MCDONALDS CORP
Form 4
October 06, 2006

FORM 4

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

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

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL
OMB Number: 3235-0287
Expires: January 31, 2005
Estimated average burden hours per response... 0.5

(Print or Type Responses)

1. Name and Address of Reporting Person *
Dillon Mary

(Last) (First) (Middle)

MCDONALD'S CORPORATION, 2915 JORIE BOULEVARD

(Street)

OAK BROOK, IL 60523

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
MCDONALDS CORP [MCD]

3. Date of Earliest Transaction (Month/Day/Year)
10/04/2006

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
Corp Exec VP, Chf Mktg Officer

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	10/04/2006		M		14,000	A	(1)	14,000	D	
Common Stock	10/04/2006		F (2)		4,273	D	$ 40	9,727	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amo Underlying Secu (Instr. 3 and 4)	
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Am or Nu of S
Restricted Stock Units	(1)	10/04/2006		M			14,000	10/04/2006 (3)	10/04/2006 (3)	Common Stock	14

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Dillon Mary MCDONALD'S CORPORATION 2915 JORIE BOULEVARD OAK BROOK, IL 60523			Corp Exec VP, Chf Mktg Officer	

Signatures

/s/ Carol A. Vix, Attorney-in-fact	10/06/2006
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Restricted Stock Units (RSUs) are granted under the Company's Amended and Restated 2001 Omnibus Stock Ownership Plan and are subject to the terms of such Plan. The Compensation Committee of the Board of Directors has approved payout of the RSUs in shares of McDonald's Corporation common stock.

(2) Shares were withheld by the Company to satisfy the tax withholding obligations upon vesting of RSUs in an exempt transaction under Rule 16b-3(d)(1).

(3) The Restricted Stock Units vest in 20% increments on the first, second, third, fourth and fifth anniversary dates of the grant.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. >

William N. Scheffel

Executive Vice President & Chief Financial Officer

Explanation of Responses:

EXHIBIT INDEX

Exhibit Number	Description
1.1	Underwriting Agreement, dated January 27, 2014 among Centene Corporation, Mark Mitchell, and Barclays Capital Inc.

at September 30, 2004. These limits will increase or decrease in response to increases or decreases in the bank's level of capital. We are able to sell participations in our larger commercial loans to other financial institutions, which allows us to manage the risk involved in these loans and to meet the lending needs of our clients requiring extensions of credit in excess of these limits. Loans that are sold as participations to other banks are sold without recourse to the bank. DEPOSIT SERVICES Our principal source of funds is core deposits. We offer a full range of deposit services, including checking accounts, commercial accounts, savings accounts, and other time deposits of various types, ranging from daily money market accounts to long-term certificates of deposit. Deposit rates are reviewed regularly by senior 42 management of the bank. We believe that the rates we offer are competitive with those offered by other financial institutions in our area. Over the past three years, we have adopted a strategy of focusing on the origination and retention of transaction accounts and the reduction of our dependence on higher cost time deposits as a funding source. We have implemented a suite of interest bearing checking account products, called High Performance Checking, with interest rates and other features tired to differing levels of minimum balances. Since 2002, time deposits have declined from 30.9% of our deposit portfolio, with an average rate of 3.06% to 26.7% of our deposit portfolio, with an average rate of 2.09% for the nine months ended September 30, 2004. Our NOW accounts, which include our High Performance Checking and commercial checking accounts, have increased from 18.8% of our average deposit portfolio for the year end of December 31, 2002 to 21.4% for the nine months ended September 30, 2004. In addition to lowering our cost of funds, we believe increasing our core deposits presents greater cross selling opportunities then are available with customers holding time deposits. To attract additional public deposits we have also developed a public fund money market account. The account allows municipal depositors to automatically transfer balances from non-interest bearing transaction accounts into a variable rate interest bearing money market account. We believe this product will provide an alternative to higher rate time deposit accounts traditionally used by public depositors. OTHER BANKING SERVICES We offer other bank services including safe deposit boxes, traveler's checks, direct deposit, United States Savings Bonds, and banking by mail. We earn fees for most of these services, including debit and credit card transactions, sales of checks, and wire transfers. We also receive ATM transaction fees from transactions performed by our clients. We are associated with the NYCE, CIRRUS, PLUS and QUEST ATM networks, which are available to our clients throughout the country. We also offer Internet banking services, bill payment services, cash management services, trust services and full service securities brokerages. INSURANCE AGENCY SERVICES Tri-State Insurance Agency, Inc. is a full service insurance agency. The Agency is primarily a property and casualty agency, with property and casualty coverage accounting for 95% of the agency's commission income. Life and health insurance accounts for 5% of commission income. Approximately 65% of the agency's premium volume is from commercial lines of insurance, with the remaining 35% from personal lines. The agency places insurance with over 15 companies. The agency is licensed to conduct business in 15 states, but 90% of its business is within the State of New Jersey. Customers primarily come from personal contacts of the senior management of the agency and the agency's producers, as well as through cross selling efforts with the bank. DESCRIPTION OF PROPERTY Certain information regarding the company's properties as of December 31, 2003 is set forth in the following table. All properties are adequately covered by insurance. DATE OF LOCATION LEASED OR OWNED LEASE EXPIRATION -------- -------------- ---------------- 399 Route 23 Owned N/A Franklin, New Jersey 7 Church Street Owned N/A Vernon, New Jersey 266 Clove Road Leased March, 2007 Montague, New Jersey 43 DATE OF LOCATION LEASED OR OWNED LEASE EXPIRATION -------- -------------- ---------------- 96 Route 206 Augusta, New Jersey Leased August, 2006 455 Route 23 Owned(1) N/A Wantage, New Jersey 15 Trinity Street Owned N/A Newton, New Jersey 165 Route 206 Owned N/A Andover, New Jersey 100 Route 206 Owned N/A Augusta, New Jersey 33 Main Street Owned N/A Sparta, New Jersey 200 Munsonhurst Road Leased December, 2008 Franklin, New Jersey (1) We own the building housing our Wantage branch. The land on which the building is located is leased pursuant to a ground lease which runs until December 31, 2020, and contains an option for us to extend the lease for an additional 25 year term. LEGAL PROCEEDINGS We are periodically parties to or otherwise involved in legal proceedings arising in the normal course of business, such as claims to enforce liens, claims involving the making and servicing of real property loans, and other issues incident to the business of the company and the bank. Management does not believe that there is any pending or threatened proceeding against the company or the bank, which if determined adversely, would have a material effect on the business or financial position of the company. EMPLOYEES As of December 31, 2003, the company employed 101 full-time employees and 28 part-time employees. None of these employees is covered by a collective bargaining agreement and we believe that our employee relations are good. 44 MANAGEMENT The direction and control of the company is vested in the board of directors. The term of each director is three years. Directors are divided into three classes and elections are staggered so that the term for one class of directors expires each year. The following table sets forth information with respect to the directors and certain executive officers, including their ages, a brief description of their recent business experience, certain directorships held by each, the year in which each became a director of the company and the year in which their terms as director of the company expire. NAME AND POSITION AGE PRINCIPAL OCCUPATION FOR THE PAST DIRECTOR SINCE TERM EXPIRES ----------------- --- ------------------------------- ------------- ------------ FIVE YEARS ---------- DIRECTORS --------- Donald L. Kovach, 69 Chairman of the Board, CEO and 1976 2006 Chairman of the Board, CEO President of the company and President Irvin Ackerson, 82 Excavating Contractor, 1976 2007 Director Ackerson Contracting Co., Oak Ridge, New Jersey Terry H. Thompson, 57 President and Chief Operating 2001 2007 Director, Secretary and Officer of the bank President of the Bank Mark J. Hontz, 37 Partner, 1998 2006 Director Hollander Hontz Hinkes & Pasculli, L.L.C., Newton, New Jersey Joel D. Marvil, 70 Chairman of Manufacturing Co., 1989 2006 Vice Chairman Ames Rubber Corporation, Hamburg, New Jersey Edward J. Leppert, 44 Owner, 2002 2005 Director E.J. Leppert & Co., C.P.A.; Former Partner, Murphy, Perry & Leppert Richard Scott, 68 Dentist, 1976 2005 Director Richard Scott, DDS, Franklin, New Jersey Joseph Zitone, 72 General Contractor, 1984 2005 Director Zitone Construction, Montague, New Jersey EXECUTIVE OFFICERS WHO ARE ------------------------- NOT DIRECTORS ------------- Tammy Case 46 Executive Vice President, Loan 2004 N/A Administration; Formerly Senior Lending Officer, Newton Trust Company Samuel L. Chaznow 46 Vice President; Formerly Area 2003 N/A Sales Manager and Assistant Vice President First Horizon Home Loan George B. Harper 50 President Tri-State Insurance 2001 N/A Agency, Inc. Candace Leatham 50 Executive Vice President and 1984 N/A Treasurer of the bank George Lista 45 Chief Operating Officer, Tri-State 2001 N/A Insurance Agency 45 EXECUTIVE OFFICERS Set forth below is certain information regarding our executive officers. DONALD L. KOVACH. Mr. Kovach is Chairman of the Board and Chief Executive Officer of the company. He is a life-long resident of Sussex County, and has been the Chairman of the bank since it was formed. Prior to becoming the company's Chief Executive Officer, Mr. Kovach was an attorney in private practice, and served as Sussex County Counsel, as municipal counsel to the Sussex County towns of Hamburg, Hopatcong and Vernon, and as counsel to the Sussex County Community College. Mr. Kovach is active in many community organizations, and is a director of Independent Community Bankers Financial Services. TERRY H. THOMPSON. Mr. Thompson is President and Chief Operating Officer of the bank. He has been our Chief Operating Officer since 1994, and was named President in 2003. Mr. Thompson began his banking career in 1970, and held a number of increasingly senior positions with Summit Bancorp, a New Jersey bank holding company with operations throughout the state. Mr. Thompson is also the New Jersey state director for the Independent Community Bankers Association, a national trade group for community banks. CANDACE LEATHAM. Ms. Leatham is the Executive Vice President and Treasurer of the bank. She has over 30 years of financial services industry experience, and has been an employee of the company and the bank for almost 25 years. She is active in her local community, serving as a member of the Hardyston Township Zoning Board of

