SENSOR SYSTEM SOLUTIONS INC
Form 10KSB/A
May 20, 2005

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

FORM 10-KSB/A

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended **- December 31, 2004**

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from

Commission file number **0-024828**

SENSOR SYSTEM SOLUTIONS, INC.
(Name of Small Business Issuer in Its Charter)

NEVADA	**98-0226032**
(State or Other jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

45 Parker Avenue, Suite A
Irvine, California 92618
(Address of Principal Executive Offices, including zip code.)

(949) 855-6688
(Issuer's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
None	**None**

Securities registered pursuant to Section 12(g) of the Act:

Title of each class	**Common Stock**

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by referenced in Part III of this Form 10-KSB or any amendment to this Form 10-KSB o

State issuer's revenues for its most fiscal year **December 31, 2004: $661,340.**

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was sold, or the average bid and asked price of such common equity. **As of May 5, 2005, the value was $39.3 million.**

State the number of shares outstanding of each of the issuer's classes of common equity, as of **May 18, 2005: 59,279,241**

PART I

ITEM 1. DESCRIPTION OF BUSINESS

Sensor System Solutions, Inc. (the "Company", "3S" or the "Company") was incorporated in Nevada in April 1982 under the name The Enchanted Village, Inc. As the result of the March 13, 2004 acquisition of Advanced Custom Sensors, Inc., a California corporation ("ACSI"), the Company is now in the business of design and manufacturing sensors and signal conditioning modules.

Acquisition of Advanced Custom Sensors

Pursuant to an Agreement and Plan of Merger (the "Merger Agreement") dated as of March 13, 2004, by and among the Company, Spectre Merger Sub, Inc., a California corporation and wholly owned subsidiary of the Company ("Merger Sub"), Ian S. Grant ("Shareholder") and ACSI, on May 24, 2004 (the "Closing Date"), Merger Sub merged with and into Advanced Custom Sensors, Inc. ("ACSI") (the "Merger"). As a result of the Merger, ACSI became a subsidiary of the Company. As consideration for the Merger, the Company issued 2,584,906 shares of common stock and warrants to purchase up to 47,802,373 shares of common stock to the shareholders of ACSI. The terms of the Merger were determined through arms-length negotiations between the management of the Company and management of ACSI. We changed our company name to Sensor System Solutions, Inc. (3S) in December 2004 to better represent our new focus. As such, the following results of operations are those of ACSI.

Until we acquired ACSI, we had only nominal assets and liabilities and limited business operations. Although ACSI became our wholly-owned subsidiary following the acquisition, because the acquisition resulted in a change of control, the acquisition was recorded as a "reverse merger" whereby ACSI is considered to be the accounting acquirer. Also, as a result of the acquisition, we have had a change of our financial position and our business. 3S is now a holding company and after the Spin-Off, defined below, will have no significant operations or assets other than its interest in Advanced Custom Sensors, Inc. ("ACSI"). Since the acquisition of ACSI, the company has been engaged in the development, manufacturing, marketing and distribution of high quality sensors and transducers at an economical price by employing innovative designs and creative manufacturing methods.

Spin-Off of Spectre Holdings

On December 15, 2004, in consideration for making and guaranteeing certain representations, warranties and obligation in connection with the Agreement and Plan of Merger dated March 13, 2004 by and between the Company and ACSI, the Company transferred 20,878,081 shares of common stock (the "Shares"), which are all of the issued and outstanding shares of Spectre Holdings, Inc., our wholly-owned subsidiary to Ian Grant. After the distribution of the Shares, the Company no longer owns any stock of Spectre Holdings, Inc. In addition, we will not have any common board members after the distribution.

Advanced Custom Sensors

ACSI was founded by an engineering management team with over 50 years of Micro-electro-mechanical-systems or "MEMS" transducer experience. Its objective is to provide high quality sensors and transducers at an economical price by employing innovative designs and creative manufacturing methods. Through ACSI, 3S offers a variety of Digital Pressure Gauges, Pressure Transducers, Pressure Sensors, Force Beams, Load Cells, Strain Gauges and Sensor Kits.

3S produces or supplies a family of nearly thirty (30) distinctive products. 3S has a volume production line with an ISO 9000 certified partner in Taiwan in 2002. This allows 3S to penetrate high-volume consumer markets that are very price sensitive. 3S also signed a letter of intent with China Automotive Systems, Inc. (CAAS) in 2004 to establish a joint venture in China targeting its automotive sensor market.

3S is a supplier of thin-film and micro-machined force and pressure sensors to the medical, chemical, oil, and gas industries. 3S believes that its technology will enable it to become a global supplier of advanced MEMS/Microelectronic products in myriad developing markets. 3S's strategic plan is to focus on developing custom MEMS pressure sensor devices and forming strategic partnerships where its strategic partners dominate the sales channels in industries accepting MEMS sensor applications.

In addition to its core operational assets dedicated to the MEMS sensor markets, 3S owns approximately 7.5% of TransOptiX, Inc., ("TransOptiX"), a business dedicated to the development and production of high performance optical switches. TransOptiX intends to make significant progress in 2005 and 2006 in the optical switch segment by offering its switches at prices up to 40% below its competition and with better performance.

We plan to grow our business in four areas.

§ **Increase the revenue of our existing sensor component business**. Once finalized, the majority of our sensor component manufacturing will be moved to our joint venture in China to help reduce the cost of our products. We will invest to increase our production capacity and will qualify offshore suppliers to meet the increasing demands. Substantial efforts will be invested in sales and marketing in order to expand our customer base and to secure additional OEM projects.

§ **Develop sensor solution business.** By leveraging the advances in technology and the large industry-wide investments in wireless and telecommunication in the last decade, we can now offer total sensor solutions at a very affordable price These sensor solutions are modules containing sensing elements, signal conditioning circuitry, software for calibration and interface, and capability of wireless communication and/or networking. These sensor solutions will provide information continuously to decision makers in all phases of business operation.

§ **Penetrate the automotive sensor market in China.** By leveraging the marketing channel of our joint venture partner, we will have access to the automotive market in China immediately. We plan to use the next three years to build up our production capacity, product offerings, and technical team there. We will import automotive sensors produced by our joint venture to North America and Europe around 2008.

§ **Strategic acquisition**: Being a public company gives us an additional tool to grow our business through acquisition besides internal growth. We will actively seek equity or debt funding to bring in the necessary resources to execute this plan.

Industry Overview

Micro-Electro-Mechanical Systems, or MEMS, is the integration of mechanical elements, sensors, actuators, and electronics on a common silicon substrate through the utilization of microfabrication technology. MEMS is an enabling technology, allowing the development of smart products by augmenting the computational ability of microelectronics with the perception and control capabilities of microsensors and microactuators. MEMS is also an extremely diverse and fertile technology, both with regard to applications, and the methodology of how electronic devices are designed and manufactured.

Microelectronic integrated circuits (“IC’s”) can be thought of as the "brains" of systems and MEMS augments this decision-making capability with "eyes" and "arms", to allow microsystems to sense and control the environment. In its most basic form, the sensors gather information from the environment through measuring mechanical, thermal, biological, chemical, optical, and magnetic phenomena; the electronics process the information derived from the sensors and through some decision making capability direct the actuators to respond by moving, positioning, regulating, pumping, and filtering, thereby, controlling the environment for some desired outcome or purpose. Since MEMS devices are manufactured using batch fabrication techniques, similar to ICs, unprecedented levels of functionality, reliability, and sophistication can be placed on a small silicon chip at a relatively low cost.

Market Size and Viability

The total MEMS market size is about $2.7 billion USD with following distribution in 1991, according to an MIRC market study report. MEMS pressure sensor, currently the focus of 3S’s operations, owns the largest market share of $6 billion USD in 2000. According to MIRC, MEMS Silicon Pressure Sensors will grow to about 80% of the total market and become the main stream of this industry. The applications of MEMS Pressure Sensors can be separated into five categories: Automotive, Process Control, Medical, Consumer /Appliances and Aerospace. Currently, the market in Consumer Electronics is enjoying the fast growth. Due to its versatility, MEMS is taking the lead in the various fast-growing electronic applications in addition to its excellent performance and price ratio. The total MEMS sensor market was $800 millions USD in 1990 with an annual growth rate of 20%. It is expected to grow to $1 billion USD by 2005.

Products

The Company’s future technology strategy is to develop and/or acquire core intellectual property that will place it in a leadership position to manufacture and market MEMS sensors. 3S has filed two (2) provisional patents with the United States Patent and Trademark Office (“USPTO”) and TransOptiX has made nine (9) provisional patent filings with the USPTO to date. In addition, each company has developed many proprietary techniques/processes. These serve as the foundation to further develop our MEMS business.

3S produces or supplies a family of nearly thirty (30) distinctive products. These products employ or utilize the latest state-of-the-art technologies. The products are primarily electro-mechanical sensing devices and are identified under the following categories: Pressure Transducers, Pressure Transmitters, Pressure Switches, Force Sensors, Load Cells, Strain Gages, and MEMS Sensors. It is expanding its product offering to include intelligent embedded systems that combine the attributes of both intelligent sensor and host systems

3S uses sputtered thin film, bonded foil, semi-conductor gages and piezoresistive strain gage technologies primarily in the design, development and manufacture of its general sensor products, although other technology options are also available. All of 3S’s products employ proven technologies with little, or no risk involved with their manufacture. What sets 3S’s products apart from their competitors is their ability to optimize the performance of their products by efficient application of their diverse technologies into unique design concepts and utilizing sophisticated materials in construction and packaging techniques.

Customers

We supply our sensors mainly to the medical and automation industries. In general customers are divided into three groups: original equipment manufacturers ("OEM's"), end users and catalogs. Each one accounted for about one third of our revenue in 2004.

Our revenue mainly was from end users before the hiring of our sales manager in March 2004. We moved our focus to OEM account since then. The success is obvious since we started 2005 with an OEM backlog of around $600K.

We have established a wide presence in the catalog houses through our Model 1200 in 2004. This penetration will allow us to increase our revenue by moving other products through the same channel.

Sales and Marketing

We use sales representatives to promote our product since sensors are quite complicated devices. We have a network of 9 sales representatives to cover North America and 6 international representatives. In addition to our sales reps network, we also have a network of distributors to handle products that do not require much technical support. Both networks are managed by our Sales Manager.

We are seeking new distribution channels for our Sensor Modules and we are working to leverage existing market intelligence. We will hire a Marketing Manager in 2005 to assist us in capturing the market opportunity in our Sensor Modules.

Research and Development

We hired two key engineers in October of 2004. Together, they have sixty years of combined experience in designing creative sensor modules. To date, two series of sensor modules have been designed, models have been constructed and beta-site tested. We anticipate beginning production in second quarter of 2005. We project that the unit price of these modules will be at least ten times higher than our current sensor component’s sale price. We expect an increase in our sales from these two product lines.

Our Goals

Our goal is to become the market leader in innovative sensor system solutions, and a dominant sensor supplier with a competitive pricing and performance mix. To accomplish this objective, the Company plans to integrate proprietary techniques and processes developed by 3S that serve as the foundation to develop the Company’s MEMS business. These MEMS core competences include MEMS front-end wafer design and processing, volume assembly and testing, application-specific environmental protection, and cost modeling. Combined with 3S’s expansion plans to increase marketing and sales efforts, these technologies present the Company with opportunities to further grow the business in international markets such as China. The Company has also partnered on or about November 2001 with an established production partner, Powertip Technology Corporate, in Taiwan to address production requirements. 3S also has MEMS wafer fabrication partners in China and Taiwan, allowing the Company to maintain sensor wafer supplies as well as to continue MEMS device research.

3S intends to upgrade from sensor component business to system solution business. It will be focused on providing complete data management solutions that can accommodate the needs of a wide range of industries and businesses. These solutions include a comprehensive set of products and services that establish the infrastructure necessary for manufacturing process partners to proactively participate in sustaining and optimizing the operation.

The Company is striving to be the dominant provider of sensor solutions with built-in network connectivity to supply critical data continuously for enterprises to monitor and control:

Ø Machine conditions
Ø Manufacturing processes
Ø Business Transactions

The Company plans to develop and integrate various core intellectual properties in the areas of MEMS sensors, intelligent sensor interface electronics, intelligent embedded control systems and meters, wireless communication network interfaces, data appliances and mobile devices that facilitate machine-to-business data sharing, software & hardware to support web-based device diagnostics and data collection/data distribution, and web-based data management.

The Company is actively seeking funding to expand its design, development and marketing of MEMS based thin-film and micro-machined force and pressure sensors to the medical, chemical, oil, and gas industries. The Company believes that MEMS is an enabling technology allowing the development of smart products by augmenting the computational ability of microelectronics with the sensing and control capabilities of microsensors and microactuators.

The Company's strategy includes the hiring of world-class engineering and sales and marketing team coupled with robust off-shore joint ventures such as the one they recently signed with CAAS. Management expects that the Company's joint venture with CAAS will enable the transformation of *3S* into a global supplier of advanced MEMS/Microelectronic products in the automotive market.

Strategy

The keys to success for *3S* are as follows:

Ø Penetrate automotive and appliance markets thru the Joint Venture with CAAS in China;
Ø Leverage the cost performance of above alliance to penetrate industrial and medical markets in N. America and Europe;
Ø Complete development of sensor-based systems to increase revenues;
Ø Merger and acquisition;

Competition

Our products and services are affected by varying degrees of competition. We compete with other companies in most markets we serve, many of which have far greater sales volumes and financial resources. The principal competitive factors in the commercial markets in which we participate are product performance, service and price. Part of product performance requires expenditures in research and development that lead to product improvement. The market for many of our products may be affected by rapid and significant technological changes and new product introduction. Our principal competitors include Honeywell, GE and MSI in our sensor component segment, and Delphi, Bosch, and Denso in automotive sensor segment. There is no major competitor in Sensor System Solutions Market at current time.

Employees and employment agreements

The Company currently employs 15 persons: There are no employment agreements with any of the employees.

ITEM 2. DESCRIPTION OF PROPERTY.

Our headquarters are located 45 Parker Avenue, Suite A, Irvine, California 92618. The facilities include 25,000 square feet of office, production and warehouse, which we lease from Irvine Company under a five year lease. Annual rental payments for this lease are listed in the MD&A Section. The office and warehouse facility is shared with TransOptix, a related party, who signed the lease as co-tenant with the Company. The Company and TransOptix have entered into an agreement stipulating each entities share of the rent, however, in event of default by TransOptix, the Company could contingently be liable for the full amount of the rent.

We believe that these facilities have the capacity to meet its manufacturing and assembly needs for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS.

We are not a party to any pending litigation and none is contemplated or threatened.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

There were no matters submitted to the stockholders in the fourth quarter of 2004.

PART II

ITEM 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDERS MATTERS AND SMALL BUSINESS ISSUERS PURCHASES OF EQUITY SECURITIES.

Our shares are quoted on the Over-The-Counter Bulletin Board. Our symbol is “SSYO.” The table shows the high and low bid price of our stock for 2003 and 2004. These prices represent prices between dealers; they do not include retail markup, markdown or commission. These are bid prices only and do not represent actual transactions and are adjusted for dividends and splits.

Quarter ended		**High**		**Low**
2003				
March 31	$	2.25	$	1.35
June 30	$	1.50	$	1.05
September 30	$	1.05	$	0.30

December 31	$	0.90	$	0.60
2004				
March 31	$	3.15	$	0.45
June 30	$	2.40	$	1.20
September 30	$	2.40	$	1.20
December 31	$	2.75	$	0.51

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Stockholders

At May 5, 2005, we had approximately 150 registered stockholders of record of our common stock. This number does not include shares held by brokerage clearing houses, depositories or otherwise in unregistered form.

Dividends

We have not declared any cash dividends, nor do we intend to do so. We are not subject to any legal restrictions respecting the payment of dividends, except that they may not be paid to render us insolvent.

Securities Authorized for Issuance under Equity Compensation Plans

The following table summarizes the securities authorized for issuance as of December 31, 2004 under our 2004 Stock Compensation Plan, the number of shares of our common stock issuable upon the exercise of outstanding options, the weighted average exercise price of such options and the number of additional shares of our common stock still authorized for issuance under such plan. The 2004 Stock Compensation Plan has not been approved by our security holders, a description of which is set forth in Note 13 of the Notes to Consolidated Financial Statements.

Plan category	**Number of securities to be issued upon exercise of outstanding options, warrants and rights**	**Weighted-average exercise price of outstanding options, warrants and rights**	**Number of securities remaining available or future issuance under equity compensation plans**
Equity compensation plans approved by security holders	—	$ —	—
Equity compensation plans not approved by security holders	96,500	.50	103,500
Total	96,500		103,500

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Recent Sales of Unregistered Securities

None.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.

The following is management's discussion and analysis of certain significant factors that have affected our financial position and operating results during the periods included in the accompanying consolidated financial statements, as well as information relating to the plans of our current management. This report includes forward-looking statements. Generally, the words "believes," "anticipates," "may," "will," "should," "expect," "intend," "estimate," "continue," and similar expressions or the negative thereof or comparable terminology are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties, including the matters set forth in this report or other reports or documents we file with the Securities and Exchange Commission from time to time, which could cause actual results or outcomes to differ materially from those projected. Undue reliance should not be place on these forward-looking statements that speak only as of the date hereof. We undertake no obligation to update these forward-looking statements.

The following discussion and analysis should be read in conjunction with and our consolidated financial statements and the related notes thereto and other financial information contained elsewhere in this Form 10-KSB.

OVERVIEW

On May 24, 2004, we acquired all of the issued and outstanding equity interests of Advanced Custom Sensors, Inc ("ACSI"). Until we acquired ACSI, we had only nominal assets and liabilities and limited business operations. Although ACSI became our wholly-owned subsidiary following the acquisition, because the acquisition resulted in a change of control, the acquisition was recorded as a "reverse merger" whereby ACSI is considered to be the accounting acquirer. We changed our company name to Sensor System Solutions, Inc. (3S) in December 2004 to better represent our new focus. As such, the following results of operations are those of ACSI.

3S was founded by an engineering management team with over 50 years of Micro-electro-mechanical-systems or "MEMS" transducer experience. Its objective is to provide high quality sensors and transducers at an economical price by employing innovative designs and creative manufacturing methods. 3S offers a variety of Digital Pressure Gauges, Pressure Transducers, Pressure Sensors, Force Beams, Load Cells, Strain Gauges and Sensor Kits.

3S commenced operations as a private company in September of 1996. 3S is headquartered in Irvine, California where 3S occupies a 25,000 square foot facility fully equipped with fabrication capability.

3S has fifteen (15) employees in the United States, and utilizes a network of independent contractors and consultants throughout the United States and Asia. 3S produces or supplies a family of nearly thirty (30) distinctive products. 3S set up a volume production line with an ISO 9000 partner in Taiwan in 2002. This allows 3S to penetrate high-volume consumer markets that are very price sensitive. 3S also signed a letter of intent with China Automotive Systems, Inc. (NASDAQ: CAAS) in 2004 to establish a joint venture in China targeting its automotive sensor market.

3S is a supplier of thin-film and micro-machined force and pressure sensors to the medical, chemical, oil, and gas industries. 3S believes that its technology will enable it to become a global supplier of advanced MEMS/Microelectronic products in myriad developing markets. 3S's strategic plan is to focus on developing custom MEMS pressure sensor devices and forming strategic partnerships where its strategic partners dominate the sales channels in industries accepting MEMS sensor applications.

In addition to its core operational assets dedicated to the MEMS sensor markets, 3S owns approximately 7.5% of TransOptiX, Inc., ("TransOptiX"), a business dedicated to the development and production of high performance optical switches. TransOptiX intends to make significant progress in 2005 and 2006 in the optical switch segment by offering its switches at prices up to 40% below its competition and with better performance.

PLAN OF OPERATION

We plan to grow our business in four areas.

§ **Increase the revenue of existing sensor component business**. Majority of our sensor component manufacturing will be moved to our joint venture in China to help reduce the cost of our products. We will invest to increase our production capacity and will qualify offshore suppliers to meet the increasing demands. Substantial efforts will be invested in sales and marketing in order to expand our customer base and to secure more OEM projects.

§ **Develop sensor solution business.** With the rapid advance in technology and huge investment in wireless and telecommunication in the last decades, we can now offer total sensor solutions at a very affordable price. These sensor solutions are modules containing sensing elements, signal conditioning circuitry, software for calibration and interface, and capability of wireless and/or networking. These sensor solutions will provide information continuously to decision makers in all phases of business operation.

