

# SBBX 10KSB 12/31/1998

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### Section 1: 10KSB

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

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FORM 10-KSB

(Mark One)

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

For the fiscal year ended: December 31, 1998

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-29030

SUSSEX BANCORP  
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(Name of small business issuer as specified in its charter)

New Jersey

22-3475473

-----  
(State of other jurisdiction  
of incorporation or organization)

(I.R.S. employer  
identification no.)

399 Route 23, Franklin, New Jersey

07416

-----  
(Address of principal executive offices)

(Zip Code)

(973) 827-2914

-----  
(Issuer's Telephone Number  
Including Area Code)

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class -----	Name of Exchange on Which Registered -----
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Common Stock, no par value	American Stock Exchange
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Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark whether the Issuer: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934, as amended, during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is not contained herein, and will not be contained, to the best of Issuer's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. (X)

The aggregate market value of the voting stock held by non-affiliates of the Issuer as of March 3, 1999, was \$12,637,420.

The number of shares of the Issuer's Common Stock, no par value, outstanding as of March 3, 1999, was 1,423,634.

For the fiscal year ended December 31, 1998, the Issuer had total revenues of \$9,164,000.

DOCUMENTS INCORPORATED BY REFERENCE

	10-KSB Item -----	Document Incorporated -----
Item 6.	Management's Discussion and Analysis or Plan of Operation	Registrant's Annual Report to Shareholders, under the caption "Management's Discussion and Analysis of Financial Conditions and Results of Operation.
Item 7.	Financial Statements	Registrant's Annual Report to shareholders under the caption "Consolidated Financial statements.
Item 9.	Directors and Executive Officers of the Company; Compliance with Section 16(a) of the Exchange Act.	Proxy Statement for 1999 Annual Meeting of Shareholders to be filed no later than April 29, 1999.
Item 10.	Executive Compensation	Proxy Statement for 1999 Annual Meeting of Shareholders to be filed not later than April 29, 1999.
Item 11.	Security Ownership of Certain Beneficial Owners and Management	Proxy Statement for 1999 Annual Meeting of Shareholders to be filed no later than April 29, 1999.
Item 12.	Certain Relationships and Related Transactions	Proxy Statement for 1999 Annual Meeting of Shareholders to be filed no later than April 29, 1999.

PART I

ITEM 1: Description of Business

General

Sussex Bancorp (the "Company" or "Registrant") is a one-bank holding company incorporated under the laws of the State of New Jersey in January, 1996 to serve as a holding company for the Sussex County State Bank (the "Bank"). The company was organized at the direction of the Board of Directors of the Bank for the purpose of acquiring all of the capital stock of the Bank (the "Acquisition"). Pursuant to the New Jersey Banking Act of 1948, as amended, (the "Banking Act"), and pursuant to approval of the shareholders of the Bank, the Company acquired the Bank and became its holding company on November 20, 1996. As part of the Acquisition, shareholders of the Bank received one share of common stock, no par value ("Common Stock") of the Company for each outstanding share of the common stock of the Bank, \$2.50 per share par value ("Bank Common Stock"). The only significant asset of the Company is its investment in the Bank. The company's main office is located at 399 Route 23, Franklin, Sussex County, New Jersey 07416.

The Bank is a commercial bank formed under the laws of the State of New

Jersey in 1975. The bank operates from its main office at 399 Route 23, Franklin, New Jersey 07416, and its six branch offices located at 7 Church Street, Vernon, New Jersey; 266 Clove Road, Montague, New Jersey; 172 Woodport Road, Sparta, New Jersey; 455 Route 23, Wantage, New Jersey; 15 Trinity Street, Newton, New Jersey; and 165 Route 206, Andover, 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"). The principal executive offices of the Company are located at 399 Route 23, Franklin, New Jersey 07416, and the telephone number is (973) 827-2914.

#### Business of the Company

The Company's primary business is ownership and supervision of the Bank. The Company, through the Bank, conducts a traditional commercial banking business, and offers services including personal and business checking accounts and time deposits, money market accounts and regular savings accounts. The Company structures its specific services and charges in a manner designed to attract the business of the small and medium sized business and professional community as well as that of individuals residing, working and shopping in the Sussex County, New Jersey trade area serviced by the Company. The Company engages in a wide range of lending activities and offers commercial, consumer, mortgage, home equity and personal loans. In addition, during 1998, the Bank formed the Sussex Bancorp Mortgage Company (the "Mortgage Company"). The Mortgage Company originates one to four family mortgage loans for resale into the secondary market. Currently, all loan are sold servicing released, although the Company, through the Bank, may seek to service the loans it originates in the future.

#### Service Area

The Company's service area primarily consists of the Sussex County, New Jersey market, although the Company makes loans throughout New Jersey. The Company operates its main office in Franklin, New Jersey and six branch offices in Vernon, Montague, Sparta, Wantage, Newton and Andover, New Jersey

#### Competition

The Company operates in a highly competitive environment competing for deposits and loans with commercial banks, thrifts and other financial institutions, many of which have greater financial resources than the Company. Many large financial institutions in New York City and other parts of New Jersey compete for the business of New Jersey residents located in the Company's service area. Certain of these institutions have significantly higher lending limits than the Company and provide services to their customers which the Company does not offer.

Management believes the Company is able to compete on a substantially equal basis with its competitors because it provides responsive personalized services through management's knowledge and awareness of the Company's service area, customers and business.

#### Employees

At December 31, 1998, the Company employed 67 full-time employees and 15 part-time employees. None of these employees is covered by a collective bargaining agreement and the Company believes that its employee relations are good.

### 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 stockholders. 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

## General

As a bank holding company registered under the Bank Holding Company Act of 1956, as amended, (the "BHCA"), the Company is subject to the regulation and supervision of the FRB. The Company is required to file with the FRB annual reports and other information regarding its business operations and those of its subsidiaries. Under the BHCA, the Company's activities and those of its subsidiaries are limited to banking, managing or controlling banks, furnishing services to or performing services for its subsidiaries or engaging in any other activity which the FRB determines to be so closely related to banking or managing or controlling banks as to be properly incident thereto.

The BHCA requires, among other things, the prior approval of the FRB 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 bank's voting shares) or (iii) merge or consolidate with any other bank holding company. The FRB 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 FRB 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.

Additionally, the BHCA 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 FRB to be so closely related to banking or managing or controlling banks as to be properly incident thereto. In making such determinations, the FRB is required to weigh the expected benefits to the public, such as greater convenience, increased competition or gains in efficiency, against the possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

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 FRB 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 FRB also has the authority under the BHCA to require a bank holding company to terminate any activity or to relinquish control of a non-bank subsidiary upon the FRB'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 FRB 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 risk-based guidelines apply on a consolidated basis to bank holding companies with consolidated assets of \$150 million or more. For bank holding companies with less than \$150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless: (a) the parent bank holding company is engaged in non-bank activity involving significant leverage; or (b) the parent company has a significant amount of outstanding debt that is held by the general public. 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 1",

consisting of common stockholders' equity and certain 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) excess of qualifying preferred stock, (c) hybrid capital instruments, (d) debt, (e) mandatory convertible securities, and (f) qualifying subordinated debt. 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 FRB (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. 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 100% risk-weighting. Transaction related contingencies such as bid bonds, standby letters of credit backing non-financial obligations, and 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 FRB 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 Department. 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 Department impact virtually all activities of the Bank, including the minimum level of capital the Bank must maintain, the ability of the Bank to pay dividends, the ability of the Bank to expand through new branches or acquisitions and various other matters.

#### Insurance of Deposits

The Bank's deposits are insured up to a maximum of \$100,000 per depositor under the BIF. The FDIC has established a risk-based insurance premium assessment system under which the FDIC has developed a matrix that sets the assessment premium for a particular institution in accordance with its capital level and overall regulatory rating by the institutions' primary federal regulatory. Under the matrix that is currently in effect, the assessment rate ranges from 0 to 27 basis points of assessed deposits. In addition to the deposit insurance premium assessment, under the deposit insurance funds act of 1996 (the "Deposit Act"), BIF insured institutions like the Bank are required to contribute to the debt service and principal repayment on bonds issued by the Federal Finance Corporation ("FFCO") in the mid-1980s to fund a portion of the thrift bailout. This assessment is currently set at 1.3 basis points of assessed deposits.

#### Dividend Rights

Under the Banking Act, a bank may declare and pay dividends only if, after 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.

#### ITEM 2. Description of Property

The Company conducts its business through its main office located at 399 Route

23, Franklin, New Jersey, and its six branch offices. The following table set forth certain information regarding the Company's properties as of December 31, 1998.

LOCATION	LEASED OR OWNED	DATE OF LEASE EXPIRATION
399 Route 23 Franklin, New Jersey	Owned	N/A
7 Church Street Vernon, New Jersey	Owned	N/A
266 Clove Road Montague, New Jersey	Leased	April, 2002
172 Woodport Road Sparta, New Jersey	Leased	September, 1998
455 Route 23 Wantage, New Jersey	Owned(1)	N/A
15 Trinity Street Newton, New Jersey	Owned	N/A
165 Route 206 Andover, New Jersey	Owned	N/A
Route 206 Frankford, New jersey	Owned	N/A

(1) The Company owns the building housing its 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 the Company to extend the lease for an additional 25 year term.

ITEM 3. Legal Proceedings

The Company and the Bank 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 Bank's business. Management does not believe that there is any pending or threatened proceeding against the Company of the Bank which, if determined adversely, would have a material effect on the business, financial position or results of operation of the Company or the Bank.

ITEM 4. Submission of Matters to a Vote of Security Holders

No matters were submitted for a vote of the registrant's shareholders during the Fourth Quarter of fiscal 1998.

PART II

ITEM 5. Market for Common Equity and Related Stockholder Matters

Historically, there has been no established public market for the common stock of the Company, which was periodically traded in the over-the-counter market through the "pink sheets" published by the National Quotation Bureau, Inc. However, commencing February 20, 1998, the Common Stock began trading on the American Stock Exchange, under the symbol "SBB". As of December 31, 1998, the Company had approximately 711 holders of record of the Common Stock.

The following table shows the high and low closing price, by quarter, for the common stock, as well as dividends declared, since the common stock began trading on the American Stock Exchange:

1998	HIGH	LOW	DIVIDENDS DECLARED
4th Quarter	11 3/8	8 1/2	\$ 0.03
3rd Quarter	11 5/8	9 3/8	\$ 0.07
2nd Quarter	11 5/16	9 3/4	\$ 0.13
1st Quarter	13	10 15/16	\$ 0.13

During 1998 the Company also declared a two for one stock split.

During 1997, the Company paid quarterly cash dividends of \$0.06, \$0.10, \$0.12 and \$0.13 and declared a 2% stock dividend.

ITEM 6. Management's Discussion and Analysis or Plan of Operation

The information required by this item is incorporated by reference from the Registrant's 1997 Annual Report to Shareholders under the caption "Management Discussion and Analysis".

ITEM 7. Financial Statements

The information required by this item is incorporated by reference from the Registrant's 1997 Annual Report to Shareholders under the caption "consolidated Financial Statements".

ITEM 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Upon completion of the 1997 audit, the Registrant replaced Arthur Andersen LLP ("Andersen") as its independent auditor with Radics & Co., LLP, who conducted the audit of the Company's financial statements for the 1998 fiscal year. The decision to change auditors was recommended by the Audit Committee and was approved by the Company's Board of Directors. For the fiscal years ended December 31, 1997 and 1996, there have been no disagreements with Andersen on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure which, if not resolved to the satisfaction of Andersen would have caused it to make reference to the subject matter of the disagreement in connection with their reports. The independent auditor's report on the consolidated financial statements for the fiscal years ended December 31, 1997 and 1996 expressed an unqualified opinion.

ITEM 9. Directors and Executive Officers of the Registrant; Compliance with Section 16(a)

Information concerning directors and executive officers is included in the definitive Proxy Statement for the Company's 1999 Annual Meeting under the caption "ELECTION OF DIRECTORS" and information concerning compliance with Section 16(a) of the Exchange Act is included under the caption "COMPLIANCE WITH SECTION 16(A) OF THE SECURITIES EXCHANGE ACT OF 1934," each of which is incorporated herein by reference. It is expected that such Proxy Statement will be filed with the Securities and Exchange Commission no later than April 29, 1999.

The following table sets forth certain information about each executive officer of the Company who is not also a director.

