

SOUTHERN CONNECTICUT BANCORP INC  
Form 10QSB  
May 14, 2007

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

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**F O R M 10 - Q S B**

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

For the Quarterly Period Ended March 31, 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 [X] No [ ]

The number of shares of the issuer's Common Stock, par value \$.01 per share, outstanding as of  
May 15, 2007: 2,943,735

Transitional Small Business Disclosure Format

Yes \_\_\_ No X \_

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

Yes\_\_\_ No X

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**SOUTHERN CONNECTICUT BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

**March 31, 2007 (unaudited) and December 31, 2006**

|   | 2007                  |           | 2006               |
|---|-----------------------|-----------|--------------------|
| <b>Assets</b>   |                       |           |                    |
| Cash and due from banks   | \$ 7,017,922          | \$        | 5,821,084          |
| Federal funds sold  | 20,000,000            |           | 22,700,000         |
| Short-term investments  | 7,409,117             |           | 6,288,663          |
| <b>Cash and cash equivalents</b>  | <b>34,427,039</b>     |           | <b>34,809,747</b>  |
| Available for sale securities, at fair value  | 7,105,940             |           | 8,054,821          |
| Federal Home Loan Bank Stock  | 66,100                |           | 66,100             |
| Loans receivable (net of allowance for loan losses of \$1,107,118 in 2007 and \$1,062,661 in 2006)                            | 78,090,922            |           | 75,306,255         |
| Loans held for sale   | 171,882               |           | 118,223            |
| Accrued interest receivable   | 535,166               |           | 467,698            |
| Premises and equipment, net   | 4,358,570             |           | 4,424,828          |
| Other assets  | 996,642               |           | 1,014,873          |
| <b>Total assets</b>   | <b>\$ 125,752,261</b> | <b>\$</b> | <b>124,262,545</b> |
| <b>Liabilities and Shareholders' Equity</b>   |                       |           |                    |
| <b>Liabilities</b>  |                       |           |                    |
| Deposits  |                       |           |                    |
| Noninterest bearing deposits  | \$ 26,297,567         | \$        | 29,463,030         |
| Interest bearing deposits   | 76,795,401            |           | 71,810,490         |
| <b>Total deposits</b>   | <b>103,092,968</b>    |           | <b>101,273,520</b> |
| Repurchase agreements   | 403,578               |           | 883,603            |
| Accrued expenses and other liabilities  | 630,430               |           | 585,445            |
| Capital lease obligations   | 1,187,839             |           | 1,188,128          |
| <b>Total liabilities</b>  | <b>105,314,815</b>    |           | <b>103,930,696</b> |
| Commitments and Contingencies (Note 9)  |                       |           |                    |
| <b>Shareholders' Equity</b>   |                       |           |                    |
| Preferred stock, no par value; 500,000 shares authorized;<br>none issued  |                       |           |                    |
| Common stock, par value \$.01; 5,000,000, shares authorized;<br>shares issued and outstanding: 2007 2,942,219; 2006 2,941,297 | 29,422                |           | 29,413             |
| Additional paid-in capital  | 24,170,644            |           | 24,147,883         |

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|  |           |                    |           |             |
|--|-----------|--------------------|-----------|-------------|
| Accumulated deficit                                      |           | <b>(3,563,448)</b> |           | (3,595,370) |
| Accumulated other comprehensive loss –<br>net unrealized |           |                    |           |             |
| loss on available for sale securities                    |           | <b>(199,172)</b>   |           | (250,077)   |
| <b>Total shareholders' equity</b>                        |           | <b>20,437,446</b>  |           | 20,331,849  |
| <br>   |           |                    |           |             |
| <b>Total liabilities and<br/>shareholders' equity</b>    | <b>\$</b> | <b>125,752,261</b> | <b>\$</b> | 124,262,545 |

See Notes to Consolidated Financial Statements.

**SOUTHERN CONNECTICUT BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**For the Three Months Ended March 31, 2007 and 2006 (unaudited)**