§ **Penetrate automotive sensor market through China.** By leverage the marketing channel of our joint venture partner, we will have access to the automotive market in China immediately. We plan use the next three years to build up our production capacity, product offerings, and technical team there. We will import automotive sensors produced by our joint venture to North America and Europe around 2008.

§ **Strategic acquisition**: Being a public company gives us an additional tool to grow our business through acquisition besides internal growth. We will actively seek equity or debt funding to bring in the necessary resources to execute this plan.

RESULTS OF OPERATIONS

Years ended December 31, 2004 and 2003

Revenues

We generated revenues of $661,340 for the year ended December 31, 2004. which was a $225,269 or a 51.7% increase from $436,071 for the year ended December 31, 2003. The increase is the result of the hiring of a full-time sales manager, the addition of new sales representatives and the introduction of new products.

Gross Profit

Gross profit for the twelve months ended December 31, 2004, was $81,550 or 12.3% of revenues, compared to $34,374 or 7.9% for the year ended December 31, 2003. The $47,176 increase in gross profit was generated by a decrease in cost of sales percentage, which was the result of increased productivity and management's efforts to reduce operating expense, and production tooling improvement.

Total Operating expenses

Operating expense

Operating expense increased to $1,292,071 for the year ended December 31, 2004 compared to $874,506 for the year ended December 31, 2003. The expense increased $417,565, or 47.7%, from 2003, primarily as a result of an increase in interest expense and additional investment in R&D personnel and development.

Amortization of discount on notes payable

Amortization of discount on notes payable increased to $651,869 for the year ended December 31, 2004 compared to $121,223 for the year ended December 31, 2003. The expense increased $530,646, or 437.7%, primarily due to the convertible loans from Sino-America and Tina Young.

Non-cash compensation costs

On May 24, 2004, the Company issued 2,584,905 shares of its common stock and warrants (the Merger Warrants) to purchase up to 47,802,373 shares of its common stock, to the shareholders of ACSI in exchange for all the issued and outstanding shares of ACSI. On May 24, 2004, the OTCBB closing price for the Company's common stock was $3.15 per share, resulting in a valuation of $12,527,134 (the Merger Valuation) for the 3,976,868 shares of common stock outstanding immediately following the Merger. On December 4, 2004, the Company granted 7,500,000 shares of its common stock to five shareholders in Spectre, including two individuals who are also Directors of the Company, for providing services to the Company. The fair value of the shares granted was determined to be $ 0.24 per share for a total of $1,800,000 and is recognized as stock-based compensation expense in the accompanying financial statements. The fair value was based on the Merger Valuation and adjusted as if the 3,976,868 shares of common stock and the 47,802,373 shares of common stock issued upon exercise of the Merger Warrants, had all been outstanding at the date of the Merger.

Net Loss

Net loss increased to ($3,662,390) for the year ended December 31, 2004 compared to ($961,355) for the year ended December 31, 2003. The loss increased $2,701,035, or 281%, from 2003, primarily as a result of $1,800,000 of stock compensation expense and $651,869 of notes payable - debt discount costs along with increase in investment in R&D and production capacity, and additional cost for being a public company.

FINANCIAL CONDITION, LIQUIDITY, CAPITAL RESOURCES

Going Concern

In their report in connection with our 2004 financial statements, our auditors included an explanatory paragraph stating that, because we have incurred a net loss of $3,662,390 and a negative cash flow from operations of $594,293 for the year ended December 31, 2004, and had a working capital deficiency of $1,353,308 and a stockholders' deficiency of $1,023,191 at December 31, 2004 there is substantial doubt about our ability to continue as a going concern.

We have relied primarily on cash flow from operations, bank loans, and advances and investments from our shareholders for our capital requirements since inception. The company received a $200K convertible loan from one of its existing shareholders on February 23, 2005. This allowed the company to pay off some of the debt and continue its operation. Current cash on hand will allow the company to continue its operation for one month.

At December 31, 2004, cash was $17,115 as compared to $10,712 at December 31, 2003. The increase is due to the net cash from promissory notes. We have a substantial working capital deficit. We require $3M to continue operations for the next three years. We are in the process of raising capital in the form of equity and/or debt. However, there is no guarantee that we will raise sufficient funds to execute our business plan. To the extent we are unable to raise sufficient funds, our business plan will be required to be substantially modified, its operations curtailed or protection under bankruptcy/reorganization laws sought.

We are addressing our liquidity requirements by the following actions: Continue our programs for selling products; continue to seek investment capital through the public markets. However, there is no guarantee that these strategies will enable us to meet our obligations for the foreseeable future.

Commitments and Contingencies

We have the following material contractual obligations and capital expenditure commitments:

On February 11, 2004, ACSI signed a promissory note payable with Sino-America. The promissory note is for $500,000 and due February 11, 2005. After maturity, the lender agreed to convert the loan into shares of the Company's stock. On March 15, 2005, an agreement was made to convert the note payable and warrant into 500,000 shares of common stock.

The Company leases certain equipment under two capital leases with monthly payments of $360 and $701, respectively, including interest at 12.75% per annum.

Future minimum annual rental payments for capitalized leases are as follows:

Years ending December 31,		Amount
2005	$	12,732
2006		12,732
2007		12,732
2008		12,732
2009		3,543
		54,471
Amount representing interest		(12,453)
Present value of minimum lease payments		42,018
Less: Current portion		(7,819)

	$	34,199

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The Company leases its office and facility through 2007 under a long term operating lease agreement. Under terms of the lease, the Company pays the cost of repairs and maintenance. The office and warehouse facility is shared with TransOptix, who signed the lease as co-tenant with the Company. The Company and TransOptix have entered into an agreement stipulating each entities share of the rent, however, in event of default by TransOptix, the Company could contingently be liable for the full amount of the rent.

Future minimum lease commitments for the Company's share under this lease at December 31, 2004 are as follows:

Year Ended December 31,		
2005	$	104,131
2006		104,906
2007		91,520
	$	300,557

The total lease commitment as of December 31, 2004 for which the Company could be contingently liable in the event of default of TransOptix is approximately $650,000. Rent expense for the years ended December 31, 2004 and 2003 was $122,905 and $116,588 respectively.

Inflation and Changing Prices

We doe not foresee any adverse effects on our earnings as a result of inflation or changing prices.

CRITICAL ACCOUNTING POLICIES

Revenue Recognition

The Company recognizes revenue when risk of loss and title to the product is transferred to the customer, which occurs at shipment

Stock – based compensation

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards (SFAS) No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosures" as well as those outlined in SFAS No. 123, "Accounting for Stock-Based Compensation". As permitted by SFAS 148 and SFAS 123, the Company continues to apply the provisions of Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock issued to Employees" and related interpretations in accounting for the Company's stock option plan. Accordingly, compensation cost for stock options is measured as the excess, if any, of the estimated fair value of the Company's stock at the date of the grant, over the amount an employee must pay to acquire the stock. Stock based awards for non-employees are accounted for at fair value equal to the excess of the estimated fair value of the Company's stock over the option price using an estimated interest rate to calculate the fair value of the option. There were no stock based awards to non-employees in 2004 or 2003.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market.

Recent Accounting Pronouncements

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, “Inventory Costs”. This Statement amends the guidance in ARB No. 43 Chapter 4 Inventory Pricing, to require items such as idle facility costs, excessive spoilage, double freight and rehandling costs to be expensed in the current period, regardless if they are abnormal amounts or not. This Statement will become effective for us in the first quarter of 2006. The adoption of SFAS No. 151 is not expected to have a material impact on our financial condition, results of operations, or cash flows.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), “Share-Based Payment” (SFAS 123R), which revises SFAS No. 123. SFAS 123R also supersedes APB No. 25 and amends SFAS No. 95, “Statement of Cash Flows”. In general, the accounting required by SFAS 123R is similar to that of SFAS No. 123. However, SFAS No. 123 gave companies a choice to either recognize the fair value of stock options in their income statements or disclose the pro forma income statement effect of the fair value of stock options in the notes to the financial statements. SFAS 123R eliminates that choice and requires the fair value of all share-based payments to employees, including the fair value of grants of employee stock options, be recognized in the income statement, generally over the option vesting period. SFAS 123R must be adopted no later than July 1, 2005. Early adoption is permitted.

The Company is currently evaluating the timing and manner in which it will adopt SFAS 123R. As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using APB 25’s intrinsic value method. Accordingly, adoption of SFAS 123R’s fair value method will have an effect on results of operations, although it will have no impact on overall financial position. The impact of adoption of SFAS 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had SFAS 123R been adopted in prior periods, the effect would have approximated the SFAS 123 pro forma net loss and loss per share disclosures as shown above. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as currently required, thereby reducing net operating cash flows and increasing net financing cash flows in periods after adoption

RISKS RELATED TO OUR BUSINESS

We have had negative cash flows from operations. Our business operations may fail if our actual cash requirements exceed our estimates, and we are not able to obtain further financing.

Our company has had negative cash flows from operations. To date, we have incurred significant expenses in product development and administration in order to ready our products for market. Our business plan calls for additional significant expenses necessary to bring our products to market. We believe we do not have sufficient funds to satisfy our short-term cash requirements. There is no assurance that actual cash requirements will not exceed our estimates, in which case we will require additional financing to bring our products into commercial operation, finance working capital and pay for operating expenses and capital requirements until we achieve a positive cash flow. In particular, additional capital may be required in the event that:

· we incur unexpected costs in completing the development of our technology or encounter any unexpected technical or other difficulties;

· we incur delays and additional expenses as a result of technology failure;

· we are unable to create a substantial market for our product and services; or

· we incur any significant unanticipated expenses.

We may not be able to obtain additional equity or debt financing on acceptable terms if and when we need it. Even if financing is available it may not be available on terms that are favorable to us or in sufficient amounts to satisfy our requirements. If we require, but are unable to obtain, additional financing in the future, we may be unable to implement our business plan and our growth strategies, respond to changing business or economic conditions, withstand adverse operating results, and compete effectively. More importantly, if we are unable to raise further financing when required, our continued operations may have to be scaled down or even ceased and our ability to generate revenues would be negatively affected.

A decline in the price of our common stock could affect our ability to raise further working capital and adversely impact our operations.

A prolonged decline in the price of our common stock could result in a reduction in the liquidity of our common stock and a reduction in our ability to raise capital. Because our operations have been primarily financed through the sale of equity securities, a decline in the price of our common stock could be especially detrimental to our liquidity and our continued operations. Any reduction in our ability to raise equity capital in the future would force us to reallocate funds from other planned uses and would have a significant negative effect on our business plans and operations, including our ability to develop new products and continue our current operations. If the stock price declines, there can be no assurance that we can raise additional capital or generate funds from operations sufficient to meet our obligations.

If we issue additional shares in the future this may result in dilution to our existing stockholders.

Our Amended Certificate of Incorporation authorizes the issuance of 200,000,000 shares of common stock. Our board of directors has the authority to issue additional shares up to the authorized capital stated in the certificate of incorporation. Our board of directors may choose to issue some or all of such shares to acquire one or more businesses or to provide additional financing in the future. The issuance of any such shares may result in a reduction of the book value or market price of the outstanding shares of our common stock. It will also cause a reduction in the proportionate ownership and voting power of all other stockholders. Further, any such issuance may result in a change of control of our corporation.

We have a history of losses and negative cash flows, which is likely to continue unless our products gain sufficient market acceptance to generate a commercially viable level of sales.

From inception through December 31, 2004, we have incurred aggregate net losses. There is no assurance that we will operate profitably or will generate positive cash flow in the future. In addition, our operating results in the future may be subject to significant fluctuations due to many factors not within our control, such as market acceptance of our products, the unpredictability of when customers will order products, the size of customers' orders, the demand for our products, and the level of competition and general economic conditions.

Although we anticipate that we will be able to increase revenues during the next 12 months, we also expect an increase in development and operating costs. Consequently, we expect to incur operating losses and net cash outflow unless and until our existing products, and/or any new products that we may develop, gain market acceptance sufficient to generate a commercially viable and sustainable level of sales.

Unless we can establish significant sales of our current products, our potential revenues may be significantly reduced.

We expect that a substantial portion, if not all, of our future revenue will be derived from the sale of our sensor products. We expect that these product offerings and their extensions and derivatives will account for a majority, if not all, of our revenue for the foreseeable future. The successful introduction and broad market acceptance of our sensor products - as well as the development, introduction and market acceptance of any future enhancements - are, therefore, critical to our future success and our ability to generate revenues. Unfortunately, there can be no assurance that we will be successful in marketing our current product offerings, or any new product offerings, applications or enhancements. Failure to achieve broad market acceptance of our sensor products, as a result of competition, technological change, or otherwise, would significantly harm our business.

We could lose our competitive advantages if we are not able to protect any proprietary technology and intellectual property rights against infringement, and any related litigation could be time-consuming and costly.

Our success and ability to compete depends to a significant degree on our proprietary technology incorporated in our products. We have taken limited action to protect our proprietary technology and proprietary computer software. If any of our competitors copies or otherwise gains access to our proprietary technology or software or develops similar technologies independently, we would not be able to compete as effectively.

Further, the laws of foreign countries may provide inadequate protection of such intellectual property rights. We may need to bring legal claims to enforce or protect such intellectual property rights. Any litigation, whether successful or unsuccessful, could result in substantial costs and diversions of resources. In addition, notwithstanding any rights we have secured in our intellectual property, other persons may bring claims against us that we have infringed on their intellectual property rights, including claims based upon the content we license from third parties or claims that our intellectual property right interests are not valid. Any claims against us, with or without merit, could be time consuming and costly to defend or litigate, divert our attention and resources, result in the loss of goodwill associated with our service marks or require us to make changes to our website or other of our technologies.

Our products may become obsolete and unmarketable if we are unable to respond adequately to rapidly changing technology and customer demands.

Our industry is characterized by rapid changes in technology and customer demands. As a result, our products may quickly become obsolete and unmarketable. Our future success will depend on our ability to adapt to technological advances, anticipate customer demands, develop new products and enhance our current products on a timely and cost-effective basis. Further, our products must remain competitive with those of other companies with substantially greater resources. We may experience technical or other difficulties that could delay or prevent the development, introduction or marketing of new products or enhanced versions of existing products. Also, we may not be able to adapt new or enhanced products to emerging industry standards, and our new products may not be favorably received.

If we fail to effectively manage our growth our future business results could be harmed and our managerial and operational resources may be strained.

As we proceed with the commercialization of our products, we expect to experience significant and rapid growth in the scope and complexity of our business. We will need to add staff to market our products, manage operations, handle sales and marketing efforts and perform finance and accounting functions. We will be required to hire a broad range of additional personnel in order to successfully advance our operations. This growth is likely to place a strain on our management and operational resources. The failure to develop and implement effective systems, or to hire and retain sufficient personnel for the performance of all of the functions necessary to effectively service and manage our potential business, or the failure to manage growth effectively, could have a materially adverse effect on our business and financial condition.

OFF BALACE SHEET ARRANGEMENTS

There are no Off-Balance Sheet Arrangements to report.

ITEM 7. FINANCIAL STATEMENTS.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 8A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive and Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-KSB. Based on this evaluation, our Chief Executive and Financial Officer has concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) are inadequate to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. We are developing a plan to ensure that all information will be recorded, processed, summarized and reported on a timely basis. This plan is dependent, in part, upon reallocation of responsibilities among various personnel, possibly hiring additional personnel and additional funding. It should also be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the fourth fiscal quarter of the fiscal year covered by this Annual Report on Form 10-KSB that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 8B. OTHER INFORMATION.

None.

PART III

ITEM 9. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

The name, age and position held by each of the directors and officers of our company are as follows:

Name	**Position**
Michael Young	Chief Executive Officer and Chairman
Hanlin Chen	Director

All directors have a term of office expiring at the next annual general meeting, unless re-elected or earlier vacated in accordance with the Bylaws. All officers have a term of office lasting until their removal or replacement by the Board of Directors.

Background of Officers and Directors

MICHAEL YOUNG founded and has served for seven years as CEO of 3S. Previously, his 20-year career includes MEMS design, fabrication, packaging and applications development at Rosemount, Endevco, Hughes Aircraft and other firms. He is responsible for leading 3S given his technical expertise and a broad range of business experiences with 3S. He holds a Master of Science degree in Mechanical Engineering from Stanford University.

HANLIN CHEN began serving as the Chairman and CEO of China Automotive Systems, Inc. in 2003. Prior to this appointment, Mr. Chen was the general manager of Jiulong Power Steering Company Limited from 1992 to 1997. Mr. Chen holds a MBA from Barrington University and serves as a board member of Political Consulting Committee of Jingzhou city and vice president of Foreign Investors Association.

Family Relationships

There are no family relationships on the Board of Directors.

Involvement in Certain Legal Proceedings

To our knowledge, during the past five years, our officers and directors: have not filed a petition under the federal bankruptcy laws or any state insolvency law, nor had a receiver, fiscal agent or similar officer appointed by a court for the business or present of such a person, or any partnership in which he was a general partner at or within two years before the time of such filing, or any corporation or business association of which he was an executive officer within two years before the time of such filing; were not convicted in a criminal proceeding or named subject of a pending criminal proceeding (excluding traffic violations and other minor offenses); were not the subject of any order, judgment or decree, not subsequently reversed, suspended or vacated, of any court of competent jurisdiction, permanently or temporarily enjoining him from or otherwise limiting their respective activities.

Compliance with Section 16 (a) of the Exchange Act

Based solely upon a review of Forms 3 and 4 and amendments thereto furnished to us pursuant to Rule 16a-3(e) under the Securities Exchange Act of 1934 during our most recent fiscal year and Forms 5 and amendments thereto furnished to us with respect to our most recent fiscal year, all officers, directors and owners of 10% or more of our outstanding shares have filed all Forms 3, 4 and 5 required by Section 16(a) of the Securities Exchange Act of 1934.

Audit Committee and Charter

Due to the size of our Board of Directors we do not have an audit committee at this time.

Audit Committee Financial Expert

We have no financial expert.

Code of Ethics

We have adopted a corporate code of ethics. We believe our code of ethics is reasonably designed to deter wrongdoing and promote honest and ethical conduct; provide full, fair, accurate, timely and understandable disclosure in public reports; comply with applicable laws; ensure prompt internal reporting of code violations; and provide accountability for adherence to the code.

ITEM 10. EXECUTIVE COMPENSATION.

The following table sets forth information with respect to compensation paid by us to the chief executive officer since the Exchange. No other executive officer received compensation in excess of $100,000 for the fiscal year ended December 31, 2004.

Summary Compensation Table

					Long Term Compensation			
		Annual Compensation			Awards		Payouts	
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Name and Principal Position	Year	Salary ($)	Bonus ($)	Other Annual Compensation ($)	Restricted Stock Award(s) ($)	Securities Underlying Options / SARs (#)	LTIP Payouts ($)	All Other Compensation ($)
Michael Young, CEO	2004	75,000	N/A	-	-	-	-	-
N/A	2003	N/A	N/A	-	-	-	-	-
N/A	2002	N/A	N/A	-	-	-	-	-

There are no stock option, retirement, pension, or profit sharing plans for the benefit of our officers and directors.

Option/SAR Grants

No individual grants of stock options, whether or not in tandem with stock appreciation rights ("SARs") and freestanding SARs have been made to any executive officer or any director since our inception, accordingly, no stock options have been exercised by any of the officers or directors in fiscal 2004.

Long-Term Incentive Plan Awards

We do not have any long-term incentive plans that provide compensation intended to serve as incentive for performance to occur over a period longer than one fiscal year, whether such performance is measured by reference to our financial performance, our stock price, or any other measure.

Compensation of Directors

The directors did not receive any other compensation for serving as members of the board of directors. The Board has not implemented a plan to award options. There are no contractual arrangements with any member of the board of directors.

We do not intend to pay any additional compensation to our directors. As of the date hereof, we have not entered into employment contracts with any of our officers and we do not intend to enter into any employment contracts until such time as it profitable to do so.

Indemnification

Nevada corporation law provides that:

· A corporation may indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative, except an action by or in the right of the corporation, by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses, including attorneys' fees, judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection with the action, suit or proceeding if he acted in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful;

· A corporation may indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses, including amounts paid in settlement and attorneys' fees actually and reasonably incurred by him in connection with the defense or settlement of the action or suit if he acted in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation. Indemnification may not be made for any claim, issue or matter as to which such a person has been adjudged by a court of competent jurisdiction, after exhaustion of all appeals therefrom, to be liable to the corporation or for amounts paid in settlement to the corporation, unless and only to the extent that the court in which the action or suit was brought or other court of competent jurisdiction determines upon application that in view of all the circumstances of the case, the person is fairly and reasonably entitled to indemnity for such expenses as the court deems proper; and

· To the extent that a director, officer, employee or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding, or in defense of any claim, issue or matter therein, the corporation shall indemnify him against expenses, including attorneys' fees, actually and reasonably incurred by him in connection with the defense.

