

SHORE BANCSHARES INC  
Form 10-K  
March 15, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

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

For the Year Ended December 31, 2011

Commission File No. 0-22345

**SHORE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

|   |   |
|---|---|
| Maryland  | 52-1974638                              |
| (State or Other Jurisdiction of<br>Incorporation or Organization) | (I.R.S. Employer<br>Identification No.) |

|   |
|---|
| 18 East Dover Street, Easton, Maryland 21601        |
| (Address of Principal Executive Offices) (Zip Code) |

(410) 763-7800

Registrant's Telephone Number, Including Area Code

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

| <u>Title of Each Class:</u>             | <u>Name of Each Exchange on Which Registered:</u> |
|---|---|
| Common stock, par value \$.01 per share | Nasdaq Global Select Market                       |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
£

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 16(d) of the Act. £

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes R No £

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (check one):

Large accelerated filer £ Accelerated filer R Non-accelerated filer £ Smaller Reporting Company £

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes £ No R

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State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$56,100,996.

The number of shares outstanding of the registrant's common stock as of the latest practicable date: 8,457,359 as of February 29, 2012.

**Documents Incorporated by Reference**

Certain information required by Part III of this annual report is incorporated therein by reference to the definitive proxy statement for the 2012 Annual Meeting of Stockholders.

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This Annual Report on Form 10-K of Shore Bancshares, Inc. (the “Company” and “we”, “our” or “us” on a consolidated basis) contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Such statements include projections, predictions, expectations or statements as to beliefs or future events or results or refer to other matters that are not historical facts. Forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause the actual results to differ materially from those contemplated by the statements. The forward-looking statements contained in this annual report are based on various factors and were derived using numerous assumptions. In some cases, you can identify these forward-looking statements by words like “may”, “will”, “should”, “expect”, “plan”, “anticipate”, “intend”, “believe”, “estimate”, “predict”, “potential”, or “continue” or those words and other comparable words. You should be aware that those statements reflect only our predictions. If known or unknown risks or uncertainties should materialize, or if underlying assumptions should prove inaccurate, actual results could differ materially from past results and those anticipated, estimated or projected. You should bear this in mind when reading this annual report and not place undue reliance on these forward-looking statements. Factors that might cause such differences include, but are not limited to:

- the risk that the weak national and local economies and depressed real estate and credit markets caused by the recent global recession will continue to decrease the demand for loan, deposit and other financial services and/or increase loan delinquencies and defaults;

- changes in market rates and prices may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet;

- our liquidity requirements could be adversely affected by changes in our assets and liabilities;

- the effect of legislative or regulatory developments, including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;

- competitive factors among financial services organizations, including product and pricing pressures and our ability to attract, develop and retain qualified banking professionals;

- the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission (the “SEC”), the Public Company Accounting Oversight Board and other regulatory agencies; and

- the effect of fiscal and governmental policies of the United States federal government.

You should also consider carefully the Risk Factors contained in Item 1A of Part I of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. The risks discussed in this annual report are factors that, individually or in the aggregate, management believes could cause our actual

results to differ materially from expected and historical results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider such disclosures to be a complete discussion of all potential risks or uncertainties.

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

## **PART I**

### **Item 1. Business.**

#### **BUSINESS**

##### **General**

The Company was incorporated under the laws of Maryland on March 15, 1996 and is a financial holding company registered under the Bank Holding Company Act of 1956, as amended (the “BHC Act”). The Company is the largest independent financial holding company located on the Eastern Shore of Maryland. The Company’s primary business is acting as the parent company to several financial institution and insurance entities. The Company engages in the banking business through CNB, a Maryland commercial bank with trust powers, The Talbot Bank of Easton, Maryland, a Maryland commercial bank (“Talbot Bank”), and, until January 1, 2011, The Felton Bank, a Delaware commercial bank (“Felton Bank”). On January 1, 2011, Felton Bank merged into CNB, with CNB as the surviving bank. Until December 31, 2009, CNB did business as The Centreville National Bank of Maryland, a national banking association. It was converted to a Maryland charter on that date. As used in this annual report, the term “Banks” refers to CNB, Talbot Bank and Felton Bank for periods prior to January 1, 2011 and to CNB and Talbot Bank for all other periods.

The Company engages in the insurance business through two general insurance producer firms, The Avon-Dixon Agency, LLC, a Maryland limited liability company, and Elliott Wilson Insurance, LLC, a Maryland limited liability company; one marine insurance producer firm, Jack Martin & Associates, Inc., a Maryland corporation; three wholesale insurance firms, Tri-State General Insurance Agency, LTD, a Maryland corporation, Tri-State General Insurance Agency of New Jersey, Inc., a New Jersey corporation, and Tri-State General Insurance Agency of Virginia, Inc., a Virginia corporation (collectively “TSGIA”); and two insurance premium finance companies, Mubell Finance, LLC, a Maryland limited liability company, and ESFS, Inc., a Maryland corporation (all of the foregoing are collectively referred to as the “Insurance Subsidiaries”).

The Company engages in the mortgage brokerage business under the name “Wye Mortgage Group” through a minority series investment in an unrelated Delaware limited liability company. The Company also has three inactive subsidiaries, Wye Financial Services, LLC, Shore Pension Services, LLC, and Wye Mortgage, LLC, all of which were organized under Maryland law.

Talbot Bank owns all of the issued and outstanding securities of Dover Street Realty, Inc., a Maryland corporation that engages in the business of holding and managing real property acquired by Talbot Bank as a result of loan foreclosures.

We operate in two business segments: community banking and insurance products and services. Financial information related to our operations in these segments for each of the two years ended December 31, 2011 is provided in Note 26 to the Company’s Consolidated Financial Statements included in Item 8 of Part II of this annual report.

### **Banking Products and Services**

CNB is a Maryland commercial bank with trust powers that commenced operations in 1876. CNB was originally chartered as a national banking association but converted to its present charter in 2009. Effective January 1, 2010, the National Bank converted into a Maryland commercial bank. Talbot Bank is a Maryland commercial bank that commenced operations in 1885 and was acquired by the Company in its December 2000 merger with Talbot Bancshares, Inc. Felton Bank was a Delaware commercial bank that commenced operations in 1908 and was acquired by the Company in April 2004 when it merged with Midstate Bancorp, Inc. The Banks operate 18 full service branches and 21 ATMs and provide a full range of commercial and consumer banking products and services to individuals, businesses, and other organizations in Kent County, Queen Anne’s County, Caroline County, Talbot County and Dorchester County in Maryland and in Kent County, Delaware. The Banks’ deposits are insured by the Federal Deposit Insurance Corporation (the “FDIC”).

The Banks are independent community banks and serve businesses and individuals in their respective market areas. Services offered are essentially the same as those offered by larger regional institutions that compete with the Banks. Services provided to businesses include commercial checking, savings, certificates of deposit and overnight investment sweep accounts. The Banks offer all forms of commercial lending, including secured and unsecured loans, working capital loans, lines of credit, term loans, accounts receivable financing, real estate acquisition development, construction loans and letters of credit. Merchant credit card clearing services are available as well as direct deposit of payroll, internet banking and telephone banking services.

Services to individuals include checking accounts, various savings programs, mortgage loans, home improvement loans, installment and other personal loans, credit cards, personal lines of credit, automobile and other consumer financing, safe deposit boxes, debit cards, 24-hour telephone banking, internet banking, and 24-hour automatic teller machine services. The Banks also offer nondeposit products, such as mutual funds and annuities, and discount brokerage services to their customers. Additionally, the Banks have Saturday hours and extended hours on certain evenings during the week for added customer convenience.

#### *Lending Activities*

The Banks originate secured and unsecured loans for business purposes. Commercial loans are typically secured by real estate, accounts receivable, inventory, equipment and/or other assets of the business. Commercial loans generally involve a greater degree of credit risk than one to four family residential mortgage loans. Repayment is often dependent on the successful operation of the business and may be affected by adverse conditions in the local economy or real estate market. The financial condition and cash flow of commercial borrowers is therefore carefully analyzed during the loan approval process, and continues to be monitored by obtaining business financial statements, personal financial statements and income tax returns. The frequency of this ongoing analysis depends upon the size and complexity of the credit and collateral that secures the loan. It is also the Company's general policy to obtain personal guarantees from the principals of the commercial loan borrowers.



Commercial real estate loans are primarily those secured by land for residential and commercial development, agricultural purpose properties, service industry buildings such as restaurants and motels, retail buildings and general purpose business space. The Banks attempt to mitigate the risks associated with these loans through thorough financial analyses, conservative underwriting procedures, including prudent loan to value ratio standards, obtaining additional collateral when prudent, closely monitoring construction projects to control disbursement of funds on loans, and management's knowledge of the local economy in which the Banks lend.

