

SUSSEX BANCORP
Form 10-Q
November 10, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

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

For the transition period from _____ to _____

Commission File Number 0-29030

SUSSEX BANCORP
(Exact name of registrant as specified in its charter)

New Jersey

22-3475473

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

100 Enterprise Drive, Suite 700, Rockaway, NJ 07866
(Address of principal executive offices) (Zip Code)

(844) 256-7328
(Registrant's telephone number, including area code)

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

Yes x No

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

Yes x No

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

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

Edgar Filing: SUSSEX BANCORP - Form 10-Q

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

As of November 3, 2016 there were 4,741,720 shares of common stock, no par value, outstanding.

SUSSEX BANCORP
FORM 10-Q

INDEX

<u>FORWARD-LOOKING STATEMENTS</u>	<u>i</u>
<u>PART I – FINANCIAL INFORMATION</u>	<u>1</u>
<u>Item 1 - Financial Statements</u>	<u>1</u>
<u>Item 2 - Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>30</u>
<u>Item 3 - Quantitative and Qualitative Disclosures about Market Risk</u>	<u>42</u>
<u>Item 4 - Controls and Procedures</u>	<u>42</u>
<u>PART II – OTHER INFORMATION</u>	<u>43</u>
<u>Item 1 - Legal Proceedings</u>	<u>43</u>
<u>Item 1A - Risk Factors</u>	<u>43</u>
<u>Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>43</u>
<u>Item 3 - Defaults Upon Senior Securities</u>	<u>43</u>
<u>Item 4 - Mine Safety Disclosures</u>	<u>43</u>
<u>Item 5 - Other Information</u>	<u>43</u>
<u>Item 6 - Exhibits</u>	<u>43</u>

FORWARD-LOOKING STATEMENTS

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

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

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

PART I – FINANCIAL INFORMATION

Item 1 – Financial Statements

SUSSEX BANCORP

CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)	September 30, 2016	December 31, 2015
ASSETS		
Cash and due from banks	\$ 4,355	\$ 2,914
Interest-bearing deposits with other banks	8,055	3,206
Cash and cash equivalents	12,410	6,120
Interest bearing time deposits with other banks	100	100
Securities available for sale, at fair value	91,630	93,776
Securities held to maturity, at amortized cost (fair value of \$6,863 and \$7,008 at September 30, 2016 and December 31, 2015, respectively)	6,628	6,834
Federal Home Loan Bank Stock, at cost	5,633	5,165
Loans receivable, net of unearned income	663,258	543,423
Less: allowance for loan losses	6,331	5,590
Net loans receivable	656,927	537,833
Foreclosed real estate	3,005	3,354
Premises and equipment, net	8,945	8,879
Accrued interest receivable	1,797	1,764
Goodwill	2,820	2,820
Bank-owned life insurance	12,749	12,524
Other assets	6,343	5,334
Total Assets	\$ 808,987	\$ 684,503
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Non-interest bearing	\$ 127,198	\$ 87,209
Interest bearing	497,723	430,647
Total deposits	624,921	517,856
Short-term borrowings	36,500	34,650
Long-term borrowings	71,000	61,000
Accrued interest payable and other liabilities	5,046	4,169
Junior subordinated debentures	12,887	12,887
Total Liabilities	750,354	630,562
Stockholders' Equity:		
Preferred stock, no par value, 1,000,000 shares authorized; none issued	—	—
Common stock, no par value, 10,000,000 shares authorized; 4,741,720 and 4,705,480 shares issued and 4,741,720 and 4,646,238 shares outstanding at September 30, 2016 and December 31, 2015, respectively	36,429	35,927
Treasury stock, at cost; 59,242 shares at December 31, 2015	—	(592)

Edgar Filing: SUSSEX BANCORP - Form 10-Q

Deferred compensation obligation under Rabbi Trust	1,359	—
Retained earnings	21,958	18,520
Accumulated other comprehensive income	246	86
Stock held by Rabbi Trust	(1,359) —
Total Stockholders' Equity	58,633	53,941
Total Liabilities and Stockholders' Equity	\$ 808,987	\$ 684,503
See Notes to Consolidated Financial Statements		

1

SUSSEX BANCORP

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
(Dollars in thousands except per share data)				
INTEREST INCOME				
Loans receivable, including fees	\$6,971	\$5,390	\$19,575	\$15,837
Securities:				
Taxable	396	321	1,116	890
Tax-exempt	201	231	592	660
Interest bearing deposits	7	1	17	8
Total Interest Income	7,575	5,943	21,300	17,395
INTEREST EXPENSE				
Deposits	619	448	1,830	1,302
Borrowings	508	390	1,393	1,150
Junior subordinated debentures	100	55	266	162
Total Interest Expense	1,227	893	3,489	2,614
Net Interest Income	6,348	5,050	17,811	14,781
PROVISION FOR LOAN LOSSES				
Net Interest Income after Provision for Loan Losses	5,890	5,049	16,757	14,275
OTHER INCOME				
Service fees on deposit accounts	245	230	726	656
ATM and debit card fees	190	198	577	573
Bank-owned life insurance	74	78	225	235
Insurance commissions and fees	1,090	955	3,850	2,846
Investment brokerage fees	(10)	40	67	103
Net gain on sales of securities	89	11	361	267
Net (loss) gain on disposal of premises and equipment	—	—	(19)	8
Other	96	143	337	369
Total Other Income	1,774	1,655	6,124	5,057
OTHER EXPENSES				
Salaries and employee benefits	3,243	2,919	9,672	8,488
Occupancy, net	463	410	1,399	1,330
Data processing	529	468	1,626	1,251
Furniture and equipment	248	221	764	645
Advertising and promotion	63	65	254	225
Professional fees	219	161	570	480
Director fees	159	105	378	418
FDIC assessment	138	120	379	368
Insurance	67	69	213	189
Stationary and supplies	47	49	149	154
Loan collection costs	24	19	109	175
Net expenses and write-downs related to foreclosed real estate	98	277	317	476
Other	353	480	1,029	1,156
Total Other Expenses	5,651	5,363	16,859	15,355
Income before Income Taxes	2,013	1,341	6,022	3,977
EXPENSE FOR INCOME TAXES				
Net Income	1,317	951	4,000	2,787

Edgar Filing: SUSSEX BANCORP - Form 10-Q

OTHER COMPREHENSIVE INCOME (LOSS):