· Our bylaws provide that we will advance all expenses incurred to any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suite or proceeding, whether civil, criminal, administrative or investigative, by reason of the fact that he is or was our director or officer, or is or was serving at our request as a director or executive officer of another company, partnership, joint venture, trust or other enterprise, prior to the final disposition of the proceeding, promptly following request. This advanced of expenses is to be made upon receipt of an undertaking by or on behalf of such person to repay said amounts should it be ultimately determined that the person was not entitled to be indemnified under our bylaws or otherwise.

· Our bylaws also provide that no advance shall be made by us to any officer in any action, suit or proceeding, whether civil, criminal, administrative or investigative, if a determination is reasonably and promptly made: (a) by the board of directors by a majority vote of a quorum consisting of directors who were not parties to the proceeding; or (b) if such quorum is not obtainable, or, even if obtainable, a quorum of disinterested directors so directs, by independent legal counsel in a written opinion, that the facts known to the decision-making party at the time such determination is made demonstrate clearly and convincingly that such person acted in bad faith or in a manner that such person did not believe to be in or not opposed to our best interests.

· Insofar as indemnification for liabilities arising under the Securities Act may be permitted to directors, officers and controlling persons of our company under Nevada law or otherwise, we have been advised the opinion of the Securities and Exchange Commission is that such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event a claim for indemnification against such liabilities (other than payment by us for expenses incurred or paid by a director, officer or controlling person of our company in successful defense of any action, suit, or proceeding) is asserted by a director, officer or controlling person in connection with the securities being registered, we will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction, the question of whether such indemnification by it is against public policy in said Act and will be governed by the final adjudication of such issue.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDERS MATTERS.

The following table sets forth, as of May 5, 2005, the beneficial shareholdings of persons or entities holding five percent or more of our common stock, each director individually, each named executive officer and all of our directors and officers as a group. Each person has sole voting and investment power with respect to the shares of common stock shown, and all ownership is of record and beneficial. Unless otherwise disclosed, the address of each person set forth below is that of the Company.

Name of Beneficial Owner	**Amount and Nature Beneficial Owner**	**Position**	**Percent of Class (1)**
Michael Young	10,620,186	Chief Executive Officer and Chairman	18%
Hanlin Chen	-	Director	*
Officers and Directors as a Group (2 persons)	10,620,186		18%
Principal Shareholders			
Andy Ju (2)	3,374,729		5.8%
Jeffrey Ju (3)	3,374,729		5.8%

*Less than 1%

(1) Based on 59,279,241 shares outstanding at May 5, 2005

(2) Andy Ju’s address is No 54, Jiango Rd., Jhongli City, Taiwan.

(3) Jeffrey Ju’s address is No 54, Jiango Rd., Jhongli City, Taiwan.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Mr. Hanlin Chen, a Director of the Company is the Chief Executive Officer of China Automotive Systems, Inc. The Company has signed a letter of intent to form a Joint Venture with China Automotive Systems, Inc

ITEM 13. EXHIBITS, LIST AND REPORTS ON FORM 8-K.

(a) Reports on Form 8-K

There were no Reports filed on Form 8-K during the fourth quarter of 2004.

(b) Exhibits

Exhibit No.	Document Description
3.1	Articles of Incorporation (1)
3.2	Bylaws (1)
10.1	Share Exchange Agreement and Plan of Reorganization (2)
10.2	License Agreement
23.1	Consent of Weinberg & Company, P.A.
31.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Rule 13a-14 and Rule 15d-14(a), promulgated under the Securities and Exchange Act of 1934, as amended. (3)
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer). (3)

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(1) Incorporated herein by reference from the Company's Form 10-QSB filed with the Securities and Exchange Commission, File No. 000-11991 on May 28, 2003.

(2) Incorporated herein by reference from the Company's Form 8-K Current Report and amendment thereto as filed with the Securities and Exchange Commission, on May 24, 2004.

(3) Filed herewith.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Weinberg & Company, P.A., was the Company's independent registered public accounting firm engaged to examine the financial statements of the Company for the fiscal years ended December 31, 2003 and 2004. Weinberg & Company, P.A. performed the following services and has been paid the following fees.

Fiscal Years Ended December 31, 2004 and 2003

Audit Fees

Weinberg & Company, P.A. was paid aggregate fees of approximately $54,500 for the fiscal year ended December 31, 2004 and 2003 for professional services rendered for the audit of the Company's annual financial statements and for the reviews of the financial statements included in the Company's interim quarterly reports.

Audit-Related Fees

Weinberg & Company, P.A. was not paid additional fees for the fiscal year December 31, 2004 for assurance and related services reasonably related to the performance of the audit or review of the Company's financial statements.

Tax Fees

Weinberg & Company, P.A. was not paid any fees for the fiscal year ended December 31, 2004 for professional services rendered for tax compliance, tax advice and tax planning. This service was not provided.

All Other Fees

Weinberg & Company, P.A. was paid no other fees for professional services during the fiscal year ended December 31, 2004.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on this 18th day of May, 2005.

SENSOR SYSTEM SOLUTIONS, INC.

By: /s/ Michael Young

Michael Young
Chief Executive Officer and Principal Accounting Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following person on behalf of the Company and in the capacities.

Signatures	**Title**	**Date**
/s/ Michael Young Michael Young	Chief Executive Officer and Principal Accounting Officer	May 18, 2005
/s/ Hanlin Chen Hanlin Chen	Director	May 18, 2005

SENSOR SYSTEM SOLUTIONS, INC. AND SUBSIDIARY

FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2004 (CONSOLIDATED) AND 2003

SENSOR SYSTEM SOLUTIONS, INC. AND SUBSIDIARY

CONTENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors of Sensor System Solutions, Inc.:

We have audited the accompanying consolidated balance sheet of Sensor System Solutions, Inc. and subsidiary as of December 31, 2004, and the related statements of operations, changes in stockholders' deficiency, and cash flows for the years ended December 31, 2004 (consolidated) and 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Sensor System Solutions, Inc. and subsidiary as of December 31, 2004, and the results of their operations and their cash flows for the years ended December 31, 2004 (consolidated) and 2003, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated 2004 financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company incurred a net loss of $3,662,390 and a negative cash flow from operations of $594,293 for the year ended December 31, 2004, and had a working capital deficiency of $1,353,308 and a stockholders' deficiency of $1,023,191 at December 31, 2004. These matters raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

WEINBERG & COMPANY, P.A.

Boca Raton, Florida
April 4, 2005

SENSOR SYSTEM SOLUTIONS, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEET
As of December 31, 2004

ASSETS		
CURRENT ASSETS		
Cash	$	17,115
Accounts receivable		100,530
Inventory		220,445
Prepaids and other current assets		24,552
Total current assets		362,642
Property and equipment, net		320,717
Other assets		54,112
Total assets	$	737,471
LIABILITIES AND STOCKHOLDERS' DEFICIENCY		
CURRENT LIABILITIES		
Accounts payable and accrued expenses	$	720,817
Notes payable		692,692
Notes payable, related parties		289,365
Current portion of capital lease obligations		7,819
Current portion of deferred rent concession		5,257
Total current liabilities		1,715,950
LONG-TERM LIABILITIES		
Capital lease obligations, net of current portion		34,199
Deferred rent concession, net of current portion		10,513
		44,712
Commitments and contingencies		-
STOCKHOLDERS' DEFICIENCY		
Preferred stock, $.001 par value, 20,000,000 shares authorized, none outstanding		-
Common stock, $.001 par value, 180,000,000 shares authorized, 3,976,868 issued and outstanding		3,977
Common stock to be issued (7,700,000 shares)		2,100,000
Additional paid-in capital		4,867,790
Deferred compensation		(186,400)
Accumulated deficit		(7,808,558)
Total stockholders' deficiency		(1,023,191)
Total liabilities and stockholders’ deficiency	$	737,471

See accompanying notes to financial statements.

SENSOR SYSTEM SOLUTIONS, INC. AND SUBSIDIARY
STATEMENTS OF OPERATIONS
For the years ended December 31, 2004 (Consolidated) and 2003

		2004 (Consolidated)		2003
Sale, net	$	661,340	$	436,071
Cost of goods sold		579,790		401,697
Gross profit		81,550		34,374
Operating expenses		1,292,072		874,506
Amortization of discount on notes payable		651,868		121,223
Stock-based compensation costs		1,800,000		-
Total operating expenses		3,743,940		995,729
Net loss	$	(3,662,390)	$	(961,355)
Loss per common share, basic and diluted	$	(1.12)	$	(0.39)
Weighted average shares outstanding, basic and diluted		3,280,831		2,486,539

See accompanying notes to financial statements.

SENSOR SYSTEM SOLUTIONS, INC. AND SUBSIDIARY
STATEMENT OF CHANGES IN STOCKHOLDERS' DEFICIENCY
For the years ended December 31, 2004 (Consolidated) and 2003

	Sensor common stock shares	Sensor common stock amount	ACSI common stock shares	ACSI common stock amount	Common stock to be issued	Treasury stock	Additional paid-in capital	Deferred compensation	Accu d
Balance January 1, 2003	-	$ -	2,466,868	$ 3,433,679	$ -	$ (10,000)	$ 198,000	$ (198,000)	$ (3,
Issuance of stock for settlement of amount due to vendor	-	-	82,969	160,000	-	-	-	-	
Issuance of stock for settlement of accounts payable	-	-	35,058	45,834	-	-	-	-	
Intrinsic value of common stock issued with notes payable	-	-	-	-	-	-	315,666	-	
Issuance of stock options	-	-	-	-	-	-	72,270	(72,270)	
Amortization of deferred compensation	-	-	-	-	-	-	-	49,500	
Net loss	-	-	-	-	-	-	-	-	(
Balance December 31, 2003	-	-	2,584,895	3,639,513	-	(10,000)	585,936	(220,770)	(4,
Common stock of Sensor outstanding when Advanced	1,391,962	1,392	-	-	-	-	(1,392)	-	

Custom Sensors, Inc was merged into Sensor, Inc.									
Exchange of Advanced Custom Sensors, Inc. common stock for Sensor, Inc. common stock	2,584,906	2,585	(2,584,895)	(3,639,513)	-	10,000	3,626,928	-	
Stock options issued to employees	-	-	-	-	-	-	19,800	(19,800)	
Common stock warrants issued with notes payable	-	-	-	-	-	-	636,518		
Amortization of deferred compensation	-	-	-	-	-	-	-	54,170	
Stock to be issued (200,000 shares) for settlement of note payable					300,000	-	-	-	
Compensatory stock to be issued (7,500,000 shares)					1,800,000	-	-	-	
Net loss	-	-	-	-	-	-		-	(3,
Balance December 31, 2004	3,976,868	$ 3,977	$ -	$ -	$ 2,100,000	$ -	$ 4,867,790	$ (186,400)	$ (7,

See accompanying notes to financial statements.

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SENSOR SYSTEM SOLUTIONS, INC. AND SUBSIDIARY
STATEMENTS OF CASH FLOWS
For the years ended December 31, 2004 (Consolidated) and 2003

		2004 (Consolidated)		2003
Cash flows from operating activities:				
Net loss	$	(3,662,390)	$	(961,355)
Adjustments to reconcile net loss to net cash used in operating activities:				
Stock-based compensation costs		1,800,000		-
Costs related to settlement of note payable		140,000		-
Depreciation and amortization		109,954		113,927
Amortization of discount cost on notes payable		651,868		121,223
Amortization of deferred compensation		54,170		49,500
Changes in operating assets and liabilities:				
Accounts receivable		(32,992)		(24,059)
Inventories		(20,913)		(31,333)
Prepaids and other current assets		(20,445)		(4,001)
Accounts payable and accrued expenses		370,685		234,399
Deferred rent concession		15,770		-
Net Cash Used In Operating Activities		(594,293)		(501,699)
Cash flows from investing activities:				
Purchase of property and equipment		(3,957)		(1,289)
Cash flows from financing activities:				
Proceeds from notes payable		590,000		407,984
Proceeds from notes payable, related parties		20,000		100,000
Principal payments on capital leases		(5,347)		-
Net Cash Provided By Financing Activities		604,653		507,984
Net increase in cash and cash equivalents		6,403		4,996
Cash and cash equivalents, beginning of the year		10,712		5,716
Cash and cash equivalents, end of the year	$	17,115	$	10,712
Supplemental disclosure of cash flow information				
Cash paid for:				
Interest	$	14,458	$	7,715
Taxes	$	800	$	800
Non-cash investing and financing activities:				
Acquisition of equipment through capital lease obligations	$	47,365	$	-
Issuance of stock options		19,800		72.270
Interest payable added to principal amount of notes payable		12,500		-
Discount related to warrants and convertible notes		636,518		316,666
Issuance of stock for settlement of due to vendor		-		(160,000)
		-		(45,834)

Issuance of stock for settlement of accounts payable

See accompanying notes to financial statements.

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SENSOR SYSTEM SOLUTIONS, INC.
NOTES TO FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2004 (CONSOLIDATED) AND 2003

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of business

The Company is a manufacturer and assembler of sensors and micro systems, and its products include thin film sensors, thin film pressure sensors and micro-machined pressure sensors, and micro systems that may include sensors, signal conditioning circuits, LCD display, computer interface and molded housing specifically designed to the customers needs.

Merger

On May 24, 2004, Sensor System Solutions (formerly known as Spectre Industries, Inc.,) a Nevada corporation, entered into an agreement and plan of merger (the Merger) with Advanced Custom Sensors, Inc. (ACSI). Sensor issued 2,584,906 shares of its common stock and warrants (the Merger Warrants) to purchase up to 47,802,373 shares of its common stock to the shareholders of ACSI in exchange for all the issued and outstanding shares of ACSI. The transaction was accounted for as a recapitalization with ACSI deemed to be the accounting acquirer and Spectre the legal acquirer. All financial information included in these financial statements prior to the Merger is that of ACSI, as if ACSI had been the registrant. The financial information since the Merger is that of ACSI and Sensor consolidated.

All references to “Sensor”, “Spectre” and “ACSI”, mean Spectre or ACSI separately prior to the Merger and Sensor (the Company) after the Merger.

The Company agreed that it would “spin-off” certain assets and liabilities included in Spectre in connection with the Merger on May 24, 2004. These assets and liabilities were transferred to Spectre Holdings, Inc. (Spectre Holdings), a wholly-owned subsidiary of the Company. On December 15, 2004, in consideration for making and guaranteeing certain representations, warranties and obligation in connection with the Agreement and Plan of Merger dated March 13, 2004 by and between the Company and ACSI, the Company transferred 20,878,081 shares of common stock, which are all of the issued and outstanding shares of Spectre Holdings to Ian Grant, a Director of the Company and shareholder in Spectre. As the Company never had direct or indirect control of those assets and liabilities, Spectre Holdings was not considered owned at the date of the Merger.

Going concern

The Company incurred a net loss of $3,662,390 and a negative cash flow from operations of $594,293 for the year ended December 31, 2004, and had a working capital deficiency of $1,353,308 and a stockholders’ deficiency of $1,023,191 at December 31, 2004. These matters raise substantial doubt about its ability to continue as a going concern. Without realization of additional capital, it would be unlikely for the Company to continue as a going concern. Management believes that actions are presently being taken to revise the Company's operating and financial requirements in order to improve the Company's financial position and operating results. However, given the levels of its cash resources and working capital deficiency at December 31, 2004, management believes cash to be generated by operations will not be sufficient to meet anticipated cash requirements for operations, working capital, and capital expenditures during 2005. The Company completed a merger and recapitalization on May 20, 2004, with Spectre Industries, Inc., a public company, to gain access to the United States and European capital markets, but there can be no assurances that the Company will ultimately be successful in this regard. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

SENSOR SYSTEM SOLUTIONS, INC.
NOTES TO FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2004 (CONSOLIDATED) AND 2003

Principles of consolidation

The 2004 consolidated financial statements include the accounts and operations of Sensor System Solutions Inc. and its wholly owned subsidiary. Intercompany accounts and transactions have been eliminated in consolidation.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Accounts receivable

The company performs ongoing credit evaluations of its customers and generally does not require collateral. An appropriate allowance for doubtful accounts is included in accounts receivable.

Inventory

Inventory is stated at the lower of cost (first-in, first-out method) or market.

Property and equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Expenditures for additions, renewals, and improvements are capitalized. Costs of repairs and maintenance are expensed when incurred. Depreciation is provided using the straight-line method over the estimated useful lives of the assets, which range from three to seven years. Leasehold improvements are amortized over the shorter of the lease term or the asset’s useful life.

Impairment of long-lived assets

Property and equipment and other long-lived assets are evaluated for impairment whenever events or conditions indicate that the carrying value of an asset may not be recoverable. If the sum of the expected undiscounted cash flows is less than the carrying value of the related asset or group of assets, a loss is recognized for the difference between the fair value and carrying value of the asset or group of assets. Such analyses necessarily involve significant judgment. There were no impairment losses recorded in 2004 or 2003.

Note payable-debt discount cost

The Company has issued warrants to investors and related parties in conjunction with notes payable. The discounts allocated to the warrants are being treated as additional consideration for notes payable and are being amortized over the life of the note as additional interest cost.

Revenue Recognition

The Company recognizes revenue when risk of loss and title to the product is transferred to the customer, which occurs at shipment

Income taxes

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SENSOR SYSTEM SOLUTIONS, INC.
NOTES TO FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2004 (CONSOLIDATED) AND 2003

The Company accounts for income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized and measured using enacted tax rates at the balance sheet date. Deferred tax expense or benefit is the result of changes in deferred tax assets and liabilities. Valuation allowances are established when necessary to reduce net deferred taxes to amounts that are more likely than not to be realized.

Stock – based compensation

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards (SFAS) No. 148, “Accounting for Stock-Based Compensation - Transition and Disclosures” as well as those outlined in SFAS No. 123, “Accounting for Stock-Based Compensation”. As permitted by SFAS 148 and SFAS 123, the Company continues to apply the provisions of Accounting Principles Board Opinion (APB) No. 25, “Accounting for Stock issued to Employees” and related interpretations in accounting for the Company’s stock option plan. Accordingly, compensation cost for stock options is measured as the excess, if any, of the estimated fair value of the Company’s stock at the date of the grant, over the amount an employee must pay to acquire the stock. Stock based awards for non-employees are accounted for at fair value equal to the excess of the estimated fair value of the Company’s stock over the option price using an estimated interest rate to calculate the fair value of the option. There were no stock based awards to non-employees in 2004 or 2003.

Had compensation cost for all stock option grants been determined based on their fair value at the grant dates, consistent with the method prescribed by SFAS 148 and SFAS 123, our net loss and loss per share would have been adjusted to the pro forma amounts indicated below:

	Year ended December 31:			
		2004		2003
Net loss	$	(3,662,390)	$	(961,355)
Add: Stock-based expense included in net loss		54,170		49,500
Deduct: Fair value based stock-based expense		(58,880)		(51,750)
Pro forma net loss	$	(3,667,100)	$	(963,605)
Basic and diluted earnings per share:				
As reported	$	(1.12)	$	(0.39)
Pro forma under SFAS No. 123	$	(1.12)	$	(0.39)

Earnings (loss) per share

Basic earnings (loss) per common share (EPS) are based on the weighted average number of common shares outstanding during each period. Diluted earnings per common share are based on shares outstanding (computed as under basic EPS) and potentially dilutive common shares. As of December 31, 2004 and 2003, the Company had granted stock options for 96,500 and 136,500 shares of common stock, respectively, that are potentially dilutive common shares but are not included in the computation of loss per share because their effect would be anti-dilutive.

Comprehensive income (loss)

The Company has no items of other comprehensive income (loss) for the years ended December 31, 2004 and 2003.

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SENSOR SYSTEM SOLUTIONS, INC.
NOTES TO FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2004 (CONSOLIDATED) AND 2003

Fair value of financial instruments

The Company believes that the carrying value of its cash, accounts receivable, accounts payable, accrued liabilities, notes payable, and notes payable to related parties as of December 31, 2004 approximates their respective fair values due to the demand or short-term nature of those instruments. The carrying value of long-term obligations approximates the fair value based on the effective interest rates compared to current market rates.

Concentration of Credit Risk

Financial instruments that are exposed to concentrations of credit risk consist principally of cash and accounts receivable. The Company places its cash in what it believes to be credit-worthy financial institutions. However, cash balances may have exceeded federally insured levels at various times during the year. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant risk in cash.

