased $36.1 million, or 37.7%, to $132.1 million for the first nine months of 2007 from $96.0 million during the first nine months of 2006. The average rate paid on time deposits during the first nine months of 2007 was 4.84%, or an 84 basis point increase over the 4.00% paid in the first nine months of 2006. Management closely monitors rates offered on deposit products. The increase reflects management's decision to actively compete for deposits on the basis of rate in order to fund our continued loan growth.

The average balance in money market accounts increased $9.3 million, or 31.8%, to $38.4 million for the nine months ended September 30, 2007 from $29.1 million for the same period in 2006. The average rate paid on money market deposits has decreased 6 basis points from 3.88% to 3.82% from the first nine months of 2006 to the same period of 2007, as the Company has promoted tiered personal and business money market accounts which offer higher rates of interest on larger average account balances and business sweep money market products. Management believes these accounts provide a lower cost source of funds than time deposits, while providing opportunities to enhance customer relationships with the Bank.

Offsetting these deposit balance increases, savings deposit balances have decreased $8.7 million, or 18.3%, to $38.9 million during the first nine months of 2007 from $47.6 million for the same period a year earlier. As current market rates of interest have increased in the first nine months of 2007 compared to the first nine months of 2006, depositors have transferred balances from lower yielding savings accounts into higher yielding products, such as the time or money market accounts.

For the nine months ended September 30, 2007, the Company's average borrowed funds increased $5.5 million to $19.8 million compared to average borrowed funds of $14.3 million during the first nine months of 2006. The average rate paid on total borrowed funds decreased 16 basis points to 4.70% during the first nine months of 2007 from 4.86% for the same period in 2006. As described in the three month comparison, the Company replaced $6.0 million in convertible notes that were called in June of 2007 with $6.0 million in lower yielding convertible advances and purchased an additional $5.0 million convertible advance in the fourth quarter of 2006 and one $2.0 million repurchase agreement during the first quarter of 2007.

As described above, the Company refinanced $5.0 million in outstanding subordinated debentures on July 9, 2007. Both debentures held a floating rate of interest tied to the three month LIBOR. The securities called for redemption bore a rate of 9.01%, while the newly issued $12.5 million in junior subordinated debentures have a current rate of 7.13% as of September 30, 2007.

Provision for Loan Losses

The provision for loan losses for the first nine months of 2007 was $868 thousand compared to a provision of $562 thousand in the first nine months of 2006, an increase of $306 thousand, or 54.5%. The increase in the provision reflects both the continued growth in the Company's loan portfolio and management's view of the risk associated with two real estate related construction loans. The provision for loan losses reflects management's judgment concerning the risks inherent in the Company's existing loan portfolio and the size of the allowance necessary to absorb the risks, as well as the average balance of the portfolio over both periods. Management reviews the adequacy of its allowance

on an ongoing basis and will provide additional provisions, as management may deem necessary.  Also the Loan and Asset Quality and the Allowance for Loan Losses sections should be referenced for additional information on the provision for loan losses.

Non-Interest Income

The Company's non-interest income is primarily generated through insurance commissions earned through the operation of Tri-State and service charges on deposit accounts.  The Company's non-interest income increased by $330 thousand, or 8.3%, to $4.3 million for the nine months ended September 30, 2007 from $4.0 million for the same period in 2006.  Tri-State's insurance commissions and fees have increased $115 thousand, or 5.7%, to $2.1 million in the first nine months of 2007 compared to $2.0 million in the same period a year earlier.  The increase is due to an increase in contingency commission income, reported in the first quarter of 2007, offset by softening market conditions for insurance premium renewals.  Investment brokerage fees have increased by $25 thousand, or 11.7%, to $239 thousand in

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the first nine months of 2007 from $214 thousand during the same period in 2006, due to the receipt of several new large brokerage accounts and their related commission income earned in the first quarter of 2007. Realized holding gains on trading securities resulted in a $192 thousand gain for the first nine months of 2007, following the adoption of SFAS 159 as of January 1, 2007. As service charges on deposit account income has remained relatively flat, at $1.0 million, between the first nine month periods of 2006 and 2007, ATM and debit card fee income has increased $24 thousand or 8.7%, to $300 thousand in the first nine months of 2007, as interchange fees were increased in 2007.