The Banks provide residential real estate construction loans to builders and individuals for single family dwellings. Residential construction loans are usually granted based upon "as completed" appraisals and are secured by the property under construction. Additional collateral may be taken if loan to value ratios exceed 80%. Site inspections are performed to determine pre-specified stages of completion before loan proceeds are disbursed. These loans typically have maturities of six to 12 months and may have fixed or variable rate features. Permanent financing options for individuals include fixed and variable rate loans with three- and five-year balloon features and one-, three- and five-year adjustable rate mortgage loans. The risk of loss associated with real estate construction lending is controlled through conservative underwriting procedures such as loan to value ratios of 80% or less at origination, obtaining additional collateral when prudent, and closely monitoring construction projects to control disbursement of funds on loans.

The Banks originate fixed and variable rate residential mortgage loans. As with any consumer loan, repayment is dependent on the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy. Underwriting standards recommend loan to value ratios not to exceed 80% at origination based on appraisals performed by approved appraisers. The Banks rely on title insurance to protect their lien priorities and protect the property securing the loans by requiring fire and casualty insurance.

Wye Mortgage Group brokers long-term fixed rate residential mortgage loans for sale on the secondary market for which it receives commissions upon settlement. The Company adjusts the balance of its investment in Wye Mortgage Group by the Company's share of Wye Mortgage Group's undistributed income or loss.

A variety of consumer loans are offered to customers, including home equity loans, credit cards and other secured and unsecured lines of credit and term loans. Careful analysis of an applicant's creditworthiness is performed before granting credit, and ongoing monitoring of loans outstanding is performed in an effort to minimize risk of loss by identifying problem loans early.

#### *Deposit Activities*

The Banks offer a full array of deposit products including checking, savings and money market accounts, regular and IRA certificates of deposit, and Christmas Savings accounts. The Banks also offer the CDARS program, providing up to \$50 million of FDIC insurance to our customers. In addition, we offer our commercial customers packages which include Cash Management services and various checking opportunities.

### *Trust Services*

CNB has a trust department through which it markets trust, asset management and financial planning services to customers within our market areas using the trade name Wye Financial & Trust.

### **Insurance Activities**

The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC, and Mubell Finance, LLC were formed as a result of the Company's acquisition of the assets of The Avon-Dixon Agency, Inc., Elliott Wilson Insurance, Inc., Avon-Dixon Financial Services, Inc., Joseph M. George & Son, Inc. and 59th Street Finance Company on May 1, 2002. In November 2002, The Avon-Dixon Agency, LLC acquired certain assets of W. M. Freestate & Son, Inc., a full-service insurance producer firm located in Centreville, Maryland. Jack Martin & Associates, Inc., Tri-State General Insurance Agency, LTD, Tri-State General Insurance Agency of New Jersey, Inc., Tri-State General Insurance Agency of Virginia, Inc., and ESFS, Inc. were acquired on October 1, 2007.

The Insurance Subsidiaries offer a full range of insurance products and services to customers, including insurance premium financing.

### **Seasonality**

Management does not believe that our business activities are seasonal in nature.

## Employees

At February 29, 2012, we employed 340 persons, of which 307 were employed on a full-time basis.

## COMPETITION

The banking business, in all of its phases, is highly competitive. Within our market areas, we compete with commercial banks (including local banks and branches or affiliates of other larger banks), savings and loan associations and credit unions for loans and deposits, with money market and mutual funds and other investment alternatives for deposits, with consumer finance companies for loans, with insurance companies, agents and brokers for insurance products, and with other financial institutions for various types of products and services. There is also competition for commercial and retail banking business from banks and financial institutions located outside our market areas.

The primary factors in competing for deposits are interest rates, personalized services, the quality and range of financial services, convenience of office locations and office hours. The primary factors in competing for loans are interest rates, loan origination fees, the quality and range of lending services and personalized services. The primary factors in competing for insurance customers are competitive rates, the quality and range of insurance products offered, and quality, personalized service.

To compete with other financial services providers, we rely principally upon local promotional activities, including advertisements in local newspapers, trade journals and other publications and on the radio, personal relationships established by officers, directors and employees with customers, and specialized services tailored to meet its customers' needs. In those instances in which we are unable to accommodate the needs of a customer, we will arrange for those services to be provided by other financial services providers with which we have a relationship. We additionally rely on referrals from satisfied customers.

The following tables set forth deposit data for FDIC-insured institutions in Kent County, Queen Anne's County, Caroline County, Talbot County and Dorchester County in Maryland and in Kent County, Delaware as of June 30, 2011, the most recent date for which comparative information is available.

|                       |          | % of  |
|-----------------------|----------|-------|
|                       | Deposits | Total |
| Kent County, Maryland |          |       |

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|                                       | (in<br>thousands) |         |
|---------------------------------------|-------------------|---------|
| Peoples Bank of Kent County, Maryland | \$ 180,738        | 35.87 % |
| PNC Bank, NA                          | 133,143           | 26.43   |
| Chesapeake Bank and Trust Co.         | 69,220            | 13.74   |
| Branch Banking & Trust                | 48,094            | 9.55    |
| CNB                                   | 44,604            | 8.85    |
| SunTrust Bank                         | 28,011            | 5.56    |
| Total                                 | \$ 503,810        | 100.00% |

*Source: FDIC DataBook*

| Queen Anne's County, Maryland   | Deposits<br>(in<br>thousands) | % of<br>Total |
|---------------------------------|-------------------------------|---------------|
| The Queenstown Bank of Maryland | \$ 361,014                    | 43.13 %       |
| CNB                             | 206,815                       | 24.71         |
| Bank of America, NA             | 61,519                        | 7.35          |
| PNC Bank, NA                    | 58,582                        | 7.00          |
| Bank Annapolis                  | 45,486                        | 5.43          |
| M&T                             | 44,087                        | 5.27          |
| Branch Banking & Trust          | 21,748                        | 2.60          |
| Peoples Bank                    | 16,255                        | 1.94          |
| Capital One Bank                | 12,491                        | 1.49          |
| Sun Trust Bank                  | 8,972                         | 1.07          |
| Total                           | \$ 836,969                    | 100.00%       |

Source: FDIC DataBook

| Caroline County, Maryland       | Deposits<br>(in<br>thousands) | % of<br>Total |
|---------------------------------|-------------------------------|---------------|
| Provident State Bank, Inc       | \$ 146,821                    | 37.72 %       |
| PNC Bank, NA                    | 95,970                        | 24.65         |
| CNB                             | 59,601                        | 15.31         |
| Branch Banking & Trust          | 29,670                        | 7.62          |
| M&T                             | 25,019                        | 6.43          |
| Bank of America, NA             | 15,603                        | 4.01          |
| Easton Bank & Trust             | 12,620                        | 3.24          |
| The Queenstown Bank of Maryland | 3,978                         | 1.02          |
| Total                           | \$ 389,282                    | 100.00%       |

Source: FDIC DataBook

| Talbot County, Maryland             | Deposits<br>(in<br>thousands) | % of<br>Total |
|-------------------------------------|-------------------------------|---------------|
| The Talbot Bank of Easton, Maryland | \$578,351                     | 48.77 %       |
| PNC Bank, NA                        | 130,197                       | 10.98         |
| Easton Bank & Trust                 | 125,879                       | 10.61         |
| Bank of America, NA                 | 123,444                       | 10.41         |

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|                                 |             |         |
|---------------------------------|-------------|---------|
| Branch Banking & Trust          | 47,322      | 3.99    |
| The Queenstown Bank of Maryland | 45,723      | 3.86    |
| SunTrust Bank                   | 42,391      | 3.57    |
| M&T                             | 32,291      | 2.72    |
| Provident State Bank, Inc       | 22,053      | 1.86    |
| First Mariner Bank              | 19,368      | 1.63    |
| Capital One Bank                | 18,919      | 1.60    |
| Total                           | \$1,185,938 | 100.00% |

*Source: FDIC DataBook*

| Dorchester County, Maryland         | Deposits<br>(in<br>thousands) | % of<br>Total |
|-------------------------------------|-------------------------------|---------------|
| The National Bank of Cambridge      | \$ 182,865                    | 30.81 %       |
| Bank of the Eastern Shore           | 167,382                       | 28.20         |
| Hebron Savings Bank                 | 66,732                        | 11.24         |
| Provident State Bank, Inc           | 47,831                        | 8.06          |
| Branch Banking & Trust              | 41,139                        | 6.93          |
| SunTrust Bank                       | 24,773                        | 4.17          |
| Bank of America, NA                 | 24,185                        | 4.07          |
| M&T                                 | 21,309                        | 3.59          |
| The Talbot Bank of Easton, Maryland | 17,384                        | 2.93          |
| Total                               | \$ 593,600                    | 100.00%       |