The Company had four customers that accounted for 29% and 42% of sales in the years ended December 31, 2004 and 2003, respectively. Approximately 90% and 10% of the Company's sales in the years ended December 31, 2004 and 2003 were to customers in North America and Asia respectively.

Reclassification

Certain prior year amounts have been reclassified to conform to the current year presentation.

Recent Accounting Pronouncements

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, "Inventory Costs". This Statement amends the guidance in ARB No. 43 Chapter 4 Inventory Pricing, to require items such as idle facility costs, excessive spoilage, double freight and rehandling costs to be expensed in the current period, regardless if they are abnormal amounts or not. This Statement will become effective for us in the first quarter of 2006. The adoption of SFAS No. 151 is not expected to have a material impact on our financial condition, results of operations, or cash flows.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R), which revises SFAS No. 123. SFAS 123R also supersedes APB No. 25 and amends SFAS No. 95, "Statement of Cash Flows". In general, the accounting required by SFAS 123R is similar to that of SFAS No. 123. However, SFAS No. 123 gave companies a choice to either recognize the fair value of stock options in their income statements or disclose the pro forma income statement effect of the fair value of stock options in the notes to the financial statements. SFAS 123R eliminates that choice and requires the fair value of all share-based payments to employees, including the fair value of grants of employee stock options, be recognized in the income statement, generally over the option vesting period. SFAS 123R must be adopted no later than July 1, 2005. Early adoption is permitted.

The Company is currently evaluating the timing and manner in which it will adopt SFAS 123R. As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using APB 25's intrinsic value method. Accordingly, adoption of SFAS 123R's fair value method will have an effect on results of operations, although it will have no impact on overall financial position. The impact of adoption of SFAS 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had SFAS 123R been adopted in prior periods, the effect would have approximated the SFAS 123 pro forma net loss and loss per share disclosures as shown above. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as currently required, thereby reducing net operating cash flows and increasing net financing cash flows in periods after adoption.

SENSOR SYSTEM SOLUTIONS, INC.
NOTES TO FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2004 (CONSOLIDATED) AND 2003

NOTE 2 INVENTORY

Inventory consists of the following as of December 31, 2004:

Raw materials	$	149,840
Work in process		1,749
Finished goods		68,856
	$	220,445

NOTE 3 PROPERTY AND EQUIPMENT

Property and equipment consists of the following as of December 31, 2004:

Machinery and equipment	$	586,812
Office equipment		2,636
Furniture and fixtures		17,398
Equipment under capital leases		47,365
Leasehold improvements		143,637
		797,848
Less accumulated depreciation and amortization		(477,131)
	$	320,717

Depreciation and amortization expense of $109,954 and $113,927 is reflected in the accompanying Statement of Operations for the years ended December 31, 2004 and 2003, respectively.

As of December 31, 2004 the Company maintained tooling assets with a net book value of approximately $160,000 at their main supplier located in Taiwan. Although this country is considered politically and economically stable, it is possible that unanticipated events in this foreign country could disrupt the operations of the Company because their main supplier is located there, has possession of the tooling assets, and manufactures certain products.

NOTE 4 INVESTMENT IN AFFILIATED ENTITY

The Company owns 7.5% of TransOptix, Inc. (TransOptix), a company involved in the design and manufacturing of optical switches for telecommunication. The Company's Chief Executive Officer is also the Chief Executive Officer of TransOptix and owns 12% of TransOptix. At December 31, 2003, the Company and the Company's Chief Executive Officer owned 14.3% and 15%, respectively, in TransOptix. These percentages were reduced in 2004 when additional investments were made from its board members. As a result of the combined equity holdings of TransOptix by the Company and its Chief Executive Officer, the Company accounts for this investment under the equity method of accounting. The Company discontinued applying the equity method in 2002 when Company's share of losses of TransOptix exceeded its investment in TransOptix. The Company did not record any income or loss from TransOptix in 2004 or 2003. The Company and TransOptix share the same office and facility. There were no transactions between the Company and TransOptix in 2004 or 2003.

SENSOR SYSTEM SOLUTIONS, INC.
NOTES TO FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2004 (CONSOLIDATED) AND 2003

Summarized unaudited financial information for TransOptix, Inc. is as follows:

		December 31, 2004
Current assets	$	363,082
Fixed assets, net		359,011
Other Assets		23,079
	$	745,172
Current liabilities	$	37,905
Note payable - stockholder		12,488
Note payable		2,249,920
Stockholders' deficiency		(1,555,141)
	$	745,172

		Year ended December 31, 2004		Year ended December 31, 2003
Revenues	$	674,702	$	94,099
Cost of revenues		441,861		26,893
Gross profit		232,841		67,206
Operating expenses		1,399,446		1,002,491
Net loss	$	(1,166,605)	$	(935,285)

NOTE 5 NOTES PAYABLE

Notes payable consist of the following at December 31, 2004:

Two lines of credit, unsecured, interest payable monthly at 8.5% and 9.5% per annum, due on demand.	$	92,983
Note Payable, unsecured, interest payable monthly at Prime + 3% per annum (prime rate at December 31, 2004 was 5.25%), due on demand.		40,000
Note payable, unsecured, interest payable monthly at 10% per annum, payable as a percentage of any future private or public stock offerings (see Note 9 with regard to the September 3, 2004 settlement agreement).		90,000
Note payable, secured by accounts receivable of the Company, interest at 10%, due February 11, 2005. In connection with this loan, the Company issued warrants to purchase 500,000 shares of ACSI’s common stock at $.50 per share. The intrinsic value of the warrants was valued at $500,000 has been recorded as loan discount costs and is being amortized over the life of the note as additional interest cost. After maturity, the lender agreed to convert the loan into shares of the		500,000

Company's stock. On March 15, 2005, an agreement was made to convert the note payable and warrant into 500,000 shares of commons stock.	
Three notes payable, secured by all assets of the Company, interest at 8% per annum, payable at various maturities through October 18, 2005. At maturity, the notes are convertible at the holder's option at a conversion price equal to 70% of the weighted average price of the common stock for the 30 trading days immediately preceding the conversion date. In addition, each note has warrants attached that, once the note is converted into stock, allow the holder to purchase stock at 85% of the weighted average price of the common stock for the 30 trading days immediately preceding the conversion date. The intrinsic value of the beneficial conversion feature of the notes and warrants, valued at $75,536, have been recorded as loan discount costs and are being amortized over the life of the respective note as additional interest cost.	117,500
Less remaining debt discount	(147,791)
	$ 692,692

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SENSOR SYSTEM SOLUTIONS, INC.
NOTES TO FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2004 (CONSOLIDATED) AND 2003

NOTE 6 NOTES PAYABLE, RELATED PARTIES

Notes payable to related parties consist of the following at December 31, 2004:

Note payable to the sister of the Company's Chief Executive Officer, secured by all assets of the Company, interest at 14.25% per annum, due December 31, 2004. In connection with the note payable, the Company issued warrants to purchase 190,665 shares of ACSI's common stock at $.50 per share and 110,000 shares of Spectre's common stock at a price equal to 85% of the average trading price of the Company common stock at March 16, 2005. The intrinsic value of the warrants, valued at $190,665, has been recorded as loan discount costs and are being amortized over the life of the note as additional interest cost. The Company is currently negotiating an extension of this note.	$	190,665
Note payable to the sister of the Company's Chief Executive Officer, secured by all assets of the Company, interest at 10.0% per annum, due March 15, 2005. At maturity, the note is convertible at the holder's option at a conversion price equal to 80% of the weighted average price of the common stock for the 30 trading days immediately preceding the conversion date. In addition, the note has warrants attached that, once the note is converted into stock, allow the holder to purchase stock at 85% of the weighted average price of the common stock for the 30 trading days immediately preceding the conversion date. The intrinsic value of the beneficial conversion feature of the note and warrants, valued at $48,125, has been recorded as loan discount costs and is being amortized over the life of the note as additional interest cost. The Company is currently negotiating an extension of this note.		110,000
Note payable to an employee of the Company, secured by all assets of the Company, interest at 10.0% per annum, due March 15, 2005. At maturity, the note is convertible at the holder's option at a conversion price equal to 80% of the weighted average price of the common stock for the 30 trading days immediately preceding the conversion date. In addition, the note has warrants attached that, once the note is converted into stock, allow the holder to purchase stock at 85% of the weighted average price of the common stock for the 30 trading days immediately preceding the conversion date. The intrinsic value of the beneficial conversion feature of the note and warrants, valued at $12,857, has been recorded as loan discount costs and is being amortized over the life of the note as additional interest cost.		20,000

Lesties at fair value
The Company has an equity securities portfolio which consists of investments in other financial institutions for market appreciation purposes, and investments in Community Reinvestment funds. The market value of these investments was $16.8 million and $18.1 million as of June 30, 2018 and December 31, 2017, respectively. Upon implementation of Accounting Standards Update 2016-01 - Financial Instruments ("ASU 2016-01"), the Company made a cumulative adjustment of $2.0 million from other comprehensive income to retained earnings as of January 1, 2018. In the first six months of 2018, the Company recorded $33,000 in market value gain on equity securities in other income.
As of June 30, 2018, the equity investments in other financial institutions and Community Reinvestment funds had a market value of $3.7 million and $13.1 million, respectively.
The Community Reinvestment funds include $9.5 million that are invested in government guaranteed loans, mortgage-backed securities, small business loans and other instruments supporting affordable housing and economic development. The Company may redeem these funds at the net

asset value calculated at the end of the current business day less any unpaid management fees. There are no restrictions on redemptions for the holdings in these investments other than the notice required by the fund manager. There are no unfunded commitments related to these investments.
The investment funds also include $3.5 million that are primarily invested in community development loans that are guaranteed by the Small Business Administration (“SBA”). Because the funds are primarily guaranteed by the federal government there are minimal changes in market value between accounting periods. These funds can be redeemed with 60 days notice at the net asset value less unpaid management fees with the approval of the fund manager. As of June 30, 2018, the net amortized cost equaled the market value of the investment. There are no unfunded commitments related to these investments.

NOTE 5 – LOANS, LEASES AND OTHER REAL ESTATE

The following sets forth the composition of the Company’s loan and lease portfolio:

	June 30, 2018	December 31, 2017
	(in thousands)	
Commercial, secured by real estate	$2,925,104	$2,831,184
Commercial, industrial and other	339,974	340,400
Leases	82,006	75,039
Real estate - residential mortgage	321,717	322,880
Real estate - construction	297,357	264,908
Home equity and consumer	315,144	322,269
Total loans and leases	4,281,302	4,156,680
Less: deferred fees	(3,763)	(3,960)
Loans and leases, net of deferred fees	$4,277,539	$4,152,720

At June 30, 2018 and December 31, 2017, home equity and consumer loans included overdraft deposit balances of $356,000 and $966,000, respectively. At June 30, 2018 and December 31, 2017, the Company had $1.2 billion and $1.1 billion, respectively, in loans pledged for actual and potential borrowings at the Federal Home Loan Bank of New York (“FHLB”).

Purchased Credit Impaired Loans

The carrying value of loans acquired in the Pascack Community Bank ("Pascack") acquisition and accounted for in accordance with ASC Subtopic 310-30, “Loans and Debt Securities Acquired with Deteriorated Credit Quality,” was $175,000 at

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June 30, 2018, which was $642,000 less than the balance at the time of acquisition on January 7, 2016. In first quarter 2017, one of the Pascack purchased credit impaired (“PCI”) loans totaling $127,000 experienced further credit deterioration and was fully charged off. In the second quarter of 2017, a loan with a net value of $218,000 was fully paid off. The carrying value of loans acquired in the Harmony Bank ("Harmony") acquisition was $511,000 at June 30, 2018 which was $258,000 less than the balance at acquisition date on July 1, 2016. In the second quarter of 2017, a loan with a net value of $247,000 was fully paid off.

The following table presents changes in the accretable yield for PCI loans:

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
	(in thousands)		(in thousands)	
Balance, beginning of period	$113	$180	$129	$145
Acquisitions	—	—	—	—
Accretion	(43)	(47)	(87)	(98)
Net reclassification non-accretable difference	30	—	58	86
Balance, end of period	$100	$133	$100	$133

Non-Performing Assets and Past Due Loans

The following schedule sets forth certain information regarding the Company’s non-performing assets and its accruing troubled debt restructurings, excluding PCI loans:

	June 30, 2018	December 31, 2017
	(in thousands)	
Commercial, secured by real estate	$7,353	$ 5,890
Commercial, industrial and other	1,171	184
Leases	834	144
Real estate - residential mortgage	2,992	3,860
Real estate - construction	—	1,472
Home equity and consumer	1,917	2,105
Total non-accrual loans and leases	$14,267	$ 13,655
Other real estate and other repossessed assets	2,184	843
TOTAL NON-PERFORMING ASSETS	$16,451	$ 14,498
Troubled debt restructurings, still accruing	$7,926	$ 11,462

Non-accrual loans included $4.9 million and $2.7 million of troubled debt restructurings for the periods ended June 30, 2018 and December 31, 2017, respectively. Non-accrual real estate-construction loans declined from December 31, 2017 to June 30, 2018 due to a foreclosure in a property which resulted in the property moving into other real estate at the end of June 2018. At June 30, 2018 and December 31, 2017, the Company had $2.3 million and $2.7 million, respectively, in residential mortgages and consumer home equity loans that were in the process of foreclosure.

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An age analysis of past due loans, segregated by class of loans as of June 30, 2018 and December 31, 2017, is as follows:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans and Leases	Recorded Investment Greater than 89 Days and Still Accruing
	(in thousands)						
June 30, 2018							
Commercial, secured by real estate	$3,727	$ 826	$3,124	$7,677	$2,917,427	$2,925,104	$ —
Commercial, industrial and other	119	—	1,100	1,219	338,755	339,974	—
Leases	129	77	834	1,040	80,966	82,006	—
Real estate - residential mortgage	1,506	311	2,992	4,809	316,908	321,717	—
Real estate - construction	—	—	—	—	297,357	297,357	—
Home equity and consumer	1,202	3	1,918	3,123	312,021	315,144	—
	$6,683	$ 1,217	$9,968	$17,868	$4,263,434	$4,281,302	$ —
December 31, 2017							
Commercial, secured by real estate	$3,663	$ 1,082	$3,817	$8,562	$2,822,622	$2,831,184	$ —
Commercial, industrial and other	80	121	56	257	340,143	340,400	—
Leases	496	139	144	779	74,260	75,039	—
Real estate - residential mortgage	939	908	3,137	4,984	317,896	322,880	—
Real estate - construction	—	—	1,472	1,472	263,436	264,908	—
Home equity and consumer	1,258	310	1,386	2,954	319,315	322,269	200
	$6,436	$ 2,560	$10,012	$19,008	$4,137,672	$4,156,680	$ 200

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Impaired Loans

The Company defines impaired loans as all non-accrual loans and leases with recorded investments of $500,000 or greater. Impaired loans also include all loans that have been modified in troubled debt restructurings. Impaired loans as of June 30, 2018 and December 31, 2017 are as follows:

June 30, 2018	Recorded Investment in Impaired Loans	Contractual Unpaid Principal Balance	Specific Allowance	Average Investment in Impaired Loans	Interest Income Recognized
	(in thousands)				
Loans without specific allowance:					
Commercial, secured by real estate	$7,398	$ 7,715	$ —	$ 6,730	$ 89
Commercial, industrial and other	1,525	1,526	—	1,381	10
Leases	—	—	—	—	—
Real estate - residential mortgage	—	—	—	478	4
Real estate - construction	—	—	—	1,463	—
Home equity and consumer	—	—	—	—	—
Loans with specific allowance:					
Commercial, secured by real estate	7,787	8,129	452	8,178	172
Commercial, industrial and other	228	228	8	228	6
Leases	663	663	393	279	—
Real estate - residential mortgage	757	902	4	557	10
Real estate - construction	—	—	—	—	—
Home equity and consumer	946	977	8	951	17
Total:					
Commercial, secured by real estate	$15,185	$ 15,844	$ 452	$ 14,908	$ 261
Commercial, industrial and other	1,753	1,754	8	1,609	16
Leases	663	663	393	279	—
Real estate - residential mortgage	757	902	4	1,035	14
Real estate - construction	—	—	—	1,463	—
Home equity and consumer	946	977	8	951	17
	$19,304	$ 20,140	$ 865	$ 20,245	$ 308

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December 31, 2017	Recorded Investment in Impaired Loans	Contractual Unpaid Principal Balance	Specific Allowance	Average Investment in Impaired Loans	Interest Income Recognized
	(in thousands)				
Loans without specific allowance:					
Commercial, secured by real estate	$12,155	$ 12,497	—	$ 12,774	$ 366
Commercial, industrial and other	618	618	—	618	25
Leases	—	—	—	—	—
Real estate - residential mortgage	963	980	—	996	15
Real estate - construction	1,471	1,471	—	1,471	—
Home equity and consumer	—	—	—	6	—
Loans with specific allowance:					
Commercial, secured by real estate	5,381	5,721	454	5,029	206
Commercial, industrial and other	164	164	9	283	14
Leases	65	65	30	29	—
Real estate - residential mortgage	781	919	4	940	27
Real estate - construction	—	—	—	—	—
Home equity and consumer	993	1,026	8	1,090	52
Total:					
Commercial, secured by real estate	$17,536	$ 18,218	$ 454	$ 17,803	$ 572
Commercial, industrial and other	782	782	9	901	39
Leases	65	65	30	29	—
Real estate - residential mortgage	1,744	1,899	4	1,936	42
Real estate - construction	1,471	1,471	—	1,471	—
Home equity and consumer	993	1,026	8	1,096	52
	$22,591	$ 23,461	$ 505	$ 23,236	$ 705

Interest income recognized on impaired loans was $308,000 and $336,000 for the six months ended June 30, 2018 and 2017, respectively. Interest that would have been accrued on impaired loans during the first six months of 2018 and 2017 had the loans been performing under original terms would have been $566,000 and $813,000, respectively.

Credit Quality Indicators

The class of loans is determined by internal risk rating. Management closely and continually monitors the quality of its loans and leases and assesses the quantitative and qualitative risks arising from the credit quality of its loans and leases. Lakeland assigns a credit risk rating to all commercial loans and loan commitments. The credit risk rating system has been developed by management to provide a methodology to be used by loan officers, department heads and senior management in identifying various levels of credit risk that exist within Lakeland's commercial loan portfolios. The risk rating system assists senior management in evaluating Lakeland's commercial loan portfolio, analyzing trends, and determining the proper level of required reserves to be recommended to the Board. In assigning risk ratings, management considers, among other things, a borrower's debt service coverage, earnings strength, loan to value ratios, industry conditions and economic conditions. Management categorizes commercial loans and commitments into a one (1) to nine (9) numerical structure with rating 1 being the strongest rating and rating 9 being the weakest. Ratings 1 through 5W are considered 'Pass' ratings.

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The following table shows the Company's commercial loan portfolio as of June 30, 2018 and December 31, 2017, by the risk ratings discussed above (in thousands):

June 30, 2018	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Real Estate - Construction
RISK RATING			
1	$ —	$ 331	$ —
2	—	16,766	—
3	67,445	44,690	—
4	907,615	99,290	23,012
5	1,841,406	149,975	262,623
5W - Watch	43,375	14,796	10,632
6 - Other assets especially mentioned	40,607	5,509	—
7 - Substandard	24,656	8,617	1,090
8 - Doubtful	—	—	—
9 - Loss	—	—	—
Total	$ 2,925,104	$ 339,974	$ 297,357

December 31, 2017	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Real Estate - Construction
RISK RATING			
1	$ —	$ 392	$ —
2	—	26,968	—
3	76,824	35,950	—
4	862,537	96,426	15,502
5	1,779,908	150,928	246,806
5W - Watch	47,178	8,779	—
6 - Other assets especially mentioned	40,245	8,670	—
7 - Substandard	24,492	12,287	2,600
8 - Doubtful	—	—	—
9 - Loss	—	—	—
Total	$ 2,831,184	$ 340,400	$ 264,908

The risk rating tables above do not include residential mortgage loans, consumer loans, or leases because they are evaluated on their payment status.