|  | <b>Three Months Ended</b> |                  |
|--|---------------------------|------------------|
|  | <b>March</b>              |                  |
|  | <b>2007</b>               | <b>2006</b>      |
| Interest Income  |                           |                  |
| Interest and fees on loans                                     | \$ 1,732,175              | \$ 1,281,113     |
| Interest on securities   | 68,028                    | 78,721           |
| Interest on federal funds sold and<br>short-term investments   | 314,310                   | 143,496          |
| <b>Total interest income</b>                                   | <b>2,114,513</b>          | <b>1,503,330</b> |
| Interest Expense   |                           |                  |
| Interest on deposits   | 743,285                   | 366,430          |
| Interest on capital lease obligations                          | 43,868                    | 43,541           |
| Interest on repurchase agreements                              | 2,234                     | 3,296            |
| <b>Total interest expense</b>                                  | <b>789,387</b>            | <b>413,267</b>   |
| <b>Net interest income</b>                                     | <b>1,325,126</b>          | <b>1,090,063</b> |
| Provision for Loan Losses                                      | 99,793                    | (58,032)         |
| <b>Net interest income after<br/>provision for loan losses</b> | <b>1,225,333</b>          | <b>1,148,095</b> |
| Noninterest Income   |                           |                  |
| Service charges and fees                                       | 138,004                   | 86,359           |
| Gains on sales of loans  | -                         | 30,772           |
| Other noninterest income                                       | 102,840                   | 63,321           |
| <b>Total noninterest income</b>                                | <b>240,844</b>            | <b>180,452</b>   |
| Noninterest Expense  |                           |                  |
| Salaries and benefits  | 905,623                   | 683,782          |
| Occupancy and equipment  | 216,816                   | 166,244          |
| Professional services  | 85,358                    | 101,667          |
| Data processing and other outside services                     | 103,911                   | 81,180           |
| Advertising and promotional expense                            | 1,806                     | 44,425           |
| Forms, printing and supplies                                   | 18,511                    | 32,303           |
| Other operating expenses                                       | 102,230                   | 140,053          |
| <b>Total noninterest expense</b>                               | <b>1,434,255</b>          | <b>1,249,654</b> |
| <b>Net income</b>  | <b>\$ 31,922</b>          | <b>\$ 78,893</b> |
| Basic income per share   | \$ 0.01                   | \$ 0.03          |
| Diluted income per share                                       | \$ 0.01                   | \$ 0.03          |

See Notes to Consolidated Financial  
Statements.



**SOUTHERN CONNECTICUT BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
**For the Three Months Ended March 31, 2007 and 2006 (unaudited)**

|   | Number<br>of Shares | Common<br>Stock  | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Loss | Total                |
|---|---------------------|------------------|----------------------------------|------------------------|---|----------------------|
| Balance December 31,<br>2005                                      | 2,937,525           | \$ 29,375        | \$ 24,083,638                    | \$ (3,477,576)         | \$ (338,594)                                  | \$ 20,296,843        |
| Comprehensive<br>Income:  |                     |                  |                                  |                        |   |                      |
| Net Income  | -                   | -                | -                                | 78,893                 | -   | 78,893               |
| Unrealized holding<br>loss on available<br>for sale<br>securities | -                   | -                | -                                | -                      | (45,232)                                      | (45,232)             |
| Total<br>comprehensive<br>income                                  |                     |                  |                                  |                        |   | 33,661               |
| Balance March 31,<br>2006   | 2,937,525           | \$ 29,375        | \$ 24,083,638                    | \$ (3,398,683)         | \$ (383,826)                                  | \$ 20,330,504        |
| <b>Balance December<br/>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<br>Income:  |                     |                  |                                  |                        |   |                      |
| Net Income  | -                   | -                | -                                | 31,922                 | -   | 31,922               |
| Unrealized holding<br>gain on available<br>for sale<br>securities | -                   | -                | -                                | -                      | 50,905  | 50,905               |
| Total<br>comprehensive<br>income                                  |                     |                  |                                  |                        |   | 82,827               |
| Directors fees settled<br>in common stock                         | 922                 | 9                | 6,602                            | -                      | -   | 6,611                |
| Restricted stock<br>compensation                                  | -                   | -                | 1,870                            | -                      | -   | 1,870                |
| Stock option<br>compensation                                      | -                   | -                | 14,289                           | -                      | -   | 14,289               |
| <b>Balance March 31,<br/>2007</b>                                 | <b>2,942,219</b>    | <b>\$ 29,422</b> | <b>\$ 24,170,644</b>             | <b>\$ (3,563,448)</b>  | <b>\$ (199,172)</b>                           | <b>\$ 20,437,446</b> |

See Notes to Consolidated Financial Statements.



**SOUTHERN CONNECTICUT BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Three Months Ended March 31, 2007 and 2006 (unaudited)**