Adjustment and the Hardyston Township Municipal Utilities Authority, GEORGE B. HARPER. Mr. Harper is President of Tri-State Insurance Agency, a subsidiary of the bank, where has been President since 1976. He is active in many community organizations, including serving as a Director of Sussex Area Charities, and has served as the Mayor and a Council Member of Sandyston Township since 1986. GEORGE LISTA. Mr. Lista is Chief Operating Officer of Tri-State Insurance Agency, a subsidiary of the bank. He has served as an executive officer of Tri-State and a predecessor agency since 1982. TAMMY CASE. Ms. Case is Executive Vice President - Loan Administration of the bank. She has over 27 years of experience in the banking industry, 23 of which has been spent in Sussex County. Prior to joining the company, Ms. Case was the Senior Vice President of Business Banking Services and the Senior Loan Officer of Newton Trust Company, another Sussex County based community bank. She is also an honors graduate of the Stonier Graduate School of Banking. SAMUEL CHAZANOW. Mr. Chazanow is the Vice President and head of residential mortgage banking operations for the Bank. Mr. Chazanow has been a mortgage banking professional since 1989, most recently as the area sales manager for the Northeast Region for First Horizon Home Loans, a large national lending company. Mr. Chazanow has been based in the northeast Pennsylvania marketplace for his entire mortgage banking career. COMMITTEES OF THE BOARD The board of directors maintains an Audit Committee and a Compensation Committee. The board of directors also plans to establish a Nominating Committee that meets the requirements of the American Stock Exchange ("AMEX") listing standards beginning with the 2005 Annual Meeting. For the 2004 Annual Meeting, the full board acted as a Nominating Committee. It is expected that the Nominating Committee will consider qualified nominations for directors that are submitted by shareholders. All shareholder recommendations will be evaluated on the same basis as any recommendation from members of the Board of management of the company. AUDIT COMMITTEE. The company's Audit Committee assists the board of directors with its oversight of our accounting and financial reporting processes, including internal audit functions, and the audits of our financial statements. In connection with its oversight responsibilities, the Audit Committee is responsible for the appointment, compensation, evaluation, retention and termination of our independent auditors. The Audit Committee has sole responsibility for oversight over the independent auditor, including resolution of disagreements between company management and the independent auditor regarding financial reporting. In connection with its oversight role, the Audit Committee reviews the independent auditor's reports regarding critical accounting policies, alternative treatments within generally accepted accounting principles, and other written communications between 46 the independent auditor and management. The Audit Committee is also responsible for receiving and responding to complaints and concerns relating to accounting and auditing matters and the pre-approval of all non-audit service provided by its independent auditor. Furthermore, the Audit Committee is also responsible for, among other things, reporting to the board of directors on the results of the annual audit, and reviewing the financial statements and related financial and non-financial disclosures included in our earnings releases and Annual Reports on Form 10-KSB. The Audit Committee has adopted a written charter outlining its practices and responsibilities. During the year ended December 31, 2003, the Audit Committee met five times. At each meeting, the Audit Committee reviewed the results of reviews performed in the areas of internal audit and compliance. The Audit Committee was apprised of the status of all audit findings and the resolutions instituted by management. The company's Audit Committee consists of directors Edward J. Leppert (Chairman), Joel D. Marvil and Richard W. Scott. All directors who serve on the Audit Committee are "independent" for purposes of the AMEX listing standards and, as required under the Sarbanes-Oxley Act, no member of the Audit Committee receives any form of compensation from the company outside from compensation for board and committee services. The board has determined that Mr. Leppert qualified as an "audit committee financial expert" as that term is defined in Item 401(e) of SEC Regulation S-B. The Audit Committee acts only in an oversight capacity, and in doing so relies on the work and assurances of our management and its independent auditors. COMPENSATION COMMITTEE. The Compensation Committee sets the compensation for the executive officers of the company. The Compensation Committee consists of directors Joel D. Marvil (Chairman), Irvin Ackerson, Edward J. Leppert and Mark J. Hontz, all of whom are "independent" for purposes of the AMEX listing standards. DIRECTORS' COMPENSATION During 2003, directors of the bank who were not full-time employees of the bank received a fee of $500 for each regular monthly bank board meeting or special bank board meeting attended, and $100 for each committee meeting attended. Each member of the bank's loan committee will receive $500 per meeting in 2004. During 2003, directors of the company received an annual retainer of $5,000 each. In addition, members of the Audit Committee will receive in 2004 an additional fee of $1,000 per Audit Committee meeting, and the Chairman will receive $1,500 per meeting. The company maintains the 1995 Stock Option Plan for Non-Employee Directors (the "Non-Employee Plan"), the purpose of which is to assist the company in attracting and retaining qualified persons to serve as members of the board of directors. Under the Non-Employee Plan, options may be granted at exercise prices which may not be less than the fair market value of the common stock on the date of grant. Under the Non-Employee Plan, each non-employee director elected at the 1995 Annual Meeting was granted an option to purchase 3,000 shares at $11.25 per share (or 6,950 shares at $4.84 as adjusted for stock dividends). In addition, each non-employee director who is elected or re-elected to serve on the board of directors at succeeding annual meetings will be granted an option to purchase 500 shares of common stock at the time of such re-election. As of December 31, 2003, 44,732 options were outstanding under this plan and 2,344 authorized shares were available for grant. In addition, members of the board of directors are eligible to participate in the 2001 Stock Option Plan, which was approved by the shareholders in 2000. Under the 2001 Stock Option Plan, options to purchase up to a total of 165,000 shares of common stock may be granted. Pursuant to the terms of the 2001 Stock Option Plan, options which qualify as incentive stock options under the Internal Revenue Code of 1986 must be granted at an exercise price of no less than 100% of the then current fair market value of the common stock, and options which are non-statutory options may be granted at an exercise price no less than 85% of the then current fair market value of the common stock. DIRECTOR RELATIONSHIPS No director of the company is also a director of any company with a class of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 or subject to the requirements of Section 15(d) thereof, or any company registered as an investment company under the Investment Company Act of 1940. 47 SECURITY OWNERSHIP OF MANAGEMENT The table sets forth certain information as of August 31, 2004 with respect to (i) each of the directors and executive officers of the company and (ii) the directors and executive officers as a group: COMMON STOCK BENEFICIALLY PERCENTAGE OF NAME OF BENEFICIAL OWNER NUMBER OF SHARES1 SHARES OUTSTANDING ------------------------ ----------------- ------------------ Irvin Ackerson 35,273(2) 1.90% George Harper 40,322(3) 2.18% Mark J. Hontz 3,817(4) 0.21% Donald L. Kovach 137,931(5) 7.42% Candace Leatham 49,411(6) 2.67% Edward J. Leppert 13,378(7) 0.72% George Lista 16,958(8) 0.91% Joel D. Marvil 49,761(9) 2.68% Richard Scott 56,319(10) 3.04% Terry H. Thompson 27,610(11) 1.49% _________________________ 1 Beneficially-owned shares include shares over which the named person exercises either sole or shared voting power or sole or shared investment power. It also includes shares owned (i) by a spouse, minor children or by relatives sharing the same home, (ii) by entities owned or controlled by the named person and (iii) by other persons if the named person has the right to acquire such shares within sixty (60) days by the exercise of any right or option. Unless otherwise noted, all shares are owned of record and beneficially by the named person, either directly or through the dividend reinvestment plan. 2 Includes (i) 11,418 shares owned by Mr. Ackerson's wife and (ii) 11,360 shares pursuant to immediately exercisable stock options. 3 Includes 4,794 shares pursuant to immediately exercisable stock options. 4 Includes 1,000 shares pursuant to immediately exercisable stock options. 5 Includes (i) 17,448 shares owned by Mr. Kovach's wife, (ii) 9,977 shares held by IRAs for the benefit of Mr. Kovach and his wife, (iii) 1,433 shares held in the name of ICBA Financial Services f/b/o Donald L. Kovach, (iv) 1,323 shares held in the name of ICBA Financial Services f/b/o Betty J. Kovach, (v) 16,764 shares pursuant to immediately exercisable stock options and (vi) 42,098 shares over which Mr. Kovach has voting authority as administrator for Sussex Bank Employee Stock Ownership Plan. 6 Includes (i) 6,477 shares pursuant to immediately exercisable stock options and (ii) 42,098 shares over which Ms. Leatham has voting authority as administrator of Sussex Bank Employee Stock Ownership Plan. 7 Includes (i) 992 shares held in the name of Sun America f/b/o Cynthia Leppert, IRA, (ii) 3,396 shares held in the name of Salomon Smith Barney f/b/o Edward J. Leppert, IRA and (iii) 3,150 shares pursuant to immediately exercisable stock options. 8 Includes 3,744 shares pursuant to immediately exercisable stock options. 9 Includes 14,429 shares pursuant to immediately exercisable stock options. 10 Includes 12,307 shares pursuant to immediately exercisable stock options. 11 Includes (i) 13,425 shares held in the name of American Express Trust Co. f/b/o Terry H. Thompson, IRA, and (ii) 9,546 shares pursuant to immediately exercisable stock options. 48 COMMON STOCK BENEFICIALLY PERCENTAGE OF NAME OF BENEFICIAL OWNER NUMBER OF SHARES SHARES OUTSTANDING ------------------------ ---------------- ------------------ Joseph Zitone 94,313(12) 5.11% Directors and Executive Officers as a Group (11 persons) 500,446 25.82% It is expected that upon consummation of this offering, our Directors and Executive Officers are expected to own approximately 17.7% of outstanding common stock. SUMMARY OF CASH AND CERTAIN OTHER COMPENSATION The following table sets forth a summary of cash and non-cash compensation for the three fiscal years ended December 31, 2003 awarded to, earned by, or paid to, the Chief Executive Officer of the company and each other executive officer whose remuneration exceeded $100,000 for the most recently completed fiscal year. SUMMARY COMPENSATION TABLE CASH AND CASH EQUIVALENT FORMS OF REMUNERATION --- ANNUAL COMPENSATION AWARD PAYOUTS SECURITIES OTHER ANNUAL UNDERLYING LTIP ALL OTHER NAME YEAR SALARY ($) BONUS ($) COMPENSATION OPTIONS/SARS PAYOUTS ($) COMPENSATION ---- ---- ---------- --------- ------------ ------------- ------------ ------------ ($) (#) ($) --- --- --- Donald L. 2003 $202,087 - N/A13 9,975 None $143,049(14) Kovach 2002 $188,143 - N/A13 3,150 None $117,869(14) 2001 $177,234 - N/A13 1,134 None $ 94,156(14) George B. 2003 $ 50,000 $21,515(15) $76,264(16) 4,988 None - Harper 2002 $ 50,000 $ 5,660(15) $67,022(16) -- None - 2001 $ 12,500(17) - $11,300(16) -- None - _________________________ 12 Includes (i) 12,467 shares held in the name of Zitone Construction & Supply Co., Inc. Profit Sharing Plan Trust, (ii) 22,509 shares held in the name of Zitone Family Limited Partnership, (iii) 17,198 shares held in the name of Smith Barney f/b/o Joseph Zitone and (iv) 3,701 shares pursuant to immediately exercisable stock options. 13 The company provided additional life insurance and an automobile and matched the contributions by Messrs. Kovach and Thompson to their respective 401(k) plans. The use made thereof for personal purposes did not exceed 10% of the total cash compensation to such person's respective base salary and bonus and there is not included in the above table. 14 Represents the amount charged by the company to expense in connection with the Supplemental Executive Retirement Plan ("SERP") implemented for the benefit of Mr. Kovach in 2000. 15 For purposes of this chart, bonus represents the fair market value of 1,516 shares in 2003 and 535 shares in 2002 of the company's common stock. 16 Represents commissions earned on the sale of insurance products. 17 Pursuant to the company's acquisition of Tri-State Insurance Agency, Inc. on October 1, 2001, Messrs. Harper and Lista became executive officers of the company at annual salaries of $50,000 and $120,000, respectively. 49 ANNUAL COMPENSATION AWARD PAYOUTS SECURITIES OTHER ANNUAL UNDERLYING LTIP ALL OTHER NAME YEAR SALARY ($) BONUS ($) COMPENSATION OPTIONS/SARS PAYOUTS ($) COMPENSATION ---- ---- ---------- --------- ------------ ------------- ------------ ------------ ($) (#) ($) --- --- --- George Lista 2003 $120,000 $21,515(15) $95,822(16) 4,988 None - 2002 $120,000 $ 5,660(15) $61,796(16) -- None - 2001 $ 30,000(17) - $16,740(16) -- None - Terry H. 2003 $109,650 - $ 1,051(18)(13) 7,481 None - Thompson 2002 $ 98,280 - N/A13 3,780 None - 2001 $ 93,880 - N/A13 735 None - EMPLOYMENT AGREEMENTS The company and the bank are parties to an Amended Employment Agreement with Mr. Donald L. Kovach pursuant to which he serves as President and Chief Executive Officer of the company and Chief Executive Officer of the bank (the "Employment Agreement"). The Employment Agreement, as amended, provides for a term ending on August 31, 2007, although it will be automatically extended on each anniversary date for up to two additional one-year periods unless either party provides notice of their intention not to extend the contract. The Employment Agreement provides that Mr. Kovach will receive a base salary of $223,300, subject to increase or decrease, and he may be granted a discretionary bonus, in cash or equity, as determined by the board of directors. The Employment Agreement permits the company to terminate Mr. Kovach's employment for cause at any time. The Employment Agreement defines cause to mean personal dishonesty, willful misconduct, breach of fiduciary duty involving personal profit, intentional failure to perform stated duties, willful violation of law, rule or regulation, other than traffic violations or similar offenses, or violation of a final cease and desist order, or a material breach of any provision of the Employment Agreement. In the event Mr. Kovach is terminated for any reason other than cause, or in the event Mr. Kovach resigns his employment because he is reassigned to a position of lesser rank or status than President and Chief Executive Officer, his place of employment is relocated by more than 30 miles from its location on the date of the Employment Agreement, or his compensation or other benefits are reduced, Mr. Kovach, or in the event of his death, his beneficiary, will be entitled to receive his base salary at the time of such termination or resignation for the remaining term of the Employment Agreement. In addition, the company will continue to provide Mr. Kovach with certain insurance and other benefits through the end of the term of the Employment Agreement. Mr. Kovach's Employment Agreement further provides that upon the occurrence of a change in control of the company, as defined in the Employment Agreement, and in the event Mr. Kovach is terminated for reasons other than cause or in the event Mr. Kovach, within 18 months of the change in control, resigns his employment for the reasons discussed above, he shall be entitled to receive a severance payment based upon his then current base salary. Under the Agreement, in the event the change in control occurs, Mr. Kovach is entitled to a severance payment equal to 2.99 times his then current base salary. The Employment Agreement also prohibits Mr. Kovach from competing with the bank and the company for a period of one year following termination of his employment. The company and the bank are parties to an employment agreement with Terry Thompson. Mr.