Source: FDIC DataBook

| Kent County, Delaware           | Deposits<br>(in<br>thousands) | % of<br>Total |
|---------------------------------|-------------------------------|---------------|
| M&T                             | \$ 530,295                    | 30.74 %       |
| PNC Bank Delaware               | 253,045                       | 14.67         |
| First NB of Wyoming             | 223,219                       | 12.94         |
| RBS Citizens NA                 | 180,620                       | 10.47         |
| Wells Fargo                     | 164,793                       | 9.55          |
| Wilmington Savings Fund Society | 129,075                       | 7.48          |
| CNB                             | 68,734                        | 3.98          |
| Artisans Bank                   | 53,934                        | 3.13          |
| TD Bank NA                      | 52,335                        | 3.03          |
| County Bank                     | 38,365                        | 2.22          |
| Midcoast Community Bank         | 25,130                        | 1.46          |
| Fort Sill National Bank         | 5,289                         | 0.31          |
| Total                           | \$ 1,724,834                  | 100.00%       |

Source: FDIC DataBook

For further information about competition in our market areas, see the Risk Factor entitled “We operate in a highly competitive market and our inability to effectively compete in our markets could have an adverse impact on our financial condition and results of operations” in Item 1A of Part I of this annual report.

## **SUPERVISION AND REGULATION**

The following is a summary of the material regulations and policies applicable to us and is not intended to be a comprehensive discussion. Changes in applicable laws and regulations may have a material effect on our business, financial condition and results of operations.

### General

The Company is a financial holding company registered with the Board of Governors of the Federal Reserve System (the "FRB") under the BHC Act and, as such, is subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the FRB.

CNB and Talbot Bank are Maryland commercial banks subject to the banking laws of Maryland and to regulation by the Commissioner of Financial Regulation of Maryland, who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Commissioner determines that an examination is unnecessary in a particular calendar year). The primary federal regulator of CNB is the FRB. The primary federal regulator of Talbot Bank is the FDIC, which is also entitled to conduct regular examinations. The deposits of the Banks are insured by the FDIC, so certain laws and regulations administered by the FDIC also govern their deposit taking operations. In addition to the foregoing, the Banks are subject to numerous state and federal statutes and regulations that affect the business of banking generally.



Nonbank affiliates of the Company are subject to examination by the FRB, and, as affiliates of the Banks, may be subject to examination by the Banks' regulators from time to time. In addition, the Insurance Subsidiaries are each subject to licensing and regulation by the insurance authorities of the states in which they do business. Retail sales of insurance products by the Insurance Subsidiaries to customers of the Banks are also subject to the requirements of the Interagency Statement on Retail Sales of Nondeposit Investment Products promulgated in 1994, as amended, by the FDIC, the FRB and the other federal banking agencies. Wye Mortgage Group is subject to supervision by the banking agencies of the states in which it does business.

### Regulation of Financial Holding Companies

In November 1999, the federal Gramm-Leach-Bliley Act (the "GLB Act") was signed into law. Effective in pertinent part on March 11, 2000, the GLB Act revised the BHC Act and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls an FDIC insured financial institution. Under the GLB Act, a bank holding company can elect, subject to certain qualifications, to become a "financial holding company". The GLB Act provides that a financial holding company may engage in a full range of financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities, with new expedited notice procedures.

Under FRB policy, the Company is expected to act as a source of strength to its subsidiary banks, and the FRB may charge the Company with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default. Accordingly, in the event that any insured subsidiary of the Company causes a loss to the FDIC, other insured subsidiaries of the Company could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guaranty liabilities generally are superior in priority to obligations of a financial institution to its stockholders and obligations to other affiliates.

### Federal Regulation of Banks

Federal and state banking regulators may prohibit the institutions over which they have supervisory authority from engaging in activities or investments that the agencies believe are unsafe or unsound banking practices. These banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to be unsafe or unsound practices. Enforcement actions may include the appointment of a conservator or receiver, the issuance of a cease and desist order, the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers,

employees and institution-affiliated parties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court actions.

The Banks are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act. Section 23A limits the amount of loans or extensions of credit to, and investments in, the Company and its nonbank affiliates by the Banks. Section 23B requires that transactions between any of the Banks and the Company and its nonbank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates.

The Banks are also subject to certain restrictions on extensions of credit to executive officers, directors, and principal stockholders or any related interest of such persons, which generally require that such credit extensions be made on substantially the same terms as are available to third parties dealing with the Banks and not involve more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels.

As part of the Federal Deposit Insurance Company Improvement Act of 1991 (“FDICIA”), each federal banking regulator adopted non-capital safety and soundness standards for institutions under its authority. These standards include internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation, fees and benefits. An institution that fails to meet those standards may be required by the agency to develop a plan acceptable to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. The Company, on behalf of the Banks, believes that the Banks meet substantially all standards that have been adopted. FDICIA also imposes capital standards on insured depository institutions.

The Community Reinvestment Act (“CRA”) requires that, in connection with the examination of financial institutions within their jurisdictions, the federal banking regulators evaluate the record of the financial institution in meeting the credit needs of their communities including low and moderate income neighborhoods, consistent with the safe and sound operation of those banks. These factors are also considered by all regulatory agencies in evaluating mergers, acquisitions and applications to open a branch or facility. As of the date of its most recent examination report, each of the Banks has a CRA rating of “Satisfactory.”

On October 14, 2008, the FDIC announced the creation of the Temporary Liquidity Guarantee Program (the “TLGP”) to decrease the cost of bank funding and, hopefully, normalize lending. This program is comprised of two components. The first component guarantees senior unsecured debt issued between October 14, 2008 and June 30, 2009. The guarantee will remain in effect until June 30, 2012 for such debts that mature beyond June 30, 2009. The second component, called the Transaction Accounts Guarantee Program (“TAG”), provided full coverage for non-interest bearing transaction deposit accounts, IOLTAs, and NOW accounts with interest rates of 0.25% or less, regardless of account balance, initially until December 31, 2009. The TAG program expired on December 31, 2010. We elected to participate in both programs and paid additional FDIC premiums in 2010 and 2009 as a result. See the section below entitled “Deposit Insurance”.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which made sweeping changes to the financial regulatory landscape and will impact all financial institutions, including the Company and the Banks.

On November 9, 2010, the FDIC issued a final rule to implement Section 343 of the Dodd-Frank Act that provides temporary unlimited deposit insurance coverage for non-interest bearing transaction accounts at all FDIC-insured depository institutions. The coverage is automatic for all FDIC-insured institutions and does not include an opt out option. The separate coverage for noninterest-bearing transaction accounts became effective on December 31, 2010 and terminates on December 31, 2012.

These new laws, regulations and regulatory actions will cause our regulatory expenses to increase. Additionally, due in part to numerous bank failures throughout the country since 2008, the FDIC imposed an emergency insurance assessment to help restore the Deposit Insurance Fund and further required insured depository institutions to prepay their estimated quarterly risk-based deposit assessments through 2012 on December 30, 2009. Given the current state of the national economy, there can be no assurance that the FDIC will not impose future emergency assessments or further revise its rate structure.

The Dodd-Frank Act’s significant regulatory changes include the creation of a new financial consumer protection agency, known as the Bureau of Consumer Financial Protection (the “Consumer Protection Bureau”), that is empowered to promulgate new consumer protection regulations and revise existing regulations in many areas of consumer compliance. Moreover, the Dodd-Frank Act permits states to adopt stricter consumer protection laws and states’ attorneys general may enforce consumer protection rules issued by the Bureau. The Dodd-Frank Act also imposes more stringent capital requirements on bank holding companies by, among other things, imposing leverage ratios on bank holding companies and prohibiting new trust preferred securities issuances from counting as Tier 1 capital. These developments may limit our future capital strategies. The Dodd-Frank Act also increases regulation of derivatives and hedging transactions, which could limit our ability to enter into, or increase the costs associated with, interest rate and other hedging transactions.

The other provisions of the Dodd-Frank Act will increase our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers. In particular, the Dodd-Frank Act will require us to invest significant management attention and resources so that we can evaluate the impact of this law and make any necessary changes to our product offerings and operations.