Unrealized gains (loss) on available for sale securities arising during the period	(575)	1,024	1,986	174
Fair value adjustments on derivatives	190	—	(1,359)	—
Reclassification adjustment for net gain on securities transactions included in net income	(89)	(11)	(361)	(267)
Income tax related to items of other comprehensive (loss) income	190	(405)	(106)	37
Other comprehensive income (loss), net of income taxes	(284)	608	160	(56)
Comprehensive income	\$1,033	\$1,559	\$4,160	\$2,731

EARNINGS PER SHARE

Basic	\$0.28	\$0.21	\$0.87	\$0.61
Diluted	\$0.28	\$0.21	\$0.86	\$0.61

See Notes to Consolidated Financial Statements

SUSSEX BANCORP
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
Nine Months Ended September 30, 2016 and 2015

(Dollars in Thousands)	Number of Shares Outstanding	Common Stock	Deferred Compensation Obligation Under Rabbi Trust	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Stock Held by Rabbi Trust	Treasury Stock	Total Stockholders' Equity
Balance December 31, 2014	4,662,606	\$ 35,553	—	\$ 15,566	\$ 169	—	\$ (59)	\$ 51,229
Net income	—	—	—	2,787	—	—	—	2,787
Other comprehensive loss	—	—	—	—	(56)	—	—	(56)
Treasury shares purchased	(48,059)	—	—	—	—	—	(533)	(533)
Restricted stock granted	31,841	—	—	—	—	—	—	—
Restricted stock forfeited	(1,001)	—	—	—	—	—	—	—
Compensation expense related to stock option and restricted stock grants	—	279	—	—	—	—	—	279
Dividends declared on common stock (\$0.12 per share)	—	—	—	(560)	—	—	—	(560)
Balance September 30, 2015	4,645,387	\$ 35,832	\$ —	\$ 17,793	\$ 113	\$—	\$ (592)	\$ 53,146
Balance December 31, 2015	4,646,238	\$ 35,927	—	\$ 18,520	\$ 86	—	\$ (592)	\$ 53,941
Net income	—	—	—	4,000	—	—	—	4,000
Other comprehensive income	—	—	—	—	160	—	—	160
Treasury shares purchased	(2,127)	—	—	—	—	—	(26)	(26)
Funding of Supplemental Director Retirement Plan	60,920	198	1,359	—	—	(1,359)	616	814
Options exercised	449	2	—	—	—	—	2	4
Restricted stock granted	41,619	—	—	—	—	—	—	—
Restricted stock forfeited	(5,379)	—	—	—	—	—	—	—
Compensation expense related to stock option and restricted stock grants	—	302	—	—	—	—	—	302
Dividends declared on common stock (\$0.12 per share)	—	—	—	(562)	—	—	—	(562)
Balance September 30, 2016	4,741,720	\$ 36,429	\$ 1,359	\$ 21,958	\$ 246	\$ (1,359)	\$—	\$ 58,633

See Notes to Consolidated Financial Statements

SUSSEX BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
(Dollars in thousands)	2016	2015
Cash Flows from Operating Activities		
Net income	\$4,000	\$2,787
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,054	506
Depreciation and amortization	837	746
Net amortization of securities premiums and discounts	1,159	1,343
Net realized gain on sale of securities	(361)	(267)
Net realized loss (gain) on disposal of premises and equipment	19	(8)
Net realized gain on sale of foreclosed real estate	(14)	(37)
Write-downs of and provisions for foreclosed real estate	199	314
Deferred income tax (benefit) expense	(68)	496
Earnings on bank-owned life insurance	(225)	(235)
Compensation expense for stock options and stock awards	302	279
Increase in assets:		
Accrued interest receivable	(33)	(200)
Other assets	(1,047)	(893)
Increase in accrued interest payable and other liabilities	332	148
Net Cash Provided by Operating Activities	6,154	4,979
Cash Flows from Investing Activities		
Securities available for sale:		
Purchases	(27,431)	(45,436)
Sales	23,685	20,705
Maturities, calls and principal repayments	6,731	6,855
Securities held to maturity:		
Purchases	(2,023)	(1,209)
Sales	1,008	—
Maturities, calls and principal repayments	1,209	1,339
Net increase in loans	(120,877)	(30,948)
Proceeds from the sale of foreclosed real estate	893	2,049
Purchases of bank premises and equipment	(927)	(896)
Proceeds from the sale of premises and equipment	5	35
(Increase) in Federal Home Loan Bank stock	(468)	(107)
Net Cash Used in Investing Activities	(118,195)	(47,613)
Cash Flows from Financing Activities		
Net increase in deposits	107,065	44,239
Increase (decrease) in short-term borrowed funds	1,850	(8,200)
Proceeds from long-term borrowings	10,000	15,000
Repayment of long-term borrowings	—	(5,000)
Purchase of treasury stock	(26)	(533)
Proceeds from exercise of stock options	4	—
Dividends paid	(562)	(560)
Net Cash Provided by Financing Activities	118,331	44,946
Net Increase in Cash and Cash Equivalents	6,290	2,312

Edgar Filing: SUSSEX BANCORP - Form 10-Q

Cash and Cash Equivalents - Beginning	6,120	5,859
Cash and Cash Equivalents - Ending	\$12,410	\$8,171
Supplementary Cash Flows Information		
Interest paid	\$3,440	\$2,592
Income taxes paid	\$2,560	\$954
Supplementary Schedule of Noncash Investing and Financing Activities		
Foreclosed real estate acquired in settlement of loans	\$729	\$1,212
Treasury stock used to fund deferred compensation liability	\$814	\$—
See Notes to Consolidated Financial Statements		

4

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

We are 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 FDIC up to applicable limits. The operations of the company and the Bank are subject to the supervision and regulation of the FRB, the FDIC and the New Jersey Department of Banking and Insurance (the “Department”) and the operations of Tri-State are subject to supervision and regulation by the Department.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by the accounting principles generally accepted in the United States of America (“U.S. GAAP”) for full year financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal, recurring nature. Operating results for the three and nine month periods ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto that are included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

New Accounting Standards

In May 2014, Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, Revenue from Contracts with Customers. The ASU’s core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date. The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. Accordingly, the amendments are effective for annual and interim periods beginning after December 15, 2017. Early adoption is permitted for annual and interim reporting periods beginning after December 15, 2016. In March, 2016, the FASB issued ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net), that clarifies how to apply revenue recognition guidance related to whether an entity is a principal or an agent. The update clarifies that an entity is a principal when it controls the specified good or service before that good or service is transferred to the customer, and is an agent when it does not control the specified good or service before it is transferred to the customer. In May, 2016, the FASB issued ASU No. 2016-12, Revenue from Contracts with Customers (Topic 606), Narrow-Scope Improvements and Practical Expedients, that amended its new revenue recognition guidance on transition, collectibility, noncash consideration and the presentation of sales and other similar taxes. The amendments

clarify that, for a contract to be considered completed at transition, all (or substantially all) of the revenue must have been recognized under legacy GAAP. The FASB also added a practical expedient to ease transition for contracts that were modified prior to adoption of the revenue standard under both the full and modified retrospective transition approaches. We do not expect the adoption of this guidance to have a material impact on our consolidated financial statements.