| <b>Cash Flows From Operations</b>   | <b>2007</b>        | <b>2006</b>        |
|---|--------------------|--------------------|
| Net income  | \$ 31,922          | \$ 78,893          |
| Adjustments to reconcile net income to net cash provided by operating activities: |                    |                    |
| Amortization and accretion of premiums and discounts on investments, net          | (214)              | (729)              |
| Provision for loan losses   | 99,793             | (58,032)           |
| Share based compensation  | 22,770             | -                  |
| Loans originated for sale, net of principal payments received                     | 5,650              | (202,000)          |
| Proceeds from sales of loans  | -                  | 276,375            |
| Gains on sales of loans   | -                  | (30,772)           |
| Depreciation and amortization   | 103,049            | 86,211             |
| Increase in cash surrender value of life insurance                                | (10,200)           | (8,250)            |
| Changes in assets and liabilities:  |                    |                    |
| Increase (decrease) in deferred loan fees   | 34,060             | (8,674)            |
| Increase in accrued interest receivable   | (67,468)           | (77,839)           |
| Decrease (increase) in other assets   | 28,431             | (28,303)           |
| Increase in accrued expenses and other liabilities                                | 44,985             | 166,419            |
| <b>Net cash provided by operating activities</b>                                  | <b>292,778</b>     | <b>193,299</b>     |
| <b>Cash Flows From Investing Activities</b>                                       |                    |                    |
| Principal repayments on available for sale securities                             | -                  | 2,608              |
| Proceeds from maturities of available for sale securities                         | 1,000,000          | -                  |
| Net increase in loans receivable  | (2,977,829)        | (2,190,337)        |
| Purchases of premises and equipment   | (36,791)           | (10,916)           |
| <b>Net cash used in investing activities</b>                                      | <b>(2,014,620)</b> | <b>(2,198,645)</b> |
| <b>Cash Flows From Financing Activities</b>                                       |                    |                    |
| Net decrease in demand, savings and money market deposits                         | (1,235,190)        | (1,781,210)        |
| Net increase in certificates of deposit   | 3,054,638          | 3,342,515          |
| Net decrease in repurchase agreements   | (480,025)          | (844,863)          |
| Principal payments on capital lease obligations                                   | (289)              | (260)              |
| <b>Net cash provided by financing activities</b>                                  | <b>1,339,134</b>   | <b>716,182</b>     |
| <b>Net decrease in cash and cash equivalents</b>                                  | <b>(382,708)</b>   | <b>(1,289,164)</b> |

**Cash and cash equivalents**

|               |    |                   |    |            |
|---------------|----|-------------------|----|------------|
| Beginning     |    | <b>34,809,747</b> |    | 16,569,287 |
| <b>Ending</b> | \$ | <b>34,427,039</b> | \$ | 15,280,123 |

(continued)

**SOUTHERN CONNECTICUT BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**  
**For the Three Months Ended March 31, 2007 and 2006 (unaudited)**

|  | 2007       |    | 2006      |
|--|------------|----|-----------|
| <b>Supplemental Disclosures of Cash Flow Information:</b>                                    |            |    |           |
| Cash paid during the period for:   |            |    |           |
| Interest   | \$ 775,756 | \$ | 394,318   |
| Income taxes   | \$ -       | \$ | -         |
| <b>Supplemental Disclosures of Noncash Investing and Financing Activities:</b>               |            |    |           |
| Transfer of loans held for sale to loans receivable  | \$ -       | \$ | (102,216) |
| Transfer of loans receivable to loans held for sale  | \$ 59,309  | \$ | -         |
| Unrealized holding gains (losses) on available for sale securities arising during the period | \$ 50,905  | \$ | (45,232)  |

See Notes to Consolidated Financial Statements.

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

**Note 1. Nature of Operations**

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 the greater New Haven and greater New London markets, as well as the approximately 62 miles of coastal towns and communities located between these two cities and extending to Rhode Island (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 "brand" names. 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 greater New Haven and greater New London markets. 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 three months ended March 31, 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 March 31, 2007 and December 31, 2006 are as follows:

| <u>March 31, 2007</u>                           | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| U.S. Government Sponsored Agency<br>Obligations | \$ 7,199,685      | \$ -                         | \$ (197,341)                  | \$ 7,002,344  |
| Mortgage Backed Securities                      | 105,427           | -                            | (1,831)                       | 103,596       |
|   | \$ 7,305,112      | \$ -                         | \$ (199,172)                  | \$ 7,105,940  |

| <u>December 31, 2006</u>                        | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| U.S. Government Sponsored Agency<br>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 March 31, 2007, gross unrealized holding losses on available for sale securities totaled \$199,172. 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 March 31, 2007 are other than temporary, as they relate to debt and mortgage-backed securities issued by U.S. Government sponsored agencies resulting from changes in the interest rate environment. Bancorp has the intent and ability to hold these securities to maturity if necessary and expects to receive all contractual principal and interest related to these investments. 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 have existed for a period of twelve months or longer.