## Capital Requirements

FDICIA established a system of prompt corrective action to resolve the problems of undercapitalized institutions. Under this system, federal banking regulators are required to rate supervised institutions on the basis of five capital categories: “well-capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized;” and to take certain mandatory actions, and are authorized to take other discretionary actions, with respect to institutions in the three undercapitalized categories. The severity of the actions will depend upon the category in which the institution is placed. A depository institution is “well capitalized” if it has a total risk based capital ratio of 10% or greater, a Tier 1 risk based capital ratio of 6% or greater, and a leverage ratio of 5% or greater and is not subject to any order, regulatory agreement, or written directive to meet and maintain a specific capital level for any capital measure. An “adequately capitalized” institution is defined as one that has a total risk based capital ratio of 8% or greater, a Tier 1 risk based capital ratio of 4% or greater and a leverage ratio of 4% or greater (or 3% or greater in the case of a bank with a composite CAMELS rating of 1).

FDICIA generally prohibits a depository institution from making any capital distribution, including the payment of cash dividends, or paying a management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. For a capital restoration plan to be acceptable, the depository institution’s parent holding company must guarantee (subject to certain limitations) that the institution will comply with such capital restoration plan.

Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized and requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized depository institutions are subject to the appointment of a receiver or conservator, generally within 90 days of the date such institution is determined to be critically undercapitalized.

As of December 31, 2011, the Banks were each deemed to be “well capitalized.” For more information regarding the capital condition of the Company, see Note 18 to the Consolidated Financial Statements appearing in Item 8 of Part II of this annual report.

### **Deposit Insurance**

The deposits of the Banks are insured to a maximum of \$250,000 per depositor through the Deposit Insurance Fund, which is administered by the FDIC, and the Banks are required to pay quarterly deposit insurance premium assessments to the FDIC. The Deposit Insurance Fund was created pursuant to the Federal Deposit Insurance Reform Act of 2005 (the “Reform Act”). This law (i) required the then-existing \$100,000 deposit insurance coverage to be indexed for inflation (with adjustments every five years, commencing January 1, 2011), and (ii) increased the deposit insurance coverage for retirement accounts to \$250,000 per participant, subject to adjustment for inflation. Effective October 3, 2008, however, the Emergency Economic Stabilization Act of 2008 (the “EESA”) was enacted and, among other things, temporarily raised the basic limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor. EESA initially contemplated that the coverage limit would return to \$100,000 after December 31, 2009, but the expiration date has since been extended to December 31, 2013. The coverage for retirement accounts did not change and remains at \$250,000. On July 21, 2010, as part of the Dodd-Frank Act, the current standard maximum deposit insurance amount was permanently raised to \$250,000.

The Reform Act also gave the FDIC greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments. On May 22, 2009, the FDIC imposed an emergency insurance assessment of five basis points in an effort to restore the Deposit Insurance Fund to an acceptable level. On November 12, 2009, the FDIC adopted a final rule requiring insured depository institutions to prepay their estimated quarterly risk-based deposit assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, on December 30, 2009, along with each institution’s risk based deposit insurance assessment for the third quarter of 2009. It was also announced that the assessment rate will increase by 3 basis points effective January 1, 2011. The prepayment will be accounted for as a prepaid expense to be amortized quarterly. The prepaid assessment will qualify for a zero risk weight under the risk-based capital requirements. The Banks’ three-year prepaid assessment was \$5.4 million. The Banks expensed a total of \$1.3 million in FDIC premiums during 2011.

USA PATRIOT Act

Congress adopted the USA PATRIOT Act (the “Patriot Act”) on October 26, 2001 in response to the terrorist attacks that occurred on September 11, 2001. Under the Patriot Act, certain financial institutions, including banks, are required to maintain and prepare additional records and reports that are designed to assist the government’s efforts to combat terrorism. The Patriot Act includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

#### Federal Securities Laws

The shares of the Company’s common stock are registered with the SEC under Section 12(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and listed on the NASDAQ Global Select Market. The Company is subject to information reporting requirements, proxy solicitation requirements, insider trading restrictions and other requirements of the Exchange Act, including the requirements imposed under the federal Sarbanes-Oxley Act of 2002. Among other things, loans to and other transactions with insiders are subject to restrictions and heightened disclosure, directors and certain committees of the Board must satisfy certain independence requirements, and the Corporation is generally required to comply with certain corporate governance requirements.

#### Governmental Monetary and Credit Policies and Economic Controls

The earnings and growth of the banking industry and ultimately of the Company are affected by the monetary and credit policies of governmental authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Government securities, changes in the federal funds rate, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the FRB authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the FRB, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or their effect on the business and earnings of the Company and its subsidiaries.

## AVAILABLE INFORMATION

The Company maintains an Internet site at [www.shbi.com](http://www.shbi.com) on which it makes available, free of charge, its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC. In addition, stockholders may access these reports and documents on the SEC's web site at [www.sec.gov](http://www.sec.gov).

### Item 1A. RISK FACTORS.

The significant risks and uncertainties related to us, our business and the Company's securities of which we are aware are discussed below. You should carefully consider these risks and uncertainties before making investment decisions in respect of the Company's securities. Any of these factors could materially and adversely affect our business, financial condition, operating results and prospects and could negatively impact the market price of the Company's securities. If any of these risks materialize, you could lose all or part of your investment in the Company. Additional risks and uncertainties that we do not yet know of, or that we currently think are immaterial, may also impair our business operations. You should also consider the other information contained in this annual report, including our financial statements and the related notes, before making investment decisions.

#### Risks Relating to Our Business

##### **The Company may not be successful if it is not able to grow its subsidiaries and their businesses.**

The Company's primary business activity for the foreseeable future will be to act as the holding company of CNB, Talbot Bank, and its other subsidiaries. Therefore, the Company's future profitability will depend on the success and growth of these subsidiaries. In the future, part of the Company's growth may come from buying other banks and buying or establishing other companies. Such entities may not be profitable after they are purchased or established, and they may lose money, particularly at first. A new bank or company may bring with it unexpected liabilities, bad loans, or bad employee relations, or the new bank or company may lose customers.

**A majority of our business is concentrated in Maryland and Delaware, a significant amount of which is concentrated in real estate lending, so a decline in the local economy and real estate markets could adversely impact our financial condition and results of operations**

Because most of our loans are made to customers who reside on the Eastern Shore of Maryland and in Delaware, a decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose loan portfolios are geographically diverse. Further, we make many real estate secured loans, including construction and land development loans, all of which are in greater demand when interest rates are low and economic conditions are good. Accordingly, a decline in local economic conditions would likely have an adverse impact on our financial condition and results of operations, and the impact on us would likely be greater than the impact felt by larger financial institutions whose loan portfolios are geographically diverse. We cannot guarantee that any risk management practices that we implement to address our geographic and loan concentrations will be effective to prevent losses relating to our loan portfolio.

The national and local economies have significantly weakened during the past three years in large part due to the widely-reported problems in the sub-prime mortgage loan market and the meltdown of the financial industry as a whole. As a result, real estate values across the country, including in our market areas, have decreased and the general availability of credit, especially credit to be secured by real estate, has also decreased. These conditions have made it more difficult for real estate owners and owners of loans secured by real estate to sell their assets at the times and at the prices they desire. Not only has this impacted the demand for credit to finance the acquisition and development of real estate, but it has also impaired the ability of banks, including the Banks, to sell real estate acquired through foreclosure. In the case of real estate acquisition, construction and development projects that we have financed, these challenging economic conditions have caused some of our borrowers to default on their loans. Because of the deterioration in the market values of real estate collateral caused by the recession, banks, including the Banks, have been unable to recover the full amount due under their loans when forced to foreclose on and sell real estate collateral. As a result, the Banks have realized significant impairments and losses in their loan portfolios, which have materially and adversely impacted our financial condition and results of operations. These conditions and their consequences are likely to continue until the nation fully recovers from the recent economic recession. Management cannot predict the extent to which these conditions will cause future impairments or losses, nor can it provide any assurances as to when, or if, economic conditions will improve.



**Our concentrations of commercial real estate loans could subject us to increased regulatory scrutiny and directives, which could force us to preserve or raise capital and/or limit our future commercial lending activities.**

The FRB and the FDIC, along with the other federal banking regulators, issued guidance in December 2006 entitled “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” directed at institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. This guidance suggests that these institutions face a heightened risk of financial difficulties in the event of adverse changes in the economy and commercial real estate markets. Accordingly, the guidance suggests that institutions whose concentrations exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk. The guidance provides that banking regulators may require such institutions to reduce their concentrations and/or maintain higher capital ratios than institutions with lower concentrations in commercial real estate. Based on our concentration of commercial real estate and construction lending as of December 31, 2011, we may be subject to heightened supervisory scrutiny during future examinations and/or be required to take steps to address our concentration and capital levels. Management cannot predict the extent to which this guidance will impact our operations or capital requirements. Further, we cannot guarantee that any risk management practices we implement will be effective to prevent losses relating from concentrations in our commercial real estate portfolio.