Table 1

Name, Age and Position -----	Officer Since (1) -----	Principal Occupation During Past Five Years -----
Candace A. Leatham, 44 Senior Vice President and Treasurer -----	1984	Senior Vice President and Treasurer of the Bank

(1) Includes prior service as an officer of the Bank.

ITEM 10. Executive Compensation

Information concerning executive compensation is incorporated by reference from the Registrant definitive Proxy Statement for the Company's 1999 Annual Meeting under the captions "ANNUAL EXECUTIVE COMPENSATION AND ALL OTHER COMPENSATION" and "COMPENSATION OF DIRECTORS". It is expected that such Proxy Statement will be filed with the Securities and Exchange Commission no later than April 29, 1999.

ITEM 11. Security Ownership of Certain Beneficial Owners and Management

Information concerning security ownership of certain beneficial owners and management is included in the definitive Proxy statement for the Company's 1998 Annual Meeting under the caption "SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT", which is incorporated herein by reference. It is expected that such Proxy statement will be filed with the Securities and

Exchange commission no later than April 29, 1999.

ITEM 12. Certain Relationships and Related Transactions

Information concerning certain relationships and related transactions is included in the definitive Proxy Statement for the Company's 1999 Annual Meeting under the caption "INTEREST OF MANAGEMENT AND OTHERS IN CERTAIN TRANSACTIONS", which is incorporated herein by reference. It is expected that such Proxy Statement will be filed with the Securities and Exchange Commission no later than April 29, 1999.

ITEM 13. Exhibits, List and Reports on Form 8-K

(a) Exhibits

Exhibit Number -----	Description of Exhibits -----
3(i)	Certificate of Incorporation of the Company (1)
3(ii)	Bylaws of the Company(1)
10(i)	1995 Incentive Stock Option Plan(1)
10(ii)	1995 Stock Option Plan for Non-Employee Directors(1)
10(iii)	1988 Non-Qualified Stock Option(1)
10(iv)	Employment Agreement with Donald Kovach
13	Annual Report to Shareholders for the year ended December 31, 1998.
21	Subsidiaries of the Registrant
23(a)	Consent of ARTHUR ANDERSEN LLP
23(b)	Consent of RADICS & CO., L.L.C.
27	Financial Data Schedule

(1) Incorporated by reference from Exhibits 5(B)(1) to 5(B)(27) from the Company's Registration Statement on form 8-B, Registration No. 1-12569.

(b) Reports on form 8-K

None.

SIGNATURES

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

SUSSEX BANCORP

By: /s/Donald L. Kovach

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Donald L. Kovach  
Chairman of the Board and  
Chief Executive Officer

Dated:

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

NAME -----	TITLE -----	DATE -----
/s/Donald L. Kovach ----- Donald L. Kovach	Chairman of the Board and Chief Executive Officer	
/s/Candace A. Leatham ----- Candace A. Leatham	Treasurer (Principal Financial Officer and Principal Accounting Officer)	
/s/Irvin Ackerson ----- Irvin Ackerson	Director	
/s/William E. Kulsar ----- William E. Kulsar	Secretary and Director	
/s/Joel D. Marvil ----- Joel D. Marvil	Director	
/s/Richard Scott ----- Richard Scott	Director	
/s/Joseph Zitone ----- Joseph Zitone	Director	

## Section 2: EX-13

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Message  
To Our  
Stockholders

Managing remarkable growth while effecting market penetration through new products and services as well as satisfying regulatory requirements for the Year 2000 were the major achievements of Sussex Bancorp in 1998.

Throughout 1998 interest margins were compressed due to economic conditions which favored lower interest rates on the asset side while interest on deposits increased, resulting in a higher cost of funds. This presented an interesting

paradox: How to stabilize net interest spread and continue to maintain the Bank's growth history. The key is and remains innovation. Strategies designed to generate more profits in the loan and investment portfolio and increasing fee income can produce both growth and increase Return On Assets. For example, in 1998 the composition of our loan portfolio changed showing an increase in small to medium size business loans of over \$2M, both secured and lines of credit, producing higher yields. Fee income through non-deposit products and trust services increased \$100,000 over last year. The investment portfolio reflects a changing composition, balancing liquidity with investments in less volatile municipal tax free bonds. By establishing the Sussex Bancorp Mortgage Company, a subsidiary of the Bank, another profit center was added that will generate fees from mortgage brokerage services and sales of first mortgages in the secondary market. Sussex Bancorp Mortgage Company, organized in the last quarter of 1998, has received Freddie Mac approval as a seller/servicer for one-to-four family mortgage loans and is on-line for internet sales.

On the deposit side, the creation of the "Senior Select" account illustrates a novel approach to overall asset growth combined with cross-selling. Total assets grew by over \$20M, or 20%, over 1997. A substantial portion of deposit growth was attributable to the Senior Select program, specifically designed for our senior clientele. The cornerstone of the "Senior Select" account is a savings account paying money market account rates with unlimited withdrawal authority without penalty. Through a menu of services our senior customers can find answers to financial questions through free investment and tax seminars. This provides the ability to cross-sell non-deposit investment products and loans tailored to the needs of the customer and their families.

Bringing our in-house computer systems into Y2K compliance and establishing contingency plans were a priority of management last year. Through prudent planning, the central computer system and corresponding software was scheduled for upgrade. Fortunately, the timing was commensurate with the banking regulators examination of our Y2K compliance. Hence, testing the new system corresponded with our Y2K preparedness requirements. By tackling the problem head-on with a confident and dedicated staff we can now look forward with optimism and excitement to the new millennium. Indeed, deposits may increase as the new year approaches and the public and our customers become more aware of the safety in keeping their money in the Sussex County State Bank, where it remains insured by the FDIC.

Improving our existing branch sites and expanding through new locations occurred in 1998 and will continue in the future. The improvement of the Andover site was completed. The purchase of the Tanis homestead on Route 206 in Augusta will provide the headquarters for our trust and investments division, as well as a full-service branch in a campus-like atmosphere. Improvement of the Vernon branch is scheduled in 1999, while efforts to upgrade the Sussex/Wantage site continue to be investigated. Architectural and site plans will be developed for an alternative site in Sparta. Potential de novo and branch acquisitions in Morris County will be considered as well. We continue to review joint venture possibilities to expand our product offerings and potential for non-interest income.

Sussex Bancorp is in a unique position, we are located in northwest New Jersey, which enjoys a vibrant and growing economy. Consolidations and mergers continue to underpin and enhance the concept of a community bank. The mega banks shoulder the marketing cost of expanded banking services for all banks, including the movement into fee income, such as non-deposit investment products and mortgage brokerage, making it easier for community banks to do the same. With a complete product menu and the ability to provide personal services, community banks are here to stay. Eleven new banks opened their doors in New Jersey during 1997 and 1998. Eight others are in the organization stage. Nationwide, 144 new community banks were launched in 1996 and 188 new banks started in 1997.

This year's business plan contemplates a secondary stock issue to address the capital needs necessary to continue our product and geographic growth. The last year of the 20th century will be another exciting year for Sussex Bancorp.

Sincerely,

/s/Donald L. Kovach

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Management  
Discussion  
and Analysis

This section presents management's discussion and analysis of and changes to the Company's consolidated financial results of operations and conditions and should be read in conjunction with the Company's financial statements and notes thereto included herein.

Management Strategy

The Company's goal is to serve as a community-oriented financial institution serving the Sussex County, New Jersey marketplace. All seven of the Company's offices are located within Sussex County, New Jersey, and over 90% of the Company's loans are made to borrowers located in Sussex County. Through the year ended December 31, 1998, management sought to change the mix of the Company's loan portfolio and enhance non-interest income. During 1998, the Company established relationships with commercial borrowers to attain a greater market share of commercial loans. In addition, the Company established the Sussex Bancorp Mortgage Company, Inc. to offer 30-year fixed mortgages to our customers. These loans will be sold in the secondary market, producing non-interest income. For 1999, management's goals for the Company include (1) further enhancing non-interest income by focusing on fee income, (2) promoting the Sussex Bancorp Mortgage Company, and (3) continuing to emphasize the expansion of product base to achieve a one-stop financial service concept to retain and gain market share. The Company will seek to increase non-interest income through the Company's relationship with Independent Bankers Financial Services, a registered broker-dealer which will sell non-deposit products, by offering 30-year fixed mortgages to be sold in the secondary market by Sussex Bancorp Mortgage Company, and through growing the Bank's trust department.

Results of Operations

For the year ended December 31, 1998, the Company's net income was \$710,000, representing an increase of \$2,000, or 0.3%, over the \$708,000 earned in 1997. The basic net income per share for 1998 was \$.50, compared to basic net income per share of \$.51 in 1997. The diluted net income per share for 1998 was \$.50, compared to diluted net income per share of \$.51 in 1997. The change in per share earnings reflects an increase in net income offset by an increased number of average shares outstanding during 1998, as the Company's average basic shares outstanding increased to 1,410,535 from 1,377,934. The increase was attributable to issuance of new shares through the Company's dividend reinvestment plan and exercises of stock options.

The Company's results for 1998 were affected by increases of \$157,000 in net interest income and \$125,000 in non-interest income and decreases of \$191,000 in provision for loan losses and \$63,000 in income taxes, partially offset by an increase of \$534,000 in total other expenses.

Net Interest Income

Net interest income is the difference between interest and fees earned on loans and other interest-earning assets and interest paid on interest-bearing liabilities. Net interest income is directly affected by changes in volume and mix of interest-earning assets and interest-bearing liabilities which support those assets, as well as changing interest rates when differences exist in repricing dates of assets and liabilities.

Net interest income, on a fully taxable basis (a 34% tax rate), increased by \$198,000 in 1998 to \$4.5 million compared to \$4.3 million in 1997. The increase in net interest income occurred as total interest income increased by \$953,000, or 12.9%, to \$8.4 million, while interest expense increased \$755,000, or 24.6%, to \$3.8 million. Interest income increased primarily as a result of an increase in average earning assets of \$17.5 million. The increase in volume was partially offset by a decrease in rate as the Company's average yield on interest earning assets declined to 7.16% for the year ended December 31, 1998, compared to 7.46% for the year ended December 31, 1997. The decrease in rate reflects the Company's offering of lower priced loan products to gain new originations, particularly in commercial

and non-residential real estate loans, and the repricing of the Company's investment portfolio as securities mature, reprice and are called and the proceeds are reinvested at lower current market rates.

Interest income on total loans increased from \$5.5 million in 1997 to \$5.6 million in 1998, an increase of \$84,000. As discussed above, this increase was primarily the result of an increase in the volume of the loan portfolio, partially offset by a decline in average rate. The average yield on loans declined one basis point from 8.15% in 1997 to 8.14% in 1998.

Total interest income on securities increased to \$1.9 million in 1998 from \$1.5 million in 1997, an increase of \$349,000, or 22.9%. Average securities increased to \$31.7 million in 1998 from \$24.6 million in 1997, an increase of \$7.1 million, reflecting investment of new deposits in excess of loan demand, primarily in state and local government securities. The average rate earned on securities declined to 5.90% in 1998 from 6.20% in 1997 due to lower current market rates.

Interest income on other interest-earning assets increased by \$520,000 in 1998 to \$886,000 from \$366,000 for 1997. The average balance of other interest-earning assets increased to \$16.2 million in 1998 from \$7.1 million in 1997. In 1998, the Company was required to keep certain municipal deposits in short term liquid investments such as term Federal funds. The average rate on other interest-earning assets increased to 5.46% in 1998 from 5.18% in 1997.

Total interest expense increased from \$3.1 million in 1997 to \$3.8 million for the year ended December 31, 1998, an increase of \$755,000, or 24.6%. The increase in interest expense was attributable to increases in both the Company's average interest-bearing deposits and the average rate paid thereon. During 1998, the Company's average interest-bearing liabilities outstanding increased by \$14 million, to \$96.1 million for the year ended December 31, 1998 compared to the \$82.2 million for the year ended December 31, 1997. The increase in deposits occurred primarily in the Company's time deposits. Average time deposits increased to \$47.4 million, an increase of \$9.5 million, or 25.1%, from 1997 to 1998, and the average rate paid on time deposits increased marginally to 5.42% in 1998 from 5.39% in 1997. The average rate paid on all the Company's liabilities increased to 3.97% in 1998 from 3.73% in 1997, due primarily to increased rates paid on savings deposits and the increase of average time deposits to 49.3% of average interest-bearing liabilities in 1998 from 46.1% in 1997.