#### Note 4. Loans Receivable

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

|   | March 31, 2007       | December 31,<br>2006 |
|---|----------------------|----------------------|
| Commercial loans secured by real estate | \$ 32,436,843        | \$ 32,004,940        |
| Commercial loans                        | 39,588,077           | 39,621,667           |
| Construction and land loans             | 5,744,474            | 3,253,511            |
| Residential mortgage loans              | 147,648              | 149,358              |
| Consumer home equity loans              | 665,638              | 603,394              |
| Consumer installment loans              | 719,400              | 806,026              |
| <b>Total gross loans</b>                | <b>79,302,080</b>    | <b>76,438,896</b>    |
| Net deferred loan fees                  | (104,040)            | (69,980)             |
| Allowance for loan losses               | (1,107,118)          | (1,062,661)          |
| <b>Loans receivable, net</b>            | <b>\$ 78,090,922</b> | <b>\$ 75,306,255</b> |



**Allowance for Loan Losses**

The following represents the activity in the allowance for loan losses for the three months ended March 31, 2007 and 2006:

|   | <b>For the Period Ended March 31,</b> |              |
|---|---------------------------------------|--------------|
|   | <b>2007</b>                           | <b>2006</b>  |
| Balance at beginning of period                      | \$ 1,062,661                          | \$ 778,051   |
| Charge-offs   | (58,739)                              | (2,568)      |
| Recoveries  | 3,403                                 | 59,339       |
| Provision charged to operations                     | 99,793                                | (58,032)     |
| Balance at end of period                            | \$ 1,107,118                          | \$ 776,790   |
| <br>  |                                       |              |
| Net (charge-offs) recoveries to average loans       | <b>(0.07%)</b>                        | <b>0.10%</b> |
| <br>  |                                       |              |
| Allowance for loan losses to gross loans receivable | <b>1.39%</b>                          | 1.31%        |

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

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

|   | <b>March 31, 2007</b> | <b>December 31, 2006</b> |
|---|-----------------------|--------------------------|
| Loans delinquent over 90 days and still accruing          | \$ -                  | \$ -                     |
| Non-accrual loans   | 297,361               | 301,833                  |
| Total nonperforming loans                                 | \$ 297,361            | \$ 301,833               |
| % of Total Loans  | <b>0.38%</b>          | 0.40%                    |
| % of Total Assets   | <b>0.24%</b>          | 0.24%                    |
| Ratio of allowance for loan losses to nonperforming loans | <b>3.72</b>           | 3.52                     |

**Note 5. Deposits**

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

|  | <b>March 31, 2007</b> | <b>December 31, 2006</b> |
|--|-----------------------|--------------------------|
| Noninterest bearing deposits           | \$ 26,297,567         | \$ 29,463,030            |
| Interest bearing deposits              |                       |                          |
| Checking                               | 7,008,152             | 4,985,187                |
| Money Market                           | 36,326,722            | 36,324,952               |
| Savings                                | 2,012,892             | 2,107,354                |
| Total checking, money market & savings | <b>45,347,766</b>     | 43,417,493               |
| <br>                                   |                       |                          |
| Time Certificates under \$100,000      | <b>15,270,140</b>     | 14,190,207               |

|  |                       |                       |
|--|-----------------------|-----------------------|
| Time Certificates of \$100,000 or more | <b>16,177,495</b>     | 14,202,790            |
| Total time deposits                    | <b>31,447,635</b>     | 28,392,997            |
| Total interest bearing deposits        | <b>76,795,401</b>     | 71,810,490            |
| Total deposits                         | <b>\$ 103,092,968</b> | <b>\$ 101,273,520</b> |

**Note 6. Available Borrowings**

The Bank is a member of the Federal Home Loan Bank of Boston (“FHLB”). At March 31, 2007, the Bank had the ability to borrow from the FHLB based on a certain percentage of the value of the Bank’s



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 March 31, 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. Income Per Share

Bancorp is required to present basic income per share and diluted income per share in its statements of income. Basic per share amounts are computed by dividing net income 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 income per share. The following is information about the computation of income per share for the three month periods ended March 31, 2007 and 2006.

#### Income per Share

##### Three Months Ended March 31,

|  | Net<br>Income | 2007<br>Weighted<br>Average<br>Shares | Amount<br>Per Share | Net<br>Income | 2006<br>Weighted<br>Average<br>Shares | Amount<br>Per Share |
|--|---------------|---------------------------------------|---------------------|---------------|---------------------------------------|---------------------|
| <b>Basic Income Per Share</b>                                    |               |                                       |                     |               |                                       |                     |
| Income available to common shareholders                          | \$ 31,922     | 2,942,147                             | \$ 0.01             | \$ 78,893     | 2,937,525                             | \$ 0.03             |
| <b>Effect of Dilutive Securities</b>                             |               |                                       |                     |               |                                       |                     |
| Warrants/Stock Options outstanding                               | -             | 10,389                                | -                   | -             | 2,171                                 | -                   |
| <b>Diluted Income Per Share</b>                                  |               |                                       |                     |               |                                       |                     |
| Income available to common shareholders plus assumed conversions | \$ 31,922     | 2,952,536                             | \$ 0.01             | \$ 78,893     | 2,939,696                             | \$ 0.03             |