**Interest rates and other economic conditions will impact our results of operations**

Our results of operations may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our profitability is in part a function of the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (*i.e.*, net interest income), including advances from the Federal Home Loan Bank (the “FHLB”) of Atlanta. Interest rate risk arises from mismatches (*i.e.*, the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities. If more assets reprice or mature than liabilities during a falling interest rate environment, then our earnings could be negatively impacted. Conversely, if more liabilities reprice or mature than assets during a rising interest rate environment, then our earnings could be negatively impacted. Fluctuations in interest rates are not predictable or controllable. There can be no assurance that our attempts to structure our asset and liability management strategies to mitigate the impact on net interest income of changes in market interest rates will be successful in the event of such changes.

**The Banks may experience credit losses in excess of their allowances, which would adversely impact our financial condition and results of operations**

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. Management of each of the Banks bases the allowance for credit losses

upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, management makes various assumptions and judgments about the ultimate collectability of the loan portfolio and provides an allowance for credit losses based upon a percentage of the outstanding balances and for specific loans when their ultimate collectability is considered questionable. If management's assumptions and judgments prove to be incorrect and the allowance for credit losses is inadequate to absorb future losses, or if the bank regulatory authorities, as a part of their examination process, require our bank subsidiaries to increase their respective allowance for credit losses, our earnings and capital could be significantly and adversely affected. Moreover, future adjustments may be necessary if economic conditions differ substantially from the assumptions used or adverse developments arise with respect to the Banks' nonperforming or performing loans. Material additions to the allowance for credit losses of one of the Banks would result in a decrease in that Bank's net income and capital and could have a material adverse effect on our financial condition.

### **The market value of our investments might decline**

As of December 31, 2011, we had classified 95% of our investment securities as available-for-sale pursuant to the Accounting Standards Codification ("ASC") Topic 320 ("ASC 320") of the Financial Accounting Standards Board ("FASB") relating to accounting for investments. ASC 320 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be "marked to market" and reflected as a separate item in stockholders' equity (net of tax) as accumulated other comprehensive income. The remaining investment securities are classified as held-to-maturity in accordance with ASC 320 and are stated at amortized cost.

In the past, gains on sales of investment securities have not been a significant source of income for us. There can be no assurance that future market performance of our investment portfolio will enable us to realize income from sales of securities. Stockholders' equity will continue to reflect the unrealized gains and losses (net of tax) of these investments. There can be no assurance that the market value of our investment portfolio will not decline, causing a corresponding decline in stockholders' equity.

CNB and Talbot Bank are members of the FHLB of Atlanta. Prior to its merger with CNB, Felton Bank was a member of the FHLB of Pittsburgh. A member of the FHLB system is required to purchase stock issued by the relevant FHLB bank based on how much it borrows from the FHLB and the quality of the collateral pledged to secure that borrowing. Accordingly, our investments include stock issued by the FHLB of Atlanta and the FHLB of Pittsburgh. These investments could be subject to future impairment charges and there can be no guaranty of future dividends.

Management believes that several factors will affect the market values of our investment portfolio. These include, but are not limited to, changes in interest rates or expectations of changes, the degree of volatility in the securities markets, inflation rates or expectations of inflation and the slope of the interest rate yield curve (the yield curve refers to the differences between shorter-term and longer-term interest rates; a positively sloped yield curve means shorter-term rates are lower than longer-term rates). Also, the passage of time will affect the market values of our investment securities, in that the closer they are to maturing, the closer the market price should be to par value. These and other factors may impact specific categories of the portfolio differently, and management cannot predict the effect these factors may have on any specific category.

**The banking industry is heavily regulated; significant regulatory changes could adversely affect our operations**

Our operations are and will be affected by current and future legislation and by the policies established from time to time by various federal and state regulatory authorities. The Company is subject to supervision by the FRB; and CNB and Talbot Bank are subject to supervision and periodic examination by the Maryland Commissioner and the FDIC. Banking regulations, designed primarily for the safety of depositors, may limit a financial institution's growth and the return to its investors by restricting such activities as the payment of dividends, mergers with or acquisitions by other institutions, investments, loans and interest rates, interest rates paid on deposits, expansion of branch offices, and the offering of securities or trust services. The Company and the Banks are also subject to capitalization guidelines established by federal law and could be subject to enforcement actions to the extent that those institutions are found by regulatory examiners to be undercapitalized. It is not possible to predict what changes, if any, will be made to existing federal and state legislation and regulations or the effect that such changes may have on our future business and earnings prospects. Management also cannot predict the nature or the extent of the effect on our business and earnings of future fiscal or monetary policies, economic controls, or new federal or state legislation. Further, the cost of compliance with regulatory requirements may adversely affect our ability to operate profitably.

**We operate in a highly competitive market, and our inability to effectively compete in our markets could have an adverse impact on our financial condition and results of operations**

We operate in a competitive environment, competing for loans, deposits, insurance products and customers with commercial banks, savings associations and other financial entities. Competition for deposits comes primarily from other commercial banks, savings associations, credit unions, money market and mutual funds and other investment

alternatives. Competition for loans comes primarily from other commercial banks, savings associations, mortgage banking firms, credit unions and other financial intermediaries. Competition for other products, such as insurance and securities products, comes from other banks, securities and brokerage companies, insurance companies, insurance agents and brokers, and other nonbank financial service providers in our market areas. Many of these competitors are much larger in terms of total assets and capitalization, have greater access to capital markets, and/or offer a broader range of financial services than those offered by us. In addition, banks with a larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the needs of larger customers. Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel.

In addition, current banking laws facilitate interstate branching, merger activity among banks, and expanded activities. Since September 1995, certain bank holding companies have been authorized to acquire banks throughout the United States. Since June 1, 1997, certain banks have been permitted to merge with banks organized under the laws of different states. As a result, interstate banking is now an accepted element of competition in the banking industry and the Corporation may be brought into competition with institutions with which it does not presently compete. Moreover, as discussed above, the GLB Act revised the BHC Act in 2000 and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls an FDIC insured financial institution. These laws may increase the competition we face in our market areas in the future, although management cannot predict the degree to which such competition will impact our financial condition or results of operations.

**Our regulatory expenses will likely increase due to federal laws, rules and programs that have been enacted or adopted in response to the recent banking crisis and the current national recession**

In response to the banking crisis that began in 2008 and the resulting national recession, the federal government took drastic steps to help stabilize the credit market and the financial industry. These steps included the enactment of EESA, which, among other things, raised the basic limit on federal deposit insurance coverage to \$250,000, and the FDIC's adoption of the TLGP, which, under the TAG portion, provides full deposit insurance coverage through December 31, 2012 for non-interest bearing transaction deposit accounts, IOLTAs, and NOW accounts with certain interest rates, regardless of account balance. The TLGP requires participating institutions, like us, to pay 10 basis points per annum for the additional insured deposits. These actions will cause our regulatory expenses to increase. Additionally, due in part to the failure of depository institutions around the country since the banking crisis began, the FDIC imposed an emergency insurance assessment to help restore the Deposit Insurance Fund and further required insured depository institutions to prepay their estimated quarterly risk-based deposit assessments through 2012 on December 30, 2009. Given the current state of the national economy, there can be no assurance that the FDIC will not impose future emergency assessments or further revise its rate structure.

In addition, and as noted above, the Dodd-Frank Act recently became law and implements significant changes in the financial regulatory landscape that will impact all financial institutions, including the Company and the Banks. The Dodd-Frank Act is likely to increase our regulatory compliance burden. It is too early, however, for us to assess the full impact that the Dodd-Frank Act may have on our business, financial condition or results of operations. Many of the Dodd-Frank Act's provisions require subsequent regulatory rulemaking. The Dodd-Frank Act's significant regulatory changes include the creation of the Consumer Protection Bureau that is empowered to promulgate new consumer protection regulations and revise existing regulations in many areas of consumer compliance, which will increase our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers. Moreover, the Dodd-Frank Act permits states to adopt stricter consumer protection laws and states' attorneys general may enforce consumer protection rules issued by the Bureau. The Dodd-Frank Act also imposes more stringent capital requirements on bank holding companies by, among other things, imposing leverage ratios on bank holding companies and prohibiting new trust preferred issuances from counting as Tier 1 capital. These restrictions may limit our future capital strategies. The Dodd-Frank Act also increases regulation of derivatives and hedging transactions, which could limit our ability to enter into, or increase the costs associated with, interest rate and other hedging transactions. The changes resulting from the legislation will impact our business, and they will also require us to invest significant management attention and resources to evaluate and make necessary changes.