The net interest margin was 3.19% in 1998, a decline from the net interest margin of 3.73% in 1997 reflecting the Company's decreased yield on interest earning assets as management continues its strategy of attempting to retain and increase its market share. Despite the declining net interest margin, the Company managed to increase net interest income by increasing average interest-earning assets by \$17.5 million, or 17.6%, in 1998, which more than offset the effects of the \$14.0 million increase in average interest-bearing liabilities and the decreased net interest margin.  
Comparative Average Balance Sheets

The following table reflects the components of the Company's net interest income, setting forth for the period presented (1) average assets, liabilities, and stockholders' equity, (2) interest income earned on interest-earning assets, and the interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) the Company's net interest spread, and (5) the Company's net yield on interest earning assets. Rates are computed on a tax equivalent-basis.

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**Table 1**

Comparative Average Balance Sheets

Year ended December 31,

	1998		Average Rates		1997		Average Rates	
	Average Balance	Interest Income/Expense	Earned/Paid	Average Balance	Income Expense	Earned/Paid		
(Dollars in Thousands)								
<b>Assets</b>								
Interest Earning assets:								
Taxable loans (net of unearned income)	\$ 68,842	\$ 5,601	8.14%	\$ 67,694	\$ 5,517	8.15%		
Tax exempt securities	3,046	182	5.97%	952	61	6.41%		
Taxable investment securities	28,658	1,688	5.89%	23,599	1,460	6.19%		
Other (1)	16,235	886	5.46%	7,059	366	5.18%		
<b>Total earning assets</b>	<b>116,781</b>	<b>8,357</b>	<b>7.16%</b>	<b>99,304</b>	<b>7,404</b>	<b>7.46%</b>		
Non-interest earning assets	8,319			8,245				
Allowance for possible loan losses	(706)			(670)				
<b>Total Assets</b>	<b>\$ 124,394</b>			<b>\$ 106,879</b>				
<b>Liabilities and Shareholders' Equity</b>								
Interest bearing liabilities:								
NOW deposits	\$ 13,496	\$ 260	1.93%	\$ 12,593	\$ 239	1.90%		
Savings deposits	30,646	867	2.83%	28,109	705	2.51%		
Money market deposits	4,590	120	2.61%	3,580	78	2.18%		
Time Deposits	47,398	2,571	5.42%	37,874	2,041	5.39%		
<b>Total interest bearing liabilities</b>	<b>96,130</b>	<b>3,818</b>	<b>3.97%</b>	<b>82,156</b>	<b>3,063</b>	<b>3.73%</b>		
Non-interest bearing liabilities:								
Demand Deposits	18,912			15,886				
Other liabilities	826			824				
<b>Total non-interest bearing liabilities</b>	<b>19,738</b>			<b>16,710</b>				
<b>Shareholders' equity</b>	<b>8,526</b>			<b>8,013</b>				
<b>Total liabilities and shareholders' equity</b>	<b>\$ 124,394</b>			<b>\$ 106,879</b>				
Net interest differential/net interest margin								
		\$ 4,539	3.19%		\$ 4,341	3.73%		
Net yield on interest-earning assets								
			3.89%			4.37%		

</TABLE>

(1) Includes federal funds sold and interest-bearing deposits.

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Management  
Discussion  
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(continued)

The following table presents by category the major factors that contributed to the changes in net interest income between the years ended December 31, 1998 and 1997. Amounts have been computed on a fully tax equivalent basis, assuming a federal tax rate of 34%.

**Table 2**

Year Ended December 31,

1998 versus 1997

Increase (Decrease) Due to Change In

	Average Volume	Average Rate	Net
(Dollars in Thousands)			
<b>Interest Income:</b>			
Loans (net of unearned income)	\$ 91	\$ (7)	\$ 84
Tax exempt securities	125	(4)	121
Taxable investment securities	301	(73)	228
Other	499	21	520
<b>Total interest income</b>	<b>1016</b>	<b>(63)</b>	<b>953</b>
<b>Interest expense:</b>			
NOW deposits	17	4	21
Savings deposits	67	95	162
Money market deposits	25	17	42
Time deposits	519	11	530
<b>Total interest expense</b>	<b>628</b>	<b>127</b>	<b>755</b>
<b>Net interest income</b>	<b>\$ 388</b>	<b>\$ (190)</b>	<b>\$ 198</b>

Provision for Possible Loan Losses

The provision for possible loan losses in 1998 was \$19,000 compared to a provision of \$210,000 in 1997. The decrease for 1998 reflects both relatively mild growth in the loan portfolio and a reduction in non-accrual and restructured loans of \$666,000, or 62.6% from 1997 to 1998. In addition, the decrease reflects management's view of the continued strong economic conditions in the Company's Sussex County market area and New Jersey generally. During 1998, the Company had \$40,000 in loans charged off.

Other Income

The Company's other income is primarily generated through service charges on deposit accounts. Other income increased \$125,000 in 1998 to \$869,000 compared to \$744,000 in 1997. The Company recognized a gain of \$65,000 on the sale of securities available for sale in 1998. The Company also experienced a gain of \$122,000 in other income, representing primarily an increase in fees from the sale of non-deposit products. The Company plans to focus on developing additional non-interest income in 1999. Although no assurances can be given regarding the success of the Company's efforts, the Company believes that opportunities to enhance non-interest income are available through the Banks' mortgage subsidiary selling loans, the expansion of the Bank's trust powers and enhanced marketing of the Company's annuities, mutual funds and discount brokerage services.

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Other Expense

Total other expense increased from \$3,753,000 in 1997 to \$4,287,000 for 1998, an increase of \$534,000 or 14.2%. Salaries and employee benefits expense, the largest element of other expenses, increased \$363,000 or 19.6%, and furniture and equipment expense increased \$154,000 or 41.5%. During 1998, the Bank upgraded its in-house computer system, formed and staffed its mortgage banking subsidiary, and paid customary compensation increases. The increase of \$363,000 in salaries and employee benefits reflects the addition of staff for the mortgage banking subsidiary as well as customary salary increases.

Income Tax Expense

The Company's income tax provisions, which includes both federal and state taxes, were \$330,000, and \$393,000 for the years ended December 31, 1998 and 1997, respectively. The decreased provision for income tax reflects a decrease

in income before income taxes and the increased income from tax-exempt securities.

FINANCIAL CONDITION

At December 31, 1998, the Company had total assets of \$137.5 million compared to total assets of \$114.3 million at December 31, 1997. Net loans increased to \$69.3 million at December 31, 1998 from \$67.4 million at December 31, 1997. Total deposits increased to \$127.7 million at December 31, 1998 from \$104.9 million at December 31, 1997.

Loans

Net loans increased from \$67.4 million at December 31, 1997 to \$69.3 million at December 31, 1998, an increase of \$2 million, or 3%. The increase in the Company's loan portfolio during 1998 occurred in commercial and construction loans. Commercial loans increased by \$1.2 million, or 49.7%, to \$3.7 million at December 31, 1998 from \$2.5 million at December 31, 1997. Construction and development loans increased by \$1.5 million, or 168.2%, to \$2.4 million at December 31, 1998 from \$877,000 at December 31, 1997. The Company's loans secured by non-residential properties increased by \$947,000 to \$11.6 million from \$10.7 million. These increases were partially offset by decreases in loans to individuals of \$108,000, and of \$2.1 million on the Company's 1-4 family mortgage loans. The Company's strategy during 1998 was to continue to diversify its loan portfolio away from residential loans, with emphasis on commercial lending. Management anticipates continuing its efforts to diversify the loan portfolio, and in particular to continue focusing on commercial customers.

The increase in loans was funded during 1998 by an increase in the Company's demand, savings and time deposits.

The Company has defined its primary market area to be Sussex County, New Jersey. Over ninety percent of all loans in the Company's portfolio are made to borrowers in Sussex County. The majority of approved loans are secured by real estate and the borrower's primary residence. The end of year loan to deposit ratios for 1998 and 1997 were 54.3% and 64.2%, respectively.

The following tables set forth certain information concerning the distribution of the Company's loan portfolio.

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Management  
Discussion  
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Table 3

	December 31,			
	1998		1997	
	Amount	Percent	Amount	Percent
(Dollars in Thousands)				
Commercial and industrial	\$ 3,742	5.35%	\$ 2,499	3.67%
Real Estate:				
Non-residential	11,612	16.60%	10,665	15.67%
Residential	49,128	70.22%	51,257	75.30%
Construction	2,352	3.36%	877	1.30%
Other loans	712	1.02%	241	0.35%
Consumer	2,416	3.45%	2,524	3.71%
<b>Total Loans</b>	<b>\$69,962</b>	<b>100.00%</b>	<b>\$68,063</b>	<b>100.00%</b>

Asset Quality

Non-performing assets consist of non-accrual loans and all loans over ninety days delinquent and other real estate owned ("OREO"). Management ceases to accrue interest on all loans when they are over ninety days delinquent. All

previously accrued interest is reversed unless management determines that the loan is adequately collateralized and that the principal and interest will be recovered within the original term of the loan.

The Company experienced a significant decline in non-performing assets during 1998. Non-accrual loans declined by \$332,000 to \$398,000 at December 31, 1998 from \$730,000 at December 31, 1997. In addition, as of December 31, 1998, the Company had no restructured loans compared to restructured loans of \$334,000 at December 31, 1997. Restructured loans are put on accrual basis if the customer demonstrates the ability to repay the debt under the terms of the renegotiation by a period of performance, by financial statements or other evidence of ability to service debt.

The Company seeks to actively manage its non-performing and questionable assets. OREO increased to \$36,000 at December 31, 1998, consisting of one property. The Company had no OREO properties at year end 1997. In addition to active monitoring and collecting on delinquent loans Management has an active loan review process for commercial customers with aggregate unsecured loan amounts of \$100,000 or more and real estate of \$250,000 or more.

The following table provides information concerning risk elements in the loan portfolio.

**Table 4**

	December 31,	
	1998	1997
Non-accrual loans	\$ 398	\$ 730
Renegotiated loans	0	334
Non-performing loans	\$ 398	\$ 1064
Non-accrual loans to total loans	0.57%	1.07%
Non-performing loans to total loans	0.57%	1.56%
Non-performing assets to total assets	0.32%	0.93%
Allowance for possible loan losses as a % of non-performing loans	167.09%	64.38%

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**Allowance for Loan Losses**

Management has established a model for calculating the adequacy of the Company's Allowance for Loan Losses ("ALL"). Restructured loans, as well as certain loans designated by the Company's internal watch list, are assigned a percentage of their balance as a specific reserve. Additionally, all other delinquent, loans are grouped by the number of days delinquent with this amount assigned a general reserve amount.

The ALL at year-end of 1998 was \$665,000 versus \$685,000 in 1997. Management recognizes the importance of adequate reserves and their proper allocation. Due to the reduction in non-accrual loans, the relatively small growth in the loan portfolio during 1998 and management's view of economic conditions in the Company's primary trade area, the ALL was increased by a provision for loan loss of \$19,000 and recoveries of \$1,000, offset by charge-off's of \$40,000.

The following table provides a three year analysis of the changes in the allowance for possible loan losses.

**Table 5**

	Year Ended December 31,		
	1998	1997	1996



Table 7

	December 31,		
	1998	1997	1996
U.S. Treasury securities and obligations of U.S. government corporations and agencies available for sale	\$25,121	\$26,600	\$22,624
Mutual fund available for sale	831	---	---
Obligations of state and political subdivisions held to Maturity	5,939	2,082	652
<b>Total Securities</b>	<b>\$31,891</b>	<b>\$28,682</b>	<b>\$23,276</b>

The Company's securities increased from \$28.7 million at December 31, 1997 to \$31.9 million at December 31, 1998. The \$3.2 million increase in securities at December 31, 1998 was due to the Company's investing excess funds as management determined that the Company's liquidity was sufficient to meet anticipated funding needs through the end of the year. The Company also holds \$693,000 in Federal Home Loan Bank of New York stock which it does not consider an investment security. Ownership of this stock is required for membership in the Federal Home Loan Bank.

Cash and Cash Equivalents

The Company's cash and cash equivalents increased by \$17.0 million for the year ended December 31, 1998, to \$30.7 million from \$13.7 million at December 31, 1997. The increase was caused primarily by the Bank's increasing more rapidly than loan demand. As discussed above, the Company focused on retaining municipal deposits, which were primarily placed in short-term certificates of deposit. To keep these funds liquid, the Company invested \$9.1 million in term federal Funds sold, classified as interest bearing deposits on the balance sheet. In addition, the Company's overnight federal funds sold increased by \$9.6 million as the Company invested excess cash in short-term, liquid assets to fund future loan demand and to have available for investment in securities.