#### Note 8. Other Comprehensive Income (Loss)

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

|   | Three Months Ended<br>March 31, 2007 |       |                      |
|---|--------------------------------------|-------|----------------------|
|   | Before-Tax<br>Amount                 | Taxes | Net-of-Tax<br>Amount |
| Unrealized holding gains arising during the period                  | \$ 50,905                            | \$ -  | \$ 50,905            |
| Reclassification adjustment for amounts<br>recognized in net income | -                                    | -     | -                    |
| Unrealized holding gains on available for sale<br>securities        | \$ 50,905                            | \$ -  | \$ 50,905            |

|   | Three Months Ended<br>March 31, 2006 |       |                      |
|---|--------------------------------------|-------|----------------------|
|   | Before-Tax<br>Amount                 | Taxes | Net-of-Tax<br>Amount |
| Unrealized holding losses arising during<br>the period              | \$ (45,232)                          | \$ -  | (\$45,232)           |
| Reclassification adjustment for amounts<br>recognized in net income | -                                    | -     | -                    |
| Unrealized holding losses on available for<br>sale<br>securities    | \$ (45,232)                          | \$ -  | \$ (45,232)          |

There is no tax effect relating to other comprehensive income (loss) 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 March 31, 2007 and December 31, 2006:

|                                     | <b>March 31,<br/>2007</b> | December 31,<br>2006 |
|-------------------------------------|---------------------------|----------------------|
| Commitments to extend credit        |                           |                      |
| Future loan commitments             | \$ 19,249,591             | \$ 7,044,313         |
| Unused lines of credit              | 23,817,530                | 22,537,570           |
| Undisbursed construction loans      | 1,690,138                 | 1,588,933            |
| Financial standby letters of credit | 3,005,588                 | 3,100,188            |
|                                     | \$ 47,762,847             | \$ 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 counter party. 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. As of January 1, 2003, newly issued or modified guarantees that are not derivative contracts have been recorded on Bancorp's consolidated balance sheet at their fair value at inception. The liability related to guarantees recorded at March 31, 2007 and December 31, 2006 was not significant.

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

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 the Company beginning January 1, 2008. Management is evaluating the impact of the adoption of SFAS 159 on the Company'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 the Company'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 months ended March 31, 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 March 31, 2007, Bancorp had \$125.8 million of total assets, \$78.1 million of loans receivable, and \$103.1 million of total deposits. Total equity capital at March 31, 2007 was \$20.4 million, representing a Tier I Leverage Capital Ratio of 17.16%. Net interest margin for the three months ended March 31, 2007 was 4.90%. Bancorp had net income of \$31,922 (or basic and diluted earnings per share of \$0.01) for the three months ended March 31, 2007, compared to a net income of \$78,893 (or basic and diluted earnings per share of \$0.03) for the three months ended March 31, 2006. The provision for loan losses for the three months ended March 31, 2007 was \$99,793 as compared to (\$58,032) for the same period in 2006, a difference of \$157,825. This increase was attributable to growth in the loan portfolio along with the repayment of several substantial loans that had been secured by readily marketable collateral (therefore requiring less reserve). The negative provision for the three months ended March 31, 2006 was due in large part to a recovery recognized by the Bank on a loan that had previously been charged-off.

### **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 principals 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 specific, general, and unallocated components. The specific component relates to loans that are classified as loss, doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component may be maintained to

cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Based upon this evaluation, management believes the allowance for loan losses of \$1,107,118 or 1.39% of gross loans at March 31, 2007 is adequate, under prevailing economic conditions, to absorb losses on existing loans. At December 31, 2006, the allowance for loan losses was \$1,062,661 or 1.39% of gross loans outstanding.

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 the Company'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 March 31, 2007 versus December 31, 2006**

#### *General*

Bancorp's total assets were \$125.8 million at March 31, 2007, an increase of \$1.5 million (1.2%) from \$124.3 million in assets as of December 31, 2006. Average interest earning assets for the three months ended March 31, 2007 were \$109.6 million, an increase of \$17.4 million (18.9%) from \$92.2 million at December 31, 2006.

#### *Investments*

Available for sale securities totaled \$7.1 million as of March 31, 2007, a decrease of \$949,000 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 March 31, 2007, gross unrealized losses on the available for sale securities portfolio totaled \$199,172. 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 both the intent and 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.

#### *Loans*

Net loans receivable increased \$2.8 million (3.7%) from \$75.3 million at December 31, 2006 to \$78.1 million at March 31, 2007. The increase in loans is due primarily to construction and land loans. The increase in the loans receivable portfolio was funded primarily by increased deposits. The ratio of loans receivable to deposits as of March 31, 2007 was 75.7%. Bancorp maintains a target ratio of loans receivable to deposits of 80% to 90%, subject to the review of Bancorp's and the Bank's Boards of Directors. 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 three months ended March 31, 2007 and 2006:

|                                 | <b>For the Period Ended March 31,</b> |             |
|---------------------------------|---------------------------------------|-------------|
|                                 | <b>2007</b>                           | <b>2006</b> |
| Balance at beginning of period  | \$ 1,062,661                          | \$ 778,051  |
| Charge-offs                     | (58,739)                              | (2,568)     |
| Recoveries                      | 3,403                                 | 59,339      |
| Provision charged to operations | 99,793                                | (58,032)    |
| Balance at end of period        | \$ 1,107,118                          | \$ 776,790  |