Non-Interest Expense

Total non-interest expense increased from $9.5 million in the first nine months of 2006 to $9.9 million in the same period in 2007, an increase of $312 thousand, or 3.3%. Salary and benefits, occupancy and furniture, equipment and data processing expenses increased during the first nine months of 2007 over the same period in 2006, while all other expenses reported nine month declines. Salaries and employee benefits increased $249 thousand, or 4.8%; occupancy expenses increased $122 thousand, or 15.1% and furniture, equipment and data processing expenses have risen $191 thousand, or 21.8%, from the Company's expansion into New York State and renovations to the data processing center and maintenance contract costs on computer software products.

Advertising and promotion expenses have decreased $25 thousand, or 5.7%, to $415 thousand in the first nine months of 2007 from $440 thousand during the first nine months of 2006 as the quantity of printed advertisements on deposit product promotions have been reduced. Professional fees have decreased $74 thousand, or 14.9%, in the first nine months of 2007 to $424 thousand from $498 thousand in the first nine months of 2007, as third party costs to assist in the initial implementation of the internal control requirements of Section 404 of the Sarbanes Oxley Act of 2002 have been completed. Postage and freight expenses have decreased $40 thousand, or 24.4%, to $124 thousand for the first nine months of 2007 from $164 thousand for the same period a year earlier, as the Company has converted to monthly statements including check images rather than physical checks.

Income Taxes

The Company's federal and state income tax provision decreased $177 thousand, or 21.1%, to $664 thousand for the nine months ended September 30, 2007 from the $841 thousand recorded for the first nine months of 2006. This decrease in income taxes resulted from a decrease in income before taxes of $452 thousand, or 17.0%, for the nine months ended September 30, 2007 as compared to the same period in 2006 and the benefit from tax-exempt interest on securities. The Company's effective tax rate decreased from 32% for the nine month period ended September 30, 2006 to 30% for the first nine months of 2007.

## FINANCIAL CONDITION

### September 30, 2007 as compared to December 31, 2006

At September 30, 2007 the Company had total assets of $391.9 million compared to total assets of $356.3 million at December 31, 2006, an increase of 10.0%, or $35.6 million. Loans receivable increased $31.6 million, or 12.1%, to $293.9 million while total deposits increased $24.7 million, or 8.3%, to $320.4 million at September 30, 2007 from $295.8 million at December 31, 2006. Additionally, borrowings increased $2.0 million to $20.2 million and junior subordinated debentures increased $7.7 million to $12.9 million at September 30, 2007 from December 31, 2006. Securities, available for sale, decreased $8.4 million, to $46.2 million and trading assets increased $11.9 million at September 30, 2007, due to the reclassification of securities under SFAS 159 and $3.5 million in net purchases over maturities, sales and paydowns.

Under the early adoption of SFAS 159, The Fair Value Option for Financial Assets and Liabilities, the Company transferred, at fair value, $14.4 million in securities, available for sale to trading assets as of January 1, 2007 and adjusted $262 thousand of unrealized losses from accumulated other comprehensive loss to retained earnings. The adjustment to fair value on trading assets at September 30, 2007 resulted in trading asset gain of $192 thousand.

Cash and Cash Equivalents

The Company's cash and cash equivalents decreased by $854 thousand at September 30, 2007 to $21.3 million from $22.2 million at December 31, 2006. This decrease mostly reflects the Company's decrease in federal funds sold of $740 thousand to $11.3 million at September 30, 2007 from $12.0 million at year-end 2006. The balance in federal funds sold continues to earn competitive short term rates while remaining available to meet current liquidity needs.

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Securities Portfolio and Trading Securities

The Company's securities, available for sale, at fair value, decreased $8.4 million from $54.6 million at December 31, 2006 to $46.2 million at September 30, 2007. Included in this decrease was the reclassification of $14.4 million in available for sale securities to trading securities, retroactive to January 1, 2007 as the Company adopted SFAS 159 in the first quarter of 2007. During the first nine months of 2007 the Company purchased $15.5 million in new available for sale securities, $4.9 million in available for sale securities matured, $2.3 million were sold and $1.9 million were repaid or called. As of September 30, 2007 trading securities balances decreased $2.5 million to $11.9 million due to the net effect of $1.2 million in new security purchases, $906 thousand in sales, $3.0 million in paydowns and net amortization expenses and $192 thousand in holding gains on trading securities.

Balances in state and municipal tax-exempt securities, at fair value, increased $1.3 million to $23.0 million from $21.7 million at December 31, 2006 as balances in taxable securities, at fair value, decreased $9.7 million to $23.2 million at September 30, 2007. The net decrease in taxable securities included $14.4 million that was transferred to trading securities and purchases that exceeded paydowns of $6.4 million.