Management Discussion and Analysis (continued)

Deposits

Total deposits increased \$22.8 million from \$104.9 million at year end 1997 to \$127.7 million at year-end 1998, a 21.8% increase. All categories of deposits contributed to the overall increase. Demand deposits increased to \$19.8 million, an increase of \$1.8 million, or 9.8%, from demand deposits of \$18 million at year-end 1997. Savings deposits increased to \$54.4 million, an increase of \$6.5 million, or 13.5%, from savings deposits of \$47.9 million at year-end 1997. Time deposits increased to \$53.6 million, an increase of \$14.6 million, or 37.4%, from time deposits of \$39 million at year-end 1997. Time deposits at December 31, 1998 include \$9 million owned by a local municipality which mature within 30 days. The increase in the overall portfolio reflects management's continued strategy of gaining market share in the Company's trade area, and growing the Company's balance sheet through the growth of the Company's securities portfolio and the origination of additional loans. Time deposits make up the largest portion of the Company's loan portfolio. Reliance on time deposits could cause liquidity concerns as time deposits may prove more volatile than other deposits. Management believes the Company's time deposits have historically renewed, although the need to maintain these time deposits could cause the Company's cost of funds to increase. Even if a large portion of the Company's time deposits do not renew, management believes the Company will have sufficient liquidity to fund its operating needs, through the Company's available for sale securities portfolio and secondary liquidity sources, such as lines of credit with the Federal Home Loan Bank of New York. The increase in time deposits primary reflects the Company's efforts to attract municipal deposits.

The following tables provide information concerning the Company's deposits.

**Table 8**

December 31,				
	1998		1997	
	Average Balance	Percent of Total	Average Balance	Percent of Total
(Dollars in Thousands)				
NOW Deposits	\$ 13,496	11.73%	\$12,593	12.85%
Savings Deposits	30,646	26.64%	28,109	28.67%
Money Market Deposits	4,590	3.99%	3,580	3.65%
Time Deposits	47,398	41.20%	37,874	38.63%
Demand Deposits	18,912	16.44%	15,886	16.20%
<b>Total Deposits</b>	<b>\$115,042</b>	<b>100.00%</b>	<b>\$98,042</b>	<b>100.00%</b>

As of December 31, 1998:

Time Deposits (\$100,000 and over) maturity:	
Three months or less	\$ 9,604
Over three months through six months	643
Over six months through twelve months	961
Over twelve months	2,532

Total \$ 13,740

**Liquidity**

Liquidity is a measure of the Company's ability to provide sufficient cash flow for current and future financial obligations and commitments on a timely basis. Sources of liquidity include deposits, liquidation or maturity of loans and investments and short-term borrowings.

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It is management's intent to fund future loan demand with deposit growth and sales of securities. In addition, the Bank is a member of Federal Home Loan Bank of New York and has available an overnight line of credit in the amount of \$6.3 million. The Bank did not borrow against this line of credit during 1998. The Company believes that its current level of liquidity is sufficient to meet its current and anticipated operational needs.

**Interest Rate Sensitivity**

An interest rate sensitive asset or liability is one that, within a defined time period, either matures or experiences an interest rate change in line with general market interest rates. Interest rate sensitivity is the volatility of a Company's earnings from a movement in market interest rates.

The Company has developed an Interest Rate Risk Policy. The policy provides for the Company to generally maintain a relatively balanced position between interest rate sensitive assets and interest rate sensitive liabilities. At December 31, 1998, the interest rate sensitivity position evident for the periodic intervals reflects an asset sensitive position.

**Table 9**

Assets:	0-3 Mos.	3-12 Mos.	1-5 Years	5+ Years
(Dollars in Thousands)				
Securities(1)	\$ 3,200	\$ 13,377	\$ 10,111	\$ 5,896
Interest bearing deposits				

in other banks	9,000	150	0	0
Federal funds	17,450	0	0	0
Commercial loans	3,310	236	705	101
Home equity (variable)	3,748	0	0	0
Consumer loans	1,241	3,302	11,695	3,907
Lease receivables	42	100	0	0
Mortgages	6,532	2,881	16,023	16,542

-----  
Total Interest Earning Assets \$ 44,523      \$ 20,046      \$ 38,534      \$ 26,446  
-----

<CAPTION>

Liabilities:

-----  
0-3 Mos.      3-12 Mos.      1-5 Years      5+ Years  
-----

(Dollars in Thousands)

Certificate of deposits	\$ 16,960	\$ 19,352	\$ 17,165	\$ 87
Money market deposit accounts	3,654	0	0	0
Savings accounts	3,621	32,913	0	0
Now accounts	1,417	12,752	0	0

-----  
Total Interest Bearing Liabilities \$ 25,652      \$ 65,017      \$ 17,165      \$ 87  
-----

Sensitivity Gap	\$ 18,851	(\$44,971)	(\$21,369)	\$26,359
Cumulative Sensitive Gap	\$ 18,851	(\$26,120)	(\$47,489)	(\$21,130)

(1) Includes \$693,000 in Federal Home Loan Bank of New York stock, included in the 5+ years category.

#### Capital Resources

Stockholders' equity inclusive of accumulated other comprehensive income, net of income taxes, was \$9.2 million at December 31, 1998. The growth in stockholders' equity is generated primarily through earnings retention.

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The Company and the Bank's regulators have classified and defined bank holding company capital into the following components (1) Tier I capital which includes tangible stockholders' equity for common stock and certain preferred stock, and (2) Tier II capital, which includes a portion of the allowance for possible loan losses, certain qualifying long-term debt and preferred stock which does not qualify for Tier I capital.

The Company's and the Bank's regulators have implemented risk-based guidelines which require banks and bank holding companies to maintain certain minimum capital as a percent of such assets and certain off-balance sheet items adjusted for predefined credit risk factors (risk-adjusted assets). Banks and bank holding companies are required to maintain, Tier I capital as a percent of risk-adjusted assets of 4.0% and combined Tier I and Tier II capital as a percent of risk-adjusted assets of 8.0%, at a minimum. At December 31, 1998, the Company's Tier I and combined Tier I and Tier II capital ratios were 12.53% and 13.51%, respectively. The Bank's Tier I and combined Tier I and Tier II were 11.89% and 12.87%, respectively.

In addition to the risk-based guidelines discussed above, the Company's and the Bank's regulators require that banks and bank holding companies which meet the regulators' highest performance and operational standards maintain a minimum leverage ratio (Tier I capital as a percent of tangible assets) of 3.0%. For those banks and bank holding companies with higher levels of risk or that are experiencing or anticipating growth, the minimum will be proportionately increased. Minimum leverage ratios for each bank and bank holding company are established and updated through the ongoing regulatory examination process. As of December 31, 1998, the Company has a leverage ratio of 6.24% and the Bank has a leverage ratio of 5.92%.

#### Effect of Inflation

Unlike most industrial companies, virtually all of the assets and

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

#### Year 2000 Compliance

The Company's data processing capabilities are critical to its business and its ability to service customers. The Year 2000 problem is caused by many computer programs that were written to identify only the last two digits of a year (a common programming practice on the past to save computer memory). The expectation is that programs may read the year 2000 as 00 or 1900, and to compute interest, payments and other data incorrectly. The Company has put together a team of senior management to evaluate both its data processing systems (software and computers) and other systems (i.e., vault timers, alarms, heating and cooling systems) that are essential to its operations. The Company has examined all of its non-data processing systems and has either received Year 2000 compliant certification from third-party vendors or determined that the systems should not be affected by the Year 2000 problem. The Company does not expect any material costs to address non-data processing systems and has not expended any material costs to date. The Company's present data processing systems have more potential for Year 2000 risk in three areas: (1) its own computers, (2) computers and systems used by borrowers, and (3) vendors who provide the Company with software systems.

#### 12 Management Discussion and Analysis (continued)

**Our Computers:** The Company has made capital expenditures of approximately \$200,000 during 1998 to upgrade its computer hardware and software systems, primarily the application software. These upgrades were anticipated in 1994 and planned and budgeted for in 1998, and they were planned to permit the Company continued growth and expansion of products and services. The Company contracted to have its primary application software tested. The test was completed November 1998 and the Company has evaluated the results by year-end 1998.

**Computers of Others Used by Borrowers:** The Company evaluated most of its borrowers and does not believe that the Year 2000 problem should, on an aggregate basis, impact their ability to repay their loans to the Bank. The Company believes that the majority of its individual borrower are not dependent on home computers for income and none of its commercial borrowers are so large that a Year 2000 problem would render them unable to continue their businesses and subsequently be unable to repay their obligations. The Company does not anticipate any material costs to address this risk area.

**Vendors Who Provide The Company With Software Systems:** As stated previously, the Company's primary application software system has been upgraded and modified to be Year 2000 compliant. The Company is in the process of having the critical systems tested to confirm Year 2000 compliance. Other peripheral software systems, which are not considered critical systems, have been reviewed and tested for Year 2000 compliance.

**Contingency Plan:** The Company has developed a remediation contingency plan and is developing business resumption contingency plans specific to the Year 2000 project. Remediation contingency plans were developed and budgeted to address the actions to be taken if the testing of our mission critical systems fell behind schedule. The testing of our mission critical systems has been on schedule and satisfactory to date.

Business resumption contingency plans are to address the actions that will be taken if critical business functions can't be handled in the normal manner due to system or third-party failures. These plans are additional to our normal disaster recovery plans.

[GRAPHIC-LOGO FOR RADICS & CO., LLC]

RADICS & CO., LLC  
 Certified Public Accountants & Consultants

Established  
 1933

Independent  
 Auditors'  
 Report

To the Board of Directors and Stockholders  
 Sussex Bancorp

We have audited the accompanying consolidated statement of condition of Sussex Bancorp (the "Corporation") and Subsidiaries as of December 31, 1998 and the related consolidated statements of income, changes in stockholders' equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of Sussex Bancorp and subsidiaries as of December 31, 1997 and for each of the years in the two-year period then ended were audited by other auditors whose report dated January 15, 1998, expressed an unqualified opinion on those statements. The other auditors' report does not cover, for the years ended December 31, 1997 and 1996, the restatement of (a) net income per common share and the weighted average number of common shares outstanding as a result of the two for one split, in 1998, of the Corporation's common stock and (b) the consolidated statements of changes in stockholders' equity for the years ended December 31, 1997 and 1996 for the purpose of presenting comprehensive income upon the implementation in 1998 of Statement of Financial Accounting Standards No. 130.

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

In our opinion, the 1998 consolidated financial statements referred to in the second preceding paragraph present fairly, in all material respects, the financial position of Sussex Bancorp and Subsidiaries at December 31, 1998, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles.

We also audited the adjustments applied to, for the years ended December 31, 1997 and 1996, restate net income per common share and the weighted average number of common shares outstanding and to present comprehensive income for the years ended December 31, 1997 and 1996. In our opinion, such adjustments are appropriate and have been properly applied.

/s/Radics & Co., LLC

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 Radics & Co., LLC

January 15, 1999

## REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Stockholders and Board of Directors of Sussex Bancorp:

We have audited the accompanying consolidated balance sheets of Sussex Bancorp (a New Jersey corporation) and subsidiary as of December 31, 1997 and 1996, and the related consolidated statements of income, changes in stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Sussex Bancorp and subsidiary as of December 31, 1997 and 1996, and the results of their operations and their cash flows for the years then ended in conformity with generally accepted accounting principles.