In June 2014, FASB issued ASU 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (a consensus of the FASB Emerging Issues Task Force), to clarify that a performance target in a share-based compensation award that could be achieved after an employee completes the requisite service period should be treated as a performance condition that affects the vesting of the award. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. For all entities, the amendments are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In April 2015, FASB issued ASU 2015-05, Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement, to clarify whether a hosting arrangement (e.g., cloud computing, software as a service, infrastructure as a service, etc.) contains a software license, and thus, whether it is to be accounted for by the customer similarly to other internal-use software. Specifically, the amendments revise the scope of Subtopic 350-40 to include internal-use software accessed through a hosting arrangement only if both of the following criteria are met: (1) the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty. There is no significant penalty if the customer has the ability to take delivery of the software without incurring significant cost and the ability to use the software separately without significant loss of utility or value and (2) it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. If both of the above criteria are present in a hosting arrangement, then the arrangement contains a software license and the customer should account for that element in accordance with Subtopic 350-40 (i.e., generally capitalize and subsequently amortize the cost of the license). If both of the above criteria are not present, the customer should account for the arrangement as a service contract (i.e., expense fees as incurred). The amendments are effective for public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. An entity can elect to adopt the amendments either (1) prospectively to all arrangements entered into or materially modified after the effective date or (2) retrospectively. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In January 2016, FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01, among other things; (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. For public entities, the guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

In February 2016, FASB issued ASU 2016-02, Leases (Topic 842). Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (i) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (ii) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Public business entities should apply the amendments in ASU 2016-02 for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted for all public business entities upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

In March 2016, FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. FASB is issuing ASU 2016-09 as part of its initiative to reduce complexity in accounting standards. The areas for simplification in this ASU 2016-09 involve several aspects of the accounting for employee share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Some of the areas for simplification apply only to nonpublic entities. For public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for any entity in any interim or annual period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

In June, 2016, the FASB issued Accounting Standards Update 2016-13, Financial Instruments – Credit Losses (Topic 326) (the “ASU”), which introduces new guidance for the accounting for credit losses on instruments within its scope. The new guidance introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. It also modifies the impairment model for available-for-sale (AFS) debt securities and provides for a simplified accounting model for purchased

financial assets with credit deterioration since their origination. The ASU will be effective for Public business entities that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All other entities will have one additional year. Early application of the guidance will be permitted for all entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

In August 2016, FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force), which addresses eight classification issues related to the statement of cash flows; (i) debt prepayment or debt extinguishment costs, (ii) settlement of zero-coupon bonds, (iii) contingent consideration payments made after a business combination, (iv) proceeds from the settlement of insurance claims, (v) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies, (vi) distributions received from equity method investees, (vii) beneficial interests in securitization transactions, and (viii) separately identifiable cash flows and application of the predominance principle. ASU 2016-15 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. For all other entities, the ASU is effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the ASU in an interim period, adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. Entities should apply this ASU using a retrospective transition method to each period presented. If it is impracticable for an entity to apply the ASU retrospectively for some of the issues, it may apply the amendments for those issues prospectively as of the earliest date practicable. The Company is currently evaluating the pending adoption of the new standard on its consolidated financial statements.

NOTE 2 – SECURITIES

Available for Sale

The amortized cost and approximate fair value of securities available for sale as of September 30, 2016 and December 31, 2015 are summarized as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2016				
U.S. government agencies	\$ 13,670	\$ 32	\$ (49)	\$13,653
State and political subdivisions	32,698	1,341	(8)	34,031
Mortgage-backed securities -				
U.S. government-sponsored enterprises	41,493	567	(114)	41,946
Corporate Debt	2,000	—	—	2,000
	\$ 89,861	\$ 1,940	\$ (171)	\$91,630
December 31, 2015				
U.S. government agencies	\$12,792	\$51	\$(55)	\$12,788
State and political subdivisions	37,771	507	(129)	38,149
Mortgage-backed securities -				
U.S. government-sponsored enterprises	43,069	206	(436)	42,839
	\$93,632	\$764	\$(620)	\$93,776

Securities with a carrying value of approximately \$33.7 million and \$33.4 million at September 30, 2016 and December 31, 2015, respectively, were pledged to secure public deposits and for borrowings at the Federal Reserve Bank as required or permitted by applicable laws and regulations.

The amortized cost and fair value of securities available for sale at September 30, 2016 are shown below by contractual maturity. Actual maturities may differ from contractual maturities as issuers may have the right to call or prepay obligations with

7

or without call or prepayment penalties. Investments which pay principal on a periodic basis are not included in the maturity categories.

(Dollars in thousands)	Amortized Fair	
	Cost	Value
Due in one year or less	\$ —	\$ —
Due after one year through five years	198	200
Due after five years through ten years	6,392	6,620
Due after ten years	28,108	29,211
Total bonds and obligations	34,698	36,031
U.S. government agencies	13,670	13,653
Mortgage-backed securities:		
U.S. government-sponsored enterprises	41,493	41,946
Total available for sale securities	\$ 89,861	\$ 91,630

Gross gains on sales of securities available for sale were \$89 thousand and \$64 thousand for the three months ended September 30, 2016 and 2015, respectively. Gross realized losses on sales of securities available for sale were less than \$1 thousand and \$53 thousand for the three months ended September 30, 2016 and 2015, respectively.

Gross realized gains on sales of securities available for sale were \$353 thousand and \$368 thousand and gross losses were less than \$1 thousand and \$101 thousand for the nine months ended September 30, 2016 and 2015, respectively.

Temporarily Impaired Securities

The following table shows gross unrealized losses and fair value of securities with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by category and length of time that individual available for sale securities have been in a continuous unrealized loss position at September 30, 2016 and December 31, 2015.