Thompson's agreement has substantially the same terms as those contained in Mr. Kovach's agreement, except that the term of Mr. Thompson's agreement expires on January 23, 2006. Mr. Thompson's agreement also provides that its terms will automatically be extended for one additional year, until January 23, 2007, unless the company provides notice three (3) months prior to the termination of the original term of the agreement Mr. Thompson's base salary is set at $110,000. ________________________ 18 Includes the implied value realized upon the exercise of options to purchase 189 shares representing the difference between the exercise price and the fair market value on the date of exercise. Because Mr. Thompson did not sell the underlying shares, he did not recognize this implied value. 50 In connection with the company's acquisition of Tri-State Insurance Agency, Inc. effective October 1, 2001, the company entered into employment agreements with each of Messrs George B. Harper and George Lista. Under these agreements, each of Messrs. Harper and Lista is to be paid a base salary ($50,000 for Mr. Harper and $120,000 for Mr. Lista) and commissions for insurance products actually placed. In addition, each of Messrs Harper and Lista is entitled to receive bonuses based upon the net before tax income of Tri-State for each twelve-month period commencing on the effective date of the acquisition. To the extent Tri-State's net before tax income exceeds certain designated targets contained in each employment agreement, each of Messrs. Harper and Lista will be entitled to receive a bonus equal to 25% of the amount by which the net before tax income of Tri State exceeds the target. The bonus is to be paid in shares of the company's common stock. The amount of stock to be issued will be determined by dividing the amount of the bonus by the fair market value of the company's common stock, determined by taking the average closing price of the common stock for the fifteen trading days prior to issuance. For the twelve-month period ended September 30, 2003, Tri-State exceeded its targeted net before tax income, and each of Messrs. Harper and Lista received a bonus of 1,516 shares of the company's common stock. The employment agreements with Messrs. Harper and Lista expire on September 30, 2006. On July 31, 2004, the bank entered into an employment agreement with Tammy Case under which she will serve as the Executive Vice-President - Loan Administration of the bank. The agreement has term of 3 years and will automatically renew for each additional year on the third anniversary of the agreement unless either party has provided notice of its intention not to renew at least 3 months before the end of the term. Under the Agreement, Ms. Case is to receive a base salary of $97,000, will be eligible to receive a production bonus in shares of the company's common stock, based upon growth in the company's loan portfolio, and will also be eligible to participate in any other cash bonus programs established by the company for its executive officers. Ms. Case may be terminated for "cause" as defined in the Agreement. In the event she is terminated without "cause" she will be entitled to receive her then current base salary for the remaining term of the Agreement, but in no event for less than 6 months, and the company will be obligated to continue her health benefits for such period. Ms. Case's agreement contains a change of control provision substantially similar to the one contained in Mr. Kovach's agreement described above, except that her payment will equal two times her then current base salary. Ms. Case's agreement also contains a covenant not to compete, whereby she is prohibited for a period of 1 year after her termination from affiliating with any enterprise that competes with the company within Sussex County, New Jersey. RETIREMENT PLANS The bank maintains a salary continuation plan for Mr. Kovach. Under this plan, as recently amended, Mr. Kovach will receive a retirement benefit equal to 35% of his average final compensation determined by his last five years of employment, provided that to the extent Mr. Kovach continues to work past age 70, his final compensation will be increased 4% per year for each year he works past age 70 until his retirement. Mr. Kovach will receive this benefit in the event that he works until retirement, or he is involuntarily discharged prior to his retirement for any reason other than "cause". For purposes of the Salary Continuation Agreement, cause is defined in the same manner as under Mr. Kovach's Employment Agreement. Annual retirement payments are to be made for fifteen years under the Salary Continuation Agreement to Mr. Kovach or, in the event of his death, to his spouse. The bank has also instituted a salary continuation plan for Mr. Thompson. Under this plan, Mr. Thompson will receive a retirement benefit equal to 35% of his average final compensation determined by his last five years of employment. Mr. Thompson's benefits under the salary continuation plan will not vest unless Mr. Thompson remains employed with the company and the bank until January, 2006. 1995 INCENTIVE STOCK OPTION PLAN AND 2001 STOCK OPTION PLAN The company maintains the 1995 Incentive Stock Option Plan that provides for options to purchase shares of common stock to be issued to key employees of the company, the bank and any other subsidiaries that the company may acquire or incorporate in the future. The company also maintains the 2001 Stock Option Plan, under which options to purchase shares of common stock may be issued to employees, officers and directors of the company, the bank and any other subsidiaries which the company may acquire or incorporate in the future. Recipients of options granted under the Plans are selected by the Stock Option Committee of the board of directors. The Stock Option Committee has the authority to determine the terms and conditions of options granted under the Plans and the exercise price therefore. The exercise price for options granted under the 1995 Incentive Stock Option Plan, and for 51 Incentive Stock Options under the 2001 Stock Option Plan may be no less than the fair market value of the common stock. The exercise price for non-statutory options granted under the 2001 Stock Option Plan may be no less than 85% of the fair market value of the common stock. The following table sets forth information with regard to stock options granted under the company's 1995 Incentive Stock Option Plan and 2001 Stock Option Plan. The following table furnishes information regarding stock options granted to the individuals named in the table above: INDIVIDUAL GRANTS ---------------- NUMBER OF PERCENTAGE OF SECURITIES TOTAL OPTIONS/SARS UNDERLYING GRANTED TO PRESENT VALUE OF OPTIONS/SARS EMPLOYEES IN FISCAL EXERCISE OR STOCK OPTION ON EXPIRATION NAME GRANTED YEAR BASE PRICE ($/SH) DATE OF GRANT(19) DATE ---- ------- ---- ---------------- ---------------- ---- Donald L. Kovach 9,975(20) 16.3% $9.90 $1.16 01/22/13 Terry H. Thompson 7,481(21) 12.2% $9.90 $1.16 01/22/13 George B. Harper 4,988(22) 8.2% $10.05 $1.15 04/23/13 George Lista 4,988(23) 8.2% $10.05 $1.15 04/23/13 The following table sets forth information concerning the fiscal year-end value of unexercised stock options held by the executive officers named in the table above. AGGREGATED OPTION/SAR EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION/SAR VALUES -------------------------------- NUMBER OF UNEXERCISED VALUE OF UNEXERCISED OPTIONS/SARS IN-THE-MONEY OPTIONS/SARS NUMBER OF AT FISCAL YEAR-END AT FISCAL YEAR-END SHARES ------------------ ------------------ ACQUIRED ON VALUE NAME EXERCISE REALIZED ($) EXERCISABLE UNEXERCISABLE EXERCISABLE UNEXERCISABLE ---- -------- ------------ ----------- ------------- ----------- ------------- Donald L. Kovach - - 10,619 9,705 $75,275 $96,107 Terry H. Thompson 189 $1,605 4,128 7,967 $41,012 $78,857 George H. Harper - - 2,297 3,741 $22,778 $37,590 George Lista - - 1,247 3,741 $12,530 $37,590 ________________________ 19 The present value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions: dividend yield of 2.41%, expected volatility of 13.24%, risk-free interest rate of 3.05% for Mr. Kovach and Mr. Thompson and 2.93% for Mr. Harper and Mr. Lista and an expected life of five (5) years. 20 As of December 31, 2003, 2,494 of these options were immediately exercisable. 21 As of December 31, 2003, 1,870 of these options were immediately exercisable. 22 As of December 31, 2003, 1,247 of these options were immediately exercisable. 23 As of December 31, 2003, 1,247 of these options were immediately exercisable. 52 TRANSACTIONS WITH MANAGEMENT The bank has made in the past and, assuming continued satisfaction of generally applicable credit standards, expects to continue to make loans to directors, executive officers and their associates (i.e. corporations or organizations for which they serve as officers or directors or in which they have beneficial ownership interests of ten percent or more). All of these loans have been made in the ordinary course of the bank's business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons and do not involve more than the normal risk of default or present other unfavorable features. The bank also had the following transactions with directors, executive officer and their associates at terms at least as favorable to the bank as could be obtained from an independent third party. The bank paid $15,770 to Irvin Ackerson for real estate appraisal services rendered to the bank for loan originations during fiscal 2003. Mr. Ackerson continues to render real estate appraisal services to the bank. The bank also paid $10,716 to related parties during 2003 for legal, tax accounting and construction services. The bank leases its Montague branch office from Montague Mini Mall, Inc. pursuant to a lease covering 1,200 square feet. The lease agreement was renewed as of April 1, 2002. As renewed, the lease will terminate on March 31, 2007 and provides for a monthly rent of $1,850 or $22,200 per year. Mr. Joseph Zitone, a director of the company, is the majority shareholder or Montague Mini Mall, Inc. The company considers the lease terms to be comparable to those which exist with unaffiliated third parties. 53 DESCRIPTION OF THE COMPANY'S SECURITIES GENERAL Sussex Bancorp is incorporated under the laws of the State of New Jersey. The rights of the holders of our stock will be governed by the New Jersey Business Corporation Act and the certificate of incorporation. The company's certificate of incorporation provides for an authorized capitalization consisting of 5,000,000 shares of common stock, without par value. As of September 30, 2004, 1,842,188 shares of the company's common stock were outstanding, leaving 3,157,812 shares of authorized common stock available to be issued. Under New Jersey law, the board of directors is generally empowered to issue authorized common stock without shareholder approval. Upon completing of the offering, assuming the exercise of the over-allotment options granted to the underwriter, there will be 2,973,338 shares of common stock outstanding. Up to an additional 268,570 shares of common stock will be issuable upon exercise of the outstanding options granted under the company's 1995 and 2001 stock option plans. DIVIDEND RIGHTS The holders of the company's common stock are entitled to dividends, when, as, and if declared by the board of directors, subject to the restrictions imposed by New Jersey law. The only statutory limitation applicable to the company is that dividends may not be paid if the company is insolvent. However, as a practical matter, unless the company expands its activities, its only source of income will be the earnings of the bank. Under the Banking Act, dividends may be paid only if, after the payment of the dividend, the capital stock of the bank will be unimpaired and either the bank will have a surplus of not less than 50% of its capital stock or the payment of the dividend will not reduce the bank's surplus. VOTING RIGHTS Each share of the common stock is entitled to one vote per share. Cumulative voting is not permitted. Under New Jersey corporate law, the affirmative vote of a majority of the votes cast is required to approve any merger, consolidation or disposition of substantially all of the company's assets. PREEMPTIVE RIGHTS Under New Jersey law, shareholders may have preemptive rights if these rights are provided in the certificate of incorporation. The company's certificate of incorporation does not provide for preemptive rights. APPRAISAL RIGHTS Under New Jersey law, dissenting shareholders will have appraisal rights (subject to the broad exception set forth in the next sentence) upon certain mergers or consolidations. Appraisal rights are not available in any such transaction if shares of the corporation are listed for trading on a national securities exchange or held of record by more than 1,000 holders. In addition, appraisal rights are not available to shareholders of an acquired corporation if, as a result of the transaction, shares of the acquired corporation are exchanged for any of the following: (i) cash; (ii) any securities listed on a national securities exchange or held of record by more than 1,000 holders; or (iii) any combination of the above. New Jersey law also provides that a corporation may grant appraisal rights in other types of transactions or regardless of the consideration received by providing for such rights in its certificate of incorporation. The company's certificate of incorporation does not provide appraisal rights beyond those called for under New Jersey law. 54 DIRECTORS Under New Jersey law and the company's certificate of incorporation, the company is to have a minimum of three (3) directors and a maximum of twenty-five (25), with the number of directors at any given time to be fixed by the board of directors. The company currently has eight (8) directors. INDEMNIFICATION The company's certificate of incorporation provides that the company will indemnify any person who was or is a party to any threatened, pending or completed action, whether civil or criminal, administrative or investigative by reason of the fact that such person is or was a director or officer of the company, or is or was serving as a director or officer of any other entity at the company's request against expenses, judgments, fines and amounts paid in settlement incurred by such person in connection with such action, provided that the director or officer acted in good faith in a manner he reasonably believed to be in or not opposed to the best interest of the company and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful. In addition, in the event that such action is in the name of the company, a director or officer may not be indemnified if he is found liable to the company unless a court determines that, despite the finding of liability, the officer or director is fairly and reasonably entitled to indemnification. LIMITATION OF LIABILITY The company's certificate of incorporation contains provisions that may limit the liability of any of its directors or officers to the company or its shareholders for damages for an alleged breach of any duty owed to the company or its shareholders. This limitation will not relieve an officer or director from liability based on any act or omission (i) which was in breach of such person's duty of loyalty to the company or its shareholders; (ii) which was not in good faith or involved a knowing violation of law; or (iii) which resulted in receipt by such officer or director of an improper personal benefit. These provisions are permissible under New Jersey law. ANTI-TAKEOVER PROVISIONS BANK REGULATORY REQUIREMENTS Under the Federal Change in Bank Control Act (the "Control Act"), a 60 day prior written notice must be submitted to the Federal Reserve Bank ("FRB") if any person, or any group acting in concert, seeks to acquire 10% or more of any class of outstanding voting securities of a bank holding company, unless the FRB determines that the acquisition will not result in a change of control. Under the Control Act, the FRB has 60 days within which to act on such notice taking into consideration certain factors, including the financial and managerial resources of the acquirer, the convenience and needs of the community served by the bank holding company and its subsidiary banks and the antitrust effects of the acquisition. Under the Bank Holding Company Act of 1956, as amended ("BHCA"), a company is generally required to obtain prior approval of the FRB before it may obtain control of a bank holding company. Under the BHCA, control is generally described to mean the beneficial ownership of 25% or more of the outstanding voting securities of a company, although a presumption of control may exist if a party beneficially owns 10% or more of the outstanding voting securities of a company and certain other circumstances are present. CLASSIFIED BOARD OF DIRECTORS Pursuant to the company's certificate of incorporation, the board of directors is divided into three classes, each of which contains approximately one-third of the whole number of the members of the board. Each class serves a staggered term, with approximately one-third of the total number of directors being elected each year. The certificate of incorporation and bylaws provide that the size of the board shall be determined by a majority of the directors. The certificate of incorporation and the bylaws provide that any vacancy occurring in the board, including a vacancy created by an increase in the number of directors or resulting from death, resignation, retirement, disqualification, removal from office or other cause, shall be filled for the remainder of the unexpired term exclusively by a majority vote of the directors then in office. The classified board is intended to provide for continuity of the board of directors and to make it more difficult and time consuming for a stockholder group to use 55 its voting power to gain control of the board of directors without the consent of the incumbent board of directors of the company. STOCKHOLDER VOTE REQUIRED TO APPROVE BUSINESS COMBINATIONS Under New Jersey law, business combinations, including mergers, consolidations and sales of all or substantially all of the assets of a corporation must, subject to certain exceptions, be approved by the vote of the holders of a majority of the outstanding shares of common stock of the company and any other affected class of stock, unless a higher vote is required under a company's certificate of incorporation. The company's certificate of incorporation does not contain any higher voting requirements. AMENDMENT OF CERTIFICATE OF INCORPORATION AND BYLAWS Amendments to the certificate of incorporation must be approved by a majority vote of the company's board of directors and also by a majority of the outstanding shares of its voting stock. NEW JERSEY SHAREHOLDERS PROTECTION ACT A provision of New Jersey law, the New Jersey Shareholders Protection Act, prohibits certain transactions involving an "interested stockholder' and a corporation. An "interested stockholder" is generally defined as one who is the beneficial owner, directly or indirectly, of 10% or more of the voting power of the outstanding stock of the corporation. The Shareholders Act prohibits certain business combinations between an interested stockholder and a New Jersey corporation subject to the Shareholders Act for a period of five years after the date the interested stockholder acquired his stock, unless the transaction was approved by the corporation's board of directors prior to the time the interested stockholder acquired his stock. After the five-year period expires, the prohibition on business combinations with an interested stockholder continues unless certain conditions are met. The conditions include (i) that the business combination is approved by the board of directors of the target corporation; (ii) that the business combination is approved by a vote of two-thirds of the voting stock not owned by the interested stockholder; and (iii) that the stockholders of the corporation receive a price in accordance with the Shareholders Act. SUPERVISION AND REGULATION Bank holding companies and banks are extensively regulated under both federal and state law. These laws and regulations are intended to protect depositors, not shareholders. To the extent that the following information describes statutory and regulatory provisions, it is qualified in its entirety by reference to the particular statutory and regulatory provisions. Any change in the applicable law or regulation may have a material effect on the business and prospects of the company and the bank. BANK HOLDING COMPANY REGULATION As a bank holding company registered under the Bank Holding Company Act, the company is subject to the regulation and supervision applicable to bank holding companies by the Board of Governors of the Federal Reserve System. The company is required to file with the Federal Reserve annual reports and other information regarding its business operations and those of its subsidiaries. The Bank Holding Company Act requires, among other things, the prior approval of the Federal Reserve in any case where a bank holding company proposes to (i) acquire all or substantially all of the assets of any other bank, (ii) acquire direct or indirect ownership or control of more than 5% of the outstanding voting stock of any bank (unless it owns a majority of such company's voting shares) or (iii) merge or consolidate with any other bank holding company. The Federal Reserve will not approve any acquisition, merger, or consolidation that would have a substantially anti-competitive effect, unless the anti-competitive impact of the proposed transaction is clearly outweighed by a greater public interest in meeting the convenience and needs of the community to be served. The Federal Reserve also considers capital adequacy and other financial and managerial resources and future prospects of the companies and the banks concerned, together with the convenience and needs of the community to be served, when reviewing acquisitions or mergers. 56 The Bank Holding Company Act generally prohibits a bank holding company, with certain limited exceptions, from (i) acquiring or retaining direct or indirect ownership or control of more than 5% of the outstanding voting stock of any company which is not a bank or bank holding company, or (ii) engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or performing services for its subsidiaries, unless such non-banking business is determined by the Federal Reserve to be so closely related to banking or managing or controlling banks as to be properly incident thereto. The Bank Holding Company Act was substantially amended through the Modernization Act. The Modernization Act permits bank holding companies and banks that meet certain capital, management and Community Reinvestment Act standards to engage in a broader range of non-banking activities. In addition, bank holding companies which elect to become financial holding companies may engage in certain banking and non-banking activities without prior Federal Reserve approval. Finally, the Modernization Act imposes certain new privacy requirements on all financial institutions and their treatment of consumer information. At this time, the company has elected not to become a financial holding company, as it does not engage in any activities which are not permissible for banks. There are a number of obligations and restrictions imposed on bank holding companies and their depository institution subsidiaries by law and regulatory policy that are designed to minimize potential loss to the depositors of such depository institutions and the FDIC insurance funds in the event the depository institution becomes in danger of default. Under a policy of the Federal Reserve with respect to bank holding company operations, a bank holding company is required to serve as a source of financial strength to its subsidiary depository institutions and to commit resources to support such institutions in circumstances where it might not do so absent such policy. The Federal Reserve also has the authority under the Bank Holding Company Act to require a bank holding company to terminate any activity or to relinquish control of a non-bank subsidiary upon the Federal Reserve's determination that such activity or control constitutes a serious risk to the financial soundness and stability of any bank subsidiary of the bank holding company. CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES The Federal Reserve has adopted risk-based capital guidelines for bank holding companies. The risk-based capital guidelines are designed to make regulatory capital requirements more sensitive to differences in risk profile among banks and bank holding companies, to account for off-balance sheet exposure, and to minimize disincentives for holding liquid assets. Under these guidelines, assets and off-balance sheet items are assigned to broad risk categories each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items. The minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) is 8%. At least 4% of the total capital is required to be "Tier I Capital," consisting of common shareholders' equity and qualifying preferred stock, less certain goodwill items and other intangible assets. The remainder ("Tier II Capital") may consist of (a) the allowance for loan losses of up to 1.25% of risk-weighted assets, (b) non-qualifying preferred stock, (c) hybrid capital instruments, (d) perpetual debt, (e) mandatory convertible securities, and (f) qualifying subordinated debt and intermediate-term preferred stock up to 50% of Tier I capital. Total capital is the sum of Tier I and Tier II capital less reciprocal holdings of other banking organizations' capital instruments, investments in unconsolidated subsidiaries and any other deductions as determined by the Federal Reserve (determined on a case by case basis or as a matter of policy after formal rule-making). Bank holding company assets are given risk-weights of 0%, 20%, 50% and 100%. In addition, certain off-balance sheet items are given similar credit conversion factors to convert them to asset equivalent amounts to which an appropriate risk-weight will apply. These computations result in the total risk-weighted assets. Most loans are assigned to the 100% risk category, except for performing first mortgage loans fully secured by residential property which carry a 50% risk-weighting and loans secured by deposits in the bank which carry a 20% risk weighting. Most investment securities (including, primarily, general obligation claims of states or other political subdivisions of the United States) are assigned to the 20% category, except for municipal or state revenue bonds, which have a 50% risk-weight, and direct obligations of the U.S. Treasury or obligations backed by the full faith and credit of the U.S. Government, which have a 0% risk-weight. In converting off-balance sheet items, direct credit substitutes including general guarantees and standby letters of credit backing financial obligations are given a 100% risk weighting. Transaction related contingencies such as bid bonds, standby letters of credit backing nonfinancial obligations, and 57 undrawn commitments (including commercial credit lines with an initial maturity of more than one year) have a 50% risk weighting. Short-term commercial letters of credit have a 20% risk weighting and certain short-term unconditionally cancelable commitments have a 0% risk weighting. In addition to the risk-based capital guidelines, the Federal Reserve has adopted a minimum Tier I capital (leverage) ratio, under which a bank holding company must maintain a minimum level of Tier I capital to average total consolidated assets of at least 3% in the case of a bank holding company that has the highest regulatory examination rating and is not contemplating significant growth or expansion. All other bank holding companies are expected to maintain a leverage ratio of at least

100 to 200 basis points above the stated minimum. BANK REGULATION As a New Jersey-chartered commercial bank, the bank is subject to the regulation, supervision, and control of the New Jersey Department of Banking and Insurance. As an FDIC-insured institution, the bank is subject to regulation, supervision and control of the FDIC, an agency of the federal government. The regulations of the FDIC and the New Jersey Department of Banking and Insurance impact virtually all of the bank's activities, including the minimum level of capital we must maintain, our ability to pay dividends, our ability to expand through new branches or acquisitions and various other matters. INSURANCE DEPOSITS. Our deposits are insured up to a maximum of $100,000 per depositor under the Bank Insurance Fund of the FDIC. The FDIC has established a risk-based assessment system for all insured depository institutions. Under the risk-based assessment system, deposit insurance premium rates range from 0-27 basis points of assessed deposits. For the year ended December 31, 2003 we paid $ 30,202 in deposit insurance premiums. CAPITAL ADEQUACY GUIDELINES. The FDIC has promulgated risk-based capital guidelines that are designed to make regulatory capital requirements more sensitive to differences in risk profile among banks, to account for off-balance sheet exposure, and to minimize disincentives for holding liquid assets. Under these guidelines, assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items. These guidelines are substantially similar to the Federal Reserve Board guidelines discussed above. In addition to the risk-based capital guidelines, the FDIC has adopted a minimum Tier 1 capital (leverage) ratio. This measurement is substantially similar to the Federal Reserve leverage capital measurement discussed above. At September 30, 2004, the company's and the bank's ratios of total capital to risk-weighted assets were 12.02% and 11.72% respectively. DIVIDENDS. The bank may pay dividends as declared from time to time by the board of directors out of funds legally available, subject to certain restrictions. Under the New Jersey Banking Act of 1948, the bank may not pay a cash dividend unless, following the payment, the bank's capital stock will be unimpaired and the bank will have a surplus of no less than 50% of the bank capital stock or, if not, the payment of the dividend will reduce the surplus. In addition, the bank cannot pay dividends in such amounts as would reduce the bank's capital below regulatory imposed minimums. SARBANES-OXLEY ACT On July 30, 2002, the Sarbanes-Oxley Act, or "SOX," was enacted. SOX is not a banking law, but applies to all public companies, including Sussex. The stated goals of SOX are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. SOX is the most far reaching U.S. securities legislation enacted in some time. SOX generally applies to all companies, both U.S. and non-U.S., that file or are required to file periodic reports with the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). SOX includes very specific additional disclosure requirements and new corporate government rules, requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of specific issues by the SEC. SOX represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state 58 corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. SOX addresses, among other matters: o audit committees; o certification of financial statements by the chief executive officer and the chief financial officer; o the forfeiture of bonuses or other incentive-based competition and profits from the sale of an issuer's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement; o a prohibition on insider trading during pension plan black out periods; o disclosure of off-balance sheet transactions; o a prohibition on personal loans to officers and directors, unless subject to Federal Reserve Regulation O; o expedited filing requirements for Form 4 statements of changes of beneficial ownership of securities required to be filed by officers, directors and 10% shareholders; o disclosure of whether or not a company has adopted a code of ethics; o "real time" filing of periodic reports; o auditor independence; and o various increased criminal penalties for violations of securities laws. Complying with the requirements of SOX as implemented by the SEC will increase our compliance costs and could make it more difficult to attract and retain board members. USA PATRIOT ACT In October 2001, President Bush signed into law the USA PATRIOT Act. This Act was in direct response to the terrorist attacks on September 11, 2001, and strengthens the anti-money laundering provisions of the Bank Secrecy Act. Most of the new provisions added by this Act apply to accounts at or held by foreign banks, or accounts of or transactions with foreign entities. The bank does not have a significant foreign business and does not expect this Act to materially affect its operations. This Act does, however,