/s/ARTHUR ANDERSEN LLP

-----  
ARTHUR ANDERSEN LLP

Roseland, New Jersey  
January 15, 1998

**Table 10**

## Consolidated Statements of Condition

	December 31,	
ASSETS	1998	1997
Cash and due from banks	\$ 4,060,000	\$ 5,793,000
Interest bearing deposits in other banks	9,150,000	--
Federal funds sold	17,450,000	7,875,000
-----		
Cash and cash equivalents	30,660,000	13,668,000
Securities available for sale, at estimated fair value	25,952,000	26,600,000
Securities held to maturity; estimated fair value of \$5,949,000 in 1998 and \$2,089,000 in 1997	5,939,000	2,082,000
Loans held for sale	354,000	--
Loans	69,346,000	67,350,000
Premises and equipment, net	2,956,000	2,287,000
Federal Home Loan Bank of New York stock, at cost	693,000	624,000
Accrued interest receivable	549,000	618,000
Other real estate owed	36,000	--
Intangible assets	703,000	787,000
Other assets	279,000	241,000
-----		
Total assets	\$137,467,000	\$114,257,000
-----		

LIABILITIES AND STOCKHOLDERS' EQUITY

Liabilities

Deposits:		
Non-interest-bearing demand	\$19,793,000	\$18,027,000
Savings club and interest-bearing demand	54,357,000	47,884,000
Time	39,824,000	35,050,000
Time of \$100,000 and over	13,740,000	3,921,000

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Total deposits	127,714,000	104,882,000
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Other liabilities	509,000	789,000
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Total liabilities	128,223,000	105,671,000
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Commitments	--	--
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**Table 11**

Stockholders' Equity

Common stock (no par value); authorized shares 5,000,000; issued 1,422,260 in 1998 and 698,959 in 1997	5,635,000	5,412,000
Retained earnings	3,547,000	3,162,000
Accumulated other comprehensive income, net of income tax	64,000	14,000
Treasury stock, at cost; 242 shares in 1998 and 145 shares in 1997	(2,000)	(2,000)

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Total stockholders' equity	9,244,000	8,586,000
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Total liabilities and stockholders' equity	\$137,467,000	\$114,257,000
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See accompanying notes to consolidated financial statements.

**Table 12**

Consolidated Statements of Income

	Year Ended December 31,		
	1998	1997	1996
<b>INTEREST INCOME:</b>			
Loans and fees	\$5,601,000	\$5,517,000	\$4,958,000
Investments securities:			
Taxable	1,688,000	1,460,000	1,512,000
Exempt from federal income tax	120,000	40,000	45,000
Federal funds sold	548,000	366,000	195,000
Interest bearing deposits	338,000	--	--
Total interest income	8,295,000	7,383,000	6,710,000
<b>INTEREST EXPENSE:</b>			
Deposits	3,818,000	3,063,000	2,728,000
Net interest income	4,477,000	4,320,000	3,982,000
PROVISION FOR POSSIBLE LOAN LOSSES	19,000	210,000	130,000
Net interest income after provision for possible loan losses	4,458,000	4,110,000	3,852,000
<b>OTHER INCOME:</b>			
Service charges on deposit accounts	490,000	500,000	512,000
Gains on sales of securities available for sale	65,000	--	--

Gain (loss) on sale of other real estate	--	44,000	(33,000)
Trust department income	2,000	10,000	9,000
Other	312,000	190,000	178,000

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Total other income	869,000	744,000	666,000
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OTHER EXPENSES:

Salaries and employee benefits	2,218,000	1,855,000	1,692,000
Occupancy, net	362,000	357,000	357,000
Furniture and equipment	525,000	371,000	319,000
Stationary and supplies	100,000	88,000	83,000
Audit and exams	93,000	86,000	85,000
Other	989,000	996,000	1,138,000

---

Total other expenses	4,287,000	3,753,000	3,674,000
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**Table 13**

INCOME BEFORE INCOME TAXES	1,040,000	1,101,000	844,000
INCOME TAXES	330,000	393,000	322,000

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NET INCOME	\$ 710,000	\$ 708,000	\$ 522,000
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Net income per common share:

Basic	\$ .50	\$ .51	\$ .38
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Diluted	\$ .50	\$ .51	\$ .38
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Weighted average number of common shares outstanding:

Basic	1,410,535	1,377,934	1,368,618
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Diluted	1,425,900	1,391,416	1,382,950
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See accompanying notes to consolidated financial statements.

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**Table 14**

Consolidated Statements of Changes  
in Stockholders' Equity

	Number of Shares Outstanding	Common Stock	Comprehensive Income	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balance, December 31, 1995	647,236	\$4,532,000		\$3,023,000	\$ --	\$ 54,000	\$7,609,000
Net income	--	--	\$ 522,000	522,000	--	--	522,000
Other comprehensive income:							
Unrealized loss on securities available for sale, net of income taxes of \$98,000	--	--	(147,000)	--	--	(147,000)	(147,000)
Comprehensive income			\$ 375,000				
Stock dividend	32,660	569,000		(569,000)	--	--	--
Stock options exercised	500	5,000		(5,000)	--	--	--
Shares issued through dividend reinvestment plan	8,100	140,000		--	--	--	140,000
Cash dividend	--	--		(242,000)	--	--	(242,000)

Balance, December 31, 1996	688,496	5,246,000		2,729,000	--	(93,000)	7,882,000
Net income	--	--	\$708,000	708,000	--	--	708,000
Other comprehensive income:							
Unrealized gain on securities available for sale, net of income taxes of \$68,000	--	--	107,000	--	--	107,000	107,000
Comprehensive income			\$ 815,000				
Treasury stock purchased	(145)	--		--	(2,000)	--	(2,000)
Stock options exercised	2,000	23,000		--	--	--	23,000
Shares issued through dividend reinvestment plan	8,608	143,000		--	--	--	143,000
Cash dividend	--	--		(275,000)	--	--	(275,000)
Balance, December 31, 1997	698,959	5,412,000		3,162,000	(2,000)	14,000	8,586,000
Net income	--	--	\$ 710,000	710,000	--	--	710,000

**Table 15**

Other comprehensive income:							
Unrealized gain on securities available for sale, net of income taxes of \$60,000			89,000				
Reclassification adjustment for gains included in income, net of income taxes of \$26,000			(39,000)				
Other comprehensive income	--	--	50,000	--	--	50,000	50,000
Comprehensive income			\$ 760,000				
Stock options exercised	4,814	55,000		--	--	--	55,000
Shares issued through dividend reinvestment plan	12,112	168,000		--	--	--	168,000
Stock split	706,133	--		--	--	--	--
Cash dividends	--	--		(325,000)	--	--	(325,000)
Balance - December 31, 1998	1,422,018	\$5,635,000		\$3,547,000	\$(2,000)	\$ 64,000	\$9,244,000

</TABLE>

See accompanying notes to consolidated financial statements.

**Table 16**

Consolidated Statements of Cash Flows

	Year Ended December 31,		
	1998	1997	1996
Cash flows from operating activities:			
Net income	\$ 710,000	\$ 708,000	\$ 522,000
Adjustments to reconcile net income to net cash provided by operating activities:			

Net amortization (accretion) of premiums, discounts and loan origination fees and expenses, net	93,000	(54,000)	(35,000)
Depreciation and amortization	439,000	370,000	343,000
Provision for loan losses	19,000	210,000	130,000
(Gain) on sales of securities available for sale	(65,000)	--	--
(Gain) loss on sale of real estate	--	(44,000)	33,000
Origination of loans held for sale	(354,000)	--	--
Deferred federal income tax (benefit)	(25,000)	(25,000)	54,000
Decrease (increase) in accrued interest receivable	69,000	(74,000)	38,000
(Increase) decrease in other assets	(47,000)	430,000	(39,000)
Decrease in other liabilities	(280,000)	(216,000)	(331,000)
<hr/>			
Net cash provided by operating activities	559,000	1,305,000	715,000
<hr/>			
Cash flows from investing activities:			
Proceeds from repayments on and maturities of securities available for sale	16,296,000	4,606,000	10,232,000
Proceeds from sales of securities available for sale	8,490,000	--	--
Purchases of securities available for sale	(24,084,000)	(8,931,000)	(11,105,000)
Proceeds from maturities of securities held to maturity	1,602,000	952,000	2,239,000
Purchases of securities held to maturity	(5,464,000)	(1,913,000)	(1,220,000)
Net increase in loans	(1,907,000)	(2,577,000)	(13,235,000)
Additions to premises and equipment	(1,024,000)	(332,000)	(201,000)
Purchase of Federal Home Loan Bank of New York stock	(69,000)	(624,000)	--
Capitalized costs on other real estate owned	(3,000)	--	--
Proceeds from sale of other real estate	--	439,000	366,000
<hr/>			
Net cash used in investing activities	(6,163,000)	(8,380,000)	(12,924,000)
<hr/>			
Cash flows from financing activities:			
Net increase in deposits	\$22,832,000	\$11,993,000	\$ 6,964,000
Exercise of stock options	55,000	23,000	5,000
Stock dividends, net of fractional shares paid	--	--	(5,000)
Payment of dividends net of reinvestment	(157,000)	(126,000)	(102,000)
Purchase of treasury stock	--	(2,000)	--
<hr/>			
Net cash provided by financing activities	22,730,000	11,888,000	6,862,000

**Table 17**

Net increase (decrease) in cash and cash equivalents	16,992,000	4,813,000	(5,347,000)
Cash and cash equivalents - beginning	13,668,000	8,855,000	14,202,000
<hr/>			
Cash and cash equivalents - ending	\$30,660,000	\$13,668,000	\$ 8,855,000

Supplemental disclosures of cash flow information:

Cash paid during the year for:			
Income taxes (federal and state)	\$ 630,000	\$ 192,000	\$ 182,000
Interest	3,816,000	3,134,000	2,968,000
Supplemental schedule of noncash investing and financing activities:			
Transfer of loans to other real estate	\$ 33,000	\$--	\$ 473,000

See accompanying notes to consolidated financial statements.

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Notes to  
Consolidated  
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1. NATURE OF OPERATIONS

Sussex Bancorp (the "Corporation") is a bank holding company whose principal activity is the ownership and management of its wholly-owned

subsidiary, Sussex County State Bank (the "Bank"), and the Bank's wholly-owned subsidiaries, Sussex Bancorp Mortgage Company and SCB Investment Company. The Corporation's business is conducted principally through the Bank. The Bank generates commercial, mortgage and consumer loans and receives deposits from customers at its seven branches located in Sussex County, New Jersey. The Bank operates under a state bank charter and provides full banking services and, accordingly, is subject to regulation by the New Jersey Department of Banking and Insurance and the Federal Deposit Insurance Corporation.

## 2. ACCOUNTING PRINCIPLES

### Principles of consolidation

The consolidated financial statements include the accounts of the Corporation, the Bank and the Bank's wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

### Basis of consolidated financial statement presentation

The consolidated financial statements of the Corporation have been prepared in conformity with generally accepted accounting principles. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the statement of condition and revenues and expenses for the period then ended. Actual results could differ significantly from those estimates.

A material estimate that is particularly susceptible to significant changes relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions in the market area.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require additions to the allowance based on their judgments about information available to them at the time of their examination.

### Cash and cash equivalents

Cash and cash equivalents include cash and due from banks, federal funds sold and interest-bearing deposits in other banks having original maturities of three months or less. Generally, federal funds sold are sold for one-day periods.

### Securities

Investments in debt securities that the Corporation has the positive intent and ability to hold to maturity are classified as held to maturity securities and reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized holding gains and losses included in earnings. Debt and equity securities not classified as trading securities nor as held to maturity securities, are classified as available for sale securities and reported at fair value, with unrealized holding gains or losses, net of deferred income taxes, reported in a separate component of stockholders' equity.

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Notes to  
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## 2. ACCOUNTING PRINCIPLES (continued)

Premiums and discounts on all securities are amortized/accreted using the interest method. Interest and dividend income on securities, which includes amortization of premiums and accretion of discounts, is recognized in the consolidated financial statements when earned. The adjusted cost basis of an identified security sold or called is used for determining security gains or losses recognized in the consolidated statements of income.

### Loans held for sale

Loans held for sale are carried at the lower of cost or market value. Valuation computations are made in the aggregate by type of loan and rate of interest. The market values used for comparison are those associated with the Bank's normal investor outlets. Gain or loss on sales of loans is recognized based on the specific identification method.

#### Loans

Loans are stated at the amount of unpaid principal less unearned interest, net deferred loan origination costs/fees, and the allowance for loan losses. Interest on commercial, mortgage and simple interest installment loans is recognized as income based on the loan principal outstanding. Recognition of interest on the accrual method is generally discontinued when factors indicate that the collection of such amounts is doubtful. At the time a loan is placed on non-accrual status, previously accrued and uncollected interest is reversed against interest income in the current period. Interest on such loans, if appropriate, is recognized as income when payments are received. A loan is returned to an accrual status when factors indicating doubtful collectibility no longer exist.

#### Loan origination costs/fees

Loan origination fees and certain direct loan origination costs are deferred and subsequently amortized as an adjustment of yield over the contractual lives of the related loans.

#### Allowance for possible loan losses

The allowance for possible loan losses is maintained at a level considered adequate to absorb future losses. Management determines the adequacy of the allowance based upon reviews of individual credits, recent loss experience, current economic conditions, the risk characteristics of the various categories of loans and other pertinent factors. Loans deemed uncollectible are charged to the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance.