(Dollars in thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
September 30, 2016						
U.S. government agencies	\$2,129	\$ (16)	\$2,229	\$ (33)	\$4,358	\$ (49)
State and political subdivisions	597	(8)	—	—	597	(8)
Mortgage-backed securities -						
U.S. government-sponsored enterprises	14,405	(107)	865	(7)	15,270	(114)
Total temporarily impaired securities	\$17,131	\$ (131)	\$3,094	\$ (40)	\$20,225	\$ (171)
December 31, 2015						
U.S. government agencies	\$5,888	\$(23)	\$2,473	\$(32)	\$8,361	\$(55)
State and political subdivisions	5,780	(107)	2,998	(22)	8,778	(129)
Mortgage-backed securities -						
U.S. government-sponsored enterprises	31,885	(436)	—	—	31,885	(436)
Total temporarily impaired securities	\$43,553	\$(566)	\$5,471	\$(54)	\$49,024	\$(620)

For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred. As of September 30, 2016, we reviewed our available for sale securities portfolio for indications of impairment. This review includes analyzing the length of time and the extent to

which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and the intent and likelihood of selling the security. The intent and likelihood of sale of debt and equity securities are evaluated based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy and interest rate risk position.

U.S. Government Agencies

At September 30, 2016 and December 31, 2015, the decline in fair value and the unrealized losses for our U.S. government agencies securities were primarily due to changes in spreads and market conditions and not credit quality. At September 30, 2016, there were three securities with a fair value of \$4.4 million that had an unrealized loss that amounted to \$49 thousand. As of September 30, 2016, we did not intend to sell and it was not more-likely-than-not that we would be required to sell any of these securities before recovery of their amortized cost basis. Therefore, none of the U.S. government agency securities at September 30, 2016 were deemed to be other-than-temporarily impaired (“OTTI”).

At December 31, 2015, there were six securities with a fair value of \$8.4 million that had an unrealized loss that amounted to \$55 thousand.

State and Political Subdivisions

At September 30, 2016 and December 31, 2015, the decline in fair value and the unrealized losses for our state and political subdivisions securities were caused by changes in interest rates and spreads and were not the result of credit quality. At September 30, 2016, there was one security with a fair value of \$597 thousand that had an unrealized loss that amounted to \$8 thousand. These securities typically have maturity dates greater than 10 years and the fair values are more sensitive to changes in market interest rates.

At December 31, 2015, there were 15 securities with a fair value of \$8.8 million that had an unrealized loss that amounted to \$129 thousand.

Mortgage-Backed Securities

At September 30, 2016 and December 31, 2015, the decline in fair value and the unrealized losses for our mortgage-backed securities guaranteed by U.S. government-sponsored enterprises were primarily due to changes in spreads and market conditions and not credit quality. At September 30, 2016, there were nine securities with a fair value of \$15.3 million that had an unrealized loss that amounted to \$114 thousand. As of September 30, 2016, we did not intend to sell and it was not more-likely-than-not that we would be required to sell any of these securities before recovery of their amortized cost basis. Therefore, none of our mortgage-backed securities at September 30, 2016 were deemed to be OTTI.

At December 31, 2015, there were 18 securities with a fair value of \$31.9 million that had an unrealized loss that amounted to \$436 thousand.

Corporate Debt

At September 30, 2016, we did not have any Corporate Debt securities in an unrealized loss position.

Held to Maturity Securities

The amortized cost and approximate fair value of securities held to maturity as of September 30, 2016 and December 31, 2015 are summarized as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2016				
State and political subdivisions	\$ 6,628	\$ 235	\$	—\$6,863
December 31, 2015				

Edgar Filing: SUSSEX BANCORP - Form 10-Q

State and political subdivisions \$ 6,834 \$ 174 \$ —\$7,008

During the nine months ended September 30, 2016, the Company sold a security out of its held to maturity portfolio due to continued credit deterioration. The gross realized gain on the sale of the security was \$8 thousand for the nine months ended September 30, 2016.

The amortized cost and carrying value of securities held to maturity at September 30, 2016 are shown below by contractual maturity. Actual maturities may differ from contractual maturities as issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

9

(Dollars in thousands)	Amortized Fair	
	Cost	Value
Due in one year or less	\$ 3,767	\$3,767
Due after one year through five years	—	—
Due after five years through ten years	1,818	1,925
Due after ten years	1,043	1,171
Total held to maturity securities	\$ 6,628	\$6,863

Temporarily Impaired Securities

For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred. As of September 30, 2016, we did not have any held to maturity investments with unrealized losses. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and the intent and likelihood of selling the security. The intent and likelihood of sale of debt securities is evaluated based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy and interest rate risk position. For each security whose fair value is less than their amortized cost basis, a review is conducted to determine if an other-than-temporary impairment has occurred.

At December 31, 2015, we did not have any held to maturity securities in an unrealized loss position.

NOTE 3 – LOANS

The composition of net loans receivable at September 30, 2016 and December 31, 2015 is as follows:

(Dollars in thousands)	September 30, December 31,	
	2016	2015
Commercial and industrial	\$ 34,152	\$ 20,023
Construction	21,912	13,348
Commercial real estate	465,600	382,262
Residential real estate	141,466	127,204
Consumer and other	1,060	1,253
Total loans receivable	664,190	544,090
Unearned net loan origination fees	(932)	(667)
Allowance for loan losses	(6,331)	(5,590)
Net loans receivable	\$ 656,927	\$ 537,833

Mortgage loans serviced for others are not included in the accompanying balance sheets. The total amount of loans serviced for the benefit of others was approximately \$438 thousand and \$454 thousand at September 30, 2016 and December 31, 2015, respectively. Mortgage servicing rights were immaterial at September 30, 2016 and December 31, 2015.

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

The following table presents changes in the allowance for loan losses disaggregated by the class of loans receivable for the three and nine months ended September 30, 2016 and 2015:

(Dollars in thousands)	Commercial and Industrial	Commercial Construction	Commercial Real Estate	Residential Real Estate	Consumer and Other	Unallocated	Total
Three Months Ended:							
September 30, 2016							
Beginning balance	\$ 199	\$ 208	\$ 4,020	\$ 914	\$ 17	\$ 630	\$5,988
Charge-offs	—	—	(91	) (25	) (11	) —	(127)
Recoveries	5	—	2	1	4	—	12
Provision	5	106	(24	) (48	) 8	411	458
Ending balance	\$ 209	\$ 314	\$ 3,907	\$ 842	\$ 18	\$ 1,041	\$6,331
September 30, 2015							
Beginning balance	\$ 86	277	\$ 3,613	\$ 898	\$ 86	\$ 792	\$5,752
Charge-offs	—	—	(119	) —	(6	) —	(125)
Recoveries	5	—	3	4	1	—	13
Provision	(8	) (57	) 134	26	5	(99	) 1
Ending balance	\$ 83	\$ 220	\$ 3,631	\$ 928	\$ 86	\$ 693	\$5,641
Nine Months Ended:							
September 30, 2016							
Beginning balance	\$ 85	220	\$ 3,646	\$ 784	\$ 87	\$ 768	\$5,590
Charge-offs	(138	) —	(156	) (59	) (30	) —	(383)
Recoveries	21	—	36	7	6	—	70
Provision	241	94	381	110	(45	) 273	1,054
Ending balance	\$ 209	\$ 314	\$ 3,907	\$ 842	\$ 18	\$ 1,041	\$6,331
September 30, 2015							
Beginning balance	\$ 231	383	\$ 3,491	\$ 903	\$ 19	\$ 614	\$5,641
Charge-offs	(19	) —	(542	) —	(17	) —	(578)
Recoveries	10	—	39	17	6	—	72
Provision	(139	) (163	) 643	8	78	79	506
Ending balance	\$ 83	\$ 220	\$ 3,631	\$ 928	\$ 86	\$ 693	\$5,641