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Allowance for Loan and Lease Losses

The following table details activity in the allowance for loan and lease losses by portfolio segment for the three and six months ended June 30, 2018 and 2017:

Three Months Ended June 30, 2018	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Leases	Real Estate-Residential Mortgage	Real Estate-Construction	Home Equity and Consumer	Total
	(in thousands)						
Beginning Balance	$25,817	$ 1,768	$1,042	$ 1,589	$ 2,932	$ 2,496	$35,644
Charge-offs	(210)	(289)	(72)	—	(248)	(144)	(963)
Recoveries	274	76	3	3	3	72	431
Provision	293	457	291	(7)	376	82	1,492
Ending Balance	$26,174	$ 2,012	$1,264	$ 1,585	$ 3,063	$ 2,506	$36,604

Three Months Ended June 30, 2017	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Leases	Real Estate-Residential Mortgage	Real Estate-Construction	Home Equity and Consumer	Total
	(in thousands)						
Beginning Balance	$22,083	$ 1,792	$502	$ 1,825	$ 2,378	$ 3,010	$31,590
Charge-offs	(83)	(71)	(120)	(169)	—	(427)	(870)
Recoveries	145	27	28	—	5	71	276
Provision	1,199	(60)	119	98	213	258	1,827
Ending Balance	$23,344	$ 1,688	$529	$ 1,754	$ 2,596	$ 2,912	$32,823

Six Months Ended June 30, 2018	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Leases	Real Estate-Residential Mortgage	Real Estate-Construction	Home Equity and Consumer	Total
	(in thousands)						
Beginning Balance	$25,704	$ 2,313	$630	$ 1,557	$ 2,731	$ 2,520	$35,455
Charge-offs	(232)	(1,301)	(95)	(93)	(248)	(244)	(2,213)
Recoveries	305	96	5	5	8	167	586
Provision	397	904	724	116	572	63	2,776
Ending Balance	$26,174	$ 2,012	$1,264	$ 1,585	$ 3,063	$ 2,506	$36,604

Six Months Ended June 30, 2017	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Leases	Real Estate-Residential Mortgage	Real Estate-Construction	Home Equity and Consumer	Total
	(in thousands)						
Beginning Balance	$21,223	$ 1,723	$548	$ 1,964	$ 2,352	$ 3,435	$31,245
Charge-offs	(303)	(234)	(163)	(310)	(609)	(611)	(2,230)
Recoveries	364	122	32	—	20	225	763
Provision	2,060	77	112	100	833	(137)	3,045
Ending Balance	$23,344	$ 1,688	$529	$ 1,754	$ 2,596	$ 2,912	$32,823

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Loans receivable summarized by portfolio segment and impairment method are as follows:

June 30, 2018	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Leases	Real Estate-Residential Mortgage	Real Estate-Construction	Home Equity and Consumer	Total
	(in thousands)						
Ending Balance: Individually evaluated for impairment	$15,185	$ 1,753	$663	$ 757	$ —	$946	$19,304
Ending Balance: Collectively evaluated for impairment	2,909,234	338,221	81,343	320,960	297,357	314,197	4,261,312
Ending Balance: Loans acquired with deteriorated credit quality	685	—	—	—	—	1	686
Ending Balance (1)	$2,925,104	$ 339,974	$82,006	$ 321,717	$ 297,357	$315,144	$4,281,302

December 31, 2017	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Leases	Real Estate-Residential Mortgage	Real Estate-Construction	Home Equity and Consumer	Total
	(in thousands)						
Ending Balance: Individually evaluated for impairment	$17,536	$ 782	$65	$ 1,744	$ 1,471	$993	$22,591
Ending Balance: Collectively evaluated for impairment	2,812,941	339,618	74,974	321,136	263,437	321,273	4,133,379
Ending balance: Loans acquired with deteriorated credit quality	707	—	—	—	—	3	710
Ending Balance (1)	$2,831,184	$ 340,400	$75,039	$ 322,880	$ 264,908	$322,269	$4,156,680

(1) Excludes deferred fees

The allowance for loan and lease losses is summarized by portfolio segment and impairment classification as follows:

June 30, 2018	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Leases	Real Estate-Residential Mortgage	Real Estate-Construction	Home Equity and Consumer	Total
	(in thousands)						
Ending Balance: Individually evaluated for impairment	$452	$ 8	$393	$ 4	$ —	$ 8	$865

Ending Balance: Collectively evaluated for impairment	25,722	2,004	871	1,581	3,063	2,498	35,739
Ending Balance	$26,174	$ 2,012	$1,264	$ 1,585	$ 3,063	$ 2,506	$36,604

December 31, 2017	Commercial, Secured by Real Estate	Commercial, Industrial and Other	Leases	Real Estate-Residential Mortgage	Real Estate-Construction	Home Equity and Consumer	Total
	(in thousands)						
Ending Balance: Individually evaluated for impairment	$454	$ 9	$ 30	$ 4	$ —	$ 8	$505
Ending Balance: Collectively evaluated for impairment	25,250	2,304	600	1,553	2,731	2,512	34,950
Ending Balance	$25,704	$ 2,313	$ 630	$ 1,557	$ 2,731	$ 2,520	$35,455

Lakeland also maintains a reserve for unfunded lending commitments which is included in other liabilities. This reserve was $2.5 million for each of the periods ended June 30, 2018 and December 31, 2017. The Company analyzes the adequacy of the reserve for unfunded lending commitments quarterly.

Troubled Debt Restructurings

Loans are classified as troubled debt restructured loans in cases where borrowers experience financial difficulties and Lakeland makes certain concessionary modifications to contractual terms. Restructured loans typically involve a modification of terms such as a reduction of the stated interest rate, a moratorium of principal payments and/or an extension of the maturity date

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at a stated interest rate lower than the current market rate of a new loan with similar risk. The Company considers the potential losses on these loans as well as the remainder of its impaired loans while considering the adequacy of the allowance for loan and lease losses.

The following table summarizes loans that have been restructured during the three and six months ended June 30, 2018 and 2017:

	For the Three Months Ended June 30, 2018			For the Three Months Ended June 30, 2017		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	(dollars in thousands)					
Commercial, secured by real estate	1	$ 170	$ 170	2	$ 159	$ 159
Commercial, industrial and other	1	950	950	2	124	124
	2	$ 1,120	$ 1,120	4	$ 283	$ 283

	For the Six Months Ended June 30, 2018			For the Six Months Ended June 30, 2017		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	(dollars in thousands)					
Commercial, secured by real estate	3	$ 1,827	$ 1,827	4	$ 3,038	$ 3,038
Commercial, industrial and other	1	950	950	2	124	124
	4	$ 2,777	$ 2,777	6	$ 3,162	$ 3,162

The following table summarizes as of June 30, 2018 and 2017, loans that were restructured within the previous twelve months that have subsequently defaulted:

	June 30, 2018		June 30, 2017	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
	(dollars in thousands)			
Commercial, secured by real estate	2	$ 1,234	—	$ —
Commercial, industrial and other	1	950	—	—
Leases	1	11	—	—
Real estate - residential mortgage	—	$ —	1	$ 254
	4	$ 2,195	1	$ 254

Other Real Estate and Other Repossessed Assets

At June 30, 2018, the Company had other real estate owned and other repossessed assets of $2.2 million and $0, respectively. At December 31, 2017, the Company had other real estate owned and other repossessed assets of $843,000 and $0, respectively. Included in other real estate owned was residential property acquired as a result of foreclosure proceedings totaling $1.9 million and $843,000 that the Company held at the periods ended June 30, 2018 and December 31, 2017, respectively.

NOTE 6 – DERIVATIVES

Lakeland is a party to interest rate derivatives that are not designated as hedging instruments. Under a program, Lakeland executes interest rate swaps with commercial lending customers to facilitate their respective risk management strategies. These interest rate swaps with customers are simultaneously offset by interest rate swaps that Lakeland executes with a third party, such that Lakeland minimizes its net risk exposure resulting from such transactions. Because the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the

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offsetting swaps are recognized directly in earnings. The changes in the fair value of the swaps offset each other, except for the credit risk of the counterparties, which is determined by taking into consideration the risk rating, probability of default and loss given default for all counterparties. Lakeland had $487,000 and $492,000, respectively, in available for sale securities pledged for collateral on its interest rate swaps with the financial institution for June 30, 2018 and December 31, 2017.

In June 2016, the Company entered into two cash flow hedges in order to hedge the variable cash outflows associated with its subordinated debentures. The notional value of these hedges was $30.0 million. The Company's objectives in using the cash flow hedge are to add stability to interest expense and to manage its exposure to interest rate movements. The Company used interest rate swaps designated as cash flow hedges which involved 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. In these particular hedges the Company is paying a third party an average of 1.10% in exchange for a payment at 3 month LIBOR. 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 six months ended June 30, 2018, the Company did not record any hedge ineffectiveness. The Company recognized $132,000 and $(4,000) of accumulated other comprehensive income (loss) that was reclassified into interest expense for the first six months of 2018 and 2017, respectively. Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Company's debt. During the next twelve months, the Company estimates that $371,000 will be reclassified as a decrease to interest expense should the rate environment remain the same.

The following table presents summary information regarding these derivatives for the periods presented (dollars in thousands):

June 30, 2018	Notional Amount	Average Maturity (Years)	Weighted Average Fixed Rate		Weighted Average Variable Rate	Fair Value
Classified in Other Assets:						
3rd Party interest rate swaps	$ 190,679	9.4	4.25	%	1 Mo. LIBOR + 2.15%	$ 8,675
Customer interest rate swaps	58,754	10.8	5.15	%	1 Mo. LIBOR + 2.12%	996
Interest rate swap (cash flow hedge)	30,000	3.0	1.10	%	3 Mo. LIBOR	1,516
Classified in Other Liabilities:						
Customer interest rate swaps	$ 190,679	9.4	4.25	%	1 Mo. LIBOR + 2.15%	$ (8,675)
3rd Party interest rate swaps	58,754	10.8	5.15	%	1 Mo. LIBOR + 2.12%	(996)

December 31, 2017	Notional Amount	Average Maturity (Years)	Weighted Average	Weighted Average Variable Rate	Fair Value

			Fixed Rate			
Classified in Other Assets:						
3rd Party interest rate swaps	$110,076	8.8	3.87	%	1 Mo. LIBOR + 2.11%	$3,634
Customer interest rate swaps	82,760	11.5	4.74	%	1 Mo. LIBOR + 2.21%	1,831
Interest rate swap (cash flow hedge)	30,000	3.5	1.10	%	3 Mo. LIBOR	1,090
Classified in Other Liabilities:						
Customer interest rate swaps	$110,076	8.8	3.87	%	1 Mo. LIBOR + 2.11%	$(3,634)
3rd party interest rate swaps	82,760	11.5	4.74	%	1 Mo. LIBOR + 2.21%	(1,831)

NOTE 7 – GOODWILL AND INTANGIBLE ASSETS

The Company had goodwill of $136.4 million for both of the periods ended June 30, 2018 and December 31, 2017. The Company reviews its goodwill and intangible assets annually, on November 30, or more frequently if conditions warrant, for impairment. In testing goodwill for impairment, the Company compares the estimated fair value of its reporting unit to its carrying amount, including goodwill. The Company has determined that it has one reporting unit, Community Banking.

The Company had core deposit intangible of $2.1 million and $2.4 million for the periods ended June 30, 2018 and December 31, 2017, respectively. The estimated future amortization expense for the remainder of 2018 and for each of the succeeding five years ended December 31 is as follows (dollars in thousands):

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For the Year Ended	
2018	$284
2019	505
2020	415
2021	326
2022	236
2023	147

NOTE 8 – BORROWINGS

Repurchase Agreements

At June 30, 2018, the Company had federal funds purchased and securities sold under agreements to repurchase of $166.3 million and $31.6 million, respectively. The securities sold under agreements to repurchase are overnight sweep arrangement accounts with our customers. As of June 30, 2018, the Company had $35.0 million in mortgage backed securities pledged for its securities sold under agreements to repurchase.

At times the market values of securities collateralizing our securities sold under agreements to repurchase may decline due to changes in interest rates and may necessitate our lenders to issue a "margin call" which requires Lakeland to pledge additional collateral to meet that margin call.

Repayment of Borrowings

In the second quarter of 2018, the Company repaid all of its $20.0 million in maturing long-term securities sold under agreements to repurchase.

In the first quarter of 2017, the Company prepaid an aggregate of $20.0 million in long-term securities sold under agreements to repurchase and recorded $2.2 million in long-term debt prepayment fees. The Company also prepaid an aggregate of $34.0 million in borrowings from the Federal Home Loan Bank of New York and recorded $638,000 in long-term debt prepayment fees.

NOTE 9 – SHARE-BASED COMPENSATION

The Company grants restricted stock, restricted stock units ("RSUs") and stock options under the 2018 Omnibus Equity Incentive Plan and previously granted such awards under the 2009 Equity Compensation Program. The Company recognized share based compensation expense on its restricted stock of $118,000 and $165,000 for the six months ended June 30, 2018 and 2017, respectively. As of June 30, 2018, there was unrecognized compensation cost of $113,000 related to unvested restricted stock that is expected to be recognized over a weighted average period of approximately 0.55 years. The Company recognized share based compensation expense of $1.3 million and $1.4 million on RSU's for the six months ended June 30, 2018 and 2017, respectively. Unrecognized compensation expense related to RSUs was approximately $3.2 million as of June 30, 2018, and that cost is expected to be recognized over a period of 1.63 years. There was no unrecognized compensation expense related to unvested stock options as of June 30, 2018.

In the first six months of 2018, the Company granted 10,945 shares of restricted stock to non-employee directors at a grant date fair value of $20.55 per share under the 2009 Equity Compensation Program. The restricted stock vests one year from the date it was granted. Compensation expense on this restricted stock is expected to be $225,000 over a one year period. In the first six months of 2017, the Company granted 13,176 shares of restricted stock to non-employee directors at a grant date fair value of $18.20 per share under the 2009 Equity Compensation Program. The restricted stock vested one year from the date it was granted. Compensation expense on this restricted stock was $240,000 over a one year period.

The following is a summary of the Company's restricted stock activity during the six months ended June 30, 2018:

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	Number of Shares	Weighted Average Price
Outstanding, January 1, 2018	22,982	$ 14.44
Granted	10,945	20.55
Vested	(22,856)	14.46
Forfeited	—	—
Outstanding, June 30, 2018	11,071	$ 20.44

In the first six months of 2018, the Company granted 151,733 RSUs to certain officers at a weighted average grant date fair value of $19.13 per share under the Company's 2009 Equity Compensation Program. These units vest within a range of two to three years. A portion of these RSUs will vest subject to certain performance conditions in the restricted stock unit agreement. There are also certain provisions in the compensation program which state that if a recipient of the RSUs reaches a certain age and years of service, the person has effectively earned a portion of the RSUs at that time. Compensation expense on the restricted stock units issued in the first six months of 2018 is expected to average approximately $968,000 per year over a three year period. In the first six months of 2017, the Company granted 117,673 RSUs at a weighted average grant date fair value of $19.96 per share under the Company's 2009 Equity Compensation Program. Compensation expense on these restricted stock units is expected to average approximately $783,000 per year over a three year period.

The following is a summary of the Company's RSU activity during the six months ended June 30, 2018:

	Number of Shares	Weighted Average Price
Outstanding, January 1, 2018	267,732	$ 13.93
Granted	151,733	19.13
Vested	(116,921)	13.80
Forfeited	(4,650)	18.61
Outstanding, June 30, 2018	297,894	$ 16.56

There were no grants of stock options in the first six months of 2018 or 2017. Option activity under the Company's stock option plans is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding, January 1, 2018	102,216	$ 8.49	4.27	$1,101,806
Granted	—	—		
Exercised	(34,728)	8.84		
Forfeited	—	—		
Expired	—	—		
Outstanding, June 30, 2018	67,488	$ 8.31	3.36	$780,627
Options exercisable at June 30, 2018	67,488	$ 8.31	3.36	$780,627

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the period and the exercise price, multiplied by the number of in-the-money options).

There were 34,728 and 31,769 stock options exercised during the first six months of 2018 and 2017, respectively. The aggregate intrinsic value of stock options exercised during the six months ended June 30, 2018 and 2017 was $406,000 and $318,000, respectively. Exercise of stock options during the first six months of 2018 and 2017, resulted in cash receipts of $307,000 and $313,000, respectively.

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NOTE 10 – COMPREHENSIVE INCOME

The components of other comprehensive income (loss) are as follows:

For the three months ended:	June 30, 2018 Before Tax Amount (in thousands)	Tax Benefit (Expense)	Net of Tax Amount	June 30, 2017 Before Tax Amount (in thousands)	Tax Benefit (Expense)	Net of Tax Amount
Net unrealized gains (losses) on available for sale securities						
Net unrealized holding (losses) gains arising during period	$(2,203)	$ 513	$(1,690)	$1,661	$ (632)	$1,029
Reclassification adjustment for net gains arising during the period	—	—	—	15	(6)	9
Net unrealized losses (income)	(2,203)	513	(1,690)	1,676	(638)	1,038
Unrealized gains (losses) on derivatives	67	(14)	53	(186)	65	(121)
Other comprehensive (loss) income, net	$(2,136)	$ 499	$(1,637)	$1,490	$ (573)	$917

For the six months ended:	June 30, 2018 Before Tax Amount (in thousands)	Tax Benefit (Expense)	Net of Tax Amount	June 30, 2017 Before Tax Amount (in thousands)	Tax Benefit (Expense)	Net of Tax Amount
Net unrealized gains (losses) on available for sale securities						
Net unrealized holding (losses) gains arising during period	$(9,705)	$ 2,283	$(7,422)	$2,845	$ (1,082)	$1,763
Reclassification adjustment for net gains arising during the period	—	—	—	(2,524)	884	(1,640)
Net unrealized losses (gains)	(9,705)	2,283	(7,422)	321	(198)	123
Unrealized gains (losses) on derivatives	425	(89)	336	(165)	58	(107)
Other comprehensive (loss) income, net	$(9,280)	$ 2,194	$(7,086)	$156	$ (140)	$16

The following table shows the changes in the balances of each of the components of other comprehensive income for the periods presented, net of tax (in thousands):

	For the Three Months Ended June 30, 2018				For the Three Months Ended June 30, 2017			
	Unrealized Losses on Available for Sale Securities	Unrealized Gains on Derivatives	Pension Items	Total	Unrealized Gains (Losses) on Available for Sale Securities	Unrealized Gains on Derivatives	Pension Items	Total
Beginning balance	$(11,007)	$ 1,145	$ 21	$(9,841)	$(1,032)	$ 686	$ 38	$(308)
Other comprehensive (loss) income before	(1,690)	53	—	(1,637)	1,029	(121)	—	908

classifications								
Amounts reclassified from accumulated other comprehensive income	—	—	—	—	9	—	—	9
Net current period other comprehensive (loss) income	(1,690)	53	—	(1,637)	1,038	(121)	—	917
Ending balance	$(12,697)	$ 1,198	$ 21	$(11,478)	$6	565	$ 38	$609

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	For the Six Months Ended June 30, 2018				For the Six Months Ended June 30, 2017			
	Unrealized Losses on Available for Sale Securities	Unrealized Gains on Derivatives	Pension Items	Total	Unrealized Gains (Losses) on Available for Sale Securities	Unrealized Gains on Derivatives	Pension Items	Total
Beginning balance	$(3,232)	$ 862	$ 21	$(2,349)	$(117)	$ 672	$ 38	$593
Adjustment for implementation of ASU 2016-01	(2,043)	—	—	(2,043)	—	—	—	—
Adjusted beginning balance	(5,275)	862	21	(4,392)	(117)	672	38	593
Other comprehensive (loss) income before classifications	(7,422)	336	—	(7,086)	1,763	(107)	—	1,656
Amounts reclassified from accumulated other comprehensive income	—	—	—	—	(1,640)	—	—	(1,640)
Net current period other comprehensive (loss) income	(7,422)	336	—	(7,086)	123	(107)	—	16
Ending balance	$(12,697)	$ 1,198	$ 21	$(11,478)	$6	565	$ 38	$609

NOTE 11 – ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENT

Fair Value Measurement

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants at the measurement date. U.S. GAAP establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels giving the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest level priority to unobservable inputs (level 3 measurements). The following describes the three levels of fair value hierarchy:

Level 1 – unadjusted quoted prices in active markets for identical assets or liabilities; includes U.S. Treasury Notes, and other U.S. Government Agency securities that actively trade in over-the-counter markets; equity securities and mutual funds that actively trade in over-the-counter markets.

Level 2 – quoted prices for similar assets or liabilities in active markets; or quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs other than quoted prices that are observable for the asset or liability including yield curves, volatilities, and prepayment speeds.

Level 3 – unobservable inputs for the asset or liability that reflect the Company’s own assumptions about assumptions that market participants would use in the pricing of the asset or liability and that are consequently not based on market activity but upon particular valuation techniques.