Loans are deemed to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measured value of an impaired loan is less than the recorded investment in that loan, the impairment is recorded in the allowance for possible loan losses. All loans identified as impaired are evaluated independently. The Bank does not aggregate such loans for evaluation purposes.

Payments received on impaired loans are applied to principal, accrued interest receivable and interest income, in that order.

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Notes to  
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## 2. ACCOUNTING PRINCIPLES (continued)

#### Concentration of risk

Lending activity is concentrated in loans secured by real estate located primarily in Sussex and adjacent counties in the State of New Jersey.

#### Premises and equipment

Land is carried at cost. Buildings, building improvements, furniture, fixtures and equipment and leasehold improvements are carried at cost less accumulated depreciation and amortization. Depreciation and amortization charges are computed on the straight-line method over the shorter of the estimated lives of the related assets or the lease term.

Significant renewals and betterments are charged to the premises and

equipment account. Maintenance and repairs are charged to expense in the years incurred. Rental income is netted against occupancy expense in the consolidated statements of income.

#### Other real estate owned ("OREO")

OREO consists of loan collateral repossessed and is carried at the lower of cost or fair value less estimated cost to sell. When a property is acquired, the excess of the carrying amount over fair value, if any, is charged to the allowance for loan losses. An allowance for OREO has been established, through charges to OREO expense, to maintain properties at the lower of cost or fair value less estimated costs to sell. Operating results of OREO, including rental income, operating expenses, and gains and losses realized from the sale of properties owned, are included in other expenses.

#### Intangible assets

Core deposit intangibles relating to premiums paid on the acquisition of deposits are amortized on a straight line basis over 15 years. Such amortization totalled \$84,000 in each of the years ended December 31, 1998, 1997 and 1996.

#### Trust operations

Trust income is recorded on a cash basis, which approximates the accrual basis. Securities and other property held by the Corporation in fiduciary or agency capacities for customers of the trust department are not assets of the Corporation and, accordingly, are not included in the accompanying consolidated financial statements.

#### Income taxes

The Corporation and its subsidiaries use the accrual basis of accounting for financial and income tax reporting. Provisions for income taxes in the consolidated financial statements differ from the amounts reflected in income tax returns due to temporary differences in the reporting of certain items for financial reporting and income tax reporting purposes. The income tax provisions shown in the consolidated financial statements relate to items of income and expense in those statements irrespective of temporary differences for income tax return purposes. The tax effect of these temporary differences is accounted for as deferred income taxes applicable to future years.

The Corporation and its subsidiaries file separate state income tax returns and a consolidated federal income tax return with the amount of income tax expense or benefit computed and allocated on a separate return basis.

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Notes to  
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## 2. ACCOUNTING PRINCIPLES (continued)

#### Net income per common share

Basic net income per share of common stock is calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted net income per share is calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period plus the potential dilutive effect of outstanding stock options. On June 18, 1998, the Corporation's Board of Directors authorized a two for one stock split, which was distributed on August 3, 1998. Basic and diluted net income per common share have been retroactively restated to give effect to the stock split.

#### Comprehensive income

Effective January 1, 1998, the Corporation adopted Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income". SFAS No. 130 requires the reporting of comprehensive income in addition to net income from operations. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of certain financial information that historically has not been recognized in the calculation of net income. As required, the provisions of SFAS No. 130 have been retroactively applied to

previously reported periods. The application of SFAS No. 130 had no material effect on the Corporation's consolidated financial condition or operations.

#### Impact of new financial Accounting Standards

In June 1998, the Financial Accounting Standards Board ("FASB") issued SFAS No. 133, "Accounting for Derivative Instruments Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. In addition, certain provisions of SFAS No. 133 will permit, at the date of initial adoption of SFAS No. 133, the transfer of any held-to-maturity security into either the available for sale or trading category and the transfer of any available for sale security into the trading category. Transfers from the held-to-maturity portfolio at the date of initial adoption will not call into question the entity's intent to hold other debt securities to maturity in the future. SFAS No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999 and is not expected to have a material impact on the Corporation. The Corporation does not intend to adopt SFAS No. 133 earlier than required.

#### Interest-rate risk

The Corporation, primarily through the Bank, is principally engaged in the business of attracting deposits from the general public and using these deposits, together with other funds, to make loans secured by real estate and, to a lesser extent, commercial and consumer loans. Additionally, such funds are utilized to purchase investment securities. The potential for interest-rate risk exists as a result of the differences in the duration of the Corporation's interest-sensitive liabilities compared to its interest-sensitive assets. In a changing interest rate environment, liabilities will reprice at different speeds and to different degrees than assets, thereby impacting net interest income. For this reason, management regularly monitors the maturity structure of the Corporation's assets and liabilities in order to measure its level of interest-rate risk and plan for future volatility.

#### Reclassification

Certain amounts for the years ended December 31, 1997 and 1996 have been reclassified to conform to the current year's presentation.

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Notes to  
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### 3. SECURITIES AVAILABLE FOR SALE

**Table 18**

	December 31, 1998			
	Amortized	Gross Unrealized		Carrying
	Cost	Gains	Losses	Value
U.S. Treasury	\$ 5,589,000	\$ 124,000	\$ 3,000	\$ 5,710,000
U.S. Government agencies including mortgage-backed securities	19,407,000	75,000	71,000	19,411,000
Equity securities	850,000	--	19,000	831,000
	\$25,846,000	\$ 199,000	\$93,000	\$25,952,000

<CAPTION>

	December 31, 1997			
	Amortized	Gross Unrealized		Carrying
	Cost	Gains	Losses	Value

U.S. Treasury	\$ 8,049,000	\$ 30,000	\$ 30,000	\$ 8,049,000
U.S. Government agencies including mortgage-backed securities	18,529,000	60,000	38,000	18,551,000
	\$26,578,000	\$ 90,000	\$ 68,000	\$26,600,000

December 31,

	1998		1997	
	Amortized Cost	Carrying Value	Amortized Cost	Carrying Value
Due in one year or less	\$ --	\$ --	\$ 2,503,000	\$ 2,510,000
Due after one year through five years	8,589,000	8,714,000	14,702,000	14,707,000
Due after five years through ten years	1,500,000	1,493,000	2,000,000	2,005,000
Due after ten years	14,907,000	14,914,000	7,373,000	7,378,000
Equity securities	850,000	831,000	--	--
	\$25,846,000	\$ 25,952,000	\$26,578,000	\$26,600,000

The amortized cost and carrying value of securities at December 31, 1998 and 1997 are shown above by contractual maturity. Actual maturities may differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The following presents details of sales of securities available for sale:

**Table 19**

	Year Ended December 31,		
	1998	1997	1996
Sales proceeds	\$ 8,490,000	\$--	\$--
Gross gains	65,000	--	--
Gross losses	--	--	--

Securities with a carrying value of approximately \$4,333,000 and \$200,000 at December 31, 1998 and 1997, respectively, were pledged to secure public deposits and for other purposes required by applicable laws and regulations.

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Notes to Consolidated Financial Statements

4. SECURITIES HELD TO MATURITY

**Table 20**

	December 31, 1998			
	Amortized Cost	Gross Unrealized		Estimated
	Cost	Gains	Losses	Fair Value
Obligations of state and political subdivisions	\$ 5,939,000	\$ 18,000	\$ 8,000	\$ 5,949,000

<CAPTION>

December 31, 1997

	Amortized	Gross Unrealized		Estimated
	Cost	Gains	Losses	Fair Value
Obligations of state and political subdivisions	\$2,082,000	\$ 7,000	\$ --	\$2,089,000
December 31,				
	1998		1997	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 3,957,000	\$ 3,963,000	\$ 1,603,000	\$ 1,603,000
Due after one year through five years	1,015,000	1,024,000	479,000	486,000
Due after five years through ten years	967,000	962,000	--	
	\$ 5,939,000	\$ 5,949,000	\$ 2,082,000	\$ 2,089,000

The amortized cost and carrying value of securities at December 31, 1998 and 1997 are shown above by contractual maturity. Actual maturities may differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

There were no sales of securities held to maturity during the years ended December 31, 1998, 1997 and 1996.

Notes to Consolidated Financial Statements

#### 5. LOANS

**Table 21**

	December 31,	
	1998	1997
Loans secured by one to four family residential properties	\$ 49,128,000	\$ 51,257,000
Loans secured by nonresidential properties	11,612,000	10,665,000
Loans to individuals	2,416,000	2,524,000
Commercial loans	3,742,000	2,499,000
Loans secured by construction and land development	2,352,000	877,000
Other loans	712,000	241,000
	69,962,000	68,063,000
Less: Unearned income and net deferred loan costs, net	(49,000)	28,000
Allowance for loan losses	665,000	685,000
	616,000	713,000
	\$ 69,346,000	\$ 67,350,000

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Notes to Consolidated Financial Statements

#### 5. LOANS (continued)

Non-performing loans consist of nonaccrual and renegotiated loans. Nonaccrual loans are those on which income under the accrual method has been discontinued with subsequent interest payments credited to interest income when received, or if ultimate collectibility of principal is in doubt, applied as principal

reductions. Renegotiated loans are loans whose contractual interest rates have been reduced or where other significant modifications have been made due to borrowers' financial difficulties. Interest on these loans is either accrued or credited directly to interest income. If interest had been accrued on these loans, the effect on net interest income would have been approximately \$9,000, \$32,000 and \$68,000 higher in 1998, 1997 and 1996, respectively. Non-performing loans were as follows:

**Table 22**

December 31,			
	1998	1997	1996
Nonaccrual	\$ 398,000	\$ 730,000	\$ 935,000
Renegotiated	--	334,000	277,000
	\$ 398,000	\$1,064,000	\$1,212,000

The Bank has entered into lending transactions in the ordinary course of business with directors, executive officers, principal stockholders and affiliates of such persons on the same terms as those prevailing for comparable transactions with other borrowers. These loans, at December 31, 1998, were current as to principal and interest payments, and do not involve more than normal risk of collectibility. A summary of lending activity with respect to such persons who had borrowings of \$60,000 or more, is as follows:

**Table 23**

Year Ended December 31,	
1998	
Balance - beginning	\$ 1,909,000
Loans originated	581,000
Repayments	(415,000)
Balance - ending	\$ 2,075,000

6. ALLOWANCE FOR LOAN LOSSES

**Table 24**

Year Ended December 31,			
	1998	1997	1996
Balance - beginning	\$ 685,000	\$ 542,000	\$ 476,000
Provision for loan losses	19,000	210,000	130,000
Loans charged off	(40,000)	(68,000)	(66,000)
Recoveries	1,000	1,000	2,000
	\$ 665,000	\$ 685,000	\$ 542,000

Impaired loans and related amounts recorded in the allowance for loan losses are summarized as follows:

**Table 25**

December 31,		
	1998	1997
Record investment in impaired loans:		
With recorded allowances	\$ 407,000	\$1,272,000
Without recorded allowances	--	--
Total impaired loans	407,000	1,272,000
Related allowance for loan losses	(121,000)	(202,000)
Net impaired loans	\$ 286,000	\$1,070,000

For the years ended December 31, 1998, 1997 and 1996, the average recorded investment in impaired loans totalled \$898,000, \$1,345,000 and \$1,864,000, respectively. Interest income recognized on such loans during the time each was impaired totalled \$79,000, \$135,000 and \$132,000, respectively.

7. PREMISES AND EQUIPMENT

**Table 26**

December 31,		
	1998	1997
Land	\$ 417,000	\$ 417,000
Buildings and building improvements	1,592,000	1,555,000
Leasehold improvements	136,000	145,000
Furniture, fixtures and equipment	2,912,000	2,648,000
Assets in progress	629,000	--
	5,686,000	4,765,000
Less accumulated depreciation and amortization	2,730,000	2,478,000
	\$2,956,000	\$2,287,000

During the years ended December 31, 1998, 1997 and 1996, depreciation and amortization expense totalled \$355,000, \$286,000 and \$259,000, respectively.

Assets in progress consist primarily of property in Frankford Township, New Jersey, which was purchased in 1998 and is being prepared for use in the Bank's branch network.

8. DEPOSITS

Scheduled maturities of certificates of deposit are as follows:

**Table 27**

December 31,		
	1998	1997
One year or less	\$ 36,312,000	\$ 33,793,000
After one through three years	17,097,000	4,874,000
After three years	155,000	304,000
	\$ 53,564,000	\$ 38,971,000

At December 31, 1998, certificates of deposit include \$9,000,000 owned by a local municipality which mature within 30 days.