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

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

|   | <b>March 31, 2007</b> | <b>December 31, 2006</b> |
|---|-----------------------|--------------------------|
| Loans delinquent over 90 days and still accruing          | \$ -                  | \$ -                     |
| Non-accrual loans   | 297,361               | 301,833                  |
| Total nonperforming loans                                 | \$ 297,361            | \$ 301,833               |
| % of Total Loans  | 0.38%                 | 0.40%                    |
| % of Total Assets   | 0.24%                 | 0.24%                    |
| Ratio of allowance for loan losses to nonperforming loans | 3.72                  | 3.52                     |

##### *Potential Problem Loans*

At March 31, 2007, the Bank had no other loans, other than those disclosed in the table above, as to which management has significant doubts as to the ability of the borrower to comply with the present repayment terms.





### *Deposits*

Deposits were \$103.1 million at March 31, 2007, an increase of \$1.8 million (1.8%) from \$101.3 million as of December 31, 2006. Non-interest bearing checking accounts were \$26.3 million at March 31, 2007, a decrease of \$3.2 million (10.8%) from \$29.5 million. Time deposits were \$31.4 million at March 31, 2007, an increase of \$3.1 million or 10.7% from December 31, 2006. Savings accounts decreased approximately \$94,000 from year-end 2006. Interest bearing checking accounts and money market demand accounts increased \$2.0 million or 4.9% from March 31, 2007 to December 31, 2006.

While the Bank's total deposit portfolio increased in the first quarter, the first quarter is traditionally a difficult time for the Bank to increase deposits. The typical commercial customer will pay down loans at the beginning of the calendar year and various tax payments generally tend to reduce deposit levels of commercial customers.

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 was in the best interest of the Bank and the Company.

### *Other*

Repurchase agreement balances decreased \$480,025 from \$883,603 at December 31, 2006 to \$403,578 as of March 31, 2007, due to normal customer activity.

## **Results of Operations - Comparison of Results for the Three Months Ended March 31, 2007 and March 31, 2006**

### *General*

Bancorp had net income of \$31,922 for the three months ended March 31, 2007 versus net income of \$78,893 for the three months ended March 31, 2006. The decrease was attributable to increased Noninterest expense as well as increased provisions to the allowance for Loan Losses in 2007 over the same period in 2006.

### *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 March 31, 2007, net interest income was \$1.3 million versus \$1.1 million for the three months ended March 31, 2006, an increase of \$200,000 or 18.2%. This increase was attributable to an increase of \$28.7 million in average earning assets. The increase in average earning assets was primarily comprised of increases in average loans of \$19.4 million and an increase in average federal funds sold of \$10.9 million, offset partially by a decrease in average investments of \$2.1 million.

The yield on average earning assets for the three months ending March 31, 2007 was 7.82% versus 7.53% for the same period in 2006, a favorable increase of 29 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 4.33% for the three months ended March 31, 2007 versus 3.50% for the three months ended March 31, 2006, an increase of 83 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

deposit accounts. The average rate of interest paid on time deposits increased 134 basis points for the three months ended March 31, 2007 versus the three months ended March 31, 2006. Also, the Bank's average cost of funds for money market and interest bearing checking increased 48 basis for the three months ended March 31, 2007 versus the three months ended March 31, 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 approximately 70% of the Bank's portfolio is comprised of checking, savings and money market accounts.

As a result of the yield curve and interest rates generally, Bancorp's net interest margin and net interest spread have decreased for the three months ended March 31, 2007 versus the same period in 2006. For the three months ended March 31, 2007, Bancorp's net interest margin was 4.90%, a decrease of 56 basis points versus 5.46% for the three months ended March 31, 2006. At the same time, Bancorp's interest spread decreased 54 basis points from 4.03% to 3.49%.

*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 March 31, 2007 and March 31, 2006.