Edgar Filing: SUSSEX BANCORP - Form 10-Q

The following table presents the balance of the allowance of loan losses and loans receivable by class at September 30, 2016 and December 31, 2015 disaggregated on the basis of our impairment methodology.

(Dollars in thousands)	Allowance for Loan Losses			Loans Receivable		
	Balance	Balance Loans Individually Evaluated for Impairment	Balance Related to Loans Collectively Evaluated for Impairment	Balance	Individually Evaluated for Impairment	Collectively Evaluated for Impairment
September 30, 2016						
Commercial and industrial	\$209	\$ —	\$ 209	\$34,152	\$ 20	\$ 34,132
Construction	314	—	314	21,912	—	21,912
Commercial real estate	3,907	90	3,817	465,600	4,293	461,307
Residential real estate	842	2	840	141,466	1,608	139,858
Consumer and other loans	18	—	18	1,060	—	1,060
Unallocated	1,041	—	—	—	—	—
Total	\$6,331	\$ 92	\$ 5,198	\$664,190	\$ 5,921	\$ 658,269
December 31, 2015						
Commercial and industrial	\$85	\$—	\$85	\$20,023	\$20	\$20,003
Construction	220	—	220	13,348	—	13,348
Commercial real estate	3,646	112	3,534	382,262	5,160	377,102
Residential real estate	784	79	705	127,204	1,546	125,658
Consumer and other loans	87	73	14	1,253	138	1,115
Unallocated	768	—	—	—	—	—
Total	\$5,590	\$264	\$4,558	\$544,090	\$6,864	\$537,226

An age analysis of loans receivable, which were past due as of September 30, 2016 and December 31, 2015, is as follows:

(Dollars in thousands)	30-59	60-89	Greater	Total	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
	Days Past Due	days Past Due	Than 90 Days (a)	Past Due			
September 30, 2016							
Commercial and industrial	\$306	\$16	\$202	\$524	\$33,628	\$34,152	\$182
Construction	216	—	—	216	21,696	21,912	—
Commercial real estate	3,881	1,908	3,282	9,071	456,529	465,600	111
Residential real estate	882	367	1,485	2,734	138,732	141,466	93
Consumer and other	3	1	—	4	1,056	1,060	—
Total	\$5,288	\$2,292	\$4,969	\$12,549	\$651,641	\$664,190	\$386
December 31, 2015							
Commercial and industrial	\$5	\$—	\$20	\$25	\$19,998	\$20,023	\$—
Construction	—	—	—	—	13,348	13,348	—
Commercial real estate	758	1,461	4,016	6,235	376,027	382,262	—
Residential real estate	335	247	1,138	1,720	125,484	127,204	—

Edgar Filing: SUSSEX BANCORP - Form 10-Q

Consumer and other	16	1	138	155	1,098	1,253	—
Total	\$1,114	\$1,709	\$5,312	\$8,135	\$535,955	\$544,090	\$—

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

Loans for which the accrual of interest has been discontinued at September 30, 2016 and December 31, 2015 were:

(Dollars in thousands)	September 30, December 31,	
	2016	2015
Commercial and industrial	\$ 20	\$ 20
Commercial real estate	3,171	4,016
Residential real estate	1,392	1,138
Consumer and other	—	138
Total	\$ 4,583	\$ 5,312

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

Our risk-rating system is consistent with the classification system used by regulatory agencies and with industry practices. Loan classifications of Substandard, Doubtful or Loss are consistent with the regulatory definitions of classified assets. The classification system is as follows:

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

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

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

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

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

Edgar Filing: SUSSEX BANCORP - Form 10-Q

The following tables illustrate our corporate credit risk profile by creditworthiness category as of September 30, 2016 and December 31, 2015:

(Dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
September 30, 2016					
Commercial and industrial	\$34,023	\$ 95	\$ 34	\$	—\$34,152
Construction	21,912	—	—	—	21,912
Commercial real estate	451,289	8,717	5,594	—	465,600
Residential real estate	139,133	563	1,770	—	141,466
Consumer and other	1,060	—	—	—	1,060
	\$647,417	\$ 9,375	\$ 7,398	\$	—\$664,190
December 31, 2015					
Commercial and industrial	\$19,983	\$ 5	\$ 35	\$—	\$—20,023
Construction	13,348	—	—	—	—13,348
Commercial real estate	367,305	8,957	6,000	—	—382,262
Residential real estate	124,915	743	1,546	—	—127,204
Consumer and other	1,115	—	138	—	—1,253
	\$526,666	\$9,705	\$7,719	\$—	\$—544,090

The following table reflects information about our impaired loans by class as of September 30, 2016 and December 31, 2015:

(Dollars in thousands)	September 30, 2016			December 31, 2015			
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance	
With no related allowance recorded:							
Commercial and industrial	\$ 20	\$ 20	\$	—\$ 20	\$ 20	\$	—
Commercial real estate	1,985	1,985	—	2,684	2,684	—	—
Residential real estate	1,383	1,409	—	1,123	1,152	—	—
With an allowance recorded:							
Commercial real estate	2,308	2,399	90	2,476	2,476	112	—
Residential real estate	225	225	2	423	423	79	—
Consumer and other	—	—	—	138	138	73	—
Total:							
Commercial and industrial	20	20	—	20	20	—	—
Commercial real estate	4,293	4,384	90	5,160	5,160	112	—
Residential real estate	1,608	1,634	2	1,546	1,575	79	—
Consumer and other	—	—	—	138	138	73	—
	\$5,921	\$6,038	\$92	\$6,864	\$6,893	\$264	—