require the banking regulators to consider a bank's record of compliance under the Bank Secrecy Act in acting on any application filed by a bank. As the bank is subject to the provisions of the Bank Secrecy Act (i.e., reporting of cash transactions in excess of $10,000), the bank's record of compliance in this area will be an additional factor in any applications filed by it in the future. To the bank's knowledge, its record of compliance in this area is satisfactory and its processes and procedures to insure compliance with this Act are satisfactory. INDEMNIFICATION OF DIRECTORS AND OFFICERS Insofar as indemnification for liabilities arising under the 1933 Act may be permitted to our directors, officers and controlling persons under the provisions discussed above or otherwise, we have been advised that, in the opinion of the SEC, such indemnification is against public policy as expressed in the ExchangeAct and is, therefore, unenforceable. REGISTRAR AND TRANSFER AGENT The registrar and transfer agent for our common stock is American Stock & Transfer Trust Company, 59 Maiden Lane, Plaza Level, New York, New York 10038. 59 UNDERWRITING We and the underwriters named below have entered into an underwriting agreement with respect to the shares of common stock being offered. Subject to the terms and conditions contained in the underwriting agreement, each underwriter has agreed to purchase from us the respective number of shares of common stock set forth opposite its name below. The underwriters' obligations are several, which means that each underwriter is required to purchase a specific number of shares, but it is not responsible for the commitment of any other underwriter to purchase shares. Keefe, Bruyette & Woods, Inc. is acting as the representative of the underwriters. UNDERWRITERS NUMBER OF SHARS ------------------------------------ --------------------- Keefe, Bruyette & Woods, Inc. 983,609 --------------------- Total 983,609 ===================== The underwriters are committed to purchase and pay for all such shares of common stock, if any are purchased, other than those covered by the over-allotment option described below. We have granted to the underwriters an option, exercisable no later than 30 days after the date of this prospectus, to purchase up to 147,541 additional shares of common stock at the public offering price less the underwriting discount set forth on the cover page of this prospectus. The underwriters may exercise this option only to cover over-allotments, if any, made in connection with this offering. To the extent the option is exercised and the conditions of the underwriting agreement are satisfied, we will be obligated to sell to the underwriters, and the underwriters will be obligated to purchase, these additional shares of common stock. The underwriters propose to offer the shares of common stock directly to the public at the offering price set forth on the cover page of this prospectus and to certain securities dealers at the public offering price less a concession not in excess of $.47025 per share. The underwriters may allow, and these dealers may re-allow, a concession not in excess of $.10 per share on sales to other dealers. After the public offering of the common stock, the underwriters may change the offering price and other selling terms. The following table shows the per share and total underwriting discount that we will pay to the underwriters and the proceeds we will receive before expenses. These amounts are shown assuming both no exercise and full exercise of the underwriters' over-allotment option to purchase additional shares. PER TOTAL WITHOUT TOTAL WITH SHARE OVER-ALLOTMENT OVER-ALLOTMENT --------------------------- ---------- ------------- ------------- Price to public $14.25000 $ 14,016,428 $ 16,118,887 Underwriting discount 0.78375 770,904 886,539 Proceeds to us, before expenses $13.46625 13,245,524 15,232,348 We estimate that the total expenses of the offering, excluding the underwriting discount, will be approximately $187 thousand and are payable by us. The shares of common stock are being offered by the several underwriters, subject to prior sale, when, as and if issued to and accepted by them, subject to approval of certain legal matters by counsel for the underwriters and other conditions specified in the underwriting agreement. The underwriters reserve the right to withdraw, cancel, or modify this offer and to reject orders in whole or in part. 60 The underwriting agreement provides that the obligations of the underwriters are conditional and may be terminated at their discretion based on their assessment of the state of the financial markets. The obligations of the underwriters may also be terminated upon the occurrence of the events specified in the underwriting agreement. The underwriting agreement provides that the underwriters are obligated to purchase all the shares of common stock in this offering if any are purchased, other than those shares covered by the over-allotment option described above. LOCK-UP AGREEMENT. We, and each of our executive officers and directors, have agreed, for a period of 180 days after the date of this prospectus, not to sell, offer, agree to sell, contract to sell, hypothecate, pledge, grant any option to sell, make any short sale, or otherwise dispose of or hedge, directly or indirectly, any shares of our common stock or securities convertible into, exchangeable, or exercisable for any shares of our common stock or warrants or other rights to purchase shares of our common stock or other similar securities without, in each case, the prior written consent of Keefe, Bruyette & Woods, Inc. These restrictions are expressly agreed to preclude us, and our executive officers and directors, from engaging in any hedging or other transaction or arrangement that is designed to, or which reasonably could be expected to, lead to or result in a sale, disposition or transfer, in whole or in part, of any of the economic consequences of ownership of our common stock, whether such transaction would be settled by delivery of common stock or other securities, in cash, or otherwise. INDEMNITY. We have agreed to indemnify the underwriters, and persons who control the underwriters, against certain liabilities, including liabilities under the Securities Act of 1933, and to contribute to payments that the underwriters may be required to make in respect of these liabilities. STABILIZATION. In connection with this offering, the underwriters may engage in stabilizing transactions, over-allotment transactions, syndicate covering transactions, and penalty bids. o Stabilizing transactions permit bids to purchase shares of common stock so long as the stabilizing bids do not exceed a specified maximum, and are engaged in for the purpose of preventing or retarding a decline in the market price of the common stock while the offering is in progress. o Over-allotment transactions involve sales by the underwriters of shares of common stock in excess of the number of shares the underwriters are obligated to purchase. This creates a syndicate short position which may be either a covered short position or a naked short position. In a covered short position, the number of shares of common stock over-allotted by the underwriters is not greater than the number of shares that they may purchase in the over-allotment option. In a naked short position, the number of shares involved is greater than the number of shares in the over-allotment option. The underwriters may close out any short position by exercising their over-allotment option and/or purchasing shares in the open market. o Syndicate covering transactions involve purchases of common stock in the open market after the distribution has been completed in order to cover syndicate short positions. In determining the source of shares to close out the short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared with the price at which they may purchase shares through exercise of the over-allotment option. If the underwriters sell more shares than could be covered by exercise of the over-allotment option and, therefore, have a naked short position, the position can be closed out only by buying shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that after pricing there could be downward pressure on the price of the shares in the open market that could adversely affect investors who purchase in the offering. o Penalty bids permit the representative to reclaim a selling concession from a syndicate member when the common stock originally sold by that syndicate member is purchased in stabilizing or syndicate covering transactions to cover syndicate short positions. These stabilizing transactions, syndicate covering transactions, and penalty bids may have the effect of raising or maintaining the market price of our common stock or preventing or retarding a decline in the market price of our common stock. As a result, the price of our common stock in the open market may be higher than it would otherwise be in the absence of these transactions. Neither we nor the underwriters make any representation or prediction as to 61 the effect that the transactions described above may have on the price of our common stock. The underwriters may discontinue these transactions at any time. From time to time, some of the underwriters have provided, and may continue to provide, investment banking services to us in the ordinary course of their respective businesses, and have received, and may continue to receive, compensation for such services. LEGAL MATTERS Windels Marx Lane & Mittendorf, LLP, New Brunswick, New Jersey, will pass upon the legality of the securities offered by this Prospectus for us. Certain legal matters will be passed upon for the underwriter by Thacher Proffitt & Wood, LLP, Summit, New Jersey. EXPERTS The consolidated financial statements of Sussex Bancorp included in this Prospectus and in the Registration Statement have been audited by Beard Miller Company LLP, independent registered public accounting firm, to the extent and for the periods set forth in their report appearing elsewhere herein and in the Registration Statement, and are included in reliance upon such report given upon the authority of said firm as experts in auditing and accounting. WHERE YOU CAN GET MORE INFORMATION At your request, we will provide you, without charge, a copy of any exhibits to our registration statement incorporated by reference in this prospectus. If you want more information, write or call us at: Sussex Bancorp 200 Munsonhurst Road Route 517 Franklin, New Jersey 07416-0353 (973) 827-2914 We are subject to the informational requirements of the 1934 Act and as required by the 1934 Act we file reports, proxy statements and other information with the SEC. Reports, proxy statements and other information filed by us may be inspected and copied at the public reference facilities maintained by the SEC at Room 1024, 450 Fifth Street, N.W., Judiciary Plaza, Washington, DC 20549 and at the SEC's regional offices located at New York, New York 10048 and Citicorp Center, 500 West Madison Street, Suite 1400, Chicago, Illinois 60661. Our SEC filings are also available to the public on the SEC Internet site at HTTP://WWW.SEC.GOV and are also available on our website at HTTP://WWW.SUSSEXBANK.COM. We have filed with the SEC a registration statement on Form SB-2 (together with all amendments and exhibits thereto, the "Registration Statement") with respect to the shares of common stock offered by this prospectus. This prospectus does not contain all of the information included in the Registration Statement. For further information about us and the shares of common stock offered by this prospectus, please refer to the Registration Statement and its exhibits. You may obtain a copy of the Registration Statement through the public reference facilities of the SEC described above. You may also access a copy of the Registration Statement by means of the SEC's website at http://www.sec.gov. 62 SUSSEX BANCORP & SUBSIDIARIES INDEX TO THE CONSOLIDATED FINANCIAL STATEMENTS Page No. -------- Consolidated Balance Sheets as of September 30, 2004 (unaudited) and December 31, 2003 F-1 Consolidated Statements of Income for the three months and the nine months ended September 30, 2004 and 2003 (unaudited) F-2 Consolidated Statements of Stockholders' Equity for the nine months ended September 30, 2004 and 2003 (unaudited) F-3 Consolidated Statements of Cash Flows for the nine months ended September 30, 2004 and 2003 (unaudited) F-4 Notes to Consolidated Financial Statements (unaudited) F-6 Report of Independent Registered Public Accounting Firm F-10 Consolidated Balance Sheets as of December 31, 2003 and 2002 F-11 Consolidated Statements of Income for the years ended December 31, 2003 and 2002 F-12 Consolidated Statements of Stockholders' Equity for the years ended December 31, 2003 and 2002 F-13 Consolidated Statements of Cash Flows for the years ended December 31, 2003 and 2002 F-14 Notes to Consolidated Financial Statements F-15 63 [This Page Intentionally Left Blank] PART I - FINANCIAL INFORMATION ITEM 1 - FINANCIAL STATEMENTS SUSSEX BANCORP CONSOLIDATED BALANCE SHEETS (DOLLARS IN THOUSANDS) (UNAUDITED) ASSETS SEPTEMBER 30, 2004 DECEMBER 31, 2003 ------ --- Cash and due from banks $13,090 $11,301 Federal funds sold - 4,195 ------------------- ------------------ Cash and cash equivalents 13,090 15,496 Interest bearing time deposits with other banks 10,900 3,500 Securities available for sale 72,612 76,545 Federal Home Loan Bank Stock, at cost 690 760 Loans receivable, net of unearned income 149,042 134,374 Less: allowance for loan losses 2,078 1,734 ------------------- ------------------ Net loans receivable 146,964 132,640 Premises and equipment, net 5,667 4,650 Accrued interest receivable 1,265 1,241 Goodwill 2,124 2,124 Other assets 6,389 3,661 ------------------- ------------------ TOTAL ASSETS $259,701 $240,617 =================== ================== LIABILITIES AND STOCKHOLDERS' EQUITY ----------------------------------- Liabilities: Deposits: Non-interest bearing $36,868 $31,715 Interest bearing demand 186,862 175,942 ------------------- ------------------ Total Deposits 223,730 207,657 Federal Funds Purchased 2,385 - Borrowings 10,000 11,000 Accrued interest payable and other liabilities 2,245 2,056 Junior subordinated debentures 5,155 - Mandatory redeemable capital debentures - 5,000 ------------------- ------------------ TOTAL LIABILITIES 243,515 225,713 Stockholders' Equity: Common stock, no par value, authorized 5,000,000 shares; issued and outstanding 1,842,188 in 2004 and 1,811,460 in 2003 9,987 9,616 Retained earnings 5,821 5,040 Accumulated other comprehensive income 378 248 ------------------- ------------------ TOTAL STOCKHOLDERS' EQUITY 16,186 14,904 ------------------- ------------------ TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY $259,701 $240,617 =================== ================== See Notes to Consolidated Financial Statements F-1 SUSSEX BANCORP CONSOLIDATED STATEMENTS OF INCOME (IN THOUSANDS EXCEPT SHARE DATA) (UNAUDITED) Three Months Ended Nine Months Ended September 30, September 30, --------------------------- --------------------------- 2004 2003 2004 2003 ------------ ------------ ------------ ------------ INTEREST INCOME Loans receivable, including fees $2,260 $2,036 $6,522 $6,008 Securities: Taxable 483 360 1,368 1,328 Tax-exempt 221 198 634 532 Federal funds sold 10 14 41 95 Interest bearing deposits 13 11 30 36 ------------ ------------ ------------ ------------ TOTAL INTEREST INCOME 2,987 2,619 8,595 7,999 ------------ ------------ ------------ ------------ INTEREST EXPENSE Deposits 493 479 1,460 1,574 Borrowings 130 142 395 437 Junior subordinated debentures 66 60 187 186 ------------ ------------ ------------ ------------ TOTAL INTEREST EXPENSE 689 681 2,042 2,197 ------------ ------------ ------------ ------------ NET INTEREST INCOME 2,298 1,938 6,553 5,802 Provision for Loan Losses 120 70 373 315 ------------ ------------ ------------ ------------ NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES 2,178 1,868 6,180 5,487 ------------ ------------ ------------ ------------ OTHER INCOME Service fees on deposit accounts 175 197 557 569 ATM fees 87 87 237 251 Insurance commissions and fees 526 512 1,696 1,599 Mortgage broker fees 130 5 456 49 Investment brokerage fees 96 54 217 192 Net gain on sale of loans held for sale - - - 24 Net gain on sale of securities available for sale 11 - 11 - Net gain on sale of foreclosed real estate - - - 63 Other 84 59 252 184 ------------ ------------ ------------ ------------ TOTAL OTHER INCOME 1,109 914 3,426 2,931 OTHER EXPENSE Salaries and employee benefits 1,564 1,371 4,654 3,998 Occupancy, net 225 154 639 478 Furniture and equipment 247 199 659 600 Stationary and supplies 43 43 126 140