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

| (Dollars in thousands)                    | Three months Ended<br>March 31, 2007 |                                |                 | Three months Ended<br>March 31, 2006 |                                |                 | Fluctuations<br>in interest<br>Income/Expense |
|---|--------------------------------------|--------------------------------|-----------------|--------------------------------------|--------------------------------|-----------------|---|
|   | Average<br>Balance                   | Interest<br>Income/<br>Expense | Average<br>Rate | Average<br>Balance                   | Interest<br>Income/<br>Expense | Average<br>Rate |   |
| <b>Interest earning assets</b>            |                                      |                                |                 |                                      |                                |                 |   |
| Loans (1)                                 | \$ 77,058                            | \$ 1,732                       | 9.12%           | \$ 57,625                            | \$ 1,281                       | 9.02%           | \$ 451  |
| Short-term investments                    | 6,588                                | 84                             | 5.17%           | 6,062                                | 65                             | 4.35%           | 19  |
| Investments                               | 7,881                                | 68                             | 3.50%           | 10,028                               | 79                             | 3.19%           | (11)  |
| Federal funds sold                        | 18,106                               | 230                            | 5.15%           | 7,227                                | 78                             | 4.38%           | 152   |
| <b>Total interest earning assets</b>      | <b>109,633</b>                       | <b>2,114</b>                   | <b>7.82%</b>    | <b>80,942</b>                        | <b>1,503</b>                   | <b>7.53%</b>    | <b>611</b>                                    |
| Cash and due from banks                   | 5,709                                |                                |                 | 1,319                                |                                |                 |   |
| Premises and equipment, net               | 4,395                                |                                |                 | 4,434                                |                                |                 |   |
| Allowance for loan losses                 | (1,087)                              |                                |                 | (780)                                |                                |                 |   |
| Other                                     | 1,504                                |                                |                 | 1,243                                |                                |                 |   |
| <b>Total assets</b>                       | <b>\$ 120,154</b>                    |                                |                 | <b>\$ 87,158</b>                     |                                |                 |   |
| <b>Interest bearing liabilities</b>       |                                      |                                |                 |                                      |                                |                 |   |
| Time certificates                         | \$ 29,843                            | 369                            | 5.01%           | \$ 13,385                            | 121                            | 3.67%           | 248   |
| Savings deposits                          | 2,026                                | 7                              | 1.40%           | 2,794                                | 10                             | 1.45%           | (3)   |
| Money market /<br>checking deposits       | 40,186                               | 367                            | 3.70%           | 29,561                               | 235                            | 3.22%           | 132   |
| Capital lease<br>obligations              | 1,188                                | 44                             | 15.02%          | 1,189                                | 44                             | 15.01%          | -   |
| Repurchase<br>agreements                  | 604                                  | 2                              | 1.34%           | 891                                  | 3                              | 1.37%           | (1)   |
| <b>Total interest bearing liabilities</b> | <b>73,847</b>                        | <b>789</b>                     | <b>4.33%</b>    | <b>47,820</b>                        | <b>413</b>                     | <b>3.50%</b>    | <b>376</b>                                    |
| Non-interest bearing deposits             | 25,254                               |                                |                 | 18,498                               |                                |                 |   |
| Accrued expenses and<br>other liabilities | 631                                  |                                |                 | 460                                  |                                |                 |   |
| Shareholder's equity                      | 20,422                               |                                |                 | 20,380                               |                                |                 |   |
| <b>Total liabilities and equity</b>       | <b>\$ 120,154</b>                    |                                |                 | <b>\$ 87,158</b>                     |                                |                 |   |
| Net interest income                       |                                      | \$ 1,325                       |                 |                                      | \$ 1,090                       |                 | \$ 235  |
| Interest spread                           |                                      |                                | 3.49%           |                                      |                                | 4.03%           |   |

|                 |              |       |
|-----------------|--------------|-------|
| Interest margin | <b>4.90%</b> | 5.46% |
|-----------------|--------------|-------|

(1) Includes nonaccruing loans.

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

The following tables summarize the variance in interest income and interest expense for the three months ended March 31, 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<br/>March 31, 2007 v. 2006</b> |                                     |             |             |
|-------------------------------------|--|-------------------------------------|-------------|-------------|
|                                     | <b>Increase<br/>Or<br/>(Decrease)</b>                | <b>Due to Change in<br/>Average</b> |             |             |
|                                     |  | <b>Volume</b>                       | <b>Rate</b> |             |
| <b>Interest earning assets</b>      |  |                                     |             |             |
| Loans                               | \$ 451   | \$ 437                              | \$          | 14          |
| Short-term investments              | 19   | 6                                   |             | 13          |
| Investments                         | (11)   | (50)                                |             | 39          |
| Federal funds sold                  | 152  | 136                                 |             | 16          |
| Total interest earning assets       | 611  | 529                                 |             | 82          |
| <b>Interest bearing liabilities</b> |  |                                     |             |             |
| Time certificates                   | 248  | 191                                 |             | 57          |
| Savings deposits                    | (3)  | (3)                                 |             | 0           |
| Money market / checking deposits    | 132  | 93                                  |             | 39          |
| Capital lease obligations           | -  | -                                   |             | -           |
| Repurchase agreements               | (1)  | (1)                                 |             | 0           |
| Total interest bearing liabilities  | 376  | 280                                 |             | 96          |
| <b>Net interest income</b>          | <b>\$ 235</b>  | <b>\$ 249</b>                       | <b>\$</b>   | <b>(14)</b> |

*Provision for Loan Losses*

Bancorp recorded \$99,793 as provision for loan losses for the three months ended March 31, 2007. The provision reflects an increase in the size of the loan portfolio as well as the payoff of several large loans that had been secured by readily marketable collateral (principally deposit accounts held by the Bank). These loans that were paid off were replaced by conventional loans, therefore requiring an increased amount of provision for loan losses (as compared to a lower reserve requirement for a loan secured by readily marketable collateral). For the three months ended March 31, 2006, Bancorp recorded a credit to the loan loss provision of \$58,000 which was charged to operations. This credit amount reflected the recovery of a loan that had previously been charged off, which resulted in a credit balance of the provision for loan losses for the quarter.