Edgar Filing: SUSSEX BANCORP - Form 10-Q

The following table presents the average recorded investment and income recognized for the three and nine months ended September 30, 2016 and 2015:

(Dollars in thousands)	For the Three Months Ended September 30, 2016		For the Three Months Ended September 30, 2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and industrial	\$20	\$ —	\$20	\$ —
Commercial real estate	2,002	4	2,119	10
Residential real estate	1,316	3	904	1
Total impaired loans without a related allowance	3,338	7	3,043	11
With an allowance recorded:				
Commercial real estate	2,394	8	2,762	8
Residential real estate	184	—	992	3
Consumer and other	—	—	104	—
Total impaired loans with an allowance	2,578	8	3,858	11
Total impaired loans	\$5,916	\$ 15	\$6,901	\$ 22

(Dollars in thousands)	For the Nine Months Ended September 30, 2016		For the Nine Months Ended September 30, 2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and industrial	\$20	\$ —	\$15	\$ —
Commercial real estate	2,224	16	2,439	24
Residential real estate	1,188	6	1,267	5
Total impaired loans without a related allowance	3,432	22	3,721	29
With an allowance recorded:				
Commercial and industrial	—	—	24	—
Commercial real estate	2,546	25	2,764	25
Residential real estate	281	—	753	8
Consumer and other	69	—	104	—
Total impaired loans with an allowance	2,896	25	3,645	33
Total impaired loans	\$6,328	\$ 47	\$7,366	\$ 62

We recognize interest income on performing impaired loans as payments are received. On non-performing impaired loans we do not recognize interest income as all payments are recorded as a reduction of principal on such loans.

Impaired loans include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, postponement or forgiveness of principal, forbearance or other actions intended to maximize collection. The concessions rarely result in the forgiveness of principal or accrued interest. In addition, we

attempt to obtain additional collateral or guarantor support when modifying such loans. Non-accruing restructured loans may be returned to accrual status when there has been a sustained period of repayment performance (generally six consecutive months of payments) and both principal and interest are deemed collectible.

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

(Dollars in thousands)	Commercial		Residential	Total
	Real Estate		Real Estate	
September 30, 2016				
Performing	\$ 1,012	\$ 130		\$ 1,142
Non-performing	1,931	—		1,931
Total	\$ 2,943	\$ 130		\$ 3,073
December 31, 2015				
Performing	\$1,144	\$409		\$1,553
Non-performing	1,831	194		2,025
Total	\$2,975	\$603		\$3,578

Troubled debt restructured loans are considered impaired and are included in the previous impaired loans disclosures in this footnote. As of September 30, 2016, we have not committed to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

There were no troubled debt restructurings that occurred during the three and nine months ended September 30, 2016 and 2015.

There were no troubled debt restructurings for which there was a payment default within twelve months following the date of the restructuring for the three and nine months ended September 30, 2016 and 2015.

We may obtain physical possession of residential real estate collateralizing a consumer mortgage loan via foreclosure on an in-substance repossession. As of September 30, 2016, we did not hold any foreclosed residential real estate properties. As of December 31, 2015, we held \$130 thousand in foreclosed residential real estate properties as a result of obtaining physical possession. In addition, as of September 30, 2016 and December 31, 2015, respectively, we had consumer loans with a carrying value of \$673 thousand and \$945 thousand collateralized by residential real estate property for which formal foreclosure proceedings were in process.

NOTE 5 – EARNINGS PER SHARE

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

Potential common shares related to stock options are determined using the treasury stock method.

(In thousands, except share and per share data)	Three Months Ended September 30, 2016		Three Months Ended September 30, 2015	
	Income Shares (Numerator)	Per Share Amount	Income Shares (Numerator)	Per Share Amount
Basic earnings per share:				
Net earnings applicable to common stockholders	\$1,317 4,646,690	\$ 0.28	\$951 4,550,923	\$ 0.21

Edgar Filing: SUSSEX BANCORP - Form 10-Q

Effect of dilutive securities:

Unvested stock awards	—	37,618	—	35,210	
Diluted earnings per share:					
Net income applicable to common stockholders and assumed conversions	\$1,317	4,684,308	\$ 0.28	\$951 4,586,133	\$ 0.21

16

(In thousands, except share and per share data)	Nine Months Ended September 30, 2016			Nine Months Ended September 30, 2015		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings per share:						
Net earnings applicable to common stockholders	\$4,000	4,605,399	\$ 0.87	\$2,787	4,561,638	\$ 0.61
Effect of dilutive securities:						
Unvested stock awards	—	28,074		—	30,062	
Diluted earnings per share:						
Net income applicable to common stockholders and assumed conversions	\$4,000	4,633,473	\$ 0.86	\$2,787	4,591,700	\$ 0.61

There were 29,813 and 52,023 shares of unvested restricted stock awards and options outstanding during the three months ended September 30, 2016 and 2015, respectively, which were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive. There was 45,845 and 66,946 shares of unvested restricted stock awards and options outstanding during the nine months ended September 30, 2016 and 2015, respectively, which were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive.

NOTE 6 – OTHER COMPREHENSIVE INCOME

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

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

(Dollars in thousands)	Three Months Ended September 30, 2016			Three Months Ended September 30, 2015		
	Before Tax	Net of Tax	Effect	Before Tax	Net of Tax	Effect
Other comprehensive income (loss):						
Unrealized gains (losses) on available for sale securities	\$(575)	\$(230)	\$(345)	\$1,024	\$409	\$615
Fair value adjustments on derivatives	190	75	115	—	—	—
Reclassification adjustment for net gains on securities transactions included in net income	(89)	(35)	(54)	(11)	(4)	(7)
Total other comprehensive income	\$(474)	\$(190)	\$(284)	\$1,013	\$405	\$608

Edgar Filing: SUSSEX BANCORP - Form 10-Q

	Nine Months Ended September 30, 2016			Nine Months Ended September 30, 2015		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
(Dollars in thousands)						
Other comprehensive income (loss):						
Unrealized gains on available for sale securities	\$1,986	\$794	\$1,192	\$174	\$70	\$104
Fair value adjustments on derivatives	(1,359)	(544)	(815)	—	—	—
Reclassification adjustment for net gains on securities transactions included in net income	(361)	(144)	(217)	(267)	(107)	(160)
Total other comprehensive income	\$266	\$106	\$160	\$(93)	\$(37)	\$(56)