Professional Fees 81 47 238 263 Advertising and promotion 96 111 279 286 Postage and freight 39 44 130 130 Amortization of intangible assets 51 42 145 119 Other 395 364 1,141 1,080 ------------ ------------- ------------ ------------ TOTAL OTHER EXPENSE 2,741 2,375 8,011 7,098 ------------ ------------- ------------ ------------ INCOME BEFORE INCOME TAXES 546 407 1,595 1,320 Provision for Income Taxes 143 91 430 331 ------------ ------------- ------------ ------------ NET INCOME $403 $316 $1,165 $989 ============ ============= ============ ============ EARNINGS PER SHARE ------------ ------------- ------------ ------------ Basic $0.22 $0.18 $0.64 $0.55 ============ ============= ============ ============ Diluted $0.21 $0.17 $0.61 $0.54 ============ ============= ============ ============ See Notes to Consolidated Financial Statements F-2 SUSSEX BANCORP CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY NINE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003 (UNAUDITED) ACCUMULATED NUMBER OF OTHER TOTAL SHARES COMMON RETAINED COMPREHENSIVE TREASURY STOCKHOLDERS OUTSTANDING STOCK EARNINGS INCOME (LOSS) STOCK EQUITY ----------- ----- -------- ------------ ----- ------ (DOLLARS IN THOUSANDS, EXCEPT SHARE AMOUNTS) -- BALANCE DECEMBER 31, 2002 1,688,130 $7,869 $5,249 $562 $ - $13,680 Comprehensive income: Net income - - 989 - - 989 Change in unrealized gains on securities available for sale, net of tax - - - (431) - (431) ------- TOTAL COMPREHENSIVE INCOME 558 Treasury shares purchased (2,400) - - - (25) (25) Treasury shares retired - (25) - - 25 - Issuance of common stock and exercise of stock options 7,037 52 - - - 52 Shares issued through dividend reinvestment plan 11,478 128 - - - 128 Dividends on common stock ($.20 per share) - - (356) - - (356) 5% Stock Dividend 85,212 1,278 (1,278) - - - -- BALANCE SEPTEMBER 30, 2003 1,789,457 $9,302 $4,604 $131 $ - $14,037 == BALANCE DECEMBER 31, 2003 1,811,460 $9,616 $5,040 $248 $ - $14,904 Comprehensive income: Net income - - 1,165 - - 1,165 Change in unrealized gains on securities available for sale, net of tax - - - 130 - 130 ------- TOTAL COMPREHENSIVE INCOME 1,295 Treasury shares purchased (1,346) - - - (23) (23) Treasury shares retired - (23) - - 23 - Issuance of common stock and exercise of stock options 23,807 205 - - - 205 Income tax benefit of stock options exercised - 52 - - - 52 Shares issued through dividend reinvestment plan 8,267 137 - - - 137 Dividends on common stock ($.21 per share) - - (384) - - (384) -- BALANCE SEPTEMBER 30, 2004 1,842,188 $9,987 $5,821 $378 $ - $16,186 == See Notes to Consolidated Financial Statements F-3 SUSSEX BANCORP CONSOLIDATED STATEMENTS OF CASH FLOWS (IN THOUSANDS) (UNAUDITED) NINE MONTHS ENDED SEPTEMBER 30, ------------------------------------ 2004 2003 ----------------- ---------------- CASH FLOWS FROM OPERATING ACTIVITIES Net income $1,165 $989 Adjustments to reconcile net income to net cash provided by operating activities: Provision for loan losses 373 315 Provision for depreciation and amortization 422 386 Net amortization of securities premiums and discounts 456 892 Net realized gain on sale of securities (11) - Net realized gain on sale of foreclosed real estate - (63) Income tax benefit of stock options exercised 52 - Proceeds from the sale of loans - 668 Net gains on sale of loans - (24) Loans originated for sale - (644) Earnings on investment in life insurance (81) (37) (Increase) decrease in assets: Accrued interest receivable (24) (104) Other assets (788) (360) Increase in accrued interest payable and other liabilities 189 (148) ----------------- ---------------- NET CASH PROVIDED BY OPERATING ACTIVITIES 1,753 1,870 ----------------- ---------------- CASH FLOWS FROM INVESTING ACTIVITIES Securities available for sale: Purchases (24,154) (42,634) Proceeds from sale of securities 7,291 - Maturities, calls and principal repayments 20,568 38,014 Net increase in loans (14,988) (16,584) Purchases of bank premises and equipment (1,439) (86) Decrease (increase) in FHLB stock 70 (10) Proceeds from sale of foreclosed real estate - 250 Decrease in interest bearing time deposits with other banks (7,400) 100 Purchase of investment in life insurance (1,500) - ----------------- ---------------- NET CASH USED IN INVESTING ACTIVITIES (21,552) (20,950) ----------------- ---------------- CASH FLOWS FROM FINANCING ACTIVITIES Net increase in deposits 16,073 11,948 Increase in fed funds purchased 2,385 - Decrease of borrowings (1,000) (3,000) Proceeds from the exercise of stock options 205 52 Purchase of treasury stock (23) (25) Dividends paid, net of reinvestments (247) (228) ----------------- ---------------- NET CASH PROVIDED BY FINANCING ACTIVITIES 17,393 8,747 ----------------- ---------------- NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS (2,406) (10,333) F-4 CASH AND CASH EQUIVALENTS - BEGINNING 15,496 26,096 ----------------- ---------------- CASH AND CASH EQUIVALENTS - ENDING $13,090 $15,763

================== ================== SUPPLEMENTARY CASH FLOWS INFORMATION Interest paid $2,041 $2,254 ================== ================== Income taxes paid $597 $623 ================== ================== SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES Foreclosed real estate acquired in settlement of loans $291 $223 ================== ================== See Notes to Consolidated Financial Statements F-5 SUSSEX BANCORP NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) 1. Basis of Presentation The consolidated financial statements include the accounts of Sussex Bancorp (the "Company") and its wholly-owned subsidiary Sussex Bank (the "Bank"). The Bank's wholly-owned subsidiaries are Sussex Bancorp Mortgage Company, Inc., SCB Investment Company, Inc., and Tri-State Insurance Agency, Inc., ("Tri-State") a full service insurance agency located in Sussex County, New Jersey. All inter-company transactions and balances have been eliminated in consolidation. Sussex Bank is also a 49% limited partner of Sussex Settlement Services, L.P, a title insurance agency whose registered office is located in King of Prussia, Pennsylvania. The Bank operates eight banking offices all located in Sussex County, New Jersey. The Company is subject to the supervision and regulation of the Board of Governors of the Federal Reserve System (the "FRB"). The Bank's deposits are insured by the Bank Insurance Fund ("BIF") of the Federal Deposit Insurance Corporation ("FDIC") up to applicable limits. The operations of the Company and the Bank are subject to the supervision and regulation of the FRB, FDIC and the New Jersey Department of Banking and Insurance (the "Department") and the operations of Tri-State are subject to the supervision and regulation by the Department. The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for full year financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal, recurring nature. Operating results for the nine-month period ended September 30, 2004, are not necessarily indicative of the results that may be expected for the year ended December 31, 2004. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto that are included in the Company's Annual Report on Form 10-KSB for the fiscal period ended December 31, 2003. 2. Earnings Per Share Basic earnings per share is calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance of potential common shares that may be issued by the Company relating to outstanding stock options and guaranteed and contingently issuable shares from the acquisition of Tri-State. Potential common shares related to stock options are determined using the treasury stock method. The following table sets forth the computations of basic and diluted earnings per share as retroactively adjusted for the 5% stock dividend declared October 15, 2003 (dollars in thousands, except per share data): Three Months Ended September 30, 2004 Three Months Ended September 30, 2003 ------------------------------------ ------------------------------------ Per Per Income Shares Share Income Shares Share (Numerator) (Denominator) Amount (Numerator) (Denominator) Amount ------------------------------------ ------------------------------------ Basic earnings per share: Net income applicable to common stockholders $403 1,839 $0.22 $316 1,788 $0.18 ========= ========= Effect of dilutive securities: Stock options - 55 - 50 Deferred common stock payments for purchase of insurance agency - 17 1 34 ------------------------- ------------------------- Diluted earnings per share: Net income applicable to common stockholders and assumed conversions $403 1,911 $0.21 $317 1,872 $0.17 ====================================== ====================================== F-6 Nine Months Ended September 30, 2004 Nine Months Ended September 30, 2003 ------------------------------------ ------------------------------------ Per Per Income Shares Share Income Shares Share (Numerator) (Denominator) Amount (Numerator) (Denominator) Amount ------------------------------------ ------------------------------------ Basic earnings per share: Net income applicable to common stockholders $1,165 1,830 $0.64 $989 1,783 $0.55 ========= ========= Effect of dilutive securities: Stock options - 73 - 28 Deferred common stock payments for purchase of insurance agency 2 15 5 38 ------------------------- ------------------------- Diluted earnings per share: Net income applicable to common stockholders and assumed conversions $1,167 1,918 $0.61 $994 1,849 $0.54 ====================================== ====================================== 3. Comprehensive Income The components of other comprehensive income and related tax effects for the three and nine months ended September 30, 2004 and 2003 are as follows: Three Months Ended Nine Months Ended September 30, September 30, 2004 2003 2004 2003 ------------ ---------- ---------- ----------- (In thousands) (In thousands) Unrealized holding gains (losses) on available for sale securities $1,340 ($1,053) $228 ($718) Less: reclassification adjustments for gains included in net income 11 - 11 - ------------ ---------- ---------- ----------- Net unrealized gains (losses) 1,329 (1,053) 217 (718) Tax effect (532) 421 (87) 287 ------------ ---------- ---------- ----------- Other comprehensive income (loss), net of tax $797 ($632) $130 ($431) ============ ========== ========== =========== 4. Segment Information The Company's insurance agency operations are managed separately from the traditional banking and related financial services that the Company also offers. The insurance agency operation provides commercial, individual, and group benefit plans and personal coverage. Three Months Ended September 30, 2004 Three Months Ended September 30, 2003 Banking and Insurance Banking and Insurance Financial Services Services Total Financial Services Services Total ----------------- -------- ----- ----------------- -------- ----- (In Thousands) (In Thousands) Net interest income from external sources $2,298 $- $2,298 $1,938 $- $1,938 Other income from external sources 583 526 1,109 402 512 914 Depreciation and amortization 136 30 166 102 20 122 Income (loss) before income taxes 567 (21) 546 339 68 407 Income tax expense (benefit) 151 (8) 143 64 27 91 Total assets 256,415 3,286 259,701 232,349 2,712 235,061 Nine Months Ended September 30, 2004 Nine Months Ended September 30, 2003 Banking and Insurance Banking and Insurance Financial Services Services Total Financial Services Services Total ----------------- -------- ----- ----------------- -------- ----- (In Thousands) (In Thousands) Net interest income from external sources $6,553 $- $6,553 $5,802 $- $5,802 Other income from external sources 1,730 1,696 3,426 1,332 1,599 2,931 Depreciation and amortization 340 82 422 330 56 386 Income (loss) before income taxes 1,480 115 1,595 1,155 165 1,320 Income tax expense (benefit) 384 46 430 265 66 331 Total assets 256,415 3,286 259,701 232,349 2,712 235,061 F-7 5. Stock Option Plans The Company accounts for stock option plans under the recognition and measurement principles of APB Opinion No. 25. "Accounting for Stock Issued to Employees," and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under the Company's plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, "Accounting for Stock-Based Compensation," to stock-based compensation for the periods presented: Three Months Ended September Nine Months Ended 30, September 30, 2004 2003 2004 2003 ------------- ------------- ------------- ----------- (In thousands) (In thousands) Net income, as reported $403 $316 $1,165 $989 Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects (39) (16) (103) (32) ------------- ------------- ------------- ----------- Pro forma net income $364 $300 $1,062 $957 ============= ============= ============= =========== Basic earnings per share: As reported $0.22 $0.18 $0.64 $0.55 Pro forma $0.20 $0.17 $0.58 $0.54 Diluted earnings per share: As reported $0.21 $0.17 $0.61 $0.54 Pro forma $0.19 $0.16 $0.55 $0.52 6. Guarantees The Company does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Company, generally, holds collateral and/or personal guarantees supporting these commitments. The Company had $382,000 of standby letters of credit as of September 30, 2004. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payment required under the corresponding guarantees. The current amount of the liability as of September 30, 2004 for guarantees under standby letters of credit issued is not material. 7. New Accounting Standards In January 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" which was revised in December 2003. The Interpretation provides guidance for the consolidation of variable interest entities (VIEs). Sussex Capital Trust I qualifies as a variable interest entity under FIN 46. Sussex Capital Trust issued mandatory redeemable preferred securities (Trust Preferred Securities) to third-party investors and loaned the proceeds to the Company. Sussex Capital Trust I holds, as its sole asset, subordinated debentures issued by the Company. FIN 46 required the Company to deconsolidate Sussex Capital Trust I from the consolidated financial statements as of March 31, 2004. There has been no restatement of prior periods. The impact of this deconsolidation was to increase junior subordinated debentures or long-term debt by $5,155,000 and reduce the mandatory capital debentures line item by $5,000,000 which had represented the trust preferred securities of the trust. The Company's equity interest in the trust subsidiary of $155,000, which had previously been eliminated in consolidation, is now reported in "Other assets". For regulatory reporting purposes, the Federal Reserve Board has indicated that the preferred securities will continue to qualify as Tier I Capital subject to previously specified limitations until further notice. If regulators make a determination that Trust Preferred Securities can no longer be considered in regulatory capital, the securities become callable and the Company may redeem them. The adoption of FIN 46 did not have an impact on the Company's results of operations or liquidity. In March 2004, the SEC released Staff Accounting Bulletin (SAB) No. 105, "Application of Accounting Principles to Loan Commitments." SAB 105 provides guidance about the measurements of loan commitments recognized at fair value under FASB F-8 Statement No. 133, "Accounting Derivative Instruments and Hedging Activities." SAB 105 also requires companies to disclose their accounting policy for those loan commitments including methods and assumptions used to estimate fair value and associated hedging strategies. SAB 105 is not effective for all loan commitments accounted for as derivatives that are entered into after March 31, 2004. The adoption of SAB 105 is not expected to have a material effect on our consolidated financial statements. In March 2004, the FASB's Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No., 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (EITF 03-1). EITF 03-1 provides guidance regarding the meaning of other-than-temporary impairment and its application to investments classified as either available-for-sale or held-to-maturity under FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and to equity securities accounted for under the cost method. Included in EITF 03-1 is guidance on how to account for impairments that are solely due to interest rate changes, including changes resulting from increases in sector credit spreads. This guidance was to become effective for reporting periods beginning after June 15, 2004. However, on September 30, 2004, the FASB issued a Staff Position that delays the effective date for the recognition and measurement guidance of EITF 03-1 until additional clarifying guidance is issued. We are not able to assess the impact of the adoption of EITF 03-1 until final guidance is issued. F-9 Report of Independent Registered Public Accounting Firm To the Board of Directors and Stockholders Sussex Bancorp Franklin, New Jersey We have audited the accompanying consolidated balance sheets of Sussex Bancorp and its subsidiaries as of December 31, 2003 and 2002, and the related consolidated statements of income, stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with the 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sussex Bancorp and its subsidiaries as of December 31, 2003 and 2002, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. /s/ Beard Miller Company LLP Allentown, Pennsylvania January 9, 2004 F-10 CONSOLIDATED BALANCE SHEETS DECEMBER 31, ----------------------------------- 2003 2002 --------------- --------------- (DOLLARS IN THOUSANDS) ASSETS Cash and due from banks $ 11,301 $ 9,186 Federal funds sold 4,195 16,910 --------------- --------------- Cash and cash equivalents 15,496 26,096 Interest bearing time deposits with other banks 3,500 3,600 Securities available for sale 76,545 72,720 Federal Home Loan Bank stock, at cost 760 750 Loans receivable, net of allowance for loan losses 2003 $1,734; 2002 $1,386 132,640 112,069 Bank premises and equipment, net 4,650 4,634 Accrued interest receivable 1,241 1,144 Goodwill 2,124 1,932 Other assets 3,661 2,959 --------------- --------------- TOTAL ASSETS $240,617 $225,904 =============== =============== LIABILITIES AND STOCKHOLDERS' EQUITY Liabilities: Deposits: Non-interest bearing $ 31,715 $ 26,514 Interest bearing 175,942 163,344 --------------- --------------- Total Deposits 207,657 189,858 Borrowings 11,000 15,000 Accrued interest payable and other liabilities 2,056 2,366 Mandatory redeemable capital debentures 5,000 5,000 --------------- --------------- TOTAL LIABILITIES 225,713 212,224 --------------- --------------- Stockholders' equity: Common stock, no par value; authorized 5,000,000 shares; issued and outstanding 1,811,460 shares in 2003 and 1,688,130 shares in 2002 9,616 7,869 Retained earnings 5,040 5,249 Accumulated other comprehensive income 248 562 --------------- --------------- TOTAL STOCKHOLDERS' EQUITY 14,904 13,680