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9. INCOME TAXES

The components of the provision for income taxes are as follows:

**Table 28**

	Year Ended December 31,		
	1998	1997	1996
Current	\$ 355,000	\$ 418,000	\$ 268,000
Deferred	(25,000)	(25,000)	54,000
Total	\$ 330,000	\$ 393,000	\$ 322,000

The tax effects of existing temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

**Table 29**

	December 31,	
	1998	1997
Deferred tax assets:		
Allowance for loan losses	\$266,000	\$262,000
Deferred loan fees	27,000	40,000
Other	19,000	3,000
	312,000	305,000
Deferred tax liabilities:		
Depreciation and amortization	(168,000)	(186,000)
Unrealized gain on securities available for sale	(42,000)	(9,000)
	(210,000)	(195,000)
Net deferred tax assets included in other assets	\$102,000	\$110,000

The following table presents a reconciliation between the reported income taxes and the income taxes that would have been computed by applying the normal federal income tax rate of 34% to income before income taxes:

**Table 30**

	Year Ended December 31,					
	1998		1997		1996	
	Amount	Percent	Amount	Percent	Amount	Percent
Federal income tax	354,000	34.0%	374,000	34.0%	287,000	34.0%
Add (deduct) effect of:						
Non-taxable interest income (38,000)	(38,000)	(3.7)	(11,000)	(1.0)	(12,000)	(1.4)
State income tax, net of						
federal income tax effect	1,000	0.1	27,000	2.4	46,000	5.5
Other items, net	13,000	1.3	3,000	0.3	1,000	0.1
	\$330,000	31.7	\$393,000	35.7	\$322,000	38.2

10. BENEFIT PLANS

## Stock Option Plans

During 1988, the stockholders approved a nonqualified stock option plan (the "1988 Plan"). As of December 31, 1998, there were 63,714 authorized shares of the Corporation's common stock to be

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### 10. BENEFIT PLANS (continued)

granted. Options may be granted to any officer of the Corporation or the Bank, at a grant price not to be less than the higher of the par value of the stock or 85% of its fair market value at the grant date. Options are exercisable when granted with the option period determined by the Corporation's Board of Directors, but not to exceed five years. As of December 31, 1998, no options have been granted.

During 1995, the stockholders approved a stock option plan for nonemployee directors (the "Director Plan"). As of December 31, 1998, there were 67,238 authorized shares of the Corporation's common stock to be granted. Upon approval of the Director Plan, each director was granted an option to purchase 5,253 shares. In addition to the foregoing, each person serving as a nonemployee director on the date of each annual meeting of the shareholders who is elected or reelected as a nonemployee director of the Corporation at such annual meeting of stockholders, shall be granted an option to purchase 1,050 shares of the Corporation's common stock with a maximum of 15,759 shares total. 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 10 year. As of December 31, 1998, 28,034 options at \$5.35, 3,060 options at \$8.70, 3,000 options at \$9.00 and 5,000 options at \$10.69 were outstanding, of which all were exercisable and none which have been forfeited.

During 1995, the stockholders approved an incentive stock option plan for executives of the Corporation (the "Executive Plan"). As of December 31, 1998 there were 134,477 authorized shares of the Corporation'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 Corporation 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 and have a term not longer than 10 years from the date of grant. As of December 31, 1998, 4,692 options at \$8.82 were outstanding, of which all were exercisable and none have been forfeited.

Transactions under all stock option plans are summarized as follows:

**Table 31**

	Number of Shares	Range of Exercise Price Per Share	Weighted Average Exercise Price Per Share
-----			
Outstanding, December 31, 1995	37,822	\$ 5.35	\$ 5.35
Options granted	5,100	8.70	8.70
Options exercised	(1,020)	5.35	5.35
-----			
Outstanding, December 31, 1996	41,902	5.35 - 8.70	5.76
Options granted	9,692	8.82 - 9.00	8.91
Options exercised	(5,200)	5.35	5.35
-----			
Outstanding, December 31, 1997	46,394	5.35 - 9.00	6.47
Options granted	5,000	10.69	10.69
Options exercised	(7,608)	5.35 - 9.00	7.27
-----			

Outstanding, December 31, 1998 43,786 \$5.35 - \$10.69 \$ 6.82  
 =====

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 Consolidated  
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The Corporation applies Accounting Principles Board Opinion 25 and related interpretations in accounting for its plans. Accordingly, no compensation cost has been recognized for its fixed stock option plans and its stock purchase plan. Had compensation cost for the Corporation's three stock based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of FASB SFAS No. 123, the Corporation's net income and income per share would have been reduced to the pro forma amounts indicated below:

**Table 32**

	Year Ended December 31,		
	1998	1997	1996
Net income			
As reported	\$ 710,000	\$ 708,000	\$ 522,000
Pro forma	700,000	696,000	516,000
Diluted income per share			
As reported	\$ 0.50	\$ 0.51	\$ 0.38
Pro forma	0.49	0.50	0.37

The following table summarizes information about fixed stock options outstanding at December 31, 1998:

**Table 33**

Exercise Price	Number Outstanding	Remaining Contractual Life	Number Exercisable
\$ 5.35	28,034	6.5 years	28,034
8.70	3,060	7.5 years	3,060
8.82	4,692	8.0 years	4,692
9.00	3,000	8.5 years	3,000
10.69	5,000	9.5 years	5,000
	43,786		43,786

11. RELATED PARTY TRANSACTIONS

Certain directors of the Corporation are associated with legal, accounting and construction businesses that rendered various services to the Corporation. The Corporation paid these companies \$168,000, \$67,000 and \$82,000 during 1988, 1997 and 1996, respectively.

12. COMMITMENTS

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of their customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. The contract or notional amounts of those instruments reflect the extent of involvement in particular classes of financial instruments. The exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they do for on-balance-sheet instruments. The commitments to extend credit are as follows:

## 12. COMMITMENTS (continued)

Table 34

	December 31,	
	1998	1997
	(In Thousands)	
Commitments to extend credit	\$ 11,543	\$ 8,259
Standby letters of credit and financial guarantees	8	49

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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary upon extension of credit is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment, residential real estate and income-producing commercial properties.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds collateral supporting those commitments for which collateral is deemed necessary.

Rentals under long-term operating leases amounted to approximately \$52,000, \$55,000 and \$53,000 for the years ended December 31, 1998, 1997 and 1996, respectively. At December 31, 1998, the minimum commitments, which include rental, real estate tax and other related amounts, under all noncancellable leases with remaining terms of more than one year and expiring through 2020 are as follows:

December 31,	Amount
	(In Thousands)
1999	\$ 52,000
2000	47,000
2001	30,000
2002	15,000
2003	10,000
Thereafter	165,000
	\$319,000

The Corporation and its subsidiaries are also subject to litigation which arises primarily in the ordinary course of business. In the opinion of management, the ultimate disposition of such litigation should not have a material adverse effect on the consolidated financial position or results of operations of the Corporation.

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## 13. DIVIDEND LIMITATION

A limitation exists on the ability of the Bank to pay dividends to the Corporation. 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.

14. REGULATORY CAPITAL REQUIREMENTS

The Corporation and the Bank are subject to various regulatory capital requirements administered by the Federal banking agencies. Failure to meet 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 Corporation's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Bank must meet specific capital guidelines that involve quantitative measures of the Corporation's and the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory account practices. The Corporation's and the Bank's capital amounts and classifications 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 Corporation and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 1998, that the Corporation and the Bank meet all capital adequacy requirements to which they are subject.

As of March 31, 1997, the most recent notification from the Federal Deposit Insurance Corporation, the Bank was categorized as well-capitalized under the regulatory framework for prompt corrective action. The Corporation has not been notified by the Federal Reserve Bank of its capital category. To be categorized as well-capitalized, the Bank must maintain minimum total risk based, Tier 1 risk based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since the aforementioned notification that management believes have changed the institution's category.

The Corporation's and the Bank's actual capital amounts and ratios are presented in the following table:

Table 35

	Actual		Minimum Capital Requirements		To Be Well Capitalized Under Prompt Corrective Actions Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in Thousands)						
December 31, 1998						
Total Capital (to risk-weighted assets):						
Corporation	\$ 9,123	13.51%	\$ 5,401	8.00%	\$ 6,751	10.00%
Bank	8,687	12.87%	5,399	8.00%	6,749	10.00%
Tier 1 Capital (to risk-weighted assets):						
Corporation	8,458	12.53%	2,701	4.00%	4,051	6.00%
Bank	8,022	11.89%	2,700	4.00%	4,050	6.00%
Tier 1 Capital (to average total assets):						
Corporation	8,458	6.24%	5,422	4.00%	6,778	5.00%
Bank	8,022	5.92%	5,422	4.00%	6,777	5.00%

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14. REGULATORY CAPITAL REQUIREMENTS (continued)

Table 36

	Actual		Minimum Capital Requirements		To Be Well Capitalized Under Prompt Corrective Actions Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in Thousands)						

December 31, 1997

Total Capital (to risk-weighted assets):						
Corporation	\$ 8,470	14.10%	\$ 4,806	8.00%	\$ 6,008	10.00%
Bank	8,215	13.67%	4,806	8.00%	6,008	10.00%
Tier 1 Capital (to risk-weighted assets):						
Corporation	7,785	12.96%	2,403	4.00%	3,605	6.00%
Bank	7,530	12.53%	2,403	4.00%	3,605	6.00%
Tier 1 Capital (to average total assets):						
Corporation	7,785	7.00%	4,477	4.00%	5,597	5.00%
Bank	7,530	6.70%	4,477	4.00%	5,597	5.00%

15. SUSSEX BANCORP, INC. (PARENT COMPANY ONLY)

Condensed financial statements of the Corporation (Parent Company only) follow:

**Table 37**

STATEMENTS OF CONDITION		
	December 31,	
	1998	1997
-----		
Assets:		
Cash and due from banks	\$ 457,000	\$ 266,000
Investment in subsidiaries	8,808,000	8,367,000
Other assets	22,000	44,000
-----		
Total assets	\$ 9,287,000	\$ 8,677,000
=====		
Liabilities:		
Dividends payable	43,000	91,000
-----		
Stockholders' equity	9,244,000	8,586,000
-----		
Total liabilities and stockholders' equity	\$ 9,287,000	\$ 8,677,000
=====		

**Table 38**

STATEMENTS OF INCOME			
	Year Ended December 31,		
	1998	1997	1996
-----			
Dividends from subsidiary bank	\$ 361,000	387,000	102,000
Other expenses	42,000	37,000	--
-----			
Income before income tax expense	319,000	350,000	102,000
Income tax expense	--	--	--
-----			
Income before undistributed earnings of subsidiaries	319,000	350,000	102,000
Equity in undistributed earnings of subsidiaries	391,000	358,000	420,000
-----			
Net income	\$ 710,000	\$ 708,000	\$ 522,000
=====			

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15. SUSSEX BANCORP, INC. (PARENT COMPANY ONLY) (continued)

Table 39

## STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	1998	1997	1996
Cash flows from operating activities:			
Net income	\$ 710,000	\$ 708,000	\$ 522,000
Adjustments to reconcile net income to net cash provided by operating activities:			
Decrease in other assets	22,000	21,000	--
Equity in undistributed earnings of subsidiaries	(391,000)	(358,000)	(420,000)
Net cash provided by operating activities	341,000	371,000	102,000
Cash dividends paid net of reinvestments			
Stock dividend, net of fractional shares	(205,000)	(126,000)	(102,000)
Purchase of treasury stock	--	--	(5,000)
Exercise of stock options	--	(2,000)	--
Exercise of stock options	55,000	23,000	5,000
Net cash (used in) financing activities	(150,000)	(105,000)	(102,000)
Net increase in cash and cash equivalents	191,000	266,000	--
Cash and cash equivalents - beginning	266,000	--	--
Cash and cash equivalents - ending	\$ 457,000	\$ 266,000	\$ --

## 16. ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of a financial instrument is defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than a forced or liquidation sale. Significant estimations were used for the purposes of this disclosure. Estimated fair values have been determined using the best available data and estimation methodology suitable for each category of financial instruments. For those loans and deposits with floating interest rates, it is presumed that estimated fair values generally approximate their recorded book balances. The estimation methodologies used and the estimated fair values and carrying values of the financial instruments are set forth below:

## Cash and cash equivalents and accrued interest receivable

The carrying amounts for cash and cash equivalents and accrued interest receivable approximate fair value.