NOTE 7 – SEGMENT INFORMATION

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

	Three Months Ended September 30, 2016			Three Months Ended September 30, 2015		
	Banking and Insurance Financial Services	Insurance Services	Total	Banking and Insurance Financial Services	Insurance Services	Total
(Dollars in thousands)						
Net interest income from external sources	\$6,348	\$	—\$6,348	\$5,050	\$	—\$5,050
Other income from external sources	707	1,067	1,774	694	961	1,655
Depreciation and amortization	283	8	291	245	4	249
Income before income taxes	1,848	165	2,013	1,168	173	1,341
Income tax expense (1)	630	66	696	321	69	390
Total assets	803,032,955		808,987	639,563,456		644,019

	Nine Months Ended September 30, 2016			Nine Months Ended September 30, 2015		
	Banking and Insurance Financial Services	Insurance Services	Total	Banking and Insurance Financial Services	Insurance Services	Total
(Dollars in thousands)						
Net interest income from external sources	\$17,811	\$	—\$17,811	\$14,781	\$	—\$14,781
Other income from external sources	2,274	3,850	6,124	2,195	2,862	5,057
Depreciation and amortization	816	21	837	731	15	746
Income before income taxes	4,918	1,104	6,022	3,376	601	3,977
Income tax expense (1)	1,580	442	2,022	950	240	1,190
Total assets	803,032	5,955	808,987	639,563	4,456	644,019

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

NOTE 8 – STOCK-BASED COMPENSATION

We currently have stock-based compensation plans in place for our directors, officers, employees, consultants and advisors. Under the terms of these plans we may grant restricted shares and stock options for the purchase of our common stock. The stock-based compensation is granted under terms determined by our Compensation Committee. Our standard stock option grants have a maximum term of 10 years, generally vest over periods ranging between one and five years, and are granted with an exercise price equal to the fair market value of the common stock on the date of grant. Restricted stock is valued at the market value of the common stock on the date of grant and generally vests over periods of three to five years. All dividends paid on restricted stock, whether vested or unvested, are paid to the shareholder.

19

Information regarding our stock option plans for the nine months ended September 30, 2016 is as follows:

	Number of Shares	Weighted Average Exercise Price per Share	Weighted Average Contractual Term	Aggregate Intrinsic Value
Options outstanding, beginning of year	51,985	\$ 10.06		
Options granted	26,216	12.83		
Options expired	(8,629	) 10.12		
Options exercised	(449	) \$ 10.25		
Options outstanding, end of quarter	69,123	\$ 11.10	8.6	\$ 361,591
Options exercisable, end of quarter	8,581	\$ 10.04	8.2	\$ 53,964
Option price range at end of quarter	\$9.97 to \$12.83			
Option price of exercisable shares	\$9.97 to \$12.83			

The following table summarizes information about stock option assumptions:

	2016	2015		
Expected dividend yield	1.25	% 1.56	%	
Expected volatility	22.72	% 34.32	%	
Risk-free interest rate	1.71	% 1.37	%	
Expected option life	7.5 years	7.5 years		

During the three months ended September 30, 2016 and 2015, we expensed \$10 thousand and \$10 thousand, respectively, in stock-based compensation under stock option awards.

During the nine month ended September 30, 2016 and 2015, we expensed \$34 thousand and \$28 thousand, respectively, in stock-based compensation under stock option awards.

The weighted average grant date fair values of options granted during the nine months ended September 30, 2016 and 2015, were \$3.37 per share and \$3.56 per share, respectively. Expected future expense relating to the unvested options outstanding as of September 30, 2016 is \$178 thousand over a weighted average period of 3.6 years. Upon exercise of vested options, management expects to draw on treasury stock as the source of the shares.

The summary of changes in unvested restricted stock awards for the nine months ended September 30, 2016, is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested restricted stock, beginning of year	93,570	\$ 7.67
Granted	41,619	12.85
Forfeited	(5,379	) 10.66
Vested	(47,754)	7.06
Unvested restricted stock, end of period	82,056	\$ 10.46

During the three months ended September 30, 2016 and 2015, we expensed \$82 thousand and \$84 thousand, respectively, in stock-based compensation under restricted stock awards. During the nine months ended September 30, 2016 and 2015, we expensed \$268 thousand and \$251 thousand, respectively, in stock-based compensation under restricted stock awards.

At September 30, 2016, unrecognized compensation expense for unvested restricted stock was \$620 thousand, which is expected to be recognized over an average period of 1.7 years.

NOTE 9 – GUARANTEES

We do not issue any guarantees that would require liability recognition or disclosure, other than standby letters of credit. Standby letters of credit are conditional commitments issued by us to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Generally, we hold collateral and/or personal guarantees supporting these commitments. As of September 30, 2016, we had \$599 thousand of outstanding letters of credit. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of September 30, 2016, for guarantees under standby letters of credit issued is not material.

NOTE 10 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Management uses its best judgment in estimating the fair value of our financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts we could have realized in a sale transaction on the dates indicated. The fair value amounts have been measured as of their respective period ends, and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period end.

In accordance with U.S. GAAP, we use a hierarchical 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 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 fair value of our financial assets measured on a recurring basis by the above pricing observability levels as of September 30, 2016 and December 31, 2015:

(Dollars in thousands)	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level I)	Significant Other Observable Inputs (Level II)	Significant Unobservable Inputs (Level III)
September 30, 2016				
U.S. government agencies	\$ 13,653	\$ —	\$ 13,653	\$ —
State and political subdivisions	34,031	—	34,031	—
Mortgage-backed securities -				
U.S. government-sponsored enterprises	41,946	—	41,946	—
Corporate debt	2,000	—	2,000	—
Derivative instruments				
Interest rate swaps	(1,359)	—	(1,359)	—
December 31, 2015				
U.S. government agencies	\$ 12,788	\$ —	\$ 12,788	\$ —
State and political subdivisions	38,149	—	38,149	—
Mortgage-backed securities -				
U.S. government-sponsored enterprises	42,839	—	42,839	—

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

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2016 and December 31, 2015 are as follows:

(Dollars in thousands)	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level I)	Significant Other Observable Inputs (Level II)	Significant Unobservable Inputs (Level III)
September 30, 2016				
Impaired loans	\$ 602	\$ —	—\$	—\$ 602
Foreclosed real estate	1,703	—	—	1,703
December 31, 2015				
Impaired loans	\$801	\$—	\$801	
Foreclosed real estate	756	—	756	

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

(Dollars in thousands)	Qualitative Information about Level III Fair Value Measurements			
	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
September 30, 2016				
Impaired loans	\$ 602	Appraisal of collateral	Appraisal adjustments (1)	0% to -27.3% (-3.5%)
Foreclosed real estate	1,703	Appraisal of collateral	Selling expenses (1)	-7.0%(-7.0%)
December 31, 2015				
Impaired loans	\$801	Appraisal of collateral	Appraisal adjustments (1)	0% to -61.8% (-5.8%)
Foreclosed real estate	756	Appraisal of collateral	Selling expenses (1)	-7.0% (-7.0%)

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

The following information should not be interpreted as an estimate of the fair value of the entire company since a fair value calculation is only provided for a limited portion of our assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between our disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair value of our financial instruments at September 30, 2016 and December 31, 2015:

Cash and Cash Equivalents (Carried at Cost): The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair value.