*Noninterest Income*

Noninterest income was \$240,844 for the three months ended March 31, 2007 versus \$180,452 for the three months ended March 31, 2006. The increase was attributable to an overall increase in business, along with substantial pre-payment penalties the Bank received for prepaid loans. The Bank did not record any gains on sales of loans during the three months ended March 31, 2007 versus approximately \$31,000 of such income recorded for the three months ended March 31, 2006, as no loans were sold in the first quarter of 2007.

### *Noninterest Expense*

Total noninterest expense was approximately \$1.4 million for the three months ended March 31, 2007 versus \$1.2 million for the same period in 2006, an increase of approximately \$200,000 or 16.7%.

A primary factor contributing to the increase in non-interest expense year-over-year 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 assets, has increased commensurately with the Bank's increase in assets. The overall increase in noninterest expense was offset slightly by a decrease in professional services expense and 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 first quarter of 2007 were \$905,623, an increase of \$221,841, or 32.4%, from the first quarter of 2006. Occupancy and equipment for the first quarter of 2007 increased by \$50,572 or 30.4%. Professional fees for the first quarter of 2007 decreased by \$16,309 or 16.0%. Data processing and other outside services for the first quarter of 2007 increased by \$22,731 or 28.0%. Advertising and promotional expense for the first quarter of 2007 decreased \$42,619 or 95.9%.

### **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 March 31, 2007 and December 31, 2006 consisted of liquid assets totaling \$41.5 million and \$42.9 million, respectively. This represents 33.0% and 34.5% of total assets at March 31, 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>March 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---|---------------------------|------------------------------|
| Tier 1 (Leverage) Capital to Average Assets | <b>17.16%</b>             | 17.56%                       |
| Tier 1 Capital to Risk-Weighted Assets      | <b>21.05%</b>             | 21.80%                       |
| Total Capital to Risk-Weighted Assets       | <b>22.18%</b>             | 22.96%                       |

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

|   | <b>March 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---|---------------------------|------------------------------|
| Tier 1 (Leverage) Capital to Average Assets | <b>14.54%</b>             | 14.82%                       |
| Tier 1 Capital to Risk-Weighted Assets      | <b>17.89%</b>             | 18.52%                       |
| Total Capital to Risk-Weighted Assets       | <b>19.06%</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 interest rate spread, Bancorp must generate loans and seek acceptable long-term 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 Asset and Liability Management Committee and 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 Financial Officer as of the end of the period covered by this report, Bancorp's Chief Executive Officer, Chief Operating Officer and Chief Financial 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 have not been any significant changes in Bancorp's internal controls or in other factors that occurred during Bancorp's quarter ended March 31, 2007 that could significantly affect these controls subsequent to the evaluation referenced in paragraph (a) above.

**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**

Not applicable.

**Item 5. Other Information**

Not applicable.

**Item 6. Exhibits**

(a) Exhibits

| <u>No.</u>  | <u>Description</u>  |
|-------------|---|
| 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))   |
| <u>31.1</u> | <u>Rule 13a-14(a)/15d-14(a) Certification by Chairman and Chief Executive Officer</u>   |
| <u>31.2</u> | <u>Rule 13a-14(a)/15d-14(a) Certification by President and Chief Operating Officer</u>  |
| <u>31.3</u> | <u>Rule 13a-14(a)/15d-14(a) Certification by Vice President and Chief Accounting Officer</u>  |
| <u>32.1</u> | <u>Section 1350 Certification by Chairman and Chief Executive Officer</u>   |
| <u>32.2</u> | <u>Section 1350 Certification by President and Chief Operating Officer</u>  |
| <u>32.3</u> | <u>Section 1350 Certification by Vice President and Chief Accounting Officer</u>  |



**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.**

Date: May 15, 2007

By: /s/ Joseph V. Ciaburri  
Name: Joseph V. Ciaburri  
Title: Chairman & Chief Executive Officer

Date: May 15, 2007

By: /s/ Michael M. Ciaburri  
Name: Michael M. Ciaburri  
Title: President & Chief Operating Officer

Date: May 15, 2007

By: /s/ Anthony M. Avellani  
Name: Anthony M. Avellani  
Title: Vice President & Chief Accounting Officer

**Exhibit Index**

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