**Customer concern about deposit insurance may cause a decrease in deposits held at the Banks**

With increased concerns about bank failures over the past three years, customers increasingly are concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits from the Banks in an effort to ensure that the amount they have on deposit with us is fully insured. Decreases in deposits may adversely affect our funding costs and net income.

**Our funding sources may prove insufficient to replace deposits and support our future growth**

We rely on customer deposits, advances from the FHLB, and lines of credit at other financial institutions to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, no assurance can be given that we would be able to replace such funds in the future if our financial condition or the financial condition of the FHLB or market conditions were to change. Our financial flexibility will be severely constrained and/or our cost of funds will increase if we are unable to maintain our access to funding or if financing necessary to accommodate future growth is not available at favorable interest rates. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our profitability would be adversely affected.

**The loss of key personnel could disrupt our operations and result in reduced earnings**

Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel. Our current executive officers provide valuable services based on their many years of experience and in-depth knowledge of the banking industry. Due to the intense competition for financial professionals, these key personnel would be difficult to replace and an unexpected loss of their services could result in a disruption to the continuity of operations and a possible reduction in earnings.

### **Our lending activities subject us to the risk of environmental liabilities**

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations of enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

### **We may be subject to other claims**

We may from time to time be subject to claims from customers for losses due to alleged breaches of fiduciary duties, errors and omissions of employees, officers and agents, incomplete documentation, the failure to comply with applicable laws and regulations, or many other reasons. Also, our employees may knowingly or unknowingly violate laws and regulations. Management may not be aware of any violations until after their occurrence. This lack of knowledge may not insulate the Company or our subsidiaries from liability. Claims and legal actions may result in legal expenses and liabilities that may reduce our profitability and hurt our financial condition.

### **We may be adversely affected by other recent legislation**

As discussed above, the GLB Act repealed restrictions on banks affiliating with securities firms and it also permitted bank holding companies that become financial holding companies to engage in additional financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities that are currently not permitted for bank holding companies. Although the Company is a financial holding company, this law may increase the competition we face from larger banks and other companies. It is not possible to predict the full effect that this law will have on us.

The Sarbanes-Oxley Act of 2002 requires management of publicly traded companies to perform an annual assessment of their internal controls over financial reporting and to report on whether the system is effective as of the end of the Company's fiscal year. Disclosure of significant deficiencies or material weaknesses in internal controls could cause an unfavorable impact to shareholder value by affecting the market value of our stock.

The Patriot Act requires certain financial institutions, such as the Banks, to maintain and prepare additional records and reports that are designed to assist the government's efforts to combat terrorism. This law includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. If we fail to comply with this law, we could be exposed to adverse publicity as well as fines and penalties assessed by regulatory agencies.

**We may not be able to keep pace with developments in technology in which case we may become less competitive and lose customers**

We use various technologies in our business, including telecommunication, data processing, computers, automation, internet-based banking, and debit cards. Technology changes rapidly. Our ability to compete successfully with other banks and non-bank entities may depend on whether we can exploit technological changes. We may not be able to exploit technological changes, and any investment we do make may not make us more profitable.

**Risks Relating to the Company's Securities**

**The shares of the Company's common stock are not insured**

The shares of the Company's common stock are not deposits and are not insured against loss by the FDIC or any other governmental or private agency.

**The Company's ability to pay dividends is limited by applicable banking and corporate law**

The Company's stockholders are entitled to dividends on their shares of common stock if, when, and as declared by the Company's Board of Directors out of funds legally available for that purpose. The Company's current ability to pay dividends to stockholders is largely dependent upon its earnings in future periods and upon the receipt of dividends from the Banks. FRB guidance requires a bank holding company, like the Company, to consult with the FRB before paying dividends if the Company's earnings do not exceed the aggregate amount of the proposed dividend. The FRB has the ability to prohibit a dividend in such a situation. Both federal and state laws impose restrictions on the ability of the Banks to pay dividends. Federal law prohibits the payment of a dividend by an insured depository institution if the depository institution is considered "undercapitalized" or if the payment of the dividend would make the institution "undercapitalized". Maryland banking law provides that a state-chartered bank may pay dividends out of undivided profits or, with the prior approval of the Maryland Commissioner, from surplus in excess of 100% of required capital



stock. If, however, the surplus of a Maryland bank is less than 100% of its required capital stock, then cash dividends may not be paid in excess of 90% of net earnings. In addition to these specific restrictions, bank regulatory agencies also have the ability to prohibit proposed dividends by a financial institution that would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice. Because of these limitations, there can be no guarantee that the Company's Board will declare dividends in any fiscal quarter.

### **The shares of the Company's common stock is not heavily traded**

Shares of the Company's common stock are listed on the NASDAQ Global Select Market, but shares are not heavily traded. Securities that are not heavily traded can be more volatile than stock trading in an active public market. Factors such as our financial results, the introduction of new products and services by us or our competitors, and various factors affecting the banking industry generally may have a significant impact on the market price of the shares of the common stock. Management cannot predict the extent to which an active public market for the shares of the common stock will develop or be sustained in the future. Accordingly, holders of shares of the common stock may not be able to sell them at the volumes, prices, or times that they desire.

### **The Company's Articles of Incorporation and By-Laws and Maryland law may discourage a corporate takeover**

The Company's Amended and Restated Articles of Incorporation, as supplemented (the "Charter"), and Amended and Restated By-Laws, as amended (the "By-Laws"), contain certain provisions designed to enhance the ability of the Board of Directors to deal with attempts to acquire control of the Company. The Charter and By-Laws provide for the classification of the Board into three classes; directors of each class generally serve for staggered three-year periods. No director may be removed except for cause and then only by a vote of at least two-thirds of the total eligible stockholder votes. The Charter gives the Board certain powers in respect of the Company's securities. First, the Board has the authority to classify and reclassify unissued shares of stock of any class or series of stock by setting, fixing, eliminating, or altering in any one or more respects the preferences, rights, voting powers, restrictions and qualifications of, dividends on, and redemption, conversion, exchange, and other rights of, such securities. Second, a majority of the Board, without action by the stockholders, may amend the Charter to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class that the Company has authority to issue. The Board could use these powers, along with its authority to authorize the issuance of securities of any class or series, to issue securities having terms favorable to management to persons affiliated with or otherwise friendly to management.

Maryland law also contains anti-takeover provisions that apply to the Company. The Maryland Business Combination Act generally prohibits, subject to certain limited exceptions, corporations from being involved in any "business combination" (defined as a variety of transactions, including a merger, consolidation, share exchange, asset transfer or issuance or reclassification of equity securities) with any "interested shareholder" for a period of five years following the most recent date on which the interested shareholder became an interested shareholder. An interested shareholder is defined generally as a person who is the beneficial owner of 10% or more of the voting power of the outstanding voting stock of the corporation after the date on which the corporation had 100 or more beneficial owners of its stock or who is an affiliate or associate of the corporation and was the beneficial owner, directly or indirectly, of 10% percent or more of the voting power of the then outstanding stock of the corporation at any time within the two-year period immediately prior to the date in question and after the date on which the corporation had 100 or more beneficial owners of its stock. The Maryland Control Share Acquisition Act applies to acquisitions of "control shares", which, subject to certain exceptions, are shares the acquisition of which entitle the holder, directly or indirectly, to exercise or direct the exercise of the voting power of shares of stock of the corporation in the election of directors

within any of the following ranges of voting power: one-tenth or more, but less than one-third of all voting power; one-third or more, but less than a majority of all voting power or a majority or more of all voting power. Control shares have limited voting rights. The By-Laws exempt the Company's capital securities from the Maryland Control Share Acquisition Act, but the Board has the authority to eliminate the exemption without stockholder approval.

Although these provisions do not preclude a takeover, they may have the effect of discouraging, delaying or deferring a tender offer or takeover attempt that a shareholder might consider in his or her best interest, including those attempts that might result in a premium over the market price for the common stock. Such provisions will also render the removal of the Board of Directors and of management more difficult and, therefore, may serve to perpetuate current management. These provisions could potentially adversely affect the market price of the Company's common stock.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

Our offices are listed in the tables below. The Company's main office is the same as Talbot Bank's main office. The Company owns real property at 28969 Information Lane in Easton, Maryland, which houses the Operations, Information Technology and Finance departments of the Company and its subsidiaries, and certain operations of The Avon-Dixon Agency, LLC.