Deposits (Carried at Cost): Fair value for fixed-rate time certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits. We generally purchase amounts below the insured limit, limiting the amount of credit risk on these time deposits.

Securities: The fair value of securities, available for sale (carried at fair value) and securities held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level I), or matrix pricing (Level II), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level III). In the absence of such evidence, management's best estimate is used.

Federal Home Loan Bank Stock (Carried at Cost): The carrying amount of restricted investment in bank stock approximates fair value and considers the limited marketability of such securities.

Loans Receivable (Carried at Cost): The fair values of non-impaired loans are estimated using discounted cash flow analyses, using the market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

Impaired Loans (Carried at Lower of Cost or Fair Value): Fair value of impaired loans is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included in Level III fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value of impaired loans totaled \$602 thousand and \$801 thousand at September 30, 2016 and December 31, 2015, respectively. These balances consist of loans that were written down or required additional reserves during the periods ended September 30, 2016 and December 31, 2015, respectively.

Deposit Liabilities (Carried at Cost): The fair values disclosed for demand, savings and money market accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

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

Derivatives (Carried at Fair Value): The Company also uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges, and which satisfy hedge accounting requirements, involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without the exchange of the underlying notional amount. These derivatives were used to hedge the variable cash outflows associated with FHLB borrowings along with our junior subordinated debenture at U.S. Capital Trust. The effective portion of changes in the fair value of these derivatives are recorded in accumulated other comprehensive income, and are subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of these derivatives are recognized directly in earnings.

The fair value of the Company's derivatives are determined using discounted cash flow analysis using observable market-based inputs, which are considered Level 2 inputs.

Junior Subordinated Debentures (Carried at Cost): Fair values of junior subordinated debt are estimated using discounted cash flow analysis, based on market rates currently offered on such debt with similar credit risk characteristics, terms and remaining maturity.

Accrued Interest Receivable and Accrued Interest Payable (Carried at Cost): The carrying amounts of accrued interest receivable and payable approximate its fair value.

Off-Balance Sheet Instruments (Disclosed at Cost): Fair values for our off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

The fair values of our financial instruments at September 30, 2016 and December 31, 2015, were as follows:

25

(Dollars in thousands)	September 30, 2016		Quoted	Significant Other Observable Inputs (Level II)	Significant Unobservable Inputs (Level III)
	Carrying Amount	Fair Value	Prices in Active Markets for Identical Assets (Level I)		
Financial assets:					
Cash and cash equivalents	\$ 12,410	\$ 12,410	\$ 12,410	\$ —	\$ —
Time deposits with other banks	100	100	—	100	—
Securities available for sale	91,630	91,630	—	91,630	—
Securities held to maturity	6,628	6,863	—	6,863	—
Federal Home Loan Bank stock	5,633	5,633	—	5,633	—
Loans receivable, net of allowance	656,927	655,302	—	—	655,302
Accrued interest receivable	1,797	1,797	—	1,797	—
Financial liabilities:					
Non-maturity deposits	446,559	446,559	—	446,559	—
Time deposits	178,362	178,558	—	178,558	—
Short-term borrowings	36,500	36,500	36,500	—	—
Long-term borrowings	71,000	72,063	—	72,063	—
Junior subordinated debentures	12,887	11,580	—	11,580	—
Accrued interest payable	330	330	—	330	—
Derivative instruments:					
Interest rate swaps	(1,359)	(1,359)	—	(1,359)	—

(Dollars in thousands)	December 31, 2015		Quoted Prices in Active Markets for Identical Assets (Level I)	Significant Other Observable Inputs (Level II)	Significant Unobservable Inputs (Level III)
	Carrying Amount	Fair Value			
Financial assets:					
Cash and cash equivalents	\$6,120	\$ 6,120	\$ 6,120	\$	—\$
Time deposits with other banks	100	100	—	100	—
Securities available for sale	93,776	93,776	—	93,776	—
Securities held to maturity	6,834	7,008	—	7,008	—
Federal Home Loan Bank stock	5,165	5,165	—	5,165	—
Loans receivable, net of allowance	537,833	528,065	—	—	528,065
Accrued interest receivable	1,764	1,764	—	1,764	—
Financial liabilities:					
Non-maturity deposits	380,983	380,983	—	380,983	—
Time deposits	136,873	136,619	—	136,619	—
Short-term borrowings	34,650	34,650	34,650	—	—
Long-term borrowings	61,000	58,685	—	58,685	—
Junior subordinated debentures	12,887	9,344	—	9,344	—
Accrued interest payable	281	281	—	281	—

NOTE 11 – DERIVATIVES

The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges are recorded in accumulated other comprehensive income and are subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During the three and nine months ended September 30, 2016 such derivatives were used to hedge the variable cash outflows associated with four FHLB borrowings totaling \$26.0 million. The Company entered into an interest rate swap agreement to hedge its \$12.5 million variable rate (3 Mo Libor +1.44%) junior subordinated debt issued by Sussex Capital Trust II, a non-consolidated wholly-owned subsidiary of the Company, for 10 years at a fixed rate of 3.10%. The ineffective portion of the change in fair value of the derivatives are recognized directly in earnings. The Company implemented this program during the quarter ended March 31, 2016.

During the three and nine months ended September 30, 2016 the Company did not record any hedge ineffectiveness.

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Consolidated Statements of Financial Condition at September 30, 2016:

	September 30, 2016			
	Notional/ Contract Amount	Fair Value	Balance Sheet Location	Expiration Date
(Dollars in thousands)				
Derivatives designated as hedging instruments				
Interest rate swaps by effective date:				
March 15, 2016	\$12,500	\$(278)	Other Liabilities	2026-03-15
December 15, 2016	5,000	(223)	Other Liabilities	2026-12-15
June 15, 2017	6,000	(280)	Other Liabilities	2027-06-15
December 15, 2017	10,000	(373)	Other Liabilities	2027-12-15
December 15, 2017	5,000	(205)	Other Liabilities	2027-12-15

Total