The Company’s assets that are measured at fair value on a recurring basis are it’s available for sale investment securities and its equity securities. The Company obtains fair values on its securities using information from a third party servicer. If quoted prices for securities are available in an active market, those securities are classified as Level 1 securities. The Company has U.S. Treasury Notes and certain equity securities that are classified as Level 1 securities. Level 2 securities were primarily comprised of U.S. Agency bonds, residential mortgage-backed securities, obligations of state and political subdivisions and corporate securities. Fair values were estimated primarily by obtaining quoted prices for similar assets in active markets or through the use of pricing models supported with market data information. Standard inputs include benchmark yields, reported trades, issuer spreads, bids and offers. On a quarterly basis, the Company reviews the pricing information received from the Company’s third party pricing service. This review includes a comparison to non-binding third-party quotes.

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The fair values of derivatives are based on valuation models from a third party using current market terms (including interest rates and fees), the remaining terms of the agreements and the credit worthiness of the counter party as of the measurement date (Level 2).

The following table sets forth the Company's financial assets that were accounted for at fair value on a recurring basis as of the periods presented by level within the fair value hierarchy. During the six months ended June 30, 2018, the Company did not make any transfers between any levels within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value
	(in thousands)			
June 30, 2018				
Assets:				
Investment securities, available for sale				
U.S. Treasury and government agencies	$4,885	$ 141,460	$ —	$146,345
Mortgage-backed securities	—	405,589	—	405,589
Obligations of states and political subdivisions	—	49,222	—	49,222
Other debt securities	—	5,075	—	5,075
Total securities available for sale	4,885	601,346	—	606,231
Equity securities, at fair value	3,735	13,063	—	16,798
Derivative assets	—	11,187	—	11,187
Total Assets	$8,620	$ 625,596	$ —	$634,216
Liabilities:				
Derivative liabilities	$—	$ 9,671	$ —	$9,671
Total Liabilities	$—	$ 9,671	$ —	$9,671
December 31, 2017				
Assets:				
Investment securities, available for sale				
U.S. Treasury and government agencies	$5,415	$ 141,840	$ —	$147,255
Mortgage-backed securities	—	424,331	—	424,331
Obligations of states and political subdivisions	—	51,320	—	51,320
Other debt securities	—	5,140	—	5,140
Total securities available for sale	5,415	622,631	—	628,046
Equity securities, at fair value	5,147	12,942	—	18,089
Derivative assets	—	6,555	—	6,555
Total Assets	$10,562	$ 642,128	$ —	$652,690
Liabilities:				
Derivative liabilities	$—	$ 5,465	$ —	$5,465
Total Liabilities	$—	$ 5,465	$ —	$5,465

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The following table sets forth the Company's assets subject to fair value adjustments (impairment) on a non-recurring basis. Assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

	(Level 1)	(Level 2)	(Level 3)	Total Fair Value
		(in thousands)		
June 30, 2018				
Assets:				
Impaired loans and leases	$ —	$ —	$ 19,304	$ 19,304
Loans held for sale	—	1,692	—	1,692
Other real estate owned and other repossessed assets	—	—	2,184	2,184
December 31, 2017				
Assets:				
Impaired loans and leases	$ —	$ —	$ 22,591	$ 22,591
Loans held for sale	—	456	—	456
Other real estate owned and other repossessed assets	—	—	843	843

Impaired loans are evaluated and valued at the time the loan is identified as impaired at the lower of cost or market value of the underlying collateral. Because most of Lakeland's impaired loans are collateral dependent, fair value is generally measured based on the value of the collateral, less estimated costs to sell, securing these loans and leases and is classified at a level 3 in the fair value hierarchy. Collateral may be real estate, accounts receivable, inventory, equipment and/or other business assets. The value of real estate is assessed based on appraisals by qualified third party licensed appraisers. The appraisers may use the sales comparison approach, the cost approach and/or the income approach to value the collateral using discount rates (with ranges of 5-11%) or capitalization rates (with ranges of 5-9%) to evaluate the property. The value of the equipment may be determined by an appraiser, if significant, inquiry through a recognized valuation resource, or by the value on the borrower's financial statements. Field examiner reviews on business assets may be conducted based on the loan exposure and reliance on this type of collateral. Appraised and reported values may be adjusted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Loans that are not collateral dependent are evaluated based on a discounted cash flow method. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

The Company has a held for sale loan portfolio that consists of residential mortgages that are being sold in the secondary market. The Company records these mortgages at the lower of cost or market value. Fair value is generally determined by the value of purchase commitments.

Other real estate owned ("OREO") and other repossessed assets, representing property acquired through foreclosure, are recorded at fair value less estimated disposal costs of the acquired property on the date of acquisition and thereafter re-measured and carried at lower of cost or fair market value. Fair value on other real estate owned is based on the appraised value of the collateral using the sales comparison approach and/or the income approach with discount rates or capitalization rates similar to those used in impaired loan valuation. The fair value of other repossessed assets is estimated by inquiry through recognized valuation resources.

Changes in the assumptions or methodologies used to estimate fair values may materially affect the estimated amounts. Changes in economic conditions, locally or nationally, could impact the value of the estimated amounts of impaired loans, OREO and other repossessed assets.

Fair Value of Certain Financial Instruments

Estimated fair values have been determined by the Company using the best available data and an estimation methodology suitable for each category of financial instruments. There may not be reasonable comparability between institutions due to the wide range of permitted assumptions and methodologies in the absence of active markets. This lack of uniformity gives rise to a high degree of subjectivity in estimating financial instrument fair values.

The estimation methodologies used, the estimated fair values, and recorded book balances at June 30, 2018 and December 31, 2017 are outlined below.

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This summary, as well as the table below, excludes financial assets and liabilities for which carrying value approximates fair value. For financial assets, these include cash and cash equivalents. For financial liabilities, these include noninterest-bearing demand deposits, savings and interest-bearing transaction accounts and federal funds sold and securities sold under agreements to repurchase. The estimated fair value of demand, savings and interest-bearing transaction accounts is the amount payable on demand at the reporting date. Carrying value is used because there is no stated maturity on these accounts, and the customer has the ability to withdraw the funds immediately. Also excluded from this summary and the following table are those financial instruments recorded at fair value on a recurring basis, as previously described.

The fair value of investment securities held to maturity was measured using information from the same third-party servicer used for investment securities available for sale using the same methodologies discussed above. Investment securities held to maturity includes $7.2 million in short-term municipal bond anticipation notes and $1.0 million in subordinated debt that are non-rated and do not have an active secondary market or information readily available on standard financial systems. As a result, the securities are classified as Level 3 securities. Management performs a credit analysis before investing in these securities.

FHLB stock is an equity interest that can be sold to the issuing FHLB, to other Federal Home Loan Banks, or to other member banks at its par value. Because ownership of these securities is restricted, they do not have a readily determinable fair value. As such, the Company’s FHLB stock is recorded at cost or par value and is evaluated for impairment each reporting period by considering the ultimate recoverability of the investment rather than temporary declines in value. The Company’s evaluation primarily includes an evaluation of liquidity, capitalization, operating performance, commitments, and regulatory or legislative events.

The net loan portfolio at June 30, 2018 has been valued using an exit price approach incorporating discounts for credit and liquidity. This is not comparable with the fair values used for December 31, 2017, which are based on entrance prices. For December 31, 2017, the loan portfolio was valued using a present value discounted cash flow where market prices are not available. The discount rate used in these calculations is the estimated current market rate adjusted for credit risk.

For fixed maturity certificates of deposit, fair value is estimated based on the present value of discounted cash flows using the rates currently offered for deposits of similar remaining maturities.

The carrying amount of accrued interest payable approximates its fair value.

The fair value of long-term debt is based upon the discounted value of contractual cash flows. The Company estimates the discount rate using the rates currently offered for similar borrowing arrangements. The fair value of subordinated debentures is based on bid/ask prices from brokers for similar types of instruments.

The fair values of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of guarantees and letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. The fair value of commitments to extend credit and standby letters of credit are deemed immaterial.

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The following table presents the carrying values, fair values and placement in the fair value hierarchy of the Company’s financial instruments as of June 30, 2018 and December 31, 2017:

	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)				
June 30, 2018					
Financial Assets:					
Investment securities held to maturity	$158,832	$155,316	$ —	$147,130	$ 8,186
Federal Home Loan Bank and other membership bank stocks	16,235	16,235	—	16,235	—
Loans and leases, net	4,240,935	4,212,454	—	—	4,212,454
Financial Liabilities:					
Certificates of deposit	806,783	799,476	—	799,476	—
Other borrowings	196,376	191,649	—	191,649	—
Subordinated debentures	104,963	102,958	—	—	102,958
December 31, 2017					
Financial Assets:					
Investment securities held to maturity	$139,685	$138,688	$ —	$127,901	$ 10,787
Federal Home Loan Bank and other membership bank stocks	12,576	12,576	—	12,576	—
Loans and leases, net	4,117,265	4,114,516	—	—	4,114,516
Financial Liabilities:					
Certificates of deposit	737,428	732,417	—	732,417	—
Other borrowings	192,011	189,080	—	189,080	—
Subordinated debentures	104,902	97,244	—	—	97,244

NOTE 12 – RECENT ACCOUNTING PRONOUNCMENTS

In June 2018, the Financial Accounting Standards Board ("FASB") issued an update expanding earlier guidance on stock compensation to include share-based payments issued to nonemployees for goods and services. Consequently, the accounting for share-based payments to nonemployees and employees will be substantially the same. This update will be effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2018. Earlier adoption is permitted. Because the Company does not have share-based payments issued to nonemployees, the adoption of this update is not expected to have a material impact on the Company's financial statements.

In March 2018, the FASB issued an update regarding the accounting implications of the recently issued Tax Cuts and Jobs Act (the "Tax Act"). The update clarifies that in a company's financial statements that include the reporting period in which the Tax Act was enacted, a company must first reflect the income tax effects of the Tax Act in which the accounting under U.S. GAAP is complete. Those amounts would not be provisional amounts. The company would also report provisional amounts for those specific income tax effects for which the accounting under U.S. GAAP will be incomplete but for which a reasonable estimate can be determined. If there are income tax effects for the Tax Act for which a reasonable estimate cannot be determined, the company would not report provisional amounts and would continue to apply U.S. GAAP based on the tax laws that were in effect immediately prior to the Tax Act being enacted. This accounting update is effective immediately. The Company believes its accounting for the the income tax effects of the Tax Act is complete. Technical corrections or other forthcoming guidance could change how we interpret provisions of the Tax Act, which may impact our effective tax rate and could affect our deferred tax assets, tax positions and/or our tax liabilities.

In February 2018, the FASB issued an update (ASU 2018-02) regarding the reclassification of certain tax effects from accumulated other comprehensive income. This update requires a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the newly enacted federal corporate tax rate. The amount of the reclassification would be the difference between the historical 35% corporate income tax rate and the newly enacted 21% corporate tax rate. This update eliminates the stranded tax effects associated with the change in the federal corporate income tax rate in the

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Tax Act and improves the usefulness of information reported to financial statement users. The amendments are effective for all entities for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. Early adoption of the amendments is permitted including adoption in any interim period, for public business entities for reporting periods for which financial statements have not yet been issued and all other entities for reporting periods for which financial statements have not yet been made available for issuance. An entity may apply the amendments in the update retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Act is recognized. The Company elected to adopt this update in December 2017, and recorded a $420,000 increase to retained earnings and reduction to accumulated other comprehensive income in December 2017.

In August 2017, the FASB issued an update intended to improve and simplify accounting rules around hedge accounting. Amendments expand and refine hedge accounting for both nonfinancial and financial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. The amendments in this update also make certain targeted improvements to simplify the application of hedge accounting guidance and ease the administrative burden of hedge documentation requirements and assessing hedge effectiveness. This update will be effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2019. The Company is still evaluating the impact that this guidance will have on its financial statements.

In July 2017, the FASB issued guidance which simplifies the accounting for certain financial instruments with down round features, a provision in an equity-linked financial instrument (or embedded feature) that provides a downward adjustment of the current exercise price based on the price of future equity offerings. The provisions of the new guidance related to down rounds are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The adoption of this update is not expected to have a material impact on the Company’s financial statements because the Company does not have any equity-linked financial instruments that have such down round features.

In May 2017, the FASB issued an update which provides clarity and reduces diversity in practice when accounting for the modification of terms and conditions for share-based payment awards. Previous accounting guidance did not distinguish between modifications which were substantive from modifications that were merely administrative. The accounting standards update requires entities to account for the effects of a modification unless the following three conditions are met: the fair value of the modified award is the same as the fair value of the original award immediately before the original award is modified; the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified; and the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified. This update will be effective for annual and interim periods beginning after December 15, 2017. The adoption of this update did not have an impact on the Company’s financial statements.

In March 2017, the FASB issued an update which shortens the amortization period for certain callable debt securities held at a premium to the earliest call date. Under current GAAP, entities amortize the premium as an adjustment of yield over the contractual life of the instrument even if the holder is certain that the call will be exercised. As a result, upon the exercise of a call on a callable debt security held at a premium, the unamortized premium is recorded as a loss in earnings.

The update shortens the amortization period for certain callable debt securities held at a premium and requires the premium be amortized to the earliest call date. This update will be effective for annual and interim periods beginning after December 15, 2018. Entities are required to apply the amendments on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The adoption of this update is not expected to have a material impact on the Company’s financial statements.

In March 2017, the FASB issued an update which changes the presentation of net periodic pension cost and net periodic postretirement benefit cost in a company’s income statement. The amendment requires that an employer report the service cost component in the same line item as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The amendment is effective for annual and interim periods beginning after December 15, 2017. Because the Company has minimal benefit plans that require the measurement of net periodic pension cost and net periodic post retirement benefit cost, the adoption of this update did not have an impact on the Company’s financial statements.

In January 2017, the FASB issued an update to simplify the test for goodwill impairment. This amendment eliminates Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit’s fair value. This update will be effective for the Company’s financial statements for

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annual years beginning after December 15, 2019. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In January 2017, the FASB issued an update that clarifies the definition of a business as it pertains to business combinations. This amendment affects all companies and other reporting organizations that must determine whether they have sold or acquired a business. This update will be effective for the Company's financial statements for fiscal years beginning after December 15, 2017. The adoption of this update did not have an impact on the Company's financial statements.

In September 2016, the FASB issued an accounting standards update to address diversity in presentation in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. This update will be effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2017. The adoption of this update did not have an impact on the Company's financial statements.

In June 2016, the FASB issued an accounting standards update pertaining to the measurement of credit losses on financial instruments. This update requires the measurement of all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. This update is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. This update will be effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2019. The Company is currently evaluating its existing systems and data to support the new standard as well as assessing the impact that the guidance will have on the Company's consolidated financial statements. The Company has formed a working group under the direction of the chief risk officer that is comprised of individuals from the credit, risk management, finance and project management areas. In early 2018, the Company contracted with a software and advisory service provider to aid in implementation. The Company continues to work with this service provider in assessing its data and preparing for implementation.

In February 2016, FASB issued accounting guidance that requires all lessees to recognize a lease liability and a right-of-use asset, measured at the present value of the future minimum lease payments, at the lease commencement date. Lessor accounting remains largely unchanged under the new guidance. The guidance is effective for fiscal years beginning after December 15, 2018, including interim reporting periods within that reporting period, with early adoption permitted. A modified retrospective approach must be applied for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company is currently assessing the impact of the new guidance on its consolidated financial statements by reviewing its existing lease contracts and service contracts that may include embedded leases. It is also considering various software providers to aid it in implementation. The Company expects to record an increase in assets and liabilities as a result of recognizing a right-of-use asset and a lease liability for its operating lease commitments.

In January 2016, the FASB issued an accounting standards update intended to improve the recognition and measurement of financial instruments. Specifically, the accounting standards update requires all equity instruments, with the exception of those that are accounted for under the equity method of accounting, to be measured at fair value with changes in the fair value recognized through net income. Additionally, public business entities are required to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The amendments in this update also require 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. In February 2018, the FASB issued further guidance that provided technical corrections to this update. Those technical corrections included clarification on accounting for equity securities without a readily determinable fair value, remeasurement requirements on forward contracts and purchased options, and presentation requirements for certain fair value option liabilities. This amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The adoption of this update required an adjustment on January 1, 2018 from other comprehensive income to retained earnings for the amount of the unrealized gain on equity securities as of December 31, 2017. Thereafter, any increases or decreases to the market value on these equity securities will be recorded through the consolidated statements of income. Please see the Consolidated Statement of Changes in Stockholders' Equity, Note 4-Investment Securities and Note 10-Comprehensive Income for more information.

In May 2014, the FASB issued an accounting standards update that clarifies the principles for recognizing revenue. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to a customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for these goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a 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.

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In 2016, the FASB issued further implementation guidance regarding revenue recognition. This additional guidance included clarification on certain principal versus agent considerations within the implementation of the guidance as well as clarification related to identifying performance obligations and licensing. The guidance also requires new qualitative and quantitative disclosures, including disaggregation of revenues and descriptions of performance obligations. The guidance along with its updates is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. In evaluating this standard, management has determined that the majority of revenue earned by the Company is from revenue streams not included in the scope of this standard. The Company has assessed its revenue streams and reviewed contracts potentially affected by the guidance including deposit related fees, interchange fees, investment commissions, merchant fee income and other noninterest income sources to determine the potential impact the new guidance is expected to have on the Company’s consolidated financial statements. The Company adopted the guidance on January 1, 2018 using the modified retrospective method. The Company did not have a cumulative-effect adjustment to opening retained earnings as a result of adopting this standard. Please see Note 2 - Revenue Recognition for more information.

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

This section should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Statements Regarding Forward Looking Information

The information disclosed in this document includes various forward-looking statements that are made in reliance upon the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 with respect to credit quality (including delinquency trends and the allowance for loan and lease losses), the Company's future tax expense, corporate objectives, and other financial and business matters. The words "anticipates," "projects," "intends," "estimates," "expects," "believes," "plans," "may," "will," "should," "could," and other similar expressions are intended to identify such forward-looking statements. The Company cautions that these forward-looking statements are necessarily speculative and speak only as of the date made, and are subject to numerous assumptions, risks and uncertainties, all of which may change over time. Actual results could differ materially from such forward-looking statements.

In addition to the risk factors disclosed elsewhere in this document, the following factors, among others, could cause the Company's actual results to differ materially and adversely from such forward-looking statements: changes in the financial services industry and the U.S. and global capital markets, changes in economic conditions nationally, regionally and in the Company's markets, the nature and timing of actions of the Federal Reserve Board and other regulators, the nature and timing of legislation and regulation affecting the financial services industry, government intervention in the U.S. financial system, changes in federal and state tax laws, changes in levels of market interest rates, pricing pressures on loan and deposit products, credit risks of Lakeland's lending and leasing activities, successful implementation, deployment and upgrades of new and existing technology, systems, services and products, customers' acceptance of Lakeland's products and services, and competition.

The above-listed risk factors are not necessarily exhaustive, particularly as to possible future events, and new risk factors may emerge from time to time. Certain events may occur that could cause the Company's actual results to be materially different than those described in the Company's periodic filings with the Securities and Exchange Commission. Any statements made by the Company that are not historical facts should be considered to be forward-looking statements. The Company is not obligated to update and does not undertake to update any of its forward-looking statements made herein.

Critical Accounting Policies, Judgments and Estimates

The accounting and reporting policies of the Company and its subsidiaries conform to accounting principles generally accepted in the United States of America and predominant practices within the banking industry. The consolidated financial statements include the accounts of the Company, Lakeland, Lakeland NJ Investment Corp., Lakeland Investment Corp., Lakeland Equity, Inc. and Lakeland Preferred Equity, Inc. All intercompany balances and transactions have been eliminated. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. These estimates and assumptions also affect reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. There have been no material changes in the Company's critical accounting policies, judgments and estimates, including assumptions or estimation techniques utilized, as compared to those disclosed in the Company's most recent Annual Report on Form 10-K.

Management Overview

The quarter and six months ended June 30, 2018 represented a period of continued growth for the Company. As discussed in this Management's Discussion and Analysis:

- For the second quarter of 2018, net income of $15.8 million increased from $13.4 million in the second quarter of 2017. Diluted earnings per share of $0.33 represents a 18% increase over $0.28 for the same period in 2017.
- For the second quarter of 2018, annualized return on average assets was 1.17%, annualized return on average common equity was 10.71%, and annualized return on average tangible common equity was 13.97% compared to 1.02%, 9.49%, and 12.58%, respectively, for the second quarter of 2017.