The Talbot Bank of Easton, Maryland

Branches

|                              |                             |                           |
|------------------------------|-----------------------------|---------------------------|
| Main Office                  | Elliott Road Branch         | Tred Avon Square Branch   |
| 18 East Dover Street         | 8275 Elliott Road           | 212 Marlboro Road         |
| Easton, Maryland 21601       | Easton, Maryland 21601      | Easton, Maryland 21601    |
| St. Michaels Branch          | Sunburst Branch             | Tilghman Branch           |
| 1013 South Talbot Street     | 424 Dorchester Avenue       | 5804 Tilghman Island Road |
| St. Michaels, Maryland 21663 | Cambridge, Maryland 21613   | Tilghman, Maryland 21671  |
|                              | Trappe Branch               |                           |
|                              | 29349 Maple Avenue, Suite 1 |                           |
|                              | Trappe, Maryland 21673      |                           |
|                              | ATMs                        |                           |

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|                             |                             |
|-----------------------------|-----------------------------|
| Memorial Hospital at Easton | Talbottown                  |
| 219 South Washington Street | 218 North Washington Street |
| Easton, Maryland 21601      | Easton, Maryland 21601      |

**CNB**

**Branches**

|                                  |   |                                     |
|----------------------------------|---|-------------------------------------|
| Main Office                      | Route 213 South Branch  | Chester Branch                      |
| 109 North Commerce Street        | 2609 Centreville Road   | 300 Castle Marina Road              |
| Centreville, Maryland 21617      | Centreville, Maryland 21617   | Chester, Maryland 21619             |
| Denton Branch                    | Grasonville Branch  | Stevensville Branch                 |
| 850 South 5 <sup>th</sup> Avenue | 202 Pullman Crossing  | 408 Thompson Creek Road             |
| Denton, Maryland 21629           | Grasonville, Maryland 21638   | Stevensville, Maryland 21666        |
| Tuckahoe Branch                  | Washington Square Branch  | Felton Branch                       |
| 22151 WES Street                 | 899 Washington Avenue   | 120 West Main Street                |
| Ridgely, Maryland 21660          | Chestertown, Maryland 21620   | Felton, Delaware 19943              |
| Milford Branch                   | Camden Wal-Mart Supercenter Division Office - Wye Financial & Trust |                                     |
| 698-A North Dupont Boulevard     | 263 Wal-Mart Drive  | 16 North Washington Street, Suite 1 |
| Milford, Delaware 19963          | Camden, Delaware 19934  | Easton, Maryland 21601              |

**ATM**

Queenstown Harbor Golf Links  
Queenstown, Maryland 21658

*The Avon-Dixon Agency, LLC*

|                           |                        |                                |
|---------------------------|------------------------|--------------------------------|
| Headquarters              | Benefits Office        | Centreville Office             |
| 106 North Harrison Street | 28969 Information Lane | 105 Lawyers Row                |
| Easton, Maryland 21601    | Easton, Maryland 21601 | Centreville, Maryland<br>21617 |

Grasonville Office  
202 Pullman Crossing  
Grasonville, Maryland 21638

*Elliott-Wilson Insurance, LLC*

106 North Harrison Street Easton,  
Maryland 21601

*Mubell Finance, LLC*

106 North Harrison Street Easton, Maryland  
21601

*Jack Martin & Associates,  
Inc.*

135 Old Solomon's Island  
Road  
Annapolis, Maryland 21401

*Tri-State General Insurance Agencies and  
ESFS, Inc.*

One Plaza East, 4<sup>th</sup> Floor  
Salisbury, Maryland 21802

Talbot Bank owns the real property on which all of its offices are located, except that it operates under leases at its St. Michaels, Tilghman and Trappe branches. CNB owns the real property on which all of its Maryland offices are located, except that it operates under a lease at the office of Wye Financial and Trust in Easton. CNB leases the real property on which all of its Delaware offices are located. The Insurance Subsidiaries do not own any real property, but operate under leases. For information about rent expense for all leased premises, see Note 5 to the Consolidated Financial Statements appearing in Item 8 of Part II of this annual report.

**Item 3. Legal Proceedings.**

We are at times, in the ordinary course of business, subject to legal actions. Management, upon the advice of counsel, believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition or results of operations.

**Item 4. Mine Safety Disclosures.**

This item is not applicable.

**PART II**

**Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

**MARKET PRICE, HOLDERS AND CASH DIVIDENDS**

The shares of the Company’s common stock are listed on the NASDAQ Global Select Market under the symbol “SHBI”. As of February 29, 2012, the Company had approximately 1,607 holders of record. The high and low sales prices for the shares of common stock of the Company, as reported on the NASDAQ Global Select Market, and the cash dividends declared on those shares for each quarterly period of 2011 and 2010 are set forth in the table below.

|                | 2011                |        |                   | 2010                |         |                   |
|----------------|---------------------|--------|-------------------|---------------------|---------|-------------------|
|                | Price Range<br>High | Low    | Dividends<br>Paid | Price Range<br>High | Low     | Dividends<br>Paid |
| First Quarter  | \$11.11             | \$9.42 | \$ 0.06           | \$14.75             | \$10.21 | \$ 0.06           |
| Second Quarter | 10.21               | 6.51   | 0.01              | 14.80               | 11.75   | 0.06              |
| Third Quarter  | 7.06                | 3.95   | 0.01              | 12.10               | 9.20    | 0.06              |
| Fourth Quarter | 6.13                | 4.20   | 0.01              | 10.73               | 9.25    | 0.06              |
|                |                     |        | \$ 0.09           |                     |         | \$ 0.24           |

On February 29, 2012, the closing sales price for the shares of common stock as reported on the NASDAQ Global Select Market was \$6.17 per share.

Stockholders received cash dividends totaling \$760 thousand and \$2.0 million in 2011 and 2010, respectively. Dividends paid per share exceeded earnings per share in both 2011 and 2010. Cash dividends are typically declared on a quarterly basis and are at the discretion of the Board of Directors, based upon such factors as operating results, financial condition, capital adequacy, regulatory requirements, and stockholder return. The Company's ability to pay dividends is limited by federal banking and state corporate law and is generally dependent on the ability of the Company's subsidiaries, particularly the Banks, to declare dividends to the Company. For more information regarding these limitations, see Item 1A of Part I of this annual report under the headings, "The Company's ability to pay dividends is limited by applicable banking and corporate law", which is incorporated herein by reference.

In an effort to preserve the Company's capital, the quarterly common stock dividend was reduced to \$0.01 from \$0.06 per share, beginning with the dividend that was payable May 31, 2011.

The transfer agent for the Company's common stock is:

Registrar & Transfer Company

10 Commerce Drive

Cranford, New Jersey 07016

Investor Relations: 1-800-368-5948

E-mail for investor inquiries: [info@rtco.com](mailto:info@rtco.com).



The performance graph below compares the cumulative total shareholder return on the common stock of the Company with the cumulative total return on the equity securities included in the NASDAQ Composite Index (reflecting overall stock market performance), the NASDAQ Bank Index (reflecting changes in banking industry stocks), and the SNL Small Cap Bank Index (reflecting changes in stocks of banking institutions of a size similar to the Company) assuming in each case an initial \$100 investment on December 31, 2006 and reinvestment of dividends as of the end of the Company's fiscal years. Returns are shown on a total return basis. The performance graph represents past performance and should not be considered to be an indication of future performance.

| Index                  | <i>Period Ending</i> |          |          |          |          |          |
|------------------------|----------------------|----------|----------|----------|----------|----------|
|                        | 12/31/06             | 12/31/07 | 12/31/08 | 12/31/09 | 12/31/10 | 12/31/11 |
| Shore Bancshares, Inc. | 100.00               | 74.64    | 83.86    | 52.62    | 39.06    | 19.30    |
| NASDAQ Composite       | 100.00               | 110.66   | 66.42    | 96.54    | 114.06   | 113.16   |
| NASDAQ Bank            | 100.00               | 80.09    | 62.84    | 52.60    | 60.04    | 53.74    |
| SNL Small Cap Bank     | 100.00               | 72.30    | 60.78    | 42.72    | 52.19    | 49.84    |

## ISSUER REPURCHASES

On February 2, 2006, the Company's Board of Directors authorized the Company to repurchase up to 165,000 shares of its common stock over a period not to exceed 60 months. Since the expiration of that repurchase program on February 2, 2011, the Board has not authorized additional repurchases.

## EQUITY COMPENSATION PLAN INFORMATION

Pursuant to the SEC's Regulation S-K Compliance and Disclosure Interpretation 106.01, the information regarding the Corporation's equity compensation plans required by this Item pursuant to Item 201(d) of Regulation S-K is located in Item 12 of Part III of this annual report and is incorporated herein by reference.