The carrying value of the available for sale portfolio at September 30, 2007 includes an unrealized loss of $72 thousand, reflected as accumulated other comprehensive loss of $44 thousand in stockholders' equity, net of income tax of $28 thousand. Also recorded in accumulated other comprehensive loss was an adjustment for the adoption of SFAS 159 of $262 thousand which was offset against retained earnings. This compares with an unrealized loss at December 31, 2006 of $216 thousand, reflected as accumulated other comprehensive loss of $129 thousand in stockholders' equity, net of income tax of $87 thousand. Management considers the unrealized losses to be temporary and primarily resulting from changes in the interest rate environment. The securities portfolio contained no high-risk securities or derivatives as of September 30, 2007. There were no held to maturity securities at September 30, 2007 or December 31, 2006.

Loans

The loan portfolio comprises the largest part of the Company's earning assets. Total loans receivable, net of unearned income, at September 30, 2007 increased $31.6 million, or 12.1%, to $293.9 million from $262.3 million at year-end 2006. The balance in loans secured by non-residential property increased $13.9 million, to $153.3 million at September 30, 2007 from $139.4 million on December 31, 2006 and accounts for 52.1% of the Company's total loan portfolio. The largest percentage increase during this nine month period was in construction and land development loans, which increased 30.7%, or $9.2 million, from $30.1 million at December 31, 2006 to $39.3 million at September 30, 2007. During the first nine months of 2007, the Company has increased its one to four family residential mortgage loans $6.5 million, or 10.6%, to $67.4 million.

The increase in loans was funded during the first nine months of 2007 by an increase in deposits and borrowings and a decrease in the Company's federal funds sold. The loan to deposit ratios at September 30, 2007 and December 31, 2006 were 90.4% and 87.6%, respectively.

Loan and Asset Quality

Total non-performing assets, which include non-accrual loans, loans past due 90 days and still accruing, restructured loans and foreclosed real estate owned ("OREO"), increased by $5.2 million to $7.9 million at September 30, 2007 from $2.7 million at year end 2006. The increase reflects both the impact of variable rate loans resetting at higher market rates of interest, which increases borrowers' costs of servicing the loans, and a slowdown in the real estate market, which has made it more difficult for commercial borrowers to lease or sell properties. Management believes these

non-performing assets are adequately collateralized. The Company's non-accrual loans increased $5.4 million to $6.8 million at September 30, 2007 from $1.4 million at December 31, 2006. The non-accrual loans at September 30, 2007 primarily consist of loans which are fully collateralized by real estate. The Company had $1.0 million in restructured loans at September 30, 2007 and $506 thousand at December 31, 2006. There were no loans past due over 90 days and still accruing and no OREO properties at September 30, 2007.

The $5.4 million increase in non-accrual loans at September 30, 2007 is primarily attributed to one $4.2 million loan that reached maturity and has not paid off. In addition, at September 30, 2007 there was an additional loan with a balance of $3.4 million that is presently performing that management has doubts about the ability of the borrowers to continue to comply with the present loan repayment terms. Repayment of these two loans is dependent upon residential unit sales that due to market conditions have not met targeted sales.

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The Company seeks to actively manage its non-performing assets. In addition to active monitoring and collecting on delinquent loans, management has an active loan review process for customers with aggregate relationships of $500,000 or more if the credit(s) are unsecured or secured, in whole or substantial part, by collateral other than real estate and $1,000,000 or more if the credit(s) are secured in whole or substantial part by real estate.

Management continues to monitor the Company's asset quality and believes that the non-accrual loans are adequately collateralized and anticipated material losses have been adequately reserved for in the allowance for loan losses. In addition the Company does not invest in sub prime investments or loans. The following table provides information regarding risk elements in the loan portfolio at each of the periods presented:

| *(Dollars in thousands)* | September 30, 2007 | December 31, 2006 |
|---|---|---|
| Non-accrual loans | $ 6,820 | $ 1,407 |
| Non-accrual loans to total loans | 2.32% | 0.54% |
| Non-performing assets to total assets | 2.01% | 0.75% |
| Allowance for loan losses as a % of non-performing loans | 52.10% | 125.61% |
| Allowance for loan losses to total loans | 1.39% | 1.27% |

Allowance for Loan Losses

The allowance is allocated to specific loan categories based upon management's classification of problem loans under the bank's internal loan grading system and to pools of other loans that are not individually analyzed. Management makes allocations to specific loans based on the present value of expected future cash flows or the fair value of the underlying collateral for impaired loans and to other classified loans based on various credit risk factors. These factors include collateral values, the financial condition of the borrower and industry and current economic trends.