---------------- ---------------- TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY $240,617 $225,904 ================ ================ See Notes to Consolidated Financial Statements F-11 CONSOLIDATED STATEMENTS OF INCOME YEARS ENDED DECEMBER 31, ------------------------------------ 2003 2002 --------------- --------------- (IN THOUSANDS, EXCEPT PER SHARE DATA) INTEREST INCOME Loans receivable, including fees $ 8,093 $ 7,734 Securities: Taxable 1,783 2,127 Tax-exempt 739 494 Federal funds sold 110 395 Interest-bearing deposits 46 110 --------------- --------------- TOTAL INTEREST INCOME 10,771 10,860 --------------- --------------- INTEREST EXPENSE Deposits 2,039 2,851 Borrowings 573 553 Mandatory redeemable capital debentures 248 132 --------------- --------------- TOTAL INTEREST EXPENSE 2,860 3,536 --------------- --------------- NET INTEREST INCOME 7,911 7,324 PROVISION FOR LOAN LOSSES 405 300 --------------- --------------- NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES 7,506 7,024 --------------- --------------- OTHER INCOME Service fees on deposit accounts 769 659 ATM and debit card fees 332 262 Insurance commissions and fees 2,063 1,689 Investment brokerage fees 244 249 Mortgage banking fees 213 14 Net realized gain on sale of securities 133 - Net gain on sale of loans 42 24 Net gain on sale of foreclosed real estate 63 - Other 244 395 --------------- --------------- TOTAL OTHER INCOME 4,103 3,292 --------------- --------------- OTHER EXPENSES Salaries and employee benefits 5,478 4,640 Occupancy, net 642 601 Furniture, equipment and data processing 837 833 Stationery and supplies 181 194 Professional fees 376 319 Advertising and promotion 416 464 Postage and freight 174 154 Amortization of intangible assets 162 131 Other 1,397 1,298 --------------- --------------- TOTAL OTHER EXPENSES 9,663 8,634 --------------- --------------- INCOME BEFORE INCOME TAXES 1,946 1,682 PROVISION FOR INCOME TAXES 505 526 --------------- --------------- NET INCOME $ 1,441 $ 1,156 =============== =============== EARNINGS PER SHARE Basic $ 0.80 $ 0.66 =============== =============== Diluted $ 0.78 $ 0.64 =============== =============== See Notes to Consolidated Financial Statements F-12 CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY YEARS ENDED DECEMBER 31, 2003 AND 2002 ACCUMULATED NUMBER OF OTHER SHARES COMMON RETAINED COMPREHENSIVE TREASURY OUTSTANDING STOCK EARNINGS INCOME STOCK TOTAL ------------ ------------ ------------- ------------ ------------- ------------ (DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) BALANCE - DECEMBER 31, 2001 1,659,057 $7,732 $4,509 $123 $(127) $12,237 ------------ Comprehensive income: Net income - - 1,156 - - 1,156 Change in unrealized gains on securities available for sale - - - 439 - 439 ------------ TOTAL COMPREHENSIVE INCOME 1,595 ------------ Treasury stock purchased (14,554) - - - (156) (156) Treasury stock retired - (283) - - 283 - Issuance of common stock and exercise of stock options 31,280 302 - - - 302 Issuance of common stock through dividend reinvestment plan 12,347 118 - - - 118 Dividends on common stock ($.24 per share) - - (416) - - (416) ------------ ------------ ------------- ------------ ------------- ------------ BALANCE - DECEMBER 31, 2002 1,688,130 7,869 5,249 562 - 13,680 ------------ Comprehensive income: Net income - - 1,441 - - 1,441 Change in unrealized gains on securities available for sale - - - (314) - (314) ------------ TOTAL COMPREHENSIVE INCOME 1,127 ------------ Treasury stock purchased (2,400) - - - (25) (25) Treasury stock retired - (25) - - 25 - Issuance of common stock and exercise of stock options 28,264 354 - - - 354 Issuance of common stock through dividend reinvestment plan 11,478 128 - - - 128 Dividends on common stock ($.20 per share) - - (356) - - (356) 5% stock dividend 85,988 1,290 (1,294) - - (4) ------------ ------------ ------------- ------------- ------------ BALANCE - DECEMBER 31, 2003 1,811,460 $9,616 $5,040 $248 $ - $14,904 ============ ============ ============= ============ ============= ============ See Notes to Consolidated Financial Statements F-13 CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, ------------------------------------ 2003 2002 --------------- --------------- (IN THOUSANDS) CASH FLOWS FROM OPERATING ACTIVITIES Net income $1,441 $1,156 Adjustments to reconcile net income to net cash provided by operating activities: Provision for loan losses 405 300 Provision for depreciation and amortization 672 695 Realized gain on sale of securities (133) - Realized gain on sale of foreclosed real estate (63) - Deferred income taxes (203) (170) Net amortization of securities premiums and discounts 1,095 569 Proceeds from sale of loans 2,446 1,220 Net gains on sale of loans (42) (24) Loans originated for sale (2,404) (1,196) Earnings on investment in life insurance (49) (55) Increase in assets: Accrued interest receivable (97) (180) Other assets (358) (53) Decrease in accrued interest payable and other liabilities (73) (56) --------------- --------------- NET CASH PROVIDED BY OPERATING ACTIVITIES 2,637 2,206 --------------- --------------- CASH FLOWS FROM INVESTING ACTIVITIES Securities available for sale: Purchases (56,128) (60,109) Maturities, calls and principal repayments 45,876 30,267 Proceeds from sale of securities 4,942 - Net increase in loans (21,199) (7,364) Purchases of bank premises and equipment (526)

(273) Acquisition of insurance agency (131) - Increase in FHLB stock (10) (65) Net (increase) decrease in interest bearing time deposits with other banks 100 (500) Proceeds from sale of foreclosed real estate 250 - --------------- --------------- NET CASH USED IN INVESTING ACTIVITIES (26,826) (38,044) --------------- --------------- CASH FLOWS FROM FINANCING ACTIVITIES Net increase in deposits 17,799 11,304 Repayments of borrowings (4,000) - Proceeds from borrowings - 5,000 Proceeds from the issuance of capital debentures - 5,000 Proceeds from the exercise of stock options 47 49 Purchase of treasury stock (25) (156) Dividends paid, net of reinvestments (228) (298) Cash paid in lieu of fractional shares (4) - --------------- --------------- NET CASH PROVIDED BY FINANCING ACTIVITIES 13,589 20,899 --------------- --------------- NET DECREASE IN CASH AND CASH EQUIVALENTS (10,600) (14,939) CASH AND CASH EQUIVALENTS - BEGINNING 26,096 41,035 --------------- --------------- CASH AND CASH EQUIVALENTS - ENDING $15,496 $26,096 =============== =============== SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION Interest paid $2,935 $3,670 =============== =============== Income taxes paid $ 798 $ 525 =============== =============== SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES Foreclosed real estate acquired in settlement of loans $ 223 $ - =============== =============== See Notes to Consolidated Financial Statements F-14 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 1 - SUMMARY OF ACCOUNTING POLICIES PRINCIPLES OF CONSOLIDATION The consolidated financial statements include the accounts of Sussex Bancorp (the "Company") and its wholly-owned subsidiaries, Sussex Bank (the "Bank") and Sussex Capital Trust I. The Bank's wholly-owned subsidiaries are Sussex Bancorp Mortgage Company, SCB Investment Company and Tri-State Insurance Agency, Inc. All intercompany transactions and balances have been eliminated in consolidation. ORGANIZATION AND NATURE OF OPERATIONS Sussex Bancorp's business is conducted principally through the Bank. Sussex Bank is a New Jersey state chartered bank and provides full banking services. The Bank generates commercial, mortgage and consumer loans and receives deposits from customers at its eight branches located in Sussex County, New Jersey. As a state bank, the Bank is subject to regulation of the New Jersey Department of Banking and Insurance and the Federal Deposit Insurance Corporation. Sussex Bancorp is subject to regulation by the Federal Reserve Board. Sussex Capital Trust I is a trust formed in 2002 for the purpose of issuing the mandatory redeemable capital debentures on behalf of the Company. Sussex Bancorp Mortgage Company brokers mortgage loans for the Bank and third parties. SCB Investment Company holds investments. Tri-State Insurance Agency, Inc. provides insurance agency services mostly through the sale of property and casualty insurance policies. ESTIMATES The preparation of consolidated 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 and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK Most of the Company's activities are with customers located within Sussex County, New Jersey. Note 4 discusses the types of securities that the Company invests in. Note 5 discusses the types of lending that the Company engages in. The Company does not have any significant concentrations in any one industry or customer. PRESENTATION OF CASH FLOWS For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks and federal funds sold. Generally, federal funds are purchased and sold for one-day periods. SECURITIES Securities classified as available for sale are those securities that the Bank intends to hold for an indefinite period of time but not necessarily to maturity. Securities available for sale are carried at fair value. Fair values for securities are based on quoted market prices or dealer prices, if available. If quoted market prices or dealer prices are not available, fair value is estimated using quoted market prices or dealer prices for similar securities. Any decision to sell a security classified as available for sale would be based on various factors, including significant movement in interest rates, changes in maturity mix of the Bank's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Unrealized gains or losses are reported as increases or decreases in other comprehensive income, net of the related deferred tax effect. Realized gains or losses, determined on the basis of the cost of the specific securities sold, are included in earnings. Premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Equity securities are comprised of stock in various companies and mutual funds. Declines in the fair value of securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length F-15 of time and the extent to which the fair value has been less than cost, (2) the financial condition and

near-term prospects of the issuer, and (3) the intent and ability of the company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Federal law requires a member institution of the Federal Home Loan Bank system to hold stock of its district FHLB according to a predetermined formula. The restricted stock is recorded at cost. LOANS RECEIVABLE Loans receivable that management has the intent and ability to hold for the foreseeable future until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) of the related loans. The Bank is generally amortizing these amounts over the contractual life of the loan. The accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans generally is either applied against principal or reported as interest income, according to management's judgment as to the collectibility of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectibility of the total contractual principal and interest is no longer in doubt. ALLOWANCE FOR LOAN LOSSES The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. Management's periodic evaluation of the adequacy of the allowance is based on known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans. The allowance consists of specific and general components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value for that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of the collateral if the loan is collateral dependent. F-16 Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer, residential and home equity loans for impairment disclosures. LOANS HELD FOR SALE Loans held for sale are comprised of residential loans that the company originates with the intention of selling in the future. These loans are carried at the lower of cost or estimated fair value, calculated in the aggregate. There were no loans held for sale at December 31, 2003 and 2002. Gain or loss on sales of loans is recognized based on the specific identification method. TRANSFERS OF FINANCIAL ASSETS Transfers of financial assets, including sales of loans and loan participations, are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. FORECLOSED ASSETS Foreclosed assets are comprised of property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure and loans classified as in-substance foreclosure. A loan is classified as in-substance foreclosure when the Bank has taken possession of the collateral regardless of whether formal foreclosure proceedings take place. Foreclosed assets initially are recorded at fair value, net of estimated selling costs, at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value minus estimated costs to sell. Revenues and expenses from operations and changes in the valuation allowance are included in other expenses. Foreclosed assets are included in other assets on the balance sheets. BANK PREMISES AND EQUIPMENT Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the following estimated useful lives of the related assets: YEARS ---------- Buildings and building improvements 20 - 40 Leasehold improvements 5 - 10 Furniture, fixtures and equipment 5 - 10 Computer equipment and software 3 - 5 GOODWILL AND OTHER INTANGIBLES Goodwill represents the excess of the purchase price over the fair market value of net assets acquired. The Company has recorded goodwill of $2,124,000 and $1,932,000 at December 31, 2003 and 2002, respectively, related to the acquisition of an insurance agency on October 1, 2001 as described in Note 2. The $192,000 and $220,000 increase in goodwill in 2003 and 2002, respectively, was due to contingent payments made to the sellers in accordance with the purchase agreement and other acquisition costs incurred. In accordance with current accounting standards, goodwill is not amortized, but evaluated at least annually for impairment. Any impairment of goodwill results in a charge to income. Goodwill was tested for impairment during 2003. The estimated fair value of the reporting segment exceeded its book value, therefore, no write-down of goodwill was required. The goodwill is not deductible for tax purposes. The Company also has amortizable intangible assets resulting from the acquisition of both insurance agencies described in Note 2, which include the value of executive employment contracts and the value of the acquired book of businesses, which are being amortized on a straight-line basis over 3 to 7 years. The total net amortizable intangible assets were $297,000 and $245,000 net of accumulated amortization of $137,000 and $58,000 at December 31, 2003 and 2002, respectively. F-17 The Company has an amortizable core deposit intangible asset related to the premiums paid on the acquisition of deposits, which is being amortized on a straight-line basis over 15 years. This core deposit intangible was $284,000 and $367,000, net of accumulated amortization of $974,000 and $891,000 as of December 31, 2003 and 2002, respectively. Other intangible assets are included in other assets on the balance sheets for December 31, 2003 and 2002. Amortization expense on intangible assets was $162,000 and $131,000 for the years ended December 31, 2003 and 2002, respectively. Amortization expense is estimated to be $175,000 per year for the years ending December 31 2004 and 2005; $139,000 for the year ending December 31, 2006; $67,000 for the year ending December 31, 2007 and $25,000 for the year ending December 31, 2008. ADVERTISING COSTS The Bank follows the policy of charging the costs of advertising to expense as incurred. INCOME TAXES Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. Sussex Bancorp and its subsidiaries file a consolidated federal income tax return. OFF-BALANCE SHEET FINANCIAL INSTRUMENTS In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit. Such financial instruments are recorded in the balance sheet when they are funded. STOCK-BASED COMPENSATION The Company accounts for its stock option plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, "Accounting for Stock-Based Compensation," to stock-based compensation for the years ended December 31, 2003 and 2002. Earnings per share has been adjusted for the 5% stock dividend granted in 2003. 2003 2002 -------------- -------------- (IN THOUSANDS) Net income, as reported $1,441 $1,156 Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects (47) (23) -------------- -------------- Pro forma net income $1,394 $1,133 ============== ============== Basic earnings per share: As reported $ 0.80 $ 0.66

Pro forma $ 0.78 $ 0.65 Diluted earnings per share: As reported $ 0.78 $ 0.64 Pro forma $ 0.75 $ 0.63 F-18 The fair value of options granted is estimated on the date of grant using the Black-Scholes option pricing model. The following represents the weighted average fair values and weighted average assumptions used to determine such fair values for options granted for the years ended December 31, 2003 and 2002: 2003 2002 ---------- ---------- Grant date fair value, as adjusted for 5% stock dividend $2.05 $1.64 Expected option lives 7 YEARS 5 years Dividend yield 2.44% 2.50% Risk-free interest rate 3.62% 4.45% Expected volatility rate 15.18% 14.43% EARNINGS PER SHARE Basic earnings per share represents net income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate to outstanding stock options and guaranteed and contingently issuable shares from the acquisition of Tri-State. Potential common shares related to stock options are determined using the treasury stock method. SEGMENT REPORTING The Company acts as an independent community financial services provider, and offers traditional banking and related financial services to individual, business and government customers. Through its branch and automated teller machine networks, the Bank offers a full array of commercial and retail financial services, including taking of time, savings and demand deposits; the making of commercial, consumer and mortgage loans; and the providing of other financial services. The Bank also performs fiduciary services through its Trust Department. Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial, retail, trust and mortgage banking operations of the Bank. As such, discrete financial information is not available and segment reporting would not be meaningful. The Company's insurance agency is managed separately from the traditional banking and related financial services that the Company offers. The insurance operations provides primarily property and casualty coverage. See Note 3 for segment reporting of insurance operations. INSURANCE AGENCY OPERATIONS Tri-State Insurance Agency, Inc. is a retail insurance broker operating in the State of New Jersey. The insurance agency's primary source of revenue is commission income, which is earned by placing insurance coverage for its customers with various insurance underwriters. The insurance agency places basic property and casualty, life and health coverage with about fifteen different insurance carriers. There are two main billing processes, direct billing (currently accounts for approximately 90% of revenues) and agency billing. Under the direct billing arrangement, the insurance carrier bills and collects from the customer directly and remits the brokers' commission to the broker on a monthly basis. For direct bill policies, Tri-State records commissions as revenue when the data necessary to reasonably determine such amounts is obtained. On a monthly basis, Tri-State receives notification from each insurance carrier of total premiums written and collected during the month, and the broker's net commission due for their share of business produced by them. Under the agency billing arrangement, the broker bills and collects from the customer directly, retains their commission, and remits the net premium amount to the insurance carrier. Virtually all agency-billed policies are billed and collected on an installment basis (the number of payments varies by policy). Although Tri-State typically bills customers 60 days prior to the effective date of a policy, revenues for the first installment are recorded at the policy effective date. Revenues from subsequent installments are recorded at the installment due date. Tri-State records its commission as a percentage of each installment due. F-19 TRUST OPERATIONS Trust income is recorded on a cash basis, which approximates the accrual basis. Securities and other property held by the Company in a fiduciary or agency capacity for customers of the trust department are not assets of the Company and, accordingly, are not included in the accompanying consolidated financial statements. RECLASSIFICATIONS Certain amounts in the 2002 financial statements have been reclassified to conform with the 2003 presentation format. These reclassifications had no effect on net income. NEW ACCOUNTING STANDARDS In November 2002, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." This Interpretation expands the disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees and requires the guarantor to recognize a liability for the fair value of an obligation assumed under certain specified guarantees. Under FIN 45, the Company does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit, as discussed in Note 18. Adoption of FIN 45 did not have a significant impact on the Company's financial condition or results of operations. In January 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." FIN 46 was revised in December 2003. This