**Item 6. Selected Financial Data.**

The following table sets forth certain selected financial data for the five years ended December 31, 2011, and is qualified in its entirety by the detailed statistical and other information contained in this annual report, including “Management’s Discussion and Analysis of Financial Condition and Results of Operations” appearing in Item 7 of Part II of this annual report and the financial statements and notes thereto appearing in Item 8 of Part II of this annual report.

| (Dollars in thousands, except per share data)         | Years Ended December 31, |            |           |           |           |
|---|--------------------------|------------|-----------|-----------|-----------|
|   | 2011                     | 2010       | 2009      | 2008      | 2007      |
| <b>RESULTS OF OPERATIONS:</b>                         |                          |            |           |           |           |
| Interest income                                       | <b>\$50,852</b>          | \$55,461   | \$58,789  | \$61,474  | \$65,141  |
| Interest expense                                      | <b>11,088</b>            | 12,822     | 17,411    | 21,555    | 24,105    |
| Net interest income                                   | <b>39,764</b>            | 42,639     | 41,378    | 39,919    | 41,036    |
| Provision for credit losses                           | <b>19,470</b>            | 21,119     | 8,986     | 3,337     | 1,724     |
| Net interest income after provision for credit losses | <b>20,294</b>            | 21,520     | 32,392    | 36,582    | 39,312    |
| Noninterest income                                    | <b>17,318</b>            | 18,041     | 19,541    | 20,350    | 14,679    |
| Noninterest expense                                   | <b>39,167</b>            | 41,720     | 40,248    | 38,370    | 32,539    |
| (Loss) income before income taxes                     | <b>(1,555 )</b>          | (2,159 )   | 11,685    | 18,562    | 21,452    |
| Income tax (benefit) expense                          | <b>(658 )</b>            | (492 )     | 4,412     | 7,092     | 8,002     |
| Net (loss) income                                     | <b>(897 )</b>            | (1,667 )   | 7,273     | 11,470    | 13,450    |
| Preferred stock dividends and discount accretion      | -                        | -          | 1,876     | -         | -         |
| Net (loss) income available to common shareholders    | <b>\$(897 )</b>          | \$(1,667 ) | \$5,397   | \$11,470  | \$13,450  |
| <b>PER COMMON SHARE DATA:</b>                         |                          |            |           |           |           |
| Net (loss) income – basic                             | <b>\$(0.11 )</b>         | \$(0.20 )  | \$0.64    | \$1.37    | \$1.61    |
| Net (loss) income – diluted                           | <b>(0.11 )</b>           | (0.20 )    | 0.64      | 1.37      | 1.60      |
| Dividends paid  | <b>0.09</b>              | 0.24       | 0.64      | 0.64      | 0.64      |
| Book value (at year end)                              | <b>14.34</b>             | 14.51      | 15.18     | 15.16     | 14.35     |
| Tangible book value (at year end) <sup>1</sup>        | <b>12.37</b>             | 12.32      | 12.64     | 12.55     | 11.68     |
| <b>FINANCIAL CONDITION (at year end):</b>             |                          |            |           |           |           |
| Loans   | <b>\$841,050</b>         | \$895,404  | \$916,557 | \$888,528 | \$776,350 |
| Assets  | <b>1,158,193</b>         | 1,130,311  | 1,156,516 | 1,044,641 | 956,911   |
| Deposits  | <b>1,009,919</b>         | 979,516    | 990,937   | 845,371   | 765,895   |
| Long-term debt  | <b>455</b>               | 932        | 1,429     | 7,947     | 12,485    |
| Stockholders’ equity                                  | <b>121,249</b>           | 122,513    | 127,810   | 127,385   | 120,235   |
| <b>PERFORMANCE RATIOS (for the year):</b>             |                          |            |           |           |           |
| Return on average total assets                        | <b>(0.08 )%</b>          | (0.15 )%   | 0.48 %    | 1.13 %    | 1.42 %    |
| Return on average stockholders’ equity                | <b>(0.74 )</b>           | (1.33 )    | 4.00      | 9.22      | 11.79     |

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|  |                 |           |        |       |       |
|--|-----------------|-----------|--------|-------|-------|
| Net interest margin                                  | <b>3.74</b>     | 4.02      | 3.90   | 4.23  | 4.64  |
| Efficiency ratio <sup>2</sup>                        | <b>68.35</b>    | 68.75     | 66.07  | 63.66 | 58.40 |
| Dividend payout ratio                                | <b>(81.82 )</b> | (120.00 ) | 100.00 | 46.72 | 39.75 |
| Average stockholders' equity to average total assets | <b>10.66</b>    | 11.05     | 11.96  | 12.30 | 12.04 |

<sup>1</sup>Total stockholders' equity, net of goodwill and other intangible assets, divided by the number of shares of common stock outstanding at year end.

<sup>2</sup>Noninterest expense as a percentage of total revenue (net interest income plus total noninterest income). Lower ratios indicate improved productivity.

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion compares the Company's financial condition at December 31, 2011 to its financial condition at December 31, 2010 and the results of operations for the years ended December 31, 2011, 2010, and 2009. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto appearing in Item 8 of Part II of this annual report.

### **PERFORMANCE OVERVIEW**

The Company recorded a net loss of \$897 thousand in 2011, compared to a net loss of \$1.7 million for 2010 and net income of \$5.4 million for 2009. The basic and diluted loss per common share was \$0.11 for 2011 and \$0.20 for 2010. The basic and diluted earnings per common share was \$0.64 for 2009.

When comparing 2011 to 2010, the principal factors resulting in the lower net loss were a \$1.7 million decrease in goodwill and other intangible assets impairment charges and a \$1.6 million decrease in the provision for credit losses, which were partially offset by a decline in net interest income of \$2.9 million. During 2011, the economic downturn continued to negatively impact our loan portfolio performance and our overall financial performance. For 2010, the main contributors to the net loss were goodwill and other impairment charges of \$3.1 million and a higher provision for credit losses of \$12.1 million when compared to 2009.

During 2009, net income available to common stockholders was negatively impacted by dividends and discount accretion associated with the sale and subsequent redemption of the Company's Series A Preferred Stock issued to the United States Department of the Treasury (the "Treasury") under the Treasury's Troubled Asset Relief Program Capital Purchase Program (the "TARP CPP"). The impact on 2009 earnings from the preferred stock activity was \$1.9 million.

Return on average assets was (0.08)% for 2011, compared to (0.15)% for 2010 and 0.48% for 2009. Return on average stockholders' equity for 2011 was (0.74)%, compared to (1.33)% for 2010 and 4.00% for 2009. Average assets were \$1.140 billion for 2011, a slight increase when compared to 2010. Average loans decreased 3.7% to \$873.2 million while average earning assets increased slightly to \$1.069 billion. Average deposits increased 1.2% to \$992.1 million while average stockholders' equity decreased 3.3% to \$121.5 million for 2011. Comparing 2010 to 2009, average assets increased less than 1.0%, average loans decreased less than 1.0%, and average earning assets remained relatively unchanged. Average deposits increased 3.2% while average stockholders' equity decreased 7.0% for 2010.

### **CRITICAL ACCOUNTING POLICIES**

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

The most significant accounting policies that the Company follows are presented in Note 1 to the Consolidated Financial Statements. These policies, along with the disclosures presented in the notes to the financial statement and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policy with respect to the allowance for credit losses to be the accounting area that requires the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available. Accordingly, the allowance for credit losses is considered to be a critical accounting policy, along with goodwill and other intangible assets and fair value, as discussed below.

The allowance for credit losses represents management's estimate of credit losses inherent in the loan portfolio as of the balance sheet date. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheets. Note 1 to the Consolidated Financial Statements describes the methodology used to determine the allowance for credit losses. A discussion of the factors driving changes in the amount of the allowance for credit losses is included in the Provision for Credit Losses and Risk Management section of this discussion.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are required to be recorded at fair value. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. Impairment testing requires that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. The Company's reporting units were identified based on an analysis of each of its individual operating segments. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss.

The Company measures certain financial assets and liabilities at fair value, with the measurements made on a recurring or nonrecurring basis. Significant financial instruments measured at fair value on a recurring basis are investment securities and interest rate caps. Impaired loans and other real estate and other assets owned are significant financial instruments measured at fair value on a nonrecurring basis. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity.

## **RECENT ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENTS**

The FASB's ASC became effective on July 1, 2009. At that date, the codification became FASB's officially recognized source of authoritative U.S. generally accepted accounting principles ("GAAP") applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants ("AICPA"), Emerging Issues Task Force ("EITF") and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the codification affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the codification involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

Note 1 to the Consolidated Financial Statements discusses new accounting policies that the Company adopted during 2011 and the expected impact of accounting policies recently issued or proposed but not yet required