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- For the first six months of 2018, net income of $31.1 million increased from $25.7 million in the first six months of 2017. Diluted earnings per share of $0.65 represents a 23% increase over $0.53 for the same period in 2017.
- For the first six months of 2018, annualized return on average assets was 1.16%, annualized return on average common equity was 10.65%, and annualized return on average tangible common equity was 13.94% compared to 1.00%, 9.26%, and 12.31%, respectively, for the first six months of 2017.
- Net interest margin (“NIM”) was 3.43% in the second quarter of 2018 compared to 3.41% in the second quarter of 2017.
- Total loans net of deferred fees grew $124.8 million, or 3%, to $4.28 billion during the first six months of 2018, with commercial loans secured by real estate and construction loans growing $93.9 million and $32.4 million, or 3% and 12%, respectively.
- Total deposits increased $31.3 million, or 1%, from December 31, 2017 to June 30, 2018, to $4.40 billion.

Comparison of Operating Results for the Three Months Ended June 30, 2018 and 2017

Net Income

Net income was $15.8 million, or $0.33 per diluted share, for the second quarter of 2018 compared to net income of $13.4 million, or $0.28 per diluted share, for the second quarter of 2017. Net income increased as a result of an increase in net interest income and as a result of a decrease in tax expense relating to the Tax Cuts and Jobs Act of 2017. Net interest income of $43.5 million for the second quarter of 2018 increased $2.1 million from the second quarter of 2017 resulting from organic growth and an increase in market interest rates.

Net Interest Income

Net interest income is the difference between interest income on earning assets and the cost of funds supporting those assets. The Company’s net interest income is determined by: (i) the volume of interest-earning assets that it holds and the yields that it earns on those assets, and (ii) the volume of interest-bearing liabilities that it has assumed and the rates that it pays on those liabilities.

Net interest income on a tax equivalent basis for the second quarter of 2018 was $43.6 million, compared to $41.7 million for the second quarter of 2017. The net interest margin increased from 3.41% in the second quarter of 2017 to 3.43% in the second quarter of 2018 primarily as a result of a 24 basis point increase in the yield on interest-earning assets. The increase in yield on interest-earning assets primarily resulted from an increase in rates caused by the recent increases in the federal funds rate and prime rate. The increase in net interest margin was augmented by an increase in interest income earned on free funds (interest-earning assets funded by noninterest-bearing liabilities) resulting from an increase in average noninterest-bearing deposits of $15.0 million. The components of net interest income will be discussed in greater detail below.

The following table reflects the components of the Company’s net interest income, setting forth for the periods presented, (1) average assets, liabilities and stockholders’ equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) the Company’s net interest spread (i.e., the average yield on interest-earning assets less the average cost of interest-bearing liabilities) and (5) the Company’s net interest margin. Rates for the three months ended June 30, 2018 are computed on a tax equivalent basis using a tax rate of 21%, while rates for the three months ended June 30, 2017 are computed on a tax equivalent basis using a tax rate of 35%.

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	For the Three Months Ended June 30, 2018			For the Three Months Ended June 30, 2017		
	Average Balance	Interest Income/ Expense	Average Rates Earned/ Paid	Average Balance	Interest Income/ Expense	Average Rates Earned/ Paid
	(dollars in thousands)					
ASSETS						
Interest-earning assets:						
Loans and leases (1)	$4,247,443	$47,659	4.50 %	$4,011,325	$42,740	4.27 %
Taxable investment securities and other	729,684	4,027	2.21 %	724,675	3,818	2.11 %
Tax-exempt securities	81,677	543	2.66 %	112,400	803	2.86 %
Federal funds sold (2)	35,244	145	1.65 %	59,088	132	0.89 %
Total interest-earning assets	5,094,048	52,374	4.12 %	4,907,488	47,493	3.88 %
Noninterest-earning assets:						
Allowance for loan and lease losses	(36,324)			(32,234)		
Other assets	379,816			365,901		
TOTAL ASSETS	$5,437,540			$5,241,155		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Interest-bearing liabilities:						
Savings accounts	$496,630	$74	0.06 %	$492,991	$71	0.06 %
Interest-bearing transaction accounts	2,195,553	3,772	0.69 %	2,295,256	2,513	0.44 %
Time deposits	792,270	2,655	1.34 %	559,665	1,200	0.86 %
Borrowings	356,511	2,266	2.54 %	344,833	2,007	2.30 %
Total interest-bearing liabilities	3,840,964	8,767	0.91 %	3,692,745	5,791	0.63 %
Noninterest-bearing liabilities:						
Demand deposits	969,965			954,966		
Other liabilities	23,223			28,233		
Stockholders' equity	593,388			565,211		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$5,427,540			$5,241,155		
Net interest income/spread		43,607	3.21 %		41,702	3.25 %
Tax equivalent basis adjustment		114			281	
NET INTEREST INCOME		$43,493			$41,421	
Net interest margin (3)			3.43 %			3.41 %

(1) Includes non-accrual loans, the effect of which is to reduce the yield earned on loans, and deferred loan fees.
(2) Includes interest-bearing cash accounts.
(3) Net interest income divided by interest-earning assets.

Interest income on a tax equivalent basis increased from $47.5 million in the second quarter of 2017 to $52.4 million in the second quarter of 2018, an increase of $4.9 million, or 10%. The increase in interest income was primarily a result of an increase in rates caused by the recent increases in the federal funds rate and prime rate as well as organic growth in loans, as average loans and leases increased $236.1 million compared to the second quarter of 2017. The yield on average loans and leases at 4.50% in the second quarter of 2018 was 23 basis points higher than the second quarter of

2017. The yield on average taxable investment securities increased 10 basis points, while the yield on average tax-exempt investment securities decreased 20 basis points. The decrease in yield on average tax-exempt investment securities was due primarily to a reduction in tax equivalent income resulting from the Tax Cut and Jobs Act of 2017.

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Total interest expense of $8.8 million in the second quarter of 2018 was $3.0 million greater than the $5.8 million reported for the same period in 2017. The cost of average interest-bearing liabilities increased from 0.63% in the second quarter of 2017 to 0.91% in the second quarter of 2018. The increase in the cost of interest-bearing liabilities was due primarily to an increasingly competitive market for deposits resulting from a higher interest rate environment as well as an increase in the cost of borrowings. The cost of interest-bearing transaction accounts and time deposits increased by 25 basis points and 48 basis points, respectively. Average time deposits increased 42% from $559.7 million in the second quarter of 2017 to $792.3 million in the second quarter of 2018 primarily as a result of the Company's certificate of deposit promotion during 2017.

Provision for Loan and Lease Losses

In determining the provision for loan and lease losses, management considers national and local economic conditions; trends in the portfolio including orientation to specific loan types or industries; experience, ability and depth of lending management in relation to the complexity of the portfolio; adequacy and adherence to policies, procedures and practices; levels and trends in delinquencies, impaired loans and charge-offs and the results of independent third party loan review.

In the second quarter of 2018, a $1.5 million provision for loan and lease losses was recorded, compared to $1.8 million for the same period last year. The Company charged off $1.0 million and recovered $431,000 in the second quarter of 2018 compared to $870,000 and $276,000, respectively, in the second quarter of 2017. For more information regarding the determination of the provision, see “Risk Elements” below.

Noninterest Income

Noninterest income of $5.7 million in the second quarter of 2018 decreased by $402,000 from $6.1 million in the second quarter of 2017. Commissions and fees increased $275,000 compared to the second quarter of 2017 due primarily to increased loan fees. Income on bank owned life insurance of $711,000 for the second quarter of 2018 increased $211,000 compared to the same period last year primarily as a result of an increase in the number of policies. Gains on sales of loans decreased $171,000 due to a decline in sales of mortgage loans. Other income decreased $603,000 compared to the same period in 2017 due primarily to $337,000 in gains on the sale of a former branch and a $324,000 gain on the payoff of an acquired loan recorded during the second quarter of 2017.

Noninterest Expense

Noninterest expense in the second quarter of 2018 totaled $27.6 million, which was $2.2 million greater than the $25.4 million reported for the second quarter of 2017. Salaries and employee benefits expense of $16.7 million increased $1.6 million, or 11%, from the same period last year, as a result of additions to our staff to support continued growth, as well as normal merit increases. Data processing expense increased $474,000 in the second quarter of 2018 compared to the same period in 2017 due primarily to the expansion and improvement of the Company's digital infrastructure. Stationary, supplies and postage expense decreased $129,000 due primarily to consumer deposit mailings in the second quarter of 2017. The Company’s efficiency ratio, a non-GAAP financial measure, was 55.6% in the second quarter of 2018, compared to 52.6% for the same period last year, primarily due to an increase in noninterest expenses. The Company uses this ratio because it believes that the ratio provides a good comparison of period-to-period performance and because the ratio is widely accepted in the banking industry. The following table shows the calculation of the efficiency ratio for the periods presented:

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	For the Three Months Ended June 30,	
	2018	2017
	(dollars in thousands)	
Calculation of Efficiency Ratio		
Total noninterest expense	$27,574	$25,366
Amortization of core deposit intangibles	(153)	(190)
Noninterest expense, as adjusted	$27,421	$25,176
Net interest income	$43,493	$41,421
Noninterest income	5,709	6,111
Total revenue	49,202	47,532
Tax-equivalent adjustment on municipal securities	114	281
(Gains) losses on sales of investment securities	—	15
Total revenue, as adjusted	$49,316	$47,828
Efficiency ratio	55.6 %	52.6 %

Income Tax Expense

The effective tax rate in the second quarter of 2018 was 21.3% compared to 34.3% during the same period last year primarily due to the change in tax rates resulting from the Tax Cuts and Jobs Act of 2017 (the "Tax Act").

On July 1, 2018, the State of New Jersey enacted new legislation that created a temporary surtax effective for tax years 2018 through 2021 and will require companies to file combined tax returns beginning in 2019. Management is currently evaluating the effect of the new legislation on our net deferred tax asset and future tax expense. We anticipate an impact to our deferred taxes in the third quarter of 2018 due to the change in state rate and, prospectively, our state tax expense will increase.

Comparison of Operating Results for the Six Months Ended June 30, 2018 and 2017

Net Income

Net income was $31.1 million, or $0.65 per diluted share, for the first six months of 2018 compared to net income of $25.7 million, or $0.53 per diluted share, for the first six months of 2017. Net income increased as a result of an increase in net interest income and as a result of a decrease in tax expense relating to the Tax Cuts and Jobs Act of 2017. Net interest income of $85.7 million for the first six months of 2018 increased $5.0 million from the first six months of 2017 resulting from organic growth and an increase in market interest rates.

Net Interest Income

Net interest income on a tax equivalent basis for the first six months of 2018 was $86.0 million, compared to $81.3 million for the first six months of 2017. The net interest margin increased from 3.37% in the first six months of 2017 to 3.41% in the first six months of 2018 primarily as a result of a 24 basis point increase in the yield on interest-earning assets, partially offset by a 25 basis point increase in the cost of interest-bearing liabilities. The increase in yield on interest-earning assets primarily resulted from an increase in rates caused by the recent increases in the federal funds rate and prime rate, while the increase in the cost of interest-bearing liabilities was due primarily to a higher cost of deposits resulting from a CD promotion in the latter half of 2017 as well as an increasingly competitive market for deposits resulting from the higher interest rate environment. The increase in net interest margin was augmented by an increase in interest income earned on free funds (interest-earning assets funded by noninterest-bearing liabilities) resulting from an increase in average noninterest-bearing deposits of $28.8 million. The components of net interest income will be discussed in greater detail below.

The following table reflects the components of the Company's net interest income, setting forth for the periods presented, (1) average assets, liabilities and stockholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) the Company's net interest spread (i.e., the average yield on interest-earning assets less the average cost of interest-

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bearing liabilities) and (5) the Company’s net interest margin. Rates for the six months ended June 30, 2018 are computed on a tax equivalent basis using a tax rate of 21%, while rates for the six months ended June 30, 2017 are computed on a tax equivalent basis using a tax rate of 35%.

	For the Six Months Ended June 30, 2018			For the Six Months Ended June 30, 2017		
	Average Balance	Interest Income/ Expense	Average Rates Earned/ Paid	Average Balance	Interest Income/ Expense	Average Rates Earned/ Paid
	(dollars in thousands)					
ASSETS						
Interest-earning assets:						
Loans and leases (1)	$4,220,972	$93,203	4.45 %	$3,958,564	$83,151	4.24 %
Taxable investment securities and other	732,995	8,019	2.19 %	700,971	7,417	2.12 %
Tax-exempt securities	83,187	1,104	2.65 %	112,719	1,588	2.82 %
Federal funds sold (2)	41,271	311	1.51 %	94,643	408	0.86 %
Total interest-earning assets	5,078,425	102,637	4.07 %	4,866,897	92,564	3.83 %
Noninterest-earning assets:						
Allowance for loan and lease losses	(36,152)			(32,063)		
Other assets	381,279			362,931		
TOTAL ASSETS	$5,423,552			$5,197,765		
LIABILITIES AND STOCKHOLDERS’ EQUITY						
Interest-bearing liabilities:						
Savings accounts	$492,173	$143	0.06 %	$491,890	$139	0.06 %
Interest-bearing transaction accounts	2,217,676	7,115	0.65 %	2,268,752	4,631	0.41 %
Time deposits	776,929	4,998	1.29 %	557,479	2,348	0.84 %
Borrowings	347,696	4,420	2.54 %	352,926	4,146	2.34 %
Total interest-bearing liabilities	3,834,474	16,676	0.87 %	3,671,047	11,264	0.62 %
Noninterest-bearing liabilities:						
Demand deposits	967,246			938,460		
Other liabilities	33,261			28,730		
Stockholders’ equity	588,571			559,528		
TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY	$5,423,552			$5,197,765		
Net interest income/spread		85,961	3.20 %		81,300	3.22 %
Tax equivalent basis adjustment		232			556	
NET INTEREST INCOME		$85,729			$80,744	
Net interest margin (3)			3.41 %			3.37 %

(1) Includes non-accrual loans, the effect of which is to reduce the yield earned on loans, and deferred loan fees.
(2) Includes interest-bearing cash accounts.
(3) Net interest income divided by interest-earning assets.

Interest income on a tax equivalent basis increased from $92.6 million in the first six months of 2017 to $102.6 million in the first six months of 2018, an increase of $10.1 million, or 11%. The increase in interest income was primarily a result of an increase in rates caused by the recent increases in the federal funds rate and prime rate as well as organic growth in loans, as

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average loans and leases increased $262.4 million compared to the first six months of 2017. The yield on average loans and leases at 4.45% in the first six months of 2018 was 21 basis points higher than the first six months of 2017. The yield on average taxable investment securities increased 7 basis points, while the yield on average tax-exempt investment securities decreased 17 basis points. The decrease in yield on average tax-exempt investment securities was due primarily to a reduction in tax equivalent income resulting from the Tax Cut and Jobs Act of 2017.

Total interest expense of $16.7 million in the first six months of 2018 was $5.4 million greater than the $11.3 million reported for the same period in 2017. The cost of average interest-bearing liabilities increased from 0.62% in the first six months of 2017 to 0.87% in the first six months of 2018. The increase in the cost of interest-bearing liabilities was due primarily to an increasingly competitive market for deposits resulting from a higher interest rate environment as well as an increase in the cost of borrowings. The cost of interest-bearing transaction accounts and time deposits increased by 24 basis points and 45 basis points, respectively, while the cost of borrowings increased 20 basis points compared to the first six months of 2017. Average time deposits increased from $557.5 million in the first six months of 2017 to $776.9 million in the first six months of 2018 primarily as a result of the Company's certificate of deposit promotion beginning in the last half of 2017.

Provision for Loan and Lease Losses

In the first six months of 2018, a $2.8 million provision for loan and lease losses was recorded, compared to $3.0 million for the same period last year. The Company charged off $2.2 million and recovered $586,000 in the first six months of 2018 compared to $2.2 million and $763,000, respectively, in the first six months of 2017. For more information regarding the determination of the provision, see “Risk Elements” below.

Noninterest Income

Noninterest income of $11.0 million in the first six months of 2018 decreased by $3.2 million from $14.2 million in the first six months of 2017. Noninterest income for the first six months of 2017 included $2.5 million in gains on sales of investment securities compared to none during the first six months of 2018. Commissions and fees increased $391,000 compared to the first six months of 2017 due primarily to the same reason discussed in the quarterly comparison. Income on bank owned life insurance of $1.4 million for the second quarter of 2018 increased $504,000 compared to the same period last year, while gains on sales of loans decreased $323,000, both due primarily to the same reasons discussed in the quarterly comparison. Other income decreased $1.2 million compared to the same period in 2017 due primarily to $706,000 in gains on the sale of two former branches and a $324,000 gain on the payoff of an acquired loan recorded during the second quarter of 2017. Additionally, gains on sales of other real estate owned in the first half of 2018 decreased $413,000 compared to the same period in 2017.

Noninterest Expense

Noninterest expense in the first six months of 2018 totaled $54.7 million, which was $0.9 million more than the $53.8 million reported for the first six months of 2017. In the first six months of 2017, noninterest expense included $2.8 million in long-term debt prepayment fees compared to none in the first six months of 2018. Salaries and employee benefits expense of $33.6 million increased $3.1 million, or 10%, from the same period last year, as a result of additions to our staff to support continued growth, as well as normal merit increases. Data processing expense and telecommunications expense in the first six months of 2018 increased $387,000 and $107,000, respectively, compared to the same period in 2017 due primarily to the expansion and improvement of the Company's digital infrastructure. Stationary, supplies and postage decreased $156,000 due primarily to the same reason discussed in the quarterly comparison. The Company’s efficiency ratio, a non-GAAP financial measure, was 56.1% in the first six months of 2018, compared to 54.4% for the same period last year. The Company uses this ratio because it believes that the ratio provides a good comparison of period-to-period performance and because the ratio is widely accepted in the banking industry. The following table shows the calculation of the efficiency ratio for the periods presented:

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	For the Six Months Ended June 30,	
	2018	2017
	(dollars in thousands)	
Calculation of Efficiency Ratio		
Total noninterest expense	$54,711	$53,836
Amortization of core deposit intangibles	(310)	(385)
Long Term Debt prepayment fee	—	(2,828)
Noninterest expense, as adjusted	$54,401	$50,623
Net interest income	$85,729	$80,744
Noninterest income	11,043	14,205
Total revenue	96,772	94,949
Tax-equivalent adjustment on municipal securities	232	556
(Gains) losses on sales of investment securities	—	(2,524)
Total revenue, as adjusted	$97,004	$92,981
Efficiency ratio	56.1 %	54.4 %

Income Tax Expense

The effective tax rate in the first six months of 2018 was 20.9% compared to 32.5% during the same period last year primarily due to the change in tax rates resulting from the Tax Act.

Financial Condition

The Company's total assets increased $128.8 million from December 31, 2017, to $5.53 billion at June 30, 2018. Total loans net of deferred fees were $4.28 billion, an increase of $124.8 million, or 3%, from $4.15 billion at December 31, 2017. Total deposits were $4.40 billion, an increase of $31.3 million, or 1%, from December 31, 2017.

Loans and Leases

Gross loans and leases of $4.28 billion at June 30, 2018 increased $124.6 million from December 31, 2017, primarily in the commercial loans secured by real estate category which increased $93.9 million, or 3%. Additionally, real estate construction loans increased $32.4 million, or 12%. For more information on the loan portfolio, see Note 5 in Notes to the Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

Risk Elements

Non-performing assets, excluding PCI loans, increased from $14.5 million at December 31, 2017 to $16.5 million at June 30, 2018. Non-accrual loans and leases in the commercial secured by real estate category, commercial, industrial and other category, and other real estate owned increased $1.5 million, $1.0 million, and $1.3 million, respectively, while real estate construction loans decreased $1.5 million. The percentage of non-performing assets to total assets was 0.30% at June 30, 2018 compared to 0.27% at December 31, 2017. Non-accrual loans at June 30, 2018 included three loan relationships with a balance of $1 million or greater, totaling $3.1 million, and four loan relationships between $500,000 and $1.0 million, totaling $2.5 million.

There were $0 in loans and leases past due ninety days or more and still accruing at June 30, 2018 compared to $200,000 at December 31, 2017. These loans primarily consist of open-end consumer loans secured by real estate which are generally placed on non-accrual and reviewed for charge-off when principal and interest payments are four months in arrears unless the obligations are well-secured and in the process of collection.

On June 30, 2018, the Company had $7.9 million in loans that were troubled debt restructurings and accruing interest income compared to $11.5 million at December 31, 2017. On June 30, 2018, the Company had $4.9 million in troubled debt restructurings that were included in non-accrual loans compared to $2.7 million at December 31, 2017. Troubled debt restructurings are those loans where the Company has granted concessions to the borrower in payment terms, either in rate or in term, as a result of the financial condition of the borrower.