Allocations to commercial loan pools are categorized by commercial loan type and are based on management's judgment concerning historical loss trends and other relevant factors. Installment and residential mortgage loan allocations are made at a total portfolio level based on historical loss experience adjusted for portfolio activity and current conditions. Additionally, all other delinquent loans are grouped by the number of days delinquent with this amount assigned a general reserve amount.

At September 30, 2007, the total allowance for loan losses was $4.1 million, an increase of $758 thousand from the $3.3 million at December 31, 2006. The total provision for loan losses was $868 thousand and there were $149 thousand in charge-offs and $39 thousand in recoveries for the first nine months of 2007. The allowance for loan losses as a percentage of total loans was 1.39% at September 30, 2007 and 1.27% at December 31, 2006. The 22.7% increase in the allowance for loan losses reflects the related growth in the Company's loan portfolio and added provisions that management deemed necessary at this time.

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.

Deposits

Total deposits increased $24.6 million, or 8.3%, from $295.8 million at December 31, 2006 to $320.4 million at September 30, 2007. The Company's total non-interest bearing deposits decreased $1.8 million to $38.3 million at September 30, 2007 from $40.1 million at December 31, 2006 and interest-bearing deposits increased $26.4 million to $282.1 million at September 30, 2007 from $255.7 million at December 31, 2006. Interest-bearing deposit balance increases included total time deposit balances increases of $26.6 million, or 21.5%, to $150.3 million and other interest bearing deposit account balance decreases of $181 thousand, or 0.1%, to $131.8 million at September 30, 2007. Included in time deposit balances are brokered time deposits which at September 30, 2007 accounted for $7.2 million of the total time deposits, an increase of $1.9 million, or 36.2%, from $5.3 million at December 31, 2006. In order to attract and retain deposits to fund our growing loan portfolio, the Company offers higher rates and emphasizes more expensive accounts, such as time deposits, which bear higher rates than transactional or savings accounts. Brokered time deposits are also available to fund liquidity needs of the Company. As a participant with a third party service provider, the Company can either buy, sell or reciprocate balances of time deposits in excess of a single bank's FDIC insurance coverage with one or more other banks, to ensure that the entire deposit is insured. This permits the Company to obtain larger time deposits, and has resulted in an increase in brokered time deposits. Management continues to monitor the shift in deposits through its Asset/Liability Committee.

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Borrowings

As of September 30, 2007, the Company had $20.2 million in borrowings at an average interest rate of 4.67%, compared to $18.3 million in borrowings at an average rate of 4.69% at December 31, 2006. The borrowings consist of four advances and one repurchase agreement from the Federal Home Loan Bank ("FHLB"). The advances are secured under terms of a blanket collateral agreement by a pledge of qualifying investment securities and certain mortgage loans and the repurchase agreement is secured by selected investment securities held at the FHLB. Three long-term advances totaling $15.0 million, all with quarterly convertible options, allow the FHLB to change the note rate to a then current market rate. In November of 2005, the Company entered into a $3.2 million amortizing advance that matures on November 3, 2010 at a rate of 5.00%. A one year $2.0 million repurchase agreement was entered into in March of 2007 at a rate of 5.15%.

Junior Subordinated Debentures

On June 28, 2007, the Company raised $12.5 million in capital through the issuance of junior subordinated debentures to a 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, 2007 was 7.13%. The securities may be called at par anytime after September 15, 2012 or if the regulatory capital or tax treatment of the securities is substantially changed. The Company's $5.0 million in trust preferred securities issued on July 11, 2002, were called on July 9, 2007. The rate on these securities at July 11, 2007 was 9.01%. These trust preferred securities are included in the Company's and the Bank's capital ratio calculations.

In accordance with FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51", our wholly-owned subsidiaries, Sussex Capital Trust I and Sussex Capital Trust II, are not included in our consolidated financial statements. For regulatory reporting purposes, the Federal Reserve allows trust preferred securities to continue to qualify as Tier 1 Capital subject to specified limitations.