Interpretation provides new guidance for the consolidation of variable interest entities (VIEs) and requires such entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risk among parties involved. The Interpretation also adds disclosure requirements for investors that are involved with unconsolidated VIEs. The disclosure requirements apply to all financial statements issued after December 31, 2003. The consolidation requirements apply to companies that have interests in special purpose entities for periods ending after December 15, 2003. Consolidation of other types of VIEs is required in financial statements for periods ending after December 15, 2004. The Company has evaluated the impact of FIN 46 on Sussex Capital Trust I, a variable interest entity, currently consolidated by the Company. Management has determined that the provisions of FIN 46 will require de-consolidation of the subsidiary trust, which issued mandatorily redeemable preferred capital securities to third-party investors. Upon adoption of FIN 46 as of March 31, 2004, the Trust will be de-consolidated and the junior subordinated debentures of the Company will be reported in the Consolidated Balance Sheets as "long-term debt," rather than the mandatory redeemable capital debentures line item that represents the preferred shares in the Trust. The Company's equity interest in the Trust, which is not significant, will be reported in "Other assets." For regulatory reporting purposes, the Federal Reserve Board has indicated that the preferred securities will continue to qualify as Tier 1 Capital subject to previously specified limitations, until further notice. Additional information on the Trust is summarized in Note 10. The adoption of this Interpretation did not have and is not expected to have a significant impact on the Company's results of operations or liquidity. In April 2003, the Financial Accounting Standards Board issued Statement No. 149, "Amendment of Statement No. 133, Accounting for Derivative Instruments and Hedging Activities." This Statement clarifies the definition of a derivative and incorporates certain decisions made by the Board as part of the Derivatives Implementation Group process. This Statement is effective for contracts entered into or modified and for hedging relationships designated after June 30, 2003 and should be applied prospectively. The provisions of the Statement that relate to implementation issues addressed by the Derivatives Implementation Group that have been effective should continue to be applied in accordance with their respective dates. Adoption of this standard did not have an impact on the Company's financial condition or results of operations. In May 2003, the Financial Accounting Standards Board issued Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This Statement requires that an issuer classify a financial instrument that is within its scope as a liability. Many of these instruments were previously classified as equity. This Statement was effective for financial instruments entered into or modified after May 31, 2003 and otherwise was F-20 effective beginning July 1, 2003. The adoption of this standard did not have an impact on the Company's financial condition or results of operations. NOTE 2 - ACQUISITIONS On October 1, 2001, the Company, through its Sussex Bank subsidiary, acquired 100% of the stock of Tri-State Insurance Agency, Inc. for guaranteed consideration, including transaction costs totaling $2,021,000. The purchase price paid by the Company for Tri-State was comprised of an upfront cash payment of $350,000 at closing, and deferred payments on the first, second and third anniversaries of the closing. These deferred payments will be satisfied through a combination of cash and common stock of the Company, with the number of shares issued based, in part, upon the then-current market price of the Company's current stock. The deferred payments have been included in other liabilities at their net present value. The acquisition has been accounted for using the purchase method of accounting and, accordingly, the purchase price has been allocated to the assets acquired and liabilities assumed based upon fair value at the date of acquisition, including identifiable intangible assets of $243,000 and $60,000 representing the fair value of the acquired book of business and executive employment contracts, respectively. The excess of the purchase price over the fair value of the identifiable net assets acquired was $1,757,000 and has been recorded as goodwill. In October 2003 and 2002, additional contingent payments were paid to the sellers in the amount of $192,000 and $175,000, respectively, based on targeted profits of the insurance agency, resulting in additional goodwill. In January 2003, the Company acquired certain assets of another insurance agency, primarily a book of business. The guaranteed purchase price was $56,000. The acquisition was accounted for using the purchase method of accounting. In 2003, additional contingent payments were paid to the seller in the amount of $75,000 based on targeted goals. The total purchase price of $131,000 has been allocated to amortizable intangible assets. NOTE 3 - SEGMENT REPORTING Segment information for 2003 and 2002 is as follows: Year Ended December 31, 2003 Year Ended December 31, 2002 Banking and Insurance Banking and Insurance Financial Services Total Financial Services Total --------- -------- ----- --------- -------- ----- Services Services -------- -------- (In Thousands) (In Thousands) Net interest income from external sources $7,911 $- $7,911 $7,324 $- $7,324 Other income from external sources 2,040 2,063 4,103 1,603 1,689 3,292 Depreciation and amortization 593

79 672 648 47 695 Income before income taxes 1,813 133 1,946 1,602 80 1,682 Income tax expense 452 53 505 494 32 526 Total assets 237,617 3,000 240,617 223,351 2,553 225,904 F-21 NOTE 4 - SECURITIES AVAILABLE FOR SALE The amortized cost and approximate fair value of securities available for sale as of December 31, 2003 and 2002 are summarized as follows: GROSS GROSS AMORTIZED UNREALIZED UNREALIZED FAIR COST GAINS LOSSES VALUE (IN THOUSANDS) DECEMBER 31, 2003: U.S. Government agencies $14,651 $ 54 $ (47) $14,658 State and political subdivisions 21,214 506 (178) 21,542 Mortgage-backed securities 35,056 179 (263) 34,972 Corporate securities 4,311 168 - 4,479 Equity securities 899 11 (16) 894 -------------- --------------- --------------- -------------- $76,131 $918 $(504) $76,545 ============== =============== =============== ============== GROSS GROSS AMORTIZED UNREALIZED UNREALIZED FAIR COST GAINS LOSSES VALUE (IN THOUSANDS) DECEMBER 31, 2002: U.S. Government agencies $13,397 $ 215 $ - $13,612 State and political subdivisions 15,605 215 (35) 15,785 Mortgage-backed securities 35,235 354 (35) 35,554 Corporate securities 6,648 238 - 6,886 Equity securities 898 6 (21) 883 -------------- --------------- --------------- -------------- $71,783 $1,028 $(91) $72,720 ============== =============== =============== ============== The following table shows the Company's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2003. LESS THAN 12 MONTHS 12 MONTHS OR MORE TOTAL FAIR UNREALIZED FAIR UNREALIZED FAIR UNREALIZED VALUE LOSSES VALUE LOSSES VALUE LOSSES (IN THOUSANDS) U.S. Government agencies $ 5,465 $ (47) $ - $ - $ 5,465 $ (47) State and political subdivisions 7,422 (178) - - 7,422 (178) Mortgage-backed securities 16,621 (260) 235 (3) 16,856 (263) Equity securities - - 833 (16) 833 (16) ------------ ------------ ------------ ------------ ------------ ------------ TOTAL TEMPORARILY IMPAIRED SECURITIES $29,508 $(485) $1,068 $(19) $30,576 $(504) ============ ============ ============ ============ ============ ============ Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. F-22 At December 31, 2003, the Company has 51 securities in an unrealized loss position. Unrealized losses detailed above relate primarily to U.S. Government agency debt and mortgage-backed securities and municipal debt securities. The decline in fair value is due only to interest rate fluctuations. As the company has the intent and ability to hold such investments until maturity or market price recovery, no securities are deemed to be other-than-temporarily impaired. None of the individual unrealized losses are significant. The amortized cost and carrying value of securities available for sale at December 31, 2003 are shown below by contractual maturity. Actual maturities may differ from contractual maturities as issuers may have the right to call or prepay obligations with or without call or prepayment penalties. AMORTIZED FAIR COST VALUE ------------- ------------- (IN THOUSANDS) Due in one year or less $ 4,010 $ 4,069 Due after one year through five years 13,925 14,045 Due after five years through ten years 4,647 4,737 Due after ten years 17,594 17,828 ------------- ------------- 40,176 40,679 Mortgage-backed securities 35,056 34,972 Equity securities 899 894 ------------- ------------- $76,131 $76,545 ============= ============= Gross gains on sales of securities were $133,000 and gross losses were $-0- for the year ended December 31, 2003. There were no sales of securities in the year ended December 31, 2002. Securities with a carrying value of approximately $12,432,000 and $12,458,000 at December 31, 2003 and 2002, respectively, were pledged to secure public deposits and for other purposes required or permitted by applicable laws and regulations. NOTE 5 - LOANS RECEIVABLE The composition of net loans receivable at December 31, 2003 and 2002 is as follows: 2003 2002 ------------- ------------- (IN THOUSANDS) Loans secured by one to four family residential properties $ 46,587 $ 49,517 Loans secured by nonresidential properties 59,182 41,035 Loans secured by construction and land development 8,656 8,310 Loans secured by farmland 5,827 774 Commercial and industrial loans 12,392 10,985 Consumer 1,430 2,189 Other loans 287 561 ------------- ------------- 134,361 113,371 Unearned loan origination costs, net 13 84 Allowance for loan losses (1,734) (1,386) ------------- ------------- NET LOANS RECEIVABLE $132,640 $112,069 ============= ============= F-23 Mortgage loans serviced for others are not included in the accompanying balance sheets. The total amount of loans serviced for the benefit of others was approximately $4,104,000 and $3,585,000 at December 31, 2003 and 2002, respectively. NOTE 6 - ALLOWANCE FOR LOAN LOSSES The following table presents changes in the allowance for loan losses for the years ended

December 31, 2003 and 2002: 2003 2002 ------------ ------------ (IN THOUSANDS) Balance, beginning $1,386 $1,143 Provision for loan losses 405 300 Loans charged off (62) (59) Recoveries 5 2 ------------ ------------ Balance, ending $1,734 $1,386 ============ ============ Loans on which the accrual of interest has been discontinued or reduced amounted to approximately $1,177,000 and $1,258,000 at December 31, 2003 and 2002, respectively. Loan balances past due 90 days or more and still accruing interest, but which management expects will eventually be paid in full, amounted to $-0- and $36,000 at December 31, 2003 and 2002, respectively. The total recorded investment in impaired loans was $1,897,000 and $1,148,000 at December 31, 2003 and 2002, respectively. Impaired loans not requiring an allowance for loan losses was $969,000 and $476,000 at December 31, 2003 and 2002, respectively. Impaired loans requiring an allowance for loan losses was $928,000 and $672,000 at December 31, 2003 and 2002, respectively. At December 31, 2003 and 2002, the related allowance for loan losses associated with those loans was $244,000 and $211,000, respectively. For the years ended December 31, 2003 and 2002, the average recorded investment in impaired loans was $1,255,000 and $1,384,000, respectively. Interest income recognized on such loans during the time each was impaired was $33,000 and $26,000, respectively. The Company recognizes income on impaired loans under the cash basis when the collateral on the loan is sufficient to cover the outstanding obligation to the Company. If these factors do not exist, the Company will record all payments as a reduction of principal on such loans. NOTE 7 - BANK PREMISES AND EQUIPMENT The components of bank premises and equipment at December 31, 2003 and 2002 are as follows: 2003 2002 ------------ ------------ (IN THOUSANDS) Land $ 577 $ 577 Building and building improvements 4,253 4,243 Leasehold improvements 95 96 Furniture, fixtures and equipment 4,267 3,918 Assets in progress 182 42 ------------ ------------ 9,374 8,876 Accumulated depreciation (4,724) (4,242) ------------ ------------ $4,650 $4,634 ============ ============ F-24 During the years ended December 31, 2003 and 2002, depreciation expense totaled $510,000 and $564,000, respectively. As of December 31, 2003, the Company has outstanding commitments of approximately $735,000 for computer upgrades and branch construction and renovations. NOTE 8 - DEPOSITS The components of deposits at December 31, 2003 and 2002 are as follows: 2003 2002 ------------ ------------ (IN THOUSANDS) Demand, non-interest bearing $ 31,715 $ 26,514 Savings, club and interest-bearing demand 119,461 110,729 Time, $100,000 and over 12,021 9,145 Time, other 44,460 43,470 ------------ ------------ $207,657 $189,858 ============ ============ At December 31, 2003 and 2002, time deposits included $3,177,000 and $3,102,000, respectively, owned by local municipalities scheduled to mature within 30 days. At December 31, 2003, the scheduled maturities of time deposits are as follows (in thousands): 2004 $40,325 2005 10,467 2006 3,032 2007 971 2008 1,316 Thereafter 370 ------------ $56,481 ============ NOTE 9 - BORROWINGS At December 31, 2003, the Bank has a line of credit commitment from the Federal Home Loan Bank of New York for borrowings up to $22,584,000. There were no borrowings under this line of credit at December 31, 2003. At December 31, 2003 and 2002, the Bank had the following borrowings from the Federal Home Loan Bank: BALANCE AT DECEMBER 31, INITIAL INTEREST ---------------------------------- MATURITY DATE CONVERSION DATE RATE 2003 2002 ----------------------------- ------------------------- ------------------ -------------- ---------------- January 27, 2003 N/A 1.96 % $ - $ 1,000,000 April 25, 2003 N/A 2.03 % - 1,000,000 July 25, 2003 N/A 2.23 % - 1,000,000 October 27, 2003 N/A 2.43 % - 1,000,000 July 26, 2004 N/A 3.01 % 1,000,000 1,000,000 December 21, 2010 December 21, 2001 4.77 % 3,000,000 3,000,000 December 21, 2010 December 21, 2002 4.90 % 3,000,000 3,000,000 December 21, 2010 December 21, 2003 5.14 % 4,000,000 4,000,000 -------------- --------------- $11,000,000 $15,000,000 =============== ================ F-25 The above three convertible notes contain a convertible option which allows the Federal Home Loan Bank (FHLB), at quarterly intervals commencing after each initial conversion date, to convert the fixed convertible advance into replacement funding for the same or lesser principal amount based on any advance then offered by the FHLB at their current market rates. The Bank has the option to repay these advances, if converted, without penalty. At December 31, 2003, the above borrowings are secured by a pledge of qualifying one-to-four family mortgage loans and selected investment securities, having an aggregate unpaid principal balance of approximately $18,510,000 of which the Bank has borrowing capacity of 75%. NOTE 10 - MANDATORY REDEEMABLE CAPITAL DEBENTURES On July 11, 2002, Sussex Capital Trust I, a Delaware statutory business trust and a wholly-owned subsidiary of the Company, issued $5 million of variable rate capital trust pass-through securities to investors. The variable interest rate reprices quarterly at the three month LIBOR plus 3.65% and was 4.80% and 5.43% at December 31, 2003 and 2002, respectively. Sussex Capital Trust I purchased $5.0 million of variable rate junior subordinated deferrable interest debentures from Sussex Bancorp. The debentures are the sole asset of the Trust. The terms of the junior subordinated debentures are the same as the terms of the capital securities. Sussex Bancorp has also fully and unconditionally guaranteed the obligations of the Trust under the capital securities. The capital securities are redeemable by Sussex Bancorp on or after October 7, 2007, at par or earlier if the deduction of related interest for federal income taxes is prohibited, classification as Tier 1 Capital is no longer allowed, or certain other contingencies arise. The capital securities must be redeemed upon final maturity of the subordinated debentures on October 7, 2032. Proceeds totaling approximately $4.8 million were contributed to paid-in capital at Sussex Bank. Financing costs related to the Company's issuance of mandatory redeemable capital debentures will be amortized over a five-year period and is included in other assets. NOTE 11 - LEASE COMMITMENTS AND TOTAL RENTAL EXPENSE The Company has operating lease agreements expiring in various years through 2020. The Company has the option to extend the lease agreements for additional lease terms. In December 2003, the Company entered into a five-year operating lease agreement for administration and operations office space which will commence January 2004. The Bank is responsible to pay all real estate taxes, insurance, utilities and maintenance and repairs on its leased facilities. Included in other income for the year ended December 31, 2002 is a $160,000 contract settlement related to a land lease of a branch facility. Future minimum lease payments by year are as follows (in thousands): 2004 $236 2005 216 2006 183 2007 91 2008 86 Thereafter 132 ------------ $944 ============ Rent expense was $175,000 and $171,000 for the years ended December 31, 2003 and 2002, respectively. In addition, the Company has plans to increase the leased space for the insurance agency. If the additional space is leased, rent expense will increase $67,000 per year for a ten year term. F-26 NOTE 12 - EMPLOYEE BENEFIT PLANS The Company has a 401(k) Profit Sharing Plan and Trust for its employees. Employees may contribute up to the statutory limit or 75% of their salary to the Plan. The Company provides a 50% match of the employee's contribution up to 6% of the employee's annual salary. The amount charged to expense related to this Plan for the years ended December 31, 2003 and 2002 was $89,000 and $66,000, respectively. The Company also has a nonqualified Supplemental Salary Continuation Plan for an executive officer. Under the provisions of the Plan, the Company has executed agreements providing the officer a retirement benefit. The Plan is funded by life insurance carried on the life of the participant. For the years ended December 31, 2003 and 2002, $143,000 and $118,000, respectively, was charged to expense in connection with this Plan. At December 31, 2003 and 2002, the Bank had an investment in life insurance of $1,195,000 and $1,146,000, respectively, related to this Plan which is included in other assets. Earnings on the investment in life insurance were $49,000 and $55,000 for the years ended December 31, 2003 and 2002, respectively. The Company has an Employee Stock Ownership Plan for the benefit of all employees who meet the eligibility requirements set forth in the Plan. The amount of employer contributions to the Plan is at the discretion of the Board of Directors. The contributions charged to expense for both the years ended December 31, 2003 and 2002 were $25,000. At December 31, 2003 and 2002, 40,084 and 35,072 shares, respectively, of the Company's common stock were held in the Plan. In the event a terminated Plan participant desires to sell his or her shares of the Company's stock, or for certain employees who elect to diversify their account balances, the Company may be required to purchase the shares from the participant at their fair market value. NOTE 13 - COMPREHENSIVE INCOME Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income. The components of other comprehensive income and related tax effects for the years ended December 31, 2003 and 2002 are as follows: 2003 2002 --------------- --------------- (IN THOUSANDS) Unrealized gains (losses) on available for sale securities $(390) $735 Less reclassification adjustment for gains included in net income 133 - --------------- --------------- NET UNREALIZED GAINS (LOSSES) (523) 735 Tax effect (209) 296 --------------- --------------- NET OF TAX AMOUNT $(314) $439 =============== =============== F-27 NOTE 14 - EARNINGS PER SHARE The following table sets forth the computations of basic and diluted earnings per share (as adjusted for the 5% stock dividend declared in 2003): INCOME SHARES PER SHARE (NUMERATOR) (DENOMINATOR) AMOUNT ---------------- --------------- --------------- (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) YEAR ENDED DECEMBER 31, 2003: Basic earnings per share: Net income applicable to common stockholders $1,441 1,790 $0.80 =============== Effect of dilutive securities: Stock options - 37 Deferred common stock payments for purchase of insurance agency 6 32 ---------------- --------------- Diluted earnings per share: Net income applicable to common stockholders and assumed conversions $1,447 1,859 $0.78 ================ ================ =============== YEAR ENDED DECEMBER 31, 2002: Basic earnings per share: Net income applicable to common stockholders $1,156 1,748 $0.66 =============== Effect of dilutive securities: Stock options - 19 Deferred common stock payments for purchase of insurance agency 10 54 --------------- -------------- Diluted earnings per share: Net income applicable to common stockholders and assumed conversions $1,166 1,821 $0.64 =============== =============== =============== NOTE 15 - STOCK OPTION PLANS The following data have been adjusted to give retroactive effect to stock dividends declared subsequent to option authorizations, grants and exercises. During 1995, the stockholders approved a stock option plan for nonemployee directors (the "Director Plan"). Options granted under the Plan are non-qualified stock options. As of December 31, 2003, there were 2,344 authorized shares of the Company's common stock to be granted. The option price under each grant shall not be less than the fair market value on the date of the grant. Options are exercisable in their entirety six months after the date of the grant and expire after ten years. As of December 31, 2003, 44,732 options were outstanding under this plan. During 1995, the stockholders approved an incentive stock option plan for executives of the Company (the "Executive Plan"). The options granted under the Plan are incentive stock options, subject to limitations under Section 422 of the Internal Revenue Code. As of December 31, 2003, there were 51,164 authorized shares of the Company's common stock to be granted. Executive Plan options are granted at the sole discretion of the Board of Directors. The option price under each grant shall not be less than the fair market value on the date of grant. The Company may establish a vesting schedule that must be satisfied before the options may be exercised, but not within six months after the date of grant. The options may F-28 have a term not longer than ten years from the date of grant. As of December 31, 2003, 89,020 options were outstanding under this plan. During 2001, the stockholders approved the 2001 Stock Option Plan established to provide equity incentives to selected persons. As of December 31, 2003, there were 98,175 authorized shares of the Company's common stock to be granted. Options may be granted to employees, officers and directors of the Company or subsidiary. Options granted under the Plan may be either incentive stock options or non-qualified stock options as designated at the time of grant. The shares granted under the Plan to directors are non-qualified stock options. The shares granted under the Plan to officers and other employees are incentive stock options and are subject to limitations under Section 422 of the Internal Revenue Code. The option price under each grant shall not be less than the fair market value on the date of the grant. The Company may establish a vesting schedule that must be satisfied before the options may be exercised, but not within six months after the date of grant. As of December 31, 2003, 74,025 options were outstanding under this Plan. Transactions under all stock option plans are summarized as follows as adjusted for the 5% stock dividend: WEIGHTED NUMBER OF RANGE OF EXERCISE AVERAGE EXERCISE SHARES PRICE PER SHARE PRICE PER SHARE --------------- --------------- -------------- Outstanding, December 31, 2001 74,447 $4.84 - $10.63 $ 7.46 Options granted 26,854 9.95 - 10.43 10.12 Options exercised (6,954) 4.84 - 9.76 7.01 Options expired (2,104) 7.98 - 9.39 8.94 --------------- --------------- -------------- Outstanding, December 31, 2002 92,243 4.84 - 10.63 8.17 Options granted 123,121 9.91 - 13.70 11.54 Options exercised (7,587) 4.84 - 10.00 5.60 --------------- --------------- -------------- Outstanding December 31, 2003 207,777 $4.84 - $13.70 $10.27 ================ ================ =============== Exercisable, December 31, 2002 71,169 $4.84 - $10.63 $ 7.70 ================ ================ =============== Exercisable, December 31, 2003 96,199 $4.84 - $10.63 $ 8.61 ================ ================ =============== The weighted-average remaining contractual life of the above options is approximately 10.2 years. The following table summarizes information about stock options outstanding at December 31, 2003: EXERCISE NUMBER REMAINING NUMBER PRICE OUTSTANDING CONTRACTUAL LIFE EXERCISABLE ---------------- ------------------- ------------------- --------------------- $ 4.84 22,130 1.8 years 22,130 7.69 2,481 6.8 years 2,481 7.87 3,374 2.8 years 3,374 8.09 2,821 1.1 years 2,116 8.14 2,205 3.8 years 2,205 9.68 4,410 4.8 years 4,410 9.76 9,450 7.8 years 9,450 9.90 51,124 9.1 years 12,781 9.95 17,404 8.1 years 8,702 10.00 7,695 2.1 years 3,848 10.05 9,450 9.8 years 9,450 10.05 9,976 9.1 years 2,494 10.43 9,450 8.8 years 9,450 10.63 3,307 5.8 years 3,308 13.70 52,500 19.5 years - ------------------- --------------------- 207,777 96,199 =================== ===================== F-29 NOTE 16 - INCOME TAXES The components of income tax expense for the years ended December 31, 2003 and 2002 are as follows: 2003 2002 -------------- -------------- (IN THOUSANDS) Current: Federal $509 $523 State 199 173 -------------- -------------- 708 696 -------------- -------------- Deferred: Federal (154) (129) State (49) (41) -------------- -------------- (203) (170) -------------- -------------- $505 $526 ============== ============== A reconciliation of the statutory federal income tax at a rate of 34% to the income tax expense included in the statements of income for the years ended December 31, 2003 and 2002 is as follows: 2003 2002 --------------------------- --------------------------- % OF % OF