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On June 30, 2018, the Company had $19.3 million in impaired loans (consisting primarily of non-accrual and restructured loans and leases) compared to $22.6 million at year-end 2017. The Company also had purchased credit impaired loans from the Pascack and Harmony acquisitions with carrying values of $175,000 and $511,000, respectively, at June 30, 2018. For more information on impaired loans and leases see Note 5 in Notes to the Consolidated Financial Statements of this Quarterly Report on Form 10-Q. The valuation allowance for impaired loans is based primarily on the fair value of the underlying collateral. Based on such evaluation, $865,000 of the allowance for loan and lease losses has been allocated for impairment at June 30, 2018 compared to $505,000 at December 31, 2017. At June 30, 2018, the Company also had $23.3 million in loans and leases that were rated substandard that were not classified as non-performing or impaired compared to $28.3 million at December 31, 2017.

There were no loans and leases at June 30, 2018, other than those designated non-performing, impaired or substandard, where the Company was aware of any credit conditions of any borrowers or obligors that would indicate a strong possibility of the borrowers not complying with present terms and conditions of repayment and which may result in such loans and leases being included as non-accrual, past due or renegotiated at a future date.

The following table sets forth for the periods presented, the historical relationships among the allowance for loan and lease losses, the provision for loan and lease losses, the amount of loans and leases charged-off and the amount of loan and lease recoveries:

(dollars in thousands)	For the Six Months Ended June 30, 2018	For the Six Months Ended June 30, 2017	For the Year Ended December 31, 2017
Balance of the allowance at the beginning of the year	$35,455	$31,245	$31,245
Loans and leases charged off:			
Commercial, secured by real estate	(232)	(303)	(762)
Commercial, industrial and other	(1,301)	(234)	(477)
Leases	(95)	(163)	(305)
Real estate - mortgage	(93)	(310)	(441)
Real estate - construction	(248)	(609)	(609)
Home equity and consumer	(244)	(611)	(852)
Total loans charged off	(2,213)	(2,230)	(3,446)
Recoveries:			
Commercial, secured by real estate	305	364	396
Commercial, industrial and other	96	122	172
Leases	5	32	59
Real estate - mortgage	5	—	5
Real estate - construction	8	20	31
Home equity and consumer	167	225	903
Total recoveries	586	763	1,566
Net charge-offs:	(1,627)	(1,467)	(1,880)
Provision for loan and lease losses	2,776	3,045	6,090
Ending balance	$36,604	$32,823	$35,455
Net charge-offs as a percentage of average loans and leases outstanding	0.08 %	0.07 %	0.05 %
Allowance as a percentage of total loans and leases outstanding	0.85 %	0.81 %	0.85 %

Allowance as a percentage of non-accrual loans	256.56 %	202.05 %	259.65 %

The determination of the adequacy of the allowance for loan and lease losses and the periodic provisioning for estimated losses included in the consolidated financial statements is the responsibility of management and the Board of Directors. Management performs a formal quarterly evaluation of the allowance for loan and lease losses. This quarterly process is performed by the credit administration department and approved by the Chief Credit Officer. All supporting documentation with regard to the evaluation process is maintained by the credit administration department. Each quarter, the evaluation along with the supporting documentation is reviewed by the finance department before approval by the Chief Credit Officer. The allowance evaluation is then presented to an Allowance for Loan and Lease Losses committee, which gives final approval to the allowance evaluation before presented to the Board of Directors for their approval.

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Additionally, the Company continually evaluates, through its governance process, the development of the allowance for loan and lease losses methodology. During 2017, the Company refined and enhanced its quantitative framework by implementing loss migration periods to determine historical loss rates. It also enhanced its qualitative framework to complement the loss migration historical loss rates. These enhancements were implemented to increase the level of precision in the allowance for loan and lease losses and did not result in a material change in the required allowance for loan and lease losses.

The methodology employed for assessing the adequacy of the allowance consists of the following criteria:

•The establishment of specific reserve amounts for impaired loans and leases, including PCI loans.

•The establishment of reserves for pools of homogeneous loans and leases not subject to specific review, including impaired loans under $500,000, leases, 1 - 4 family residential mortgages, and consumer loans.

The establishment of reserve amounts for pools of homogeneous loans and leases are based upon the determination of historical loss rates, which are adjusted to reflect current conditions through the use of qualitative factors. The qualitative factors considered by the Company include an evaluation of the results of the Company's independent loan review function, the Company's reporting capabilities, the adequacy and expertise of Lakeland's lending staff, underwriting policies, loss histories, trends in the portfolio, delinquency trends, economic and business conditions and capitalization rates. Since many of Lakeland's loans depend on the sufficiency of collateral as a secondary source of repayment, any adverse trends in the real estate market could affect the underlying values available to protect Lakeland from losses.

Additionally, management determines the loss emergence periods for each loan segment, which are used to define loss migration periods and establish appropriate ranges for qualitative adjustments for each loan segment. The loss emergence period is the estimated time from the date of a loss event (such as a personal bankruptcy) to the actual recognition of the loss (typically via the first partial or full loan charge-off), and is determined based upon a study of our past loss experience by loan segment. All of the factors considered in the analysis of the adequacy of the allowance for loan and lease losses may be subject to change. To the extent actual outcomes differ from management estimates, additional provisions for loan and lease losses may be required that would adversely impact earnings in future periods.

The overall balance of the allowance for loan and lease losses of $36.6 million at June 30, 2018 increased $1.1 million, from December 31, 2017, an increase of 3%. The change in the allowance within loan segments during the two comparable periods captures changes in the non-performing loan and charge-off statistics, changes in the risk ratings of the loans and the level of growth. Non-performing loans and leases of $14.3 million at June 30, 2018 increased $612,000 from December 31, 2017. The allowance for loan and lease losses as a percent of total loans was 0.85% at both June 30, 2018 and December 31, 2017. Management believes, based on appraisals and estimated selling costs that the majority of its non-performing loans and leases are adequately secured and reserves on its non-performing loans and leases are adequate. Based upon the process employed and giving recognition to all accompanying factors related to the loan and lease portfolio, management considers the allowance for loan and lease losses to be adequate at June 30, 2018.

Investment Securities

For detailed information on the composition and maturity distribution of the Company's investment securities portfolio, see Note 4 in Notes to Consolidated Financial Statements contained in this Quarterly Report on Form 10-Q. Total investment securities decreased $2.7 million, from $767.7 million at December 31, 2017 to $765.1 million at June 30, 2018.

Deposits

Total deposits increased from $4.37 billion at December 31, 2017 to $4.40 billion at June 30, 2018, an increase of $31.3 million, or 1%. Time deposits increased $69.4 million, while savings and interest-bearing transaction accounts decreased $38.7 million.

Liquidity

"Liquidity" measures whether an entity has sufficient cash flow to meet its financial obligations and commitments on a timely basis. The Company is liquid when its subsidiary bank has the cash available to meet the borrowing and cash withdrawal requirements of customers and the Company can pay for current and planned expenditures and satisfy its debt obligations.

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Lakeland funds loan demand and operation expenses from several sources:

- Net income. Cash provided by operating activities was $43.9 million for the first six months of 2018 compared to $33.1 million for the same period in 2017.
- Deposits. Lakeland can offer new products or change its rate structure in order to increase deposits. In the first six months of 2018, Lakeland’s deposits increased $31.3 million.
- Sales of securities. At June 30, 2018 the Company had $606.2 million in securities designated “available for sale.” Of these securities, $320.3 million were pledged to secure public deposits and for other purposes required by applicable laws and regulations.
- Repayments on loans and leases can also be a source of liquidity to fund further loan growth.
- Credit lines. As a member of the FHLB, Lakeland has the ability to borrow overnight based on the market value of collateral pledged. Lakeland had $50.0 million in overnight borrowings from the FHLB on June 30, 2018. Lakeland also has overnight federal funds lines available for it to borrow up to $210.0 million of which $116.3 million was outstanding at June 30, 2018. Lakeland may also borrow from the discount window of the Federal Reserve Bank of New York based on the market value of collateral pledged. Lakeland had no borrowings with the Federal Reserve Bank of New York as of June 30, 2018.
- Other borrowings. Lakeland can also generate funds by utilizing long-term debt or securities sold under agreements to repurchase that would be collateralized by security or mortgage collateral. At times the market values of securities collateralizing our securities sold under agreements to repurchase may decline due to changes in interest rates and may necessitate our lenders to issue a “margin call” which requires Lakeland to pledge additional collateral to meet that margin call.

Management and the Board monitor the Company’s liquidity through the Asset/Liability Committee, which monitors the Company’s compliance with certain regulatory ratios and other various liquidity guidelines.

The cash flow statements for the periods presented provide an indication of the Company’s sources and uses of cash, as well as an indication of the ability of the Company to maintain an adequate level of liquidity. A discussion of the cash flow statement for the six months ended June 30, 2018 follows.

Cash and cash equivalents totaling $142.8 million on June 30, 2018 decreased $121,000 from December 31, 2017. Operating activities provided $43.9 million in net cash. Investing activities used $142.2 million in net cash, primarily reflecting an increase in loans and leases and the purchase of securities. Financing activities provided $98.2 million in net cash primarily reflecting the net increase in deposits of $31.5 million and net proceeds from federal funds purchased and other borrowings of $77.4 million. The Company anticipates that it will have sufficient funds available to meet its current loan commitments and deposit maturities. This constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995.

The following table sets forth contractual obligations and other commitments representing required and potential cash outflows as of June 30, 2018. Interest on subordinated debentures and long-term borrowed funds is calculated based on current contractual interest rates.

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	Total	Within One Year	After One But Within Three Years	After Three But Within Five Years	After Five Years
	(dollars in thousands)				
Minimum annual rentals on noncancellable operating leases	$29,794	$3,235	$ 5,978	$ 4,949	$ 15,632
Benefit plan commitments	5,811	306	793	855	3,857
Remaining contractual maturities of time deposits	806,783	570,881	194,736	41,166	—
Subordinated debentures	104,963	—	—	—	104,963
Loan commitments	986,829	681,689	113,716	40,165	151,259
Other borrowings	196,376	66,082	81,040	39,817	9,437
Interest on other borrowings*	65,751	8,794	15,142	12,182	29,633
Standby letters of credit	20,228	18,400	1,748	—	80
Total	$2,216,535	$1,349,387	$ 413,153	$ 139,134	$314,861

*Includes interest on other borrowings and subordinated debentures at a weighted rate of 3.06%.

Capital Resources

Total stockholders' equity increased from $583.1 million on December 31, 2017 to $597.9 million on June 30, 2018, an increase of $14.7 million. Book value per common share increased to $12.59 on June 30, 2018 from $12.31 on December 31, 2017. Tangible book value per share increased from $9.38 per share on December 31, 2017 to $9.67 per share on June 30, 2018, an increase of 3%. Please see "Non-GAAP Financial Measures" below. The increase in stockholders' equity from December 31, 2017 to June 30, 2018 was primarily due to $31.1 million of net income, partially offset by other comprehensive loss on the Company's available for sale securities portfolio of $7.1 million and the payment of cash dividends on common stock of $10.3 million.

The Company and Lakeland are subject to various regulatory capital requirements that are monitored by federal banking agencies. Failure to meet minimum capital requirements can lead to certain supervisory actions by regulators; any supervisory action could have a direct material adverse effect on the Company or Lakeland's financial statements. As of June 30, 2018, the Company and Lakeland met all capital adequacy requirements to which they are subject.

The final rules implementing the Basel Committee on Banking Supervision's ("BCBS") capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final rule's requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of June 30, 2018, the Company's capital levels remained characterized as "well-capitalized" under the new rules.

The capital ratios for the Company and Lakeland for the periods presented are as follows:

	Tier 1 Capital to Total Average Assets Ratio		Common Equity Tier 1 to Risk-Weighted Assets Ratio		Tier 1 Capital to Risk-Weighted Assets Ratio		Total Capital to Risk-Weighted Assets Ratio	
	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017
The Company	9.43 %	9.12 %	10.49 %	10.18 %	11.16 %	10.87 %	13.67 %	13.40 %
Lakeland Bank	10.26 %	10.06 %	12.14 %	12.00 %	12.14 %	12.00 %	13.01 %	12.86 %
Required capital ratios including conservation buffer	4.00 %	4.00 %	6.38 %	5.750 %	7.88 %	7.250 %	9.88 %	9.250 %
"Well capitalized" institution under	5.00 %	5.00 %	6.50 %	6.50 %	8.00 %	8.00 %	10.00 %	10.00 %

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The Economic Growth, Regulatory Relief, and Consumer Protection Act (the “Act”) was signed into law during the second quarter of 2018. The Act, among other matters, amends the Federal Deposit Insurance Act to require federal banking agencies to develop a specified Community Bank Leverage Ratio (the ratio of a bank's equity capital to its consolidated assets) for banks with assets of less than $10 billion. Banks that exceed this ratio shall be deemed to comply with all other capital and leverage requirements. The Act also expands the definition of qualified mortgages that may be held by a financial institution. We are unable to predict the specific impact the Act and the implementing rules and regulations, which have not yet been written, will have on the Company and Lakeland Bank.

Non-GAAP Financial Measures

Reported amounts are presented in accordance with U.S. GAAP. The Company’s management uses certain supplemental non-GAAP information in its analysis of the Company’s financial results. Specifically, the Company provides measurements and ratios based on tangible equity and tangible assets. These measures are utilized by regulators and market analysts to evaluate a company’s financial condition and therefore, such information is useful to investors.

The Company also provides measures based on what it believes are its operating earnings on a consistent basis, and excludes material non-routine operating items which affect the GAAP reporting of results of operations. The Company’s management believes that providing this information to analysts and investors allows them to better understand and evaluate the Company’s core financial results for the periods in question.

These disclosures should not be viewed as a substitute for financial results determined in accordance with U.S. GAAP, nor are they necessarily comparable to non-GAAP performance measures which may be presented by other companies.

(dollars in thousands, except per share amounts)	June 30, 2018	December 31, 2017
Calculation of Tangible Book Value per Common Share		
Total common stockholders’ equity at end of period - GAAP	$597,864	$583,122
Less:		
Goodwill	136,433	136,433
Other identifiable intangible assets, net	2,052	2,362
Total tangible common stockholders’ equity at end of period - Non-GAAP	$459,379	$444,327
Shares outstanding at end of period	47,484	47,354
Book value per share - GAAP	$12.59	$12.31
Tangible book value per share - Non-GAAP	$9.67	$9.38
Calculation of Tangible Common Equity to Tangible Assets		
Total tangible common stockholders’ equity at end of period - Non-GAAP	$459,379	$444,327
Total assets at end of period	$5,534,488	$5,405,639
Less:		
Goodwill	136,433	136,433
Other identifiable intangible assets, net	2,052	2,362
Total tangible assets at end of period - Non-GAAP	$5,396,003	$5,266,844
Common equity to assets - GAAP	10.80 %	10.79 %
Tangible common equity to tangible assets - Non-GAAP	8.51 %	8.44 %

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(dollars in thousands)	For the Three Months Ended June 30, 2018	June 30, 2017	For the Six Months Ended June 30, 2018	June 30, 2017
Calculation of Return on Average Tangible Common Equity				
Net income - GAAP	$15,838	$13,370	$31,093	$25,682
Total average common stockholders' equity	$593,388	$565,211	$588,571	$559,528
Less:				
Average goodwill	136,433	135,755	136,433	135,751
Average other identifiable intangible assets, net	2,134	3,069	2,217	3,172
Total average tangible common stockholders' equity - Non-GAAP	$454,821	$426,387	$449,921	$420,605
Return on average common stockholders' equity - GAAP	10.71 %	9.49 %	10.65 %	9.26 %
Return on average tangible common stockholders' equity - Non-GAAP	13.97 %	12.58 %	13.94 %	12.31 %

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company manages interest rate risk and market risk by identifying and quantifying interest rate risk exposures using simulation analysis and economic value at risk models. Net interest income simulation considers the relative sensitivities of the balance sheet including the effects of interest rate caps on adjustable rate mortgages and the relatively stable aspects of core deposits. As such, net interest income simulation is designed to address the probability of interest rate changes and the behavioral response of the balance sheet to those changes. Market Value of Portfolio Equity represents the fair value of the net present value of assets, liabilities and off-balance-sheet items. Changes in estimates and assumptions made for interest rate sensitivity modeling could have a significant impact on projected results and conclusions. These assumptions could include prepayment rates, sensitivity of non-maturity deposits and other similar assumptions. Therefore, if our assumptions should change, this technique may not accurately reflect the impact of general interest rate movements on the Company's net interest income or net portfolio value.

The starting point (or "base case") for the following table is an estimate of the following year's net interest income assuming that both interest rates and the Company's interest-sensitive assets and liabilities remain at period-end levels. The net interest income estimated for the next twelve months (the base case) is $173.6 million. The information provided for net interest income assumes that changes in interest rates of plus 200 basis points and minus 200 basis points change gradually in equal increments ("rate ramp") over the twelve month period.

	Changes in Interest Rates	
Rate Ramp	+200 bp	-200 bp
Asset/Liability policy limit	(5.0)%	(5.0)%
June 30, 2018	(1.3)%	(2.0)%
December 31, 2017	(1.1)%	(3.6)%

The Company's review of interest rate risk also includes policy limits for net interest income changes in various "rate shock" scenarios. Rate shocks assume that current interest rates change immediately. The information provided for net interest income assumes fluctuations or "rate shocks" for changes in interest rates as shown in the table below.

	Changes in Interest Rates			
Rate Shock	+300 bp	+200 bp	+100 bp	-100 bp

Asset/Liability policy limit	(15.0)%	(10.0)%	(5.0)%	(5.0)%
June 30, 2018	(1.5)%	(1.0)%	(0.4)%	(2.5)%
December 31, 2017	0.3 %	0.3 %	0.3 %	(5.9)%

The base case for the following table is an estimate of the Company’s net portfolio value for the periods presented using current discount rates, and assuming the Company’s interest-sensitive assets and liabilities remain at period-end levels. The net portfolio value at June 30, 2018 (the base case) was $833.8 million. The information provided for the net portfolio value assumes

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fluctuations or “rate shocks” for changes in interest rates as shown in the table below. Rate shocks assume that current interest rates change immediately.

	Changes in Interest Rates			
Rate Shock	+300 bp	+200 bp	+100 bp	-100 bp
Asset/Liability policy limit	(25.0)%	(20.0)%	(10.0)%	(10.0)%
June 30, 2018	(5.4)%	(3.4)%	(1.6)%	0.3 %
December 31, 2017	(5.0)%	(3.3)%	(1.4)%	(0.4)%

The information set forth in the above tables is based on significant estimates and assumptions, and constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995. For more information regarding the Company’s market risk and assumptions used in the Company’s simulation models, please refer to the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Certain shortcomings are inherent in the methodologies used in the above interest rate risk measurements. Modeling changes in net interest income requires the making of certain assumptions regarding prepayment and deposit decay rates, which may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. While management believes such assumptions are reasonable, there can be no assurance that assumed prepayment rates and decay rates will approximate actual future loan prepayment and deposit withdrawal activity. Moreover, the net interest income table presented assumes that the composition of interest sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and also assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration to maturity or repricing of specific assets and liabilities. Accordingly, although the net interest income table provides an indication of the Company’s interest rate risk exposure at a particular point in time, such measurement is not intended to and does not provide a precise forecast of the effect of changes in market interest rates on net interest income and will differ from actual results.

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Item 4. Controls and Procedures

(a)Disclosure controls and procedures. As of the end of the Company's most recently completed fiscal quarter covered by this report, the Company carried out an evaluation, with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-15. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms and are operating in an effective manner and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b)Changes in internal controls over financial reporting. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

There are no pending legal proceedings involving the Company or Lakeland other than those arising in the normal course of business. Management does not anticipate that the potential liability, if any, arising out of such legal proceedings will have a material effect on the financial condition or results of operations of the Company and Lakeland on a consolidated basis.

Item 1A. Risk Factors

There have been no material changes in risk factors from those disclosed under Item 1A, "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds Not Applicable

Item 3. Defaults Upon Senior Securities Not Applicable

Item 4. Mine Safety Disclosures Not Applicable

Item 5. Other Information Not Applicable

Item 6. Exhibits

3.1	Restated Certificate of Incorporation of Lakeland Bancorp, Inc.
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Lakeland Bancorp, Inc.
(Registrant)

/s/ Thomas J. Shara
Thomas J. Shara
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Thomas F. Splaine
Thomas F. Splaine
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)
Date: August 8, 2018