Equity

Stockholders' equity, inclusive of accumulated other comprehensive income (loss), net of income taxes, was $35.2 million at September 30, 2007, an increase of $653 thousand over the $34.6 million at year-end 2006. Stockholders' equity increased due to $1.6 million in net income earned in the first nine months of 2007, $256 thousand from the exercise of stock options, $87 thousand through the compensation expense of stock options, restricted stock grants and stock awards and the tax benefit of stock options exercised. Upon the adoption of SFAS 159, accumulated other comprehensive loss decreased by $262 thousand, as retained earnings were charged the same $262 thousand. These changes were offset by a $397 thousand decrease in common stock due to the purchase and retirement of treasury shares, cash dividends paid of $667 thousand and an unrealized loss on securities available for sale, net of income tax, decreased stockholders' equity by $177 thousand.

Liquidity and Capital Resources

It is management's intent to fund future loan demand with deposits and maturities and pay downs on investments. In addition, the bank is a member of the Federal Home Loan Bank of New York and as of September 30, 2007, had the ability to borrow up to $29.5 million against its one to four family mortgages and selected investment securities as collateral for borrowings. The Company had outstanding borrowings with the FHLBNY totaling $20.2 million. The bank also has available an overnight line of credit and a one-month overnight repricing line of credit, each in an amount of $35.5 million at the Federal Home Loan Bank and an overnight line of credit in the amount of $4.0 million

at the Atlantic Central Bankers Bank.

At September 30, 2007, the amount of liquid assets remained at a level management deemed adequate to ensure that contractual liabilities, depositors' withdrawal requirements, and other operational customer credit needs could be satisfied. At September 30, 2007, liquid investments totaled $21.3 million and all mature within 30 days.

At September 30, 2007, the Company had $46.2 million of securities classified as available for sale. Of these securities, $16.6 million had $338 thousand of unrealized losses and therefore are not available for liquidity purposes because management's intent is to hold them until market price recovery.

At September 30, 2007 the Company and the Bank both meet the well-capitalized regulatory standards applicable to them. The table below presents the capital ratios at September 30, 2007, for the Company and the Bank, as well as the minimum regulatory requirements.

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| *(Dollars in thousands)* | Amount | Ratio | Minimum Amount | Minimum Ratio |
|---|---|---|---|---|
| The Company: | | | | |
| Leverage Capital | $ 44,112 | 11.43% | ≥$15,435 | 4% |
| Tier 1 - Risk Based | 44,112 | 13.90% | ≥ 12,691 | 4% |
| Total Risk-Based | 49,209 | 15.51% | ≥ 25,381 | 8% |
| The Bank: | | | | |
| Leverage Capital | 30,775 | 8.00% | ≥ 15,383 | 4% |
| Tier 1 Risk-Based | 30,775 | 9.78% | ≥ 12,585 | 4% |
| Total Risk-Based | 34,713 | 11.03% | ≥ 25,170 | 8% |

Contractual Obligations

The following table represents the Company's contractual obligations to make future payments.

| | | Payments due by period | | | |
|---|---|---|---|---|---|
| *(Dollars in thousands)* | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| Borrowings | 20,213 | $ 2,053 | $ 115 | $ 7,045 | $ 11,000 |
| Operating lease obligations | 2,224 | 421 | 574 | 495 | 734 |
| Purchase obligations | 311 | 311 | - | - | - |
| Time deposits | 150,358 | 119,801 | 29,982 | 474 | 101 |
| Nonqualified supplemental salary continuation plan | 2,115 | 33 | 158 | 215 | 1,709 |
| Junior subordinated debentures | 12,887 | - | - | - | 12,887 |
| Total | $ 188,108 | $ 122,619 | $ 30,829 | $ 8,229 | $ 26,431 |

The Company has 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 junior subordinated debentures of Sussex Capital Trust II, which is included in the above table. The Company is 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

The Company's 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, 2007 totaled $67.9 million and consisted of $30.5 million in commitments to grant commercial real estate, construction and land development loans, $11.9 million in home equity lines of credit, and $25.5 million in other unused commitments. 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 the Company. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

Effect of Inflation

Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, the level of interest rates has a more significant impact on a financial institution's performance than effects of general levels of inflation. Interest rates do not necessarily move in the same direction or change with the same magnitude as the price of goods and services, which prices are affected by inflation. Accordingly, the liquidity, interest rate sensitivity and maturity characteristics of the Company's assets and liabilities are more indicative of its ability to maintain acceptable performance levels. Management of the Company monitors and seeks to mitigate the impact of interest rate changes by attempting to match the maturities of assets and liabilities to gap, thus seeking to minimize the potential effect of inflation.

## Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Sensitivity Analysis

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An interest rate sensitive asset or liability is one that, within a defined time period, either matures or experiences an interest rate change in line with general market interest rates. Interest rate sensitivity is the volatility of a Company's earnings from a movement in market interest rates. Interest rate "gap" analysis is a common, though imperfect, measure of interest rate risk. We do not employ gap analysis as a rate risk management tool, but rather we rely upon earnings at risk analysis to forecast the impact on our net interest income of instantaneous 100 and 200 basis point increases and decreases in market rates. In assessing the impact on earnings, the rate shock analysis assumes that no change occurs in our funding sources or types of assets in response to the rate change.

Our board of directors has established limits for interest rate risk based on the percentage change in interest income we would incur in differing interest rate scenarios. Through the first nine months of 2007, we sought to remain relatively balanced, and our policies provide for a variance of no more than 25% of net interest income, at a 100 and 200 basis point increase or decrease. At September 30, 2007 the percentages of change were within policy limits.

Our financial modeling simulates our cash flows, interest income and interest expense from earning assets and interest bearing liabilities for a twelve month period in each of the different interest rate environments, using actual individual deposit, loan and investment maturities and rates in the model calculations. Assumptions regarding the likelihood of prepayments on residential mortgage loans and investments are made based on historical relationships between interest rates and prepayments. Commercial loans with prepayment penalties are assumed to pay on schedule to maturity. In actual practice, commercial borrowers may request and be granted interest rate reductions during the life of a commercial loan due to competition from financial institutions and declining interest rates.

The following table sets forth our interest rate risk profile at September 30, 2007 and 2006. The interest rate sensitivity of our assets and liabilities, and the impact on net interest income, illustrated in the following table would vary substantially if different assumptions were used or if actual experience differs from that indicated by the assumptions.

| | September 30, 2007 | | | September 30, 2006 | | |
|---|---|---|---|---|---|---|
| *(Dollars in thousands)* | Change in Net Interest Income | Percent Change in Net Interest Income | Gap as a % of Total Assets | Change in Net Interest Income | Percent Change in Net Interest Income | Gap as a % of Total Assets |
| Down 200 basis points | $ (160) | -0.04% | 2.05% | $ 76 | 0.02% | -1.11% |
| Down 100 basis points | 209 | 0.05% | -5.39% | 299 | 0.09% | -8.69% |
| Up 100 basis points | (557) | -0.14% | -14.35% | (558) | -0.16% | -16.24% |
| Up 200 basis points | (1,402) | -0.36% | -18.04% | (1,394) | -0.41% | -20.27% |

**Item 4. <u>Controls and Procedures</u>**

(a) Evaluation of disclosure controls and procedures

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the

Company's disclosure controls and procedures are, as of the end of the period covered by this report, effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic SEC filings.

(b) Report on Internal Control over Financial Reporting

Not applicable

**PART II – OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There have been no changes in the risks associated with our securities from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006.

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**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On April 16, 1999 the Company announced a stock repurchase plan whereby the Company may purchase up to 50,000 shares of outstanding stock. There is no expiration date to this plan. On April 27, 2005, the Company's Board increased this plan to 100,000 shares; on April 19, 2006 to 150,000 shares and on August 23, 2007 to 250,000 shares of the Company's common stock.

| Period | Total Number of Shares Purchased | | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|---|
| July 1, 2007 through July 31, 2007 | - | | - | | |
| August 1. 2007 through August 31, 2007 | 24,000 | $ | 12.33 | | |
| September 1, 2007 through September 30, 2007 | - | | - | | |
| Total | 24,000 | $ | 12.33 | 132,646 | 117,354 |

**Item 3. Defaults upon Senior Securities**

Not applicable

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits**

| Number | Description |
|---|---|
| 10.1 | Sussex Bank Executive Incentive and Deferred Compensation Plan – Amendment #1 |
| 10.2 | First Amendment to the Sussex Bank Salary Continuation Agreement Dated January 8, 2004 for Terry H. Thompson |
| 10.3 | Third Amendment to the Sussex Bank Salary Continuation Agreement Dated May 15, 2000 for Donald L. Kovach |

| | |
|---|---|
| 31.1 | Certification of Donald L. Kovach pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Candace A. Leatham pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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/ Candace A. Leatham
**CANDACE A. LEATHAM**
Executive Vice President and
Chief Financial Officer
Date: November 14, 2007