PRE-TAX PRE-TAX AMOUNT INCOME AMOUNT INCOME ------------ ------------ ------------ ------------ (DOLLAR AMOUNTS IN THOUSANDS) Federal income tax at statutory rate $662 34 % $572 34 % Tax exempt interest (234) (12) (152) (9) State income tax, net of federal income tax effect 99 5 87 5 Other (22) (1) 19 1 ------------ ------------ ------------ ------------ $505 26 % $526 31 % ============ ============ ============ ============ The income tax provision includes $53,000 and $-0- in 2003 and 2002, respectively, of income tax expense related to net gains on sales of securities. F-30 NOTE 16 - INCOME TAXES (CONTINUED) The components of the net deferred tax asset at December 31, 2003 and 2002 are as follows: 2003 2002 --------------- --------------- (IN THOUSANDS) Deferred tax assets: Allowance for loan losses $692 $554 Deferred compensation 158 101 Other 95 86 --------------- --------------- TOTAL DEFERRED TAX ASSETS 945 741 --------------- --------------- Deferred tax liabilities: Bank premises and equipment (106) (105) Unrealized gains on securities available for sale (166) (375) --------------- --------------- TOTAL DEFERRED TAX LIABILITIES (272) (480) --------------- --------------- NET DEFERRED TAX ASSET $673 $261 =============== =============== NOTE 17 - TRANSACTIONS WITH EXECUTIVE OFFICERS, DIRECTORS AND PRINCIPAL STOCKHOLDERS The Company has had, and may be expected to have in the future, banking transactions in the ordinary course of business with its executive officers, directors, principal stockholders, their immediate families and affiliated companies (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. The related party loan activity for the year ended December 31, 2003 is summarized as follows (in thousands): Balance, beginning $3,798 Disbursements 1,688 Repayments (1,986) ------------ Balance, ending $3,500 ============ Certain related parties of the Company provided legal, tax accounting, real estate appraisal and construction services to the Company. Such services totaled $27,000 during both 2003 and 2002. The Company also paid rent to a related party for a branch location in the amount of $22,000 for both 2003 and 2002. NOTE 18 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. F-31 A summary of the Company's financial instrument commitments at December 31, 2003 and 2002 is as follows: 2003 2002 ------------ ------------ (IN THOUSANDS) Commitments to grant loans $ 6,211 $ 3,379 Unfunded commitments under lines of credit 26,893 18,828 Outstanding standby letters of credit 1,002 597 Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include personal or commercial real estate, accounts receivable, inventory and equipment. Outstanding letters of credit written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments. These standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Company requires collateral and personal guarantees supporting these letters of credit as deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral and enforcement of personal guarantees would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of December 31, 2003 for guarantees under standby letters of credit issued is not material. NOTE 19 - CONCENTRATION OF CREDIT RISK The Company grants commercial, residential and consumer loans to customers primarily located in Sussex County and adjacent counties in the states of Pennsylvania, New Jersey and New York. The concentration of credit by type of loan is set forth in Note 5. Although the Company has a diversified loan portfolio, its debtors' ability to honor their contracts is influenced by the region's economy. NOTE 20 - REGULATORY MATTERS The Company is required to maintain cash reserve balances with the Federal Reserve Bank. The total of those reserve balances was approximately $4,441,000 at December 31, 2003. The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2003, that the Company and the Bank meet all capital adequacy requirements to which they are subject. F-32 As of December 31, 2003, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category. The Company's and the Bank's actual capital amounts and ratios at December 31, 2003 and 2002 are presented below: TO BE WELL CAPITALIZED UNDER FOR CAPITAL ADEQUACY PROMPT CORRECTIVE ACTUAL PURPOSES ACTION PROVISIONS --------------------- -------------------- --------------------- AMOUNT RATIO AMOUNT RATIO AMOUNT RATIO -------- --------- -------- --------- -------- --------- (DOLLAR AMOUNTS IN THOUSANDS) AS OF DECEMBER 31, 2003: Total capital (to risk-weighted assets): Company $18,682 12.37 % $>12,086 >8.00 % N/A N/A = = C> Bank 18,253 12.11 >12,063 >8.00 $>15,078 >10.00 % = = = = Tier 1 capital (to risk-weighted assets): Company 16,832 11.14 > 6,043 >4.00 N/A N/A = = Bank 16,519 10.96 > 6,031 >4.00 > 9,047 > 6.00 = = = = Tier 1 capital (to average assets): Company 16,832 7.15 > 9,416 >4.00 N/A N/A = = Bank 16,519 7.02 > 9,411 >4.00 >11,764 > 5.00 = = = = AS OF DECEMBER 31, 2002: Total capital (to risk-weighted assets): Company $16,951 13.36 % $>10,147 >8.00 % N/A N/A = = Bank 16,595 13.12 >10,117 >8.00 $>12,646 >10.00 % = = = = Tier 1 capital (to risk-weighted assets): Company 14,935 11.77 > 5,074 >4.00 N/A N/A = = Bank 15,209 12.03 > 5,058 >4.00 > 7,588 > 6.00 = = = = Tier 1 capital (to average assets): Company 14,935 6.66 > 8,976 >4.00 N/A N/A = = Bank 15,209 6.78 > 8,968 >4.00 >11,210 > 5.00 = = = = The Bank is subject to certain restrictions on the amount of dividends that it may declare due to regulatory considerations. The State of New Jersey banking laws specify that no dividend shall be paid by the Bank on its capital stock unless, following the payment of each such dividend, the capital stock of the Bank will be unimpaired and the Bank will have a surplus of not less than 50% of its capital stock or, if not, the payment of such dividend will not reduce the surplus of the Bank. At December 31, 2003, the Bank's funds available for the payment of dividends was $11,724,000. Accordingly, $7,503,000 of the Company's equity in the net assets of the Bank was restricted at December 31, 2003. In addition, dividends paid by the Bank to the Company would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements. NOTE 21 - FAIR VALUE OF FINANCIAL INSTRUMENTS Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective year ends, and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated F-33 fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each year end. The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair value of the Company's financial instruments at December 31, 2003 and 2002: CASH AND CASH EQUIVALENTS The carrying amounts for cash and cash equivalents approximate fair value. TIME DEPOSITS WITH OTHER BANKS The fair value of time deposits with other banks is estimated by discounting future cash flows using the current rates available for time deposits with similar remaining maturities. SECURITIES AND FEDERAL HOME LOAN BANK STOCK The fair values for securities are based on quoted market prices or dealer prices, if available. If quoted market prices or dealers prices are not available, fair value is estimated using quoted market prices or dealer prices for similar securities. The Federal Home Loan Bank stock is restricted; accordingly, its carrying amount approximates its fair value. LOANS The fair value of loans is estimated by discounting the future cash flows, using the current rates at which similar loans with similar remaining maturities would be made to borrowers with similar credit ratings. DEPOSITS For demand, savings and club accounts, fair value is the carrying amount reported in the consolidated financial statements. For fixed-maturity certificates of deposit, fair value is estimated by discounting the future cash flows, using the rates currently offered for deposits of similar remaining maturities. BORROWINGS AND MANDATORY REDEEMABLE CAPITAL DEBENTURES The fair values of these borrowings and debentures are estimated by discounting future cash flows, using rates currently available on borrowings with similar remaining maturities. ACCRUED INTEREST RECEIVABLE AND ACCRUED INTEREST PAYABLE The carrying amounts of accrued interest receivable and payable approximate fair value. OFF-BALANCE SHEET 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. F-34 The estimated fair values of the Company's financial instruments at December 31, 2003 and 2002 were as follows: 2003 2002 --------------------------- --------------------------- CARRYING FAIR CARRYING FAIR AMOUNT VALUE AMOUNT VALUE ----------- ------------ ------------ ------------ (IN THOUSANDS) Financial assets: Cash and cash equivalents $ 15,496 $ 15,496 $ 26,096 $ 26,096 Time deposits with other banks 3,500 3,500 3,600 3,600 Securities available for sale 76,545 76,545 72,720 72,720 Federal Home Loan Bank stock 760 760 750 750 Loans receivable, net of allowance 132,640 133,293 112,069 113,428 Accrued interest receivable 1,241 1,241 1,144 1,144 Financial liabilities: Deposits 207,657 208,007 189,858 190,250 Borrowings 11,000 12,014 15,000 15,097 Mandatory redeemable capital debentures 5,000 5,059 5,000 5,067 Accrued interest payable 228 228 303 303 Off-balance sheet financial instruments: Commitments to extend credit - - - - Outstanding letters of credit - - - - NOTE 22 - PARENT COMPANY ONLY FINANCIAL INFORMATION Condensed financial statements of Sussex Bancorp (Parent Company only) follows: BALANCE SHEETS DECEMBER 31, ---------------------------- 2003 2002 ------------ ------------ ASSETS (IN THOUSANDS) Cash $ 175 $ 45 Investment in subsidiaries 19,475 18,324 Other assets 311 376 ------------ ------------ TOTAL ASSETS $19,961 $18,745 ============ ============ LIABILITIES AND STOCKHOLDERS' EQUITY Liabilities: Other liabilities $ 57 $ 65 Junior subordinated debentures 5,000 5,000 ------------ ------------ TOTAL LIABILITIES 5,057 5,065 Stockholders' Equity 14,904 13,680 ------------ ------------ TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY $19,961 $18,745 ============ ============ F-35 YEARS ENDED DECEMBER 31, ---------------------------- STATEMENTS OF INCOME 2003 2002 ------------ ------------ (IN THOUSANDS) Dividends from banking subsidiary $ 485 $ 416 Interest expense on junior subordinated debentures (248) (132) Other expenses (88) (23) ------------ ------------ INCOME BEFORE INCOME TAX BENEFIT AND EQUITY IN 149 261 UNDISTRIBUTED NET INCOME OF BANKING SUBSIDIARY Income tax benefits 134 62 ------------ ------------ INCOME BEFORE EQUITY IN UNDISTRIBUTED NET 283 323 INCOME OF BANKING SUBSIDIARY Equity in undistributed net income of banking subsidiary 1,158 833 ------------ ------------ NET INCOME $1,441 $1,156 ============ ============ YEARS ENDED DECEMBER 31, ---------------------------- STATEMENTS OF CASH FLOWS 2003 2002 ------------ ------------ (IN THOUSANDS) CASH FLOWS FROM OPERATING ACTIVITIES Net income $1,441 $1,156 Adjustments to reconcile net income to net cash provided by operating activities: Net change in other assets and liabilities 57 111 Equity in undistributed net income of banking subsidiary (1,158) (833) ------------ ------------ NET CASH PROVIDED BY OPERATING ACTIVITIES 340 434 ------------ ------------ CASH FLOWS FROM FINANCING ACTIVITIES Cash dividends paid, net of reinvestments (228) (298) Capital contribution to subsidiary - (5,255) Proceeds from the issuance of capital debentures - 5,000 Purchase of treasury stock (25) (156) Proceeds from exercise of stock options 47 49 Cash paid in lieu of fractional shares (4) - ------------ ------------ NET CASH USED IN FINANCING ACTIVITIES (210) (660) ------------ ------------ NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS 130 (226) CASH AND CASH EQUIVALENTS

- BEGINNING OF YEAR 45 271 ------------ ------------ CASH AND CASH EQUIVALENTS - END OF YEAR $ 175 $ 45 ============ ============ F-36