## Securities

The 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.

## Loans held for sale

The fair value of loans held for sale is based on prices associated with the Bank's normal investor outlets.

## 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.

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## 16. ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

## 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 using the rates currently offered for deposits of similar remaining maturities.

#### Commitments

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

The carrying values and estimated fair values of the Corporation's financial instruments are as follows:

**Table 40**

December 31,				
1998		1997		
Financial assets	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
(In Thousands)				
Cash and cash equivalents	\$30,660	\$30,660	\$13,668	\$13,668
Securities available for sale	25,952	25,952	26,600	26,600
Securities held to maturity	5,939	5,949	2,082	2,089
Loans held for sale	354	354	--	--
Loans	69,346	68,545	67,350	67,326
Accrued interest receivable	549	549	618	618
Financial liabilities				
Deposits	127,714	128,005	104,882	112,783
Commitments				
To extend credit	11,543	11,543	8,259	8,259
Standby letters of credit	8	8	49	49

Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. Because no established secondary market exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of the financial instruments, and other factors. These estimates are subjective in nature, involve uncertainties and matters of judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

In addition, fair value estimates are based on existing on-and-off balance sheet financial instruments without attempting to estimate the value of anticipated future business, and exclude the value of assets and liabilities that are not considered financial instruments. Other significant assets and

#### 16. ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

liabilities that are not considered financial assets and liabilities include premises and equipment, other assets and other liabilities. In addition, the income tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

Finally, reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates which must be made given the absence of active secondary markets for many of the financial instruments. This lack of uniform evaluation methodologies introduces a greater degree of subjectivity to these estimated fair values.

17. QUARTERLY FINANCIAL DATA (UNAUDITED)

**Table 41**

	Quarter Ended			
	March 31, 1998	June 30, 1998	September 30, 1998	December 31, 1998
(In Thousands, Except Per Share Amounts)				
Total interest income	\$ 1,951	\$ 2,049	\$ 2,098	\$ 2,197
Total interest expense	831	932	989	1,066
Net interest income	1,120	1,117	1,109	1,131
Provision for loan losses	21	21	21	(44)
Other income	183	205	231	250
Other expenses	999	1,065	1,062	1,161
Income taxes	101	77	79	73
Net income	\$ 182	\$ 159	\$ 178	\$ 191
Net income per common share - basic and diluted	\$ 0.13	\$ 0.11	\$ 0.13	\$ 0.13

**Table 42**

	Quarter Ended			
	March 31, 1997	June 30, 1997	September 30, 1997	December 31, 1997
(In Thousands, Except Per Share Amounts)				
Total interest income	\$ 1,755	\$ 1,810	\$ 1,892	\$ 1,926
Total interest expense	731	754	777	801
Net interest income	1,024	1,056	1,115	1,125
Provision for loan losses	75	75	45	15
Other income	165	205	167	207
Other expenses	927	938	971	917
Income taxes	63	88	93	149
Net income	\$ 124	\$ 160	\$ 173	\$ 251
Net income common per share - basic and diluted	\$ 0.09	\$0.12	\$0.12	\$0.18

Net income per common share for the quarters ended June 30, 1998 and prior have been restated to give retroactive effect to the subsequent 2 for 1 stock split.

Sussex  
Bancorp,  
Inc.

OFFICE LOCATIONS

Main Office:

FRANKLIN  
399 Route 23, Franklin Bank - 827-2404  
Administrative Offices - 827-2914 Loan

Department - 827-3726

Branch Offices:

ANDOVER  
165 Route 206, Andover  
786-5150

NEWTON  
15 Trinity Street,  
Newton 383-2211

MONTAGUE  
266 Clove Road, Montague  
293-3488

SPARTA  
172 Woodport Road,  
Sparta 729-7223

VERNON  
7 Church Street, Vernon  
754-6175

WANTAGE  
455 Route 23, Wantage  
875-9957

Transfer and Dividend Paying  
Agent/Registrar  
American Stock Transfer & Trust Company  
40 WallStreet  
New York, NY 10005  
800-937-5449  
Common Stock Data  
Common stock is traded on the American  
Stock Exchange under the Symbol SBB.  
SUSSEX BANCORP, INC.

Board of Directors and Executive Officers

Donald L. Kovach	Chairman of the Board, President and Chief Executive Officer
Irvin Ackerson	Excavator, Ackerson Excavating
William Kulsar	CPA, Caristia, Kulsar and Wade, P.A.
Joel D. Marvil	President and Chief Executive Officer, Ames Rubber Corporation
Richard W. Scott	Dentist, Richard W. Scott, D.D.S.
Joseph Zitone	General Contractor, Zitone Construction Co.

SUSSEX COUNTY STATE BANK

Board of Directors

Donald L. Kovach	Chairman of the Board, President and Chief Executive Officer
Terry H. Thompson	Secretary, Senior Vice President/COO
Irvin Ackerson	Excavator, Ackerson Excavating
Mark J. Hontz	Attorney, Dolan & Dolan, P.A.
William E. Kulsar	CPA, Caristia, Kulsar and Wade, P.A.
Candace Leatham	Senior Vice President/Treasurer
Joel D. Marvil	President and Chief Executive Officer of Ames Rubber Corp.
Richard W. Scott	Dentist, Richard W. Scott, D.D.S.

Joseph Zitone            General Contractor, Zitone Construction Co.

Officers

Donald L. Kovach        President/Chief Executive Officer

Candace Leatham        Senior Vice President/Treasurer

Terry H. Thompson      Senior Vice President/COO

Mary Cannistra         Vice President/Personnel Officer

Gary Chuisano          Vice President/Trust Officer/Non-deposit Products

James Ciaravolo        Vice President/Branch Administration/Security

Elizabeth Martin       Vice President/Operations

Valerie Seufert        Vice President/Senior Loan Officer

Samuel Tolley          Vice President/Loans & Compliance Officer

Janice Mandeville      Asst. Vice President/Loan Administration

Maryann Parker         Asst. Vice President/Branch Manager-Franklin

Mardella Venable       Asst. Vice President/Branch Manager-Newton

Diana Whitehead        Asst. Vice President/Asst. Operations Officer

Laurie Grafeld         Asst. Secretary/Branch Manager-Montague

Colleen Herman         Asst. Secretary/Branch Manager-Wantage

Lori Hotchkiss         Asst. Secretary/Data Processing

Margaret Sisco         Asst. Secretary/Deposit Operations

Patricia Backman       Asst. Treasurer/Controllers Office

SUSSEX BANCORP MORTGAGE CO., INC.

Officers

Gerald R. Lake         President

David K. VerHage       Vice President

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Sussex  
Bancorp,  
Inc.

[GRAPHIC-PHOTO OF INDIVIDUALS LISTED BELOW]

Trust/Estate Advisory Committee:

-----  
LEFT to RIGHT (sitting):  
Candace Leatham, Donald L. Kovach  
and Pat Bauernfeind  
LEFT to RIGHT (standing):  
Gary Chiusano and William E. Kulsar

[GRAPHIC-PHOTO OF INDIVIDUALS LISTED BELOW AT AMEX]

OPENING DAY ON THE AMEX:

-----  
LEFT: FRONT - William E. Kulsar, Donald L. Kovach,

Candace Leatham:  
 BACK - Joel D. Marvil, Richard W. Scott  
 and Terry H. Thompson

-----  
 Below:  
 Donald L. Kovach with a Senior Amex Representative

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Five Year  
 Summary

(Not covered by Report  
 of Independent Public  
 Accountants)

**Table 43**

	Year Ended December 31				
	1998	1997	1996	1995	1994
<b>SUMMARY OF INCOME:</b>					
Interest income	\$ 8,295,000	\$ 7,383,000	\$ 6,710,000	\$ 6,050,000	\$ 5,516,000
Interest expense	3,818,000	3,063,000	2,728,000	2,267,000	1,656,000
Net interest income	4,477,000	4,320,000	3,982,000	3,783,000	3,860,000
Provision for possible loan losses	19,000	210,000	130,000	64,000	187,000
Net interest income after provision for possible loan losses	4,458,000	4,110,000	3,852,000	3,719,000	3,673,000
Other income	869,000	744,000	666,000	677,000	592,000
Other expense	4,287,000	3,753,000	3,764,000	3,641,000	3,431,000
Income before provision for income taxes	1,040,000	1,101,000	844,000	755,000	834,000
Provision for income taxes	330,000	393,000	322,000	254,000	234,000
Net income	\$ 710,000	\$ 708,000	\$ 522,000	\$ 501,000	\$ 600,000
<b>BASIC AVERAGE NUMBER OF SHARES OUTSTANDING (a)</b>					
	1,410,535	1,377,934	1,368,618	1,345,616	1,334,418
<b>DILUTED AVERAGE NUMBER OF SHARES OUTSTANDING (a)</b>					
	1,425,900	1,391,416	1,382,950	1,349,658	1,334,418
<b>PER SHARE INFORMATION:</b>					
Basic net income	\$.50	\$.51	\$.38	\$.37	\$.45
Diluted net income	\$.50	\$.51	\$.38	\$.37	\$.45
Cash dividends (b)	\$.23	\$.20	\$.18	\$.22	\$.16
Stock dividends (b)	100%	0%	5%	0%	0%
Dividend payout ratio	46%	39%	46%	59%	36%
<b>PERFORMANCE YIELDS:</b>					
Return on average assets	.57%	.66%	.54%	.57%	.73%
Return on average stockholders' equity	8.33%	8.84%	6.84%	6.98%	8.84%
Average equity/average costs	6.85%	7.50%	7.87%	8.11%	8.24%
<b>END OF PERIOD DATA:</b>					
Total assets	\$137,467,000	\$114,257,000	\$101,776,000	\$94,870,000	\$82,243,000
Total deposits	127,714,000	104,882,000	92,889,000	85,925,000	75,087,000
Total stockholders' equity	9,244,000	8,586,000	7,882,000	7,609,000	6,646,000
Average assets	124,394,000	106,879,000	96,996,000	88,535,000	82,344,000
Average stockholders' equity	8,526,000	8,013,000	7,630,000	7,178,000	6,785,000

- (a) The average number of shares outstanding was computed based on the average number of shares outstanding during each period as adjusted for subsequent stock dividends.
- (b) Cash and stock dividends per common share are based on the actual number of common shares outstanding on the dates of record as adjusted for subsequent stock dividends.

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### Section 3: EX-21

#### EXHIBIT 21

##### SUBSIDIARIES OF THE REGISTRANT

Sussex Bancorp has a single subsidiary, Sussex County State Bank.

Sussex County State Bank has a single subsidiary, Sussex Bancorp Mortgage Corp.

### Section 4: EX-23

#### EXHIBIT 23(a)

##### CONSENT OF INDEPENDENT PUBLIC ACCOUNTANTS

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To Sussex Bancorp:

We hereby consent to the incorporation by reference, into the previously filed Registration Statements No. 333-20643 on Form S-3 and No. 333-20603 on Form S-8 of Sussex Bancorp (the "Company"), of our report dated January 15, 1999, included in the Company's annual report on Form 10-KSB for the year ended December 31, 1998.

/s/RADICS & CO., L.L.C.

-----  
RADICS & CO., L.L.C.

Pine Brook, New Jersey  
March 30, 1999

#### EXHIBIT 23(b)

##### CONSENT OF INDEPENDENT PUBLIC ACCOUNTANTS

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To Sussex Bancorp:

As independent public accountants, we hereby consent to the incorporation by reference of our report dated January 15, 1998 and to all references to our Firm included in this Form 10-KSB into Sussex Bancorp's previously filed Registration Statement No. 333-20643 on Form S-3 and Registration Statement No. 333-20603 on Form S-8. It should be noted that we have not audited any financial statements of Sussex Bancorp subsequent to December 31, 1997 or performed any audit procedures subsequent to the date of our report.

/s/ARTHUR ANDERSEN L.L.P.  
-----  
ARTHUR ANDERSEN L.L.P.

Roseland, New Jersey  
March 30, 1999

## Section 5: EX-27

Table 1

<ARTICLE> 9

<PERIOD-TYPE>	12-MOS	12-MOS
<FISCAL-YEAR-END>	DEC-31-1998	DEC-31-1997
<PERIOD-END>	DEC-31-1998	DEC-31-1997
<CASH>	4,060	5,693
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<TOTAL-ASSETS>	137,467	114,257
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<COMMON>	5,635	5,412
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