

SOUTHERN CONNECTICUT BANCORP INC  
Form 10QSB  
November 09, 2007

**U. S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

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**F O R M 10 – Q S B**

Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended September 30, 2007

Commission file number 0-49784

SOUTHERN CONNECTICUT BANCORP, INC.  
(Name of Small Business Issuer as Specified in Its Charter)

Connecticut  
(State or Other Jurisdiction of Incorporation or  
Organization)

06-1609692  
(I.R.S. Employer Identification Number)

215 Church Street  
New Haven, Connecticut 06510  
(Address of Principal Executive Offices)

(203) 782-1100  
(Issuer's Telephone Number)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months, and (2) has been subject to such filing requirements for the past 90 days. YES  No

The number of shares of the issuer's Common Stock, par value \$.01 per share, outstanding as of  
November 9, 2007: 2,946,162

1  
Transitional Small Business Disclosure Format

Yes  No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes  No

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**SOUTHERN CONNECTICUT BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**September 30, 2007 and December 31, 2006**  
**(unaudited)**

	2007	2006
<b>Assets</b>		
Cash and due from banks	\$ 4,453,352	\$ 5,821,084
Federal funds sold	16,700,000	22,700,000
Short-term investments	7,693,707	6,288,663
<b>Cash and cash equivalents</b>	<b>28,847,059</b>	<b>34,809,747</b>
Available for sale securities, at fair value	7,195,754	8,054,821
Federal Home Loan Bank Stock	66,100	66,100
Loans receivable (net of allowance for loan losses of \$1,164,871 in 2007 and \$1,062,661 in 2006)	88,638,314	75,306,255
Loans held for sale	57,588	118,223
Accrued interest receivable	546,718	467,698
Premises and equipment, net	4,177,440	4,424,828
Other assets	1,095,551	1,014,873
<b>Total assets</b>	<b>\$ 130,624,524</b>	<b>\$ 124,262,545</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
Deposits		
Noninterest bearing deposits	\$ 28,444,026	\$ 29,463,030
Interest bearing deposits	79,030,868	71,810,490
<b>Total deposits</b>	<b>107,474,894</b>	<b>101,273,520</b>
Repurchase agreements	689,769	883,603
Accrued expenses and other liabilities	850,812	585,445
Capital lease obligations	1,187,237	1,188,128
<b>Total liabilities</b>	<b>110,202,712</b>	<b>103,930,696</b>
Commitments and Contingencies (Note 9)	-	-
<b>Shareholders' Equity</b>		
Preferred stock, no par value; 500,000 shares authorized; none issued		
Common stock, par value \$.01; 5,000,000, shares authorized; shares issued and outstanding: 2007 2,946,182; 2006 2,941,297	29,462	29,413
Additional paid-in capital	24,231,050	24,147,883
Accumulated deficit	(3,729,209)	(3,595,370)
Accumulated other comprehensive loss – net unrealized loss on available for sale securities	(109,491)	(250,077)
<b>Total shareholders' equity</b>	<b>20,421,812</b>	<b>20,331,849</b>

<b>Total liabilities and shareholders' equity</b>	<b>\$</b>	<b>130,624,524</b>	<b>\$</b>	<b>124,262,545</b>
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See Notes to Consolidated Financial Statements.

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**SOUTHERN CONNECTICUT BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

**For the Three Months and Nine Months Ended September 30, 2007 and 2006 (unaudited)**

	Three Months Ended September		Nine Months Ended September	
	2007	2006	2007	2006
Interest Income				
Interest and fees on loans	\$ 2,004,997	\$ 1,507,958	\$ 5,574,987	\$ 4,187,360
Interest on securities	65,331	78,715	195,640	234,879
Interest on federal funds sold and short-term investments	339,171	256,617	1,010,950	576,095
<b>Total interest income</b>	<b>2,409,499</b>	<b>1,843,290</b>	<b>6,781,577</b>	<b>4,998,334</b>
Interest Expense				
Interest on deposits	837,803	516,872	2,395,799	1,333,285
Interest on capital lease obligations	43,978	43,713	131,782	130,894
Interest on repurchase agreements	2,244	5,484	6,739	13,096
<b>Total interest expense</b>	<b>884,025</b>	<b>566,069</b>	<b>2,534,320</b>	<b>1,477,275</b>
<b>Net interest income</b>	<b>1,525,474</b>	<b>1,277,221</b>	<b>4,247,257</b>	<b>3,521,059</b>
Provision for Loan Losses	319,218	152,334	446,462	256,809
<b>Net interest income after provision for loan losses</b>	<b>1,206,256</b>	<b>1,124,887</b>	<b>3,800,795</b>	<b>3,264,250</b>
Noninterest Income				
Service charges and fees	171,448	134,410	452,450	353,161
Gains on sales of loans	-	73,012	45,286	124,033
Other noninterest income	54,434	49,908	248,824	157,169
<b>Total noninterest income</b>	<b>225,882</b>	<b>257,330</b>	<b>746,560</b>	<b>634,363</b>
Noninterest Expense				
Salaries and benefits	774,420	810,536	2,600,138	2,237,446
Occupancy and equipment	202,052	206,485	634,582	556,766
Professional services	267,845	102,789	526,298	360,001
Data processing and other outside services	102,639	84,201	313,218	257,644
Advertising and promotional expense	7,364	51,098	19,213	171,847
Forms, printing and supplies	20,795	38,847	59,961	103,276
FDIC Insurance	30,625	6,783	94,097	19,914
Other operating expenses	169,143	136,415	433,687	410,171
<b>Total noninterest expense</b>	<b>1,574,883</b>	<b>1,437,154</b>	<b>4,681,194</b>	<b>4,117,065</b>
<b>Net loss</b>	<b>\$ (142,745)</b>	<b>\$ (54,937)</b>	<b>\$ (133,839)</b>	<b>\$ (218,452)</b>
Basic loss per share	\$ (0.05)	\$ (0.02)	\$ (0.05)	\$ (0.07)

Diluted loss per share	\$	<b>(0.05)</b>	\$	(0.02)	\$	<b>(0.05)</b>	\$	(0.07)
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See Notes to Consolidated Financial Statements.

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**SOUTHERN CONNECTICUT BANCORP, INC. AND  
SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS'  
EQUITY**

**For the Nine Months Ended September 30, 2007 and 2006  
(unaudited)**

	Number of Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total
Balance December 31, 2005	2,937,525	\$ 29,375	\$ 24,083,638	\$ (3,477,576)	\$ (338,594)	\$ 20,296,843
Comprehensive Loss:						
Net loss	-	-	-	(218,452)	-	(218,452)
Unrealized holding gains on available for sale securities	-	-	-	-	65,382	65,382
Total comprehensive loss						(153,070)
Directors fees settled in common stock	2,625	26	19,117	-	-	19,143
Restricted stock compensation	-	-	2,673	-	-	2,673
Stock option compensation	-	-	17,019	-	-	17,019
Balance September 30, 2006	2,940,150	\$ 29,401	\$ 24,122,447	\$ (3,696,028)	\$ (273,212)	\$ 20,182,608
<b>Balance December 31, 2006</b>	<b>2,941,297</b>	<b>\$ 29,413</b>	<b>\$ 24,147,883</b>	<b>\$ (3,595,370)</b>	<b>\$ (250,077)</b>	<b>\$ 20,331,849</b>
Comprehensive Income:						
Net loss	-	-	-	(133,839)	-	(133,839)
Unrealized holding gains on available for sale securities	-	-	-	-	140,586	140,586
Total comprehensive income						6,747
Directors fees settled in common stock	3,885	39	29,291	-	-	29,330
Restricted stock compensation	1,000	10	16,085	-	-	16,095
Stock option compensation	-	-	37,791	-	-	37,791
<b>Balance September 30, 2007</b>	<b>2,946,182</b>	<b>\$ 29,462</b>	<b>\$ 24,231,050</b>	<b>\$ (3,729,209)</b>	<b>\$ (109,491)</b>	<b>\$ 20,421,812</b>

See Notes to Consolidated Financial Statements.

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**SOUTHERN CONNECTICUT BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**For the Nine Months Ended September 30, 2007 and 2006 (unaudited)**

<b>Cash Flows From Operations</b>	<b>2007</b>	<b>2006</b>
Net loss	\$ (133,839)	\$ (218,452)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Amortization and accretion of premiums and discounts on investments, net	(349)	(1,420)
Provision for loan losses	446,462	256,809
Share based compensation	53,886	19,692
Loans originated for sale, net of principal payments received	(148,674)	(958,950)
Proceeds from sales of loans	195,286	1,282,122
Gains on sales of loans	(45,286)	(124,033)
Depreciation and amortization	309,557	289,896
Increase in cash surrender value of life insurance	(30,600)	(24,750)
Changes in assets and liabilities:		
Decrease in deferred loan fees	(11,375)	(33,666)
Increase in accrued interest receivable	(79,020)	(119,669)
Increase in other assets	(50,078)	(93,938)
Increase in accrued expenses and other liabilities	294,697	208,725
<b>Net cash provided by operating activities</b>	<b>800,667</b>	<b>482,366</b>
<b>Cash Flows From Investing Activities</b>		
Principal repayments on available for sale securities	2	8,922
Proceeds from maturities of available for sale securities	1,000,000	1,000,000
Purchases of Federal Home Loan Bank Stock	-	(6,100)
Net increase in loans receivable	(13,707,837)	(14,716,593)
Purchases of premises and equipment	(62,169)	(289,822)
<b>Net cash used in investing activities</b>	<b>(12,770,004)</b>	<b>(14,003,593)</b>
<b>Cash Flows From Financing Activities</b>		
Net increase in demand, savings and money market deposits	2,040,927	11,310,992
Net increase in certificates of deposit	4,160,447	6,107,634
Net (decrease) increase in repurchase agreements	(193,834)	616,055
Principal payments on capital lease obligations	(891)	(802)
<b>Net cash provided by financing activities</b>	<b>6,006,649</b>	<b>18,033,879</b>
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(5,962,688)</b>	<b>4,512,652</b>
<b>Cash and cash equivalents</b>		
Beginning	34,809,747	16,569,287
<b>Ending</b>	<b>\$ 28,847,059</b>	<b>\$ 21,081,939</b>

(continued)

**SOUTHERN CONNECTICUT BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**  
**For the Nine Months Ended September 30, 2007 and 2006 (unaudited)**

	2007	2006
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Cash paid during the period for:		
Interest	\$ 2,523,719	\$ 1,455,308
Income taxes	\$ -	\$ -
<b>Supplemental Disclosures of Noncash Investing and Financing Activities:</b>		
Transfer of loans held for sale to loans receivable	\$ -	\$ (86,884)
Transfer of loans receivable to loans held for sale	\$ 59,309	\$ -
Accrued director's fees settled in common stock	\$ 29,330	\$ 19,143
Unrealized holding gains on available for sale securities arising during the period	\$ 140,586	\$ 65,382

See Notes to Consolidated Financial Statements.

**Southern Connecticut Bancorp, Inc.**  
**Notes to Consolidated Financial Statements**  
**(Unaudited)**

**Note 1. Nature of Operation**

Southern Connecticut Bancorp, Inc. (“Bancorp”), is a bank holding company headquartered in New Haven, Connecticut that was incorporated on November 8, 2000. Bancorp’s strategic objective is to serve as a bank holding company for a community-based commercial bank serving primarily greater New Haven and New Haven County (the “Southern Connecticut Market”). Bancorp owns 100% of the capital stock of The Bank of Southern Connecticut (the “Bank”) a Connecticut-chartered bank with its headquarters in New Haven, Connecticut. The Bank commenced operations on October 1, 2001. The Bank operates five branches, through three divisions. The Bank of Southern Connecticut is headquartered in New Haven, Connecticut with branch offices in the Amity/Westville section of New Haven, and in Branford, Connecticut, just east of New Haven. The Bank of Southeastern Connecticut, a division of The Bank of Southern Connecticut, opened March 6, 2006, and is headquartered in New London, Connecticut. The Bank of North Haven, a division of The Bank of Southern Connecticut, opened July 10, 2006, and is headquartered in North Haven, Connecticut. Each division is marketed as an independent entity and is staffed with senior executives who take an active role in community affairs.

The Bank focuses on serving the banking needs of small to medium-sized businesses, professionals and professional corporations, and their owners and employees in the Southern Connecticut market. The Bank’s target commercial customer has between \$1.0 and \$30.0 million in revenues, 15 to 150 employees, and borrowing needs of up to \$3.0 million. The primary focus on this commercial market makes the Bank uniquely qualified to move deftly in responding to the needs of its clients. The Bank has been successful in winning business by offering a combination of competitive pricing for its services, quick decision making processes and a high level of personalized, “high touch” customer service.

**Note 2. Basis of Financial Statement Presentation**

The consolidated interim financial statements include the accounts of Southern Connecticut Bancorp, Inc. and its subsidiaries. The consolidated interim financial statements and notes thereto have been prepared in conformity with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-QSB and Item 310b of Regulation SB. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany transactions have been eliminated in consolidation. Amounts in prior period financial statements are reclassified whenever necessary to conform to current period presentations. The results of operations for the nine months ended September 30, 2007 are not necessarily indicative of the results which may be expected for the year as a whole. The accompanying consolidated financial statements and notes thereto should be read in conjunction with the audited financial statements of Bancorp and notes thereto as of December 31, 2006, filed with the Securities and Exchange Commission on Form 10-KSB on March 28, 2007.

**Note 3. Available for Sale Securities**

The amortized cost, gross unrealized gains, gross unrealized losses and approximate fair values of available for sale securities at September 30, 2007 and December 31, 2006 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>September 30, 2007</b>				
U.S. Government Sponsored Agency Obligations	\$ 7,199,825	\$ 470	\$ (104,872)	\$ 7,095,423
Mortgage Backed Securities	105,420	-	(5,089)	100,331
	\$ 7,305,245	\$ 470	\$ (109,961)	\$ 7,195,754

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 2006</b>				
U.S. Government Sponsored Agency Obligations	\$ 8,199,467	\$ -	\$ (247,627)	\$ 7,951,840
Mortgage Backed Securities	105,431	-	(2,450)	102,981
	\$ 8,304,898	\$ -	\$ (250,077)	\$ 8,054,821

At September 30, 2007, gross unrealized holding losses on available for sale securities totaled \$109,961. All such unrealized losses have existed for a period of twelve months or longer. Management does not believe that any of the unrealized losses as of September 30, 2007 are other than temporary, as they relate to debt and mortgage-backed securities issued by U.S. Government sponsored agencies, which Bancorp has the ability to hold until maturity or until the fair value fully recovers. As a result, management believes that these unrealized losses will not have a negative impact on future earnings or a permanent effect on capital.

At December 31, 2006, gross unrealized holding losses on available for sale securities totaled \$250,077. All such unrealized losses had existed for a period of twelve months or longer.

#### **Note 4. Loans Receivable**

A summary of Bancorp's loan portfolio at September 30, 2007 and December 31, 2006 is as follows:

	<b>September 30, 2007</b>	December 31, 2006
Commercial loans secured by real estate	\$ 38,299,261	\$ 32,004,940
Commercial loans	43,453,160	39,621,667
Construction and land loans	6,697,426	3,253,511
Residential mortgage loans	143,538	149,358
Consumer home equity loans	640,535	603,394
Consumer installment loans	650,620	806,026
<b>Total gross loans</b>	<b>89,884,540</b>	76,438,896
Net deferred loan fees	(81,355)	(69,980)
Allowance for loan losses	(1,164,871)	(1,062,661)
<b>Loans receivable, net</b>	<b>\$ 88,638,314</b>	\$ 75,306,255

**Allowance for Loan Losses**

The following represents the activity in the allowance for loan losses for the nine months ended September 30, 2007 and 2006:

	<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Balance at beginning of period	\$ 1,062,661	\$ 778,051
Charge-offs	(356,149)	(3,643)
Recoveries	11,897	60,041
Provision charged to operations	446,462	256,809
Balance at end of period	\$ 1,164,871	\$ 1,091,258
Net (charge-offs) recoveries to average loans	<b>(0.42)%</b>	<b>0.09%</b>

**Non-Accrual, Past Due and Restructured Loans**

The following is a summary of non-accrual and past due loans:

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Loans delinquent over 90 days and still accruing	\$ -	\$ -
Non-accrual loans	530,323	301,833
Total nonperforming loans	\$ 530,323	\$ 301,833
% of Total Loans	0.59%	0.40%
% of Total Assets	0.41%	0.24%
Ratio of allowance for loan losses to nonperforming loans	2.20	3.52

**Note 5. Deposits**

At September 30, 2007 and December 31, 2006, deposits consisted of the following:

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Noninterest bearing deposits	\$ 28,444,026	\$ 29,463,030
Interest bearing deposits		
Checking	6,354,074	4,985,187
Money Market	38,402,876	36,324,952
Savings	1,720,474	2,107,354
Total checking, money market & savings	46,477,424	43,417,493
Time Certificates under \$100,000	16,783,432	14,190,207
Time Certificates of \$100,000 or more	15,770,012	14,202,790
Total time deposits	32,553,444	28,392,997
Total interest bearing deposits	79,030,868	71,810,490
Total deposits	\$ 107,474,894	\$ 101,273,520

**Note 6. Available Borrowings**

The Bank is a member of the Federal Home Loan Bank of Boston (“FHLB”). At September 30, 2007, the Bank had the ability to borrow from the FHLB based on a certain percentage of the value of the Bank’s

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qualified collateral, as defined in the FHLB Statement of Products Policy, at the time of the borrowing. In accordance with an agreement with the FHLB, the qualified collateral must be free and clear of liens, pledges and encumbrances. There were no borrowings outstanding with the FHLB at September 30, 2007.

The Bank is required to maintain an investment in capital stock of the FHLB in an amount equal to a percentage of its outstanding mortgage loans and contracts secured by residential properties, including mortgage-backed securities. No ready market exists for FHLB stock and it has no quoted market value. For disclosure purposes, such stock is assumed to have a market value which is equal to cost since the Bank can redeem the stock with FHLB at cost.

#### Note 7. Loss Per Share

Bancorp is required to present basic loss per share and diluted loss per share in its statements of operations. Basic per share amounts are computed by dividing net loss by the weighted average number of common shares outstanding. Diluted per share amounts assume exercise of all potential common stock equivalents in weighted average shares outstanding, unless the effect is antidilutive. Bancorp is also required to provide a reconciliation of the numerator and denominator used in the computation of both basic and diluted loss per share. For three months and nine months ended September 30, 2007 and 2006 common stock equivalents have been excluded from the computation of net loss per share because their inclusion would be antidilutive. The following is information about the computation of loss per share for the three month and nine month periods ended September 30, 2007 and 2006.

#### Loss per Share

##### Three Months Ended September 30,

	Net Loss	2007 Weighted Average Shares	Amount Per Share	Net Loss	2006 Weighted Average Shares	Amount Per Share
<b>Basic Loss Per Share</b>						
Loss available to common shareholders	\$ (142,745)	2,944,370	\$ (0.05)	\$ (54,937)	2,939,593	\$ (0.02)
Effect of Dilutive Securities Warrants/Stock Options outstanding	-	-	-	-	-	-
<b>Diluted Loss Per Share</b>						
Loss available to common shareholders plus assumed conversions	\$ (142,745)	2,944,370	\$ (0.05)	\$ (54,937)	2,939,593	\$ (0.02)

##### Nine Months Ended September 30,

	Net Loss	2007 Weighted Average Shares	Amount Per Share	Net Loss	2006 Weighted Average Shares	Amount Per Share
<b>Basic Loss Per Share</b>						
Loss available to common shareholders	\$ (133,839)	2,943,403	\$ (0.05)	\$ (218,452)	2,938,419	\$ (0.07)
Effect of Dilutive Securities	-	-	-	-	-	-

**Warrants/Stock Options  
outstanding**

**Diluted Loss Per Share**

**Loss available to common  
shareholders plus assumed  
conversions**

<b>\$ (133,839)</b>	<b>2,943,403</b>	<b>\$ (0.05)</b>	<b>\$ (218,452)</b>	<b>2,938,419</b>	<b>\$ (0.07)</b>
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**Note 8. Other Comprehensive Income**

Other comprehensive income, which is comprised solely of the change in unrealized gains on available for sale securities, is as follows:

	<b>Nine Months Ended September 30, 2007</b>		
	<b>Before-Tax Amount</b>	<b>Taxes</b>	<b>Net-of-Tax Amount</b>
<b>Unrealized holding gains arising during the period</b>	<b>\$ 140,586</b>	<b>\$ -</b>	<b>\$ 140,586</b>
<b>Reclassification adjustment for amounts recognized in net loss</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Unrealized holding gains on available for sale securities</b>	<b>\$ 140,586</b>	<b>\$ -</b>	<b>\$ 140,586</b>
	<b>Nine Months Ended September 30, 2006</b>		
	<b>Before-Tax Amount</b>	<b>Taxes</b>	<b>Net-of-Tax Amount</b>
Unrealized holding gains arising during the period	\$ 65,382	\$ -	\$ 65,382
Reclassification adjustment for amounts recognized in net loss	-	-	-
Unrealized holding gains on available for sale securities	\$ 65,382	\$ -	\$ 65,382

There is no tax effect relating to other comprehensive income because there is a full valuation allowance recorded against the deferred tax asset.

**Note 9. Financial Instruments with Off-Balance-Sheet Risk**

In the normal course of business, Bancorp is a party to financial instruments with off-balance-sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit and involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the financial statements. The contractual amounts of these instruments reflect the extent of involvement Bancorp has in particular classes of financial instruments.

The contractual amounts of commitments to extend credit represent the amounts of potential accounting loss should: the contract be fully drawn upon; the customer default; and the value of any existing collateral become worthless. Bancorp uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments and evaluates each customer's creditworthiness on a case-by-case basis. Bancorp controls the credit risk of these financial instruments through credit approvals, credit limits, monitoring procedures and the receipt of collateral as deemed necessary.



Financial instruments whose contract amounts represent credit risk are as follows at September 30, 2007 and December 31, 2006:

	<b>September 30, 2007</b>	December 31, 2006
Commitments to extend credit		
Future loan commitments	<b>\$ 8,453,671</b>	\$ 7,044,313
Unused lines of credit	<b>24,240,071</b>	22,537,570
Undisbursed construction loans	<b>1,288,312</b>	1,588,933
Financial standby letters of credit	<b>4,325,778</b>	3,100,188
	<b>\$ 38,307,832</b>	\$ 34,271,004

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 to extend credit generally have fixed expiration dates or other termination clauses and may require payment of a fee by the borrower. Since these commitments could expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if deemed necessary by Bancorp upon extension of credit, is based upon management's credit evaluation of the counterparty. Collateral held varies, but may include residential and commercial property, deposits and securities.

Standby letters of credit are written commitments issued by Bancorp to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The liability related to guarantees recorded at September 30, 2007 and December 31, 2006 was not significant.

#### **Note 10. Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principals, and expands disclosure about fair value measurements. This Statement is effective on January 1, 2008, with early adoption permitted. Statement No. 157 is not anticipated to have a material impact on Bancorp's financial statements.

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 155* (SFAS 159). SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value. SFAS 159 is effective for Bancorp beginning January 1, 2008. Management is evaluating the impact of the adoption of SFAS 159 on Bancorp's financial position and results of operations.

Effective January 1, 2007 Bancorp adopted Financial Accounting Standards Board Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes, which clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements and provides guidance on the recognition, de-recognition and measurement of benefits related to an entity's uncertain income tax positions. Based on a detailed review of all tax positions, it was determined that Bancorp has no significant unrecognized tax benefits, and therefore Bancorp's adoption of FIN 48 had no impact on Bancorp's consolidated financial statements. If such amounts are recorded in future periods, Bancorp will present any related interest and penalties as part of the provision for income taxes.



## **Item 2. Management's Discussion and Analysis or Plan of Operation**

The following discussion and analysis is intended to assist you in understanding the financial condition and results of operations of Bancorp. This discussion should be read in conjunction with the accompanying unaudited financial statements as of and for the three and nine months ended September 30, 2007 and 2006, along with the audited financial statements as of and for the year ended December 31, 2006, included in Bancorp's Form 10-KSB filed with the Securities and Exchange Commission on March 28, 2007.

### **Summary**

As of September 30, 2007, Bancorp had \$130.6 million of total assets, \$88.6 million of loans receivable, and \$107.5 million of total deposits. The increase in total assets, loans receivable and total deposits from December 31, 2006 is attributable to Bancorp's ongoing marketing efforts. Total equity capital at September 30, 2007 was \$20.4 million, and Bancorp's Tier I Leverage Capital Ratio was 15.68%.

Net interest margin for the three and nine months ended September 30, 2007 was 4.98% and 4.90%, respectively, as compared to 5.38% and 5.41% for the three and nine months ended September 30, 2006. The decrease in Net interest margin is largely attributable to prevailing interest rates as opposed to changes in the Bank's practices. In addition, as the Bank continues to grow, it is considering larger loan requests from larger businesses that are much more price sensitive on both the loan and deposit sides, thus making it necessary for the Bank to slightly sacrifice some of its spread in order to increase its overall market share.

Bancorp had a net loss of \$143,000 (or basic and diluted loss per share of \$0.05) for the three months ended September 30, 2007, compared to a net loss of \$55,000 (or basic and diluted loss per share of \$0.02) for the three months ended September 30, 2006. Bancorp had a net loss of \$134,000 (or basic and diluted loss per share of \$0.05) for the nine months ended September 30, 2007, compared to a net loss of \$218,000 (or basic and diluted loss per share of \$0.07) for the nine months ended September 30, 2006. The provision for loan losses for the three and nine months ended September 30, 2007 was \$319,000 and \$446,000, respectively, as compared to \$152,000 and \$257,000 for the same periods in 2006. Bancorp's operating results for the three and nine months ended September 30, 2007 were significantly impacted by the provision for loan losses of \$319,000 recorded in the third quarter of 2007. In addition, noninterest income for the quarter ended September 30, 2007 was \$31,000 lower than the same period in 2006, the result of the recognition of the gain on sale of loans of \$73,000 recorded in the three-month period ended September 30, 2006. Noninterest expense increased by \$138,000 for the quarter ended September 30, 2007 versus the same period in 2006, primarily the result of increases in professional services, data processing costs and other operating expenses.

### **Critical Accounting Policy**

In the ordinary course of business, Bancorp has made a number of estimates and assumptions relating to reporting results of operations and financial condition in preparing its financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ significantly from those estimates under different assumptions and conditions. Bancorp believes the following discussion addresses Bancorp's only critical accounting policy, which is the policy that is most important to the portrayal of Bancorp's financial condition and results and requires management's most difficult, subjective and complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Bancorp has reviewed this critical accounting policy and estimate with its audit committee. Refer to the discussion below under "Allowance for Loan Losses" and Note 1 to the audited financial statements as of and for the year ended December 31, 2006, included in Bancorp's Form 10-KSB filed with the Securities and Exchange Commission on March 28, 2007.



### *Allowance for Loan Losses*

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loans are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of general and specific components. The general component of the allowance for loan losses is accounted for under Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. The specific component relates to loans that are considered impaired pursuant to Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan – an amendment of FASB Statements No. 5 and 15*.

Based upon this evaluation, management believes the allowance for loan losses of \$1,165,000 or 1.30% of gross loans receivable and 2.20 times non-accrual loans at September 30, 2007 is adequate, under prevailing economic conditions, to absorb losses on existing loans. At December 31, 2006, the allowance for loan losses was \$1,063,000 or 1.39% of gross loans receivable and 3.52 times non-accrual loans.

During the quarter ended September 30, 2007, the Bank the need to record a provision for loan losses of \$319,000, of which \$241,000 was related to the charge-off of the Bank's exposure in one commercial credit. The provision was deemed necessary based on management's review of the loan portfolio and this specific loan.

The accrual of interest income on loans is discontinued whenever reasonable doubt exists as to its collectibility and generally is discontinued when loans are past due 90 days as to either principal or interest, or are otherwise considered impaired. When the accrual of interest income is discontinued, all previously accrued and uncollected interest is reversed against interest income. The accrual of interest on loans past due 90 days or more may be continued if the loan is well secured, it is believed all principal and accrued interest income due on the loan will be realized, and the loan is in the process of collection. A non-accrual loan is restored to an accrual status when it is no longer delinquent and collectibility of interest and principal is no longer in doubt.

Management considers all non-accrual loans, other loans past due 90 days or more, based on contractual terms, and restructured loans to be impaired. Loans for which payments are past due, but not more than 90 days past due, are not considered to be impaired unless management determines that full collection of principal and interest is doubtful.

### ***Recent Accounting Changes***

Effective January 1, 2007 Bancorp adopted Financial Accounting Standards Board Interpretation (FIN) No. 48, *Accounting for uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements and provides guidance on the recognition, de-recognition and measurement of benefits related to an entity's uncertain income tax positions. Based on a detailed review of all tax positions, it was determined that Bancorp has no significant unrecognized tax benefits, and therefore Bancorp's adoption of FIN 48 had no impact on Bancorp's consolidated financial statements. If such amounts

are recorded in future periods, Bancorp will present any related interest and penalties as part of the provision for income taxes.

### Comparison of Financial Condition as of September 30, 2007 versus December 31, 2006

#### General

Bancorp's total assets were \$130.6 million at September 30, 2007, an increase of \$6.3 million (5.1%) from \$124.3 million in assets as of December 31, 2006. Interest earning assets for the nine months ended September 30, 2007 were \$120.3 million, an increase of \$7.8 million (6.9%) from \$112.5 million for the year ended December 31, 2006.

#### Investments

Available for sale securities totaled \$7.2 million as of September 30, 2007, a decrease of \$859,000 from a balance of \$8.1 million December 31, 2006. The available for sale securities portfolio is invested entirely in U.S. government sponsored agency and sponsored agency issued mortgage backed securities. The reduction in balance was due to the maturity of one of Bancorp's investments. The proceeds from the maturity were reinvested in short-term financial instruments.

As of September 30, 2007, gross unrealized losses on the available for sale securities portfolio totaled \$110,000. Management believes that none of the unrealized losses on available for sale securities are other than temporary because all of the unrealized losses in Bancorp's investment portfolio are due to market interest rate changes related to debt and mortgage-backed securities issued by U.S. Government sponsored agencies, which Bancorp has the ability to hold until maturity or until the fair value fully recovers. In addition, management considers the issuers of the securities to be financially sound and further believes that Bancorp will receive all contractual principal and interest related to these investments. Management regularly reviews the investment portfolio with respect to the appropriateness of the investments. This includes the consideration of profitability, quality of the investment, interest rate risk and liquidity, as well as other considerations. While management feels the current portfolio is appropriate, in the future, as Bancorp's needs change, Bancorp may make changes to its investment portfolio.

#### Loans

Net loans receivable increased \$13.3 million (17.7%) from \$75.3 million at December 31, 2006 to \$88.6 million at September 30, 2007. The increase in loans is due primarily to commercial real estate and construction loans. The increase in the loans receivable portfolio was funded primarily by increased deposits. The ratio of loans receivable to deposits as of September 30, 2007 was 82.5%. The Bank currently has a large amount of loans pending closing; if these loans are closed, the ratio of loans receivable to deposits is expected to increase as well.

### Allowance for Loan Losses and Non-Accrual, Past Due and Restructured Loans

#### Allowance for Loan Losses

The following represents the activity in the allowance for loan losses for the nine months ended September 30, 2007 and 2006:

	<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Balance at beginning of period	<b>\$ 1,062,661</b>	\$ 778,051
Charge-offs	<b>(356,149)</b>	(3,643)
Recoveries	<b>11,897</b>	60,041
Provision charged to operations	<b>446,462</b>	256,809
Balance at end of period	<b>\$ 1,164,871</b>	\$ 1,091,258





**Non-Accrual, Past Due and Restructured Loans**

The following is a summary of non-accrual and past due loans:

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Loans delinquent over 90 days and still accruing	\$ -	\$ -
Non-accrual loans	<b>530,323</b>	301,833
Total nonperforming loans	<b>\$ 530,323</b>	\$ 301,833
% of Total Loans	<b>0.59%</b>	0.40%
% of Total Assets	<b>0.41%</b>	0.24%
Ratio of allowance for loan losses to nonperforming loans	<b>2.20</b>	3.52

*Potential Problem Loans*

At September 30, 2007, the Bank had loans totaling \$1.4 million, which were not disclosed in the table above, which were not on non-accrual status but deemed impaired pursuant to Statement of Financial Accounting Standards No. 114. Each of these loans is current with respect to principal and interest. Management of Bancorp has reviewed the collateral for each of these loans and considers the current reserves on these loans adequate to cover potential losses, if any, related to these relationships. Other than loans identified as non-accrual at December 31, 2006, the Bank had no material loans as to which management had significant doubts as to the ability of the borrower to comply with the present repayment terms.

During the quarter ended September 30, 2007, the Bank determined the need to record a provision for loan losses of \$319,000, of which \$241,000 was related to the charge-off of the Bank's exposure in one commercial credit. The provision was deemed necessary based on management's review of the loan portfolio and this specific loan.

*Deposits*

Deposits were \$107.5 million at September 30, 2007, an increase of \$6.2 million (6.1%) from \$101.3 million at December 31, 2006. Non-interest bearing checking accounts were \$28.4 million at September 30, 2007, a decrease of \$1.1 million (3.4%) from \$29.5 million at December 31, 2006. The balance of non-interest bearing checking can fluctuate as much as 5-10% on a daily basis. Total interest bearing checking, money market and savings increased \$3.1, or 7.0%, to \$46.5 million at September 30, 2007, from \$43.4 million at December 31, 2006. Certificates of deposit increased to \$32.6 million at September 30, 2007 from \$28.4 million at December 31, 2006, a 14.7% increase. The overall growth of the Bank's deposit portfolio is the result of the Bank's ongoing marketing efforts.

Currently the Bank does not have any brokered deposits. The Bank does maintain relationships with several deposit brokers and could utilize the services of one or more of such brokers if management determines that issuing brokered certificates of deposits would be in the best interest of the Bank and Bancorp.

*Other*

Repurchase agreement balances totaled 690,000 at September 30, 2007 as compared to \$884,000 at December 31, 2006. The decrease is due to normal customer activity.

**Results of Operations – Comparison of Results for the three months and nine months Ended September 30, 2007 and September 30, 2006***General*

Bancorp had a net loss of \$143,000 for the three months ended September 30, 2007 as compared to a net loss of \$55,000 for the three months ended September 30, 2006. Bancorp had a net loss of \$134,000 for the nine months ended September 30, 2007 versus a net loss of \$218,000 for the nine months ended September 30, 2006. The loss for the three month and nine month periods of 2007 is primarily attributable to the provision for loan losses of \$319,000 recorded during the third quarter of 2007.

#### *Net Interest Income*

The principal source of revenue is net interest income. Bancorp's net interest income is dependent primarily upon the difference or spread between the average yield earned on loans receivable and securities and the average rate paid on deposits and borrowings, as well as the relative amounts of such assets and liabilities. Bancorp, like other banking institutions, is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different times, or on a different basis, than its interest-earning assets.

For the three months ended September 30, 2007, net interest income was \$1.5 million versus \$1.3 million for the three months ended September 30, 2006, an increase of \$248,000 or 19.4%. This increase was mainly attributable to an increase of \$27.3 million in average earning assets for the three months. The increase in average earning assets was primarily comprised of increases in average loans of \$22.9 million (a 35.0% increase).

For the nine months ended September 30, 2007, net interest income was \$4.2 million versus \$3.5 million for the nine months ended September 30, 2006, an increase of \$726,000 or 20.6%. This increase was mainly attributable to an increase of \$28.8 million in average earning assets. The increase in average earning assets was primarily comprised of increases in average loans of \$20.8 million (a 33.7% increase).

The yield on average earning assets for the three months ended September 30, 2007 was 7.86% versus 7.76% for the same period in 2006, a favorable increase of 10 basis points. The increase in the yield on assets reflects the increases in market interest rates that occurred throughout 2006 and early 2007, particularly in the prime lending rate and the Bank's base lending rate.

The yield on average earning assets for the nine months ended September 30, 2007 was 7.83% versus 7.68% for the same period in 2006, a favorable increase of 15 basis points. The increase in the yield on assets reflects the increases in market interest rates that occurred throughout 2006 and early 2007, particularly in the prime lending rate and the Bank's base lending rate.

The cost of average interest bearing liabilities was 4.29% for the three months ended September 30, 2007 versus 3.89% for the three months ended September 30, 2006, an increase of 40 basis points, reflecting a general increase in market interest rates. The increase in the cost of interest bearing liabilities was due principally to an increase in rates paid on time deposit accounts. The average rate of interest paid on time deposits increased 73 basis points for the three months ended September 30, 2007 versus the three months ended September 30, 2006.

The cost of average interest bearing liabilities was 4.31% for the nine months ended September 30, 2007 versus 3.75% for the nine months ended September 30, 2006, an increase of 56 basis points, reflecting a general increase in market interest rates. The increase in the cost of interest bearing liabilities was due principally to an increase in rates paid on time deposit accounts. The average rate of interest paid on time deposits increased 98 basis points for the nine months ended September 30, 2007 versus the nine months ended September 30, 2006.

The prevailing interest rate market over the past year poses a challenge for the Bank. Short-term rates have exceeded longer-term rates for much of the past year. The inverted nature of the yield curve has adversely affected the Bank's net interest income, as much of the Bank's deposit base is short-term. The Bank has taken

steps to extend deposit repricing by increasing its percentage of time deposits, but 70% of the Bank's portfolio is comprised of checking, savings and money market accounts as of September 30, 2007.

As a result of the yield curve and interest rates in general, Bancorp's net interest margin and net interest spread have decreased for the nine months ended September 30, 2007 versus the same period in 2006. For the nine months ended September 30, 2007, Bancorp's net interest margin was 4.90%, a decrease of 51 basis points versus 5.41% for the nine months ended September 30, 2006. At the same time, Bancorp's interest spread decreased 41 basis points from 3.93% to 3.52%.

*Average Balances, Yields, and Rates*

The following table presents average balance sheets (daily averages), interest income, interest expense, and the corresponding annualized rates on earning assets and rates paid on interest bearing liabilities for the three months ended September 30, 2007 and 2006.

**Distribution of Assets, Liabilities and Shareholders' Equity;  
Interest Rates and Interest Differential**

(Dollars in thousands)	Three months Ended September 30, 2007 Interest			Three months Ended September 30, 2006 Interest			Fluctuations in interest Income/Expense
	Average Balance	Income/ Expense	Average Rate	Average Balance	Income/ Expense	Average Rate	
Interest earning assets							
Loans (1)	\$ 88,500	\$ 2,005	8.99%	\$ 65,566	\$ 1,508	9.12%	\$ 497
Short-term investments	7,616	98	5.11%	5,459	69	5.01%	29
Investments	7,188	65	3.59%	9,014	79	3.48%	(14)
Federal funds sold	18,290	241	5.23%	14,214	187	5.22%	54
Total interest earning assets	121,594	2,409	7.86%	94,253	1,843	7.76%	566
Cash and due from banks	4,680			1,055			
Premises and equipment, net	4,228			4,466			
Allowance for loan losses	(1,171)			(939)			
Other	1,599			1,423			
Total assets	\$ 130,930			\$ 100,258			
Interest bearing liabilities							
Time certificates	\$ 31,492	402	5.06%	\$ 16,589	181	4.33%	221
Savings deposits	1,955	7	1.42%	2,686	9	1.33%	(2)
Money market / checking deposits	46,431	429	3.67%	35,826	327	3.62%	102
Capital lease obligations	1,188	44	14.69%	1,189	44	14.68%	-
Repurchase agreements	592	2	1.34%	1,450	5	1.37%	(3)
Total interest bearing liabilities	81,658	884	4.29%	57,740	566	3.89%	318

Non-interest bearing deposits	<b>27,965</b>	21,682	
Accrued expenses and other liabilities	<b>748</b>	618	
Shareholder's equity	<b>20,559</b>	20,218	
Total liabilities and equity	<b>\$ 130,930</b>	\$ 100,258	
Net interest income	<b>\$ 1,525</b>	\$ 1,277	\$ 248
Interest spread	<b>3.57%</b>	3.87%	
Interest margin	<b>4.98%</b>	5.38%	

(1) Includes nonaccruing loans.

*Changes in Assets and Liabilities and Fluctuations in Interest Rates*

The following table summarizes the variance in interest income and interest expense for the three months ended September 30, 2007 and 2006 resulting from changes in assets and liabilities and fluctuations in interest rates earned and paid. The changes in interest attributable to both rate and volume have been allocated to both rate and volume on a pro rata basis.

<u>(Dollars in thousands)</u>	<b>Three months Ended September 30, 2007 v. 2006</b>		
	<b>Increase Or (Decrease)</b>	<b>Due to Change in Average Volume</b>	<b>Rate</b>
<b>Interest earning assets</b>			
Loans	\$ 497	\$ 641	\$ (144)
Short-term investments	29	28	1
Investments	(14)	(29)	15
Federal funds sold	54	54	0
Total interest earning assets	566	694	(128)
<b>Interest bearing liabilities</b>			
Time certificates	221	186	35
Savings deposits	(2)	(5)	3
Money market / checking deposits	102	97	5
Capital lease obligations	-	-	-
Repurchase agreements	(3)	(3)	-
Total interest bearing liabilities	318	275	43
<b>Net interest income</b>	<b>\$ 248</b>	<b>\$ 419</b>	<b>\$ (171)</b>

*Average Balances, Yields and Rates*

The following table presents average balance sheets (daily averages), interest income, interest expense, and the corresponding annualized rates on earning assets and rates paid on interest bearing liabilities for the nine months ended September 30, 2007 and September 30, 2006.

**Distribution of Assets, Liabilities and Shareholders' Equity;  
Interest Rates and Interest differential**

(Dollars in thousands)	Nine Months Ended September 30, 2007			Nine Months Ended September 30, 2006			Fluctuations in interest Income/Expense
	Average Balance	Interest Income/ Expense	Average Rate	Average Balance	Interest Income/ Expense	Average Rate	
<b>Interest earning assets</b>							
Loans (1)	\$ 82,485	\$ 5,575	9.04%	\$ 61,717	\$ 4,187	9.07%	\$ 1,388
Short-term investments	7,221	279	5.17%	5,887	207	4.70%	72
Investments	7,410	196	3.54%	9,407	235	3.34%	(39)
Federal funds sold	18,715	732	5.23%	10,017	369	4.93%	363
<b>Total interest earning assets</b>	<b>115,831</b>	<b>6,782</b>	<b>7.83%</b>	87,028	4,998	7.68%	1,784
<b>Cash and due from banks</b>							
	<b>5,570</b>			1,076			
<b>Premises and equipment, net</b>							
	<b>4,316</b>			4,434			
<b>Allowance for loan losses</b>							
	<b>(1,123)</b>			(840)			
<b>Other</b>							
	<b>1,536</b>			1,367			
<b>Total assets</b>	<b>\$ 126,130</b>			\$ 93,065			
<b>Interest bearing liabilities</b>							
Time certificates	\$ 30,809	1,160	5.03%	\$ 15,098	457	4.05%	703
Savings deposits	1,949	19	1.30%	2,717	28	1.38%	(9)
Money market / checking deposits	44,167	1,217	3.68%	32,463	848	3.49%	369
Capital lease obligations	1,188	132	14.86%	1,189	131	14.73%	1
Repurchase agreements	606	7	1.54%	1,167	13	1.49%	(6)
<b>Total interest bearing liabilities</b>	<b>78,719</b>	<b>2,535</b>	<b>4.31%</b>	52,634	1,477	3.75%	1,058



Non-interest bearing deposits	<b>26,256</b>	19,604	
Accrued expenses and other liabilities	<b>681</b>	528	
Shareholder's equity	<b>20,474</b>	20,299	
Total liabilities and equity	<b>\$ 126,130</b>	\$ 93,065	
Net interest income	<b>\$ 4,247</b>	\$ 3,521	\$ 726
Interest spread	<b>3.52%</b>	3.93%	
Interest margin	<b>4.90%</b>	5.41%	

(1) Includes nonaccruing loans.

*Changes in Assets and Liabilities and Fluctuations in Interest Rates*

The following table summarizes the variance in interest income and interest expense for the nine months ended September 30, 2007 and 2006 resulting from changes in assets and liabilities and fluctuations in interest rates earned and paid. The changes in interest attributable to both rate and volume have been allocated to both rate and volume on a pro rata basis.

<u>(Dollars in thousands)</u>	<b>Nine months Ended September 30, 2007 v. 2006</b>		
	<b>Increase Or (Decrease)</b>	<b>Due to Change in Average Volume</b>	<b>Rate</b>
<b>Interest earning assets</b>			
Loans	\$ 1,388	\$ 1,412	\$ (24)
Short-term investments	72	50	22
Investments	(39)	(60)	21
Federal funds sold	363	339	24
Total interest earning assets	1,784	1,741	43
<b>Interest bearing liabilities</b>			
Time certificates	703	570	133
Savings deposits	(9)	(8)	(1)
Money market / checking deposits	369	320	49
Capital lease obligations	1	-	1
Repurchase agreements	(6)	(7)	1
Total interest bearing liabilities	1,058	875	183
<b>Net interest income</b>	<b>\$ 726</b>	<b>\$ 866</b>	<b>\$ (140)</b>

*Provision for Loan Losses*

For the three months ended September 30, 2007, Bancorp's provision for loan losses was \$319,000 versus \$152,000 for the three months ended September 30, 2006. During the quarter ended September 30, 2007, the Bank determined the need to record a provision for loan losses of \$319,000, of which \$241,000 was related to the charge-off of the Bank's exposure in one commercial credit. The provision was deemed necessary based on management's review of the loan portfolio and this specific loan. The Bancorp recorded \$446,000 as provision for loan losses for the nine months ended September 30, 2007. The provision reflects the action discussed above as well as an increase in the size of the loan portfolio. For the nine months ended September 30, 2006, Bancorp recorded a provision for loan losses of \$257,000.

*Noninterest Income*

The \$31,000 decline in noninterest income for the three months ended September 2007 versus the three months ended September 30, 2006 is due to a decline of \$73,000 on gains on sales of loans offset by a \$37,000 increase in deposit service charges and fees.

Noninterest income was \$747,000 for the nine months ended September 30, 2007 versus \$634,000 for the nine months ended September 30, 2006. The increase was attributable to an overall increase in business, offset in part by the decline in the recorded amount in gains from sales of loans.

*Noninterest Expense*

Total noninterest expense was approximately \$1.6 million for the three months ended September 30, 2007 versus \$1.4 million for the same period in 2006, an increase of approximately \$138,000 or 9.6%.

Total noninterest expense was approximately \$4.7 million for the nine months ended September 30, 2007 versus \$4.1 million for the same period in 2006, an increase of approximately \$564,000 or 13.7%.

A primary factor contributing to the increase in noninterest expense year-over-year for the three and nine months ended September 30, 2007 and 2006 was the opening of two new branches of The Bank of Southern Connecticut. The Bank of Southeastern Connecticut, a division of The Bank of Southern Connecticut located in New London, Connecticut opened on March 6, 2006. The Bank of North Haven, a division of The Bank of Southern Connecticut located in North Haven, Connecticut opened on July 10, 2006, however costs were incurred in the first quarter of 2006 in anticipation of the branch opening. The opening of these two branches has increased the Bank's operating expenses, primarily salaries and benefits expense and occupancy expense. In addition, the Bank's data processing expense, which varies depending on the Bank's total loans and deposits, has increased commensurately with the Bank's increase in size. Bancorp earnings were also negatively affected by the increase in deposit insurance payable to the FDIC, as well as one-time expenses related to employee severance and retirement benefits.

The overall increase in noninterest expense was offset slightly by a large decrease in advertising expense. The reduction in advertising expense was related largely to the decision by the Bank to hire an in-house marketing officer rather than retaining the services of a third party.

Salaries and benefits for the three months ended September 30, 2007 were \$774,000, a decline of \$36,000, or 4.5%, from the same period in 2006. Occupancy and equipment for the third quarter of 2007 decreased by \$4,000 or 2.1%. Professional services increased by \$165,000 or 160.6% for the quarter ended September 30, 2007, the result of higher legal costs, consulting fees and also expenses related to Bancorp's implementation of the Sarbanes Oxley Act. Data processing and other outside services for the three months ended September 30, 2007 increased by \$18,000 or 21.9%. In addition to increased data processing expense related to the growth of Bancorp, data processing expense also increased due to increased on-line services being offered by Bancorp to its customers.

Salaries and benefits for the nine months ended September 30, 2007 were \$2.6 million, an increase of \$363,000, or 16.2%, from the same period in 2006. Occupancy and equipment for the first nine months of 2007 increased by \$78,000 or 14.0%. Professional services increased by \$166,000 or 46.2% for the nine months ended September 30, 2007, the result of higher legal costs, consulting fees and also expenses related to Bancorp's implementation of the Sarbanes Oxley Act. Data processing and other outside services for the first nine months of 2007 increased by \$56,000 or 21.6%. In addition to increased data processing expense related to the growth of Bancorp, data processing expense also increased due to increased on-line services being offered by Bancorp to its customers.

### **Off-Balance Sheet Arrangements**

See Note 9 to the Financial Statements for information regarding Bancorp's off-balance sheet arrangements.

### **Liquidity**

Management believes that Bancorp's short-term assets offer sufficient liquidity to cover potential fluctuations in deposit accounts and loan demand and to meet other anticipated operating cash requirements.

Bancorp's liquidity position as of September 30, 2007 and December 31, 2006 consisted of liquid assets totaling \$36.0 million and \$42.9 million, respectively. This represents 27.6% and 34.5% of total assets at September 30, 2007 and December 31, 2006, respectively. The liquidity ratio is defined as the percentage of liquid assets to total assets. The following categories of assets as described in the accompanying balance sheet are considered liquid assets: cash and due from banks, federal funds sold, short-term investments, and securities available for sale. Liquidity is a measure of Bancorp's ability to generate adequate cash to meet financial obligations. The principal cash requirements of a financial institution are to cover downward fluctuations in deposits and increases in its loan portfolio.

In addition to the foregoing sources of liquidity, the Bank maintains a relationship with the Federal Home Loan Bank of Boston and has the ability to pledge certain of the Bank's assets as collateral for borrowings from that institution. In addition, the Bank maintains relationships with several brokers of certificates of deposits and could utilize the services of these brokers if the Bank needed additional liquidity to meet its needs.

## Capital

The following table illustrates Bancorp's regulatory capital ratios at:

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Tier 1 (Leverage) Capital to Average Assets	<b>15.68%</b>	17.56%
Tier 1 Capital to Risk-Weighted Assets	<b>18.92%</b>	21.80%
Total Capital to Risk-Weighted Assets	<b>19.99%</b>	22.96%

The following table illustrates the Bank's regulatory capital ratios at:

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Tier 1 (Leverage) Capital to Average Assets	<b>13.40%</b>	14.82%
Tier 1 Capital to Risk-Weighted Assets	<b>16.25%</b>	18.52%
Total Capital to Risk-Weighted Assets	<b>17.35%</b>	19.72%

Capital adequacy is one of the most important factors used to determine the safety and soundness of individual banks and the banking system. Based on the above ratios, Bancorp is considered to be "well capitalized" under applicable regulations specified by the Federal Reserve. The Bank also is considered to be "well capitalized" under applicable regulations. To be considered "well capitalized" an institution must generally have a leverage capital ratio of at least 5%, a Tier 1 risk-based capital ratio of at least 6% and a total risk-based capital ratio of at least 10%.

## Market Risk

Market risk is defined as the sensitivity of income to fluctuations in interest rates, foreign exchange rates, equity prices, commodity prices and other market-driven rates or prices. Based upon the nature of Bancorp's business, market risk is primarily limited to interest rate risk, defined as the impact of changing interest rates on current and future earnings.

Bancorp's goal is to maximize long-term profitability, while minimizing its exposure to interest rate fluctuations. The first priority is to structure and price Bancorp's assets and liabilities to maintain an acceptable interest rate spread,

while reducing the net effect of changes in interest rates. In order to reach an acceptable

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interest rate spread, Bancorp must generate loans and seek acceptable investments to replace the lower yielding balances in Federal Funds sold and short-term investments. The focus also must be on maintaining a proper balance between the timing and volume of assets and liabilities re-pricing within the balance sheet. One method of achieving this balance is to originate variable rate loans for the portfolio to offset the short-term re-pricing of the liabilities. In fact, a number of the interest bearing deposit products have no contractual maturity. Customers may withdraw funds from their accounts at any time and deposit balances may therefore run off unexpectedly due to changing market conditions.

The exposure to interest rate risk is monitored by senior management of the Bank and is reported quarterly to the Board of Directors of the Bank and Bancorp. Management reviews the interrelationships within the balance sheet to maximize net interest income within acceptable levels of risk.

### **Impact of Inflation and Changing Prices**

Bancorp's financial statements have been prepared in terms of historical dollars, without considering changes in relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effect of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services. Notwithstanding this fact, inflation can directly affect the value of loan collateral, in particular, real estate. Inflation, or disinflation, could significantly affect Bancorp's earnings in future periods.

### **“Safe Harbor” Statement Under Private Securities Litigation Reform Act of 1995**

Some of the statements under “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” “Business” and elsewhere in this Report on Form 10-QSB may include forward-looking statements which reflect our current views with respect to future events and financial performance. Statements which include the words “expect,” “intend,” “plan,” “believe,” “project,” “anticipate” and similar statements of a future or forward-looking nature identify forward-looking statements for purposes of the federal securities laws or otherwise. All forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause actual results to differ materially from those indicated in these statements or that could adversely affect the holders of our common stock. These factors include, but are not limited to, (1) changes in prevailing interest rates which would affect the interest earned on Bancorp's interest earning assets and the interest paid on its interest bearing liabilities, (2) the timing of re-pricing of Bancorp's interest earning assets and interest bearing liabilities, (3) the effect of changes in governmental monetary policy, (4) the effect of changes in regulations applicable to Bancorp and the conduct of its business, (5) changes in competition among financial service companies, including possible further encroachment of non-banks on services traditionally provided by banks and the impact of recently enacted federal legislation, (6) the ability of competitors which are larger than Bancorp to provide products and services which are impractical for Bancorp to provide, (7) the volatility of quarterly earnings, due in part to the variation in the number, dollar volume and profit realized from SBA guaranteed loan participation sales in different quarters, (8) the effect of a loss of any executive officer, key personnel, or directors, (9) the effect of Bancorp's opening of branches and the receipt of regulatory approval to complete such actions, (10) concentration of Bancorp's business in southern Connecticut, (11) the concentration of Bancorp's loan portfolio in commercial loans to small-to-medium sized businesses, which may be impacted more severely than larger businesses during periods of economic weakness, (12) lack of seasoning in Bancorp's loan portfolio, which may increase the risk of future credit defaults, and (13) the effect of any decision by Bancorp to engage in any business not historically permitted to it. Other such factors may be described in other filings made by Bancorp with the SEC.

Although Bancorp believes that it offers the loan and deposit products and has the resources needed for success, future revenues and interest spreads and yields cannot be reliably predicted. These trends may cause Bancorp to adjust its operations in the future. Because of the foregoing and other factors, recent trends should not be considered reliable indicators of future financial results or stock prices.

Any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise.

### **Item 3. Controls and Procedures**

#### **(a) Evaluation of Disclosure Controls and Procedures.**

Based upon an evaluation of the effectiveness of Bancorp's disclosure controls and procedures performed by Bancorp's management, with participation of Bancorp's Chief Executive Officer, its Chief Operating Officer, and its Chief Accounting Officer as of the end of the period covered by this report, Bancorp's Chief Executive Officer, Chief Operating Officer and Chief Accounting Officer concluded that Bancorp's disclosure controls and procedures have been effective in ensuring that material information relating to Bancorp, including its subsidiary, is made known to the certifying officer by others within Bancorp and the Bank during the period covered by this report.

As used herein, "disclosure controls and procedures" mean controls and other procedures of Bancorp that are designed to ensure that information required to be disclosed by Bancorp in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by Bancorp in the reports that it files or submits under the Securities Exchange Act is accumulated and communicated to Bancorp's management, including its principal executive, and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

#### **(b) Changes in Internal Controls**

There has not been any change in Bancorp's internal control over financial reporting that occurred during Bancorp's quarter ended September 30, 2007 that has materially affected, or is reasonably likely to affect, Bancorp's internal control over financial reporting.

**PART II**  
**Other Information**

**Item 1. Legal Proceedings**

Not applicable.

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

Not applicable.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

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

None

**Item 5. Other Information**

Not applicable.



**Item 6. Exhibits**

(a) Exhibits

No.      Description

3(i)      Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3(i) to Bancorp's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2002, as filed with the Securities and Exchange Commission on August 14, 2002)

3(ii)      By-Laws (incorporated by reference to Exhibit 3(ii) to Bancorp's Registration Statement on Form SB-2, as filed with the Securities and Exchange Commission on April 30, 2001 (No. 333-59824))

31.1      Rule 13a-14(a)/15d-14(a) Certification by President and Chief Executive Officer

31.2      Rule 13a-14(a)/15d-14(a) Certification by Executive Vice President and Chief Operating Officer

31.3      Rule 13a-14(a)/15d-14(a) Certification by Vice President and Chief Accounting Officer

32.1      Section 1350 Certification by President and Chief Executive Officer

32.2      Section 1350 Certification by Executive Vice President and Chief Operating Officer

32.3      Section 1350 Certification by Vice President and Chief Accounting Officer

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**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**SOUTHERN CONNECTICUT BANCORP, INC.**

By: /s/ Michael M. Ciaburri

Name: Michael M. Ciaburri

Date: November 9, 2007

Title: President & Chief Executive Officer

By: /s/ John H. Howland

Name: John H. Howland

Date: November 9, 2007

Title: Executive Vice President & Chief Operating Officer

By: /s/ Anthony M. Avellani

Name: Anthony M. Avellani

Date: November 9, 2007

Title: Vice President & Chief Accounting Officer

**Exhibit Index**

<u>No.</u>	<u>Description</u>
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<u>31.3</u>	<u>Rule 13a-14(a)/15d-14(a) Certification by Vice President and Chief Accounting Officer</u>
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<u>32.2</u>	<u>Section 1350 Certification by Executive Vice President and Chief Operating Officer</u>
<u>32.3</u>	<u>Section 1350 Certification by Vice President and Chief Accounting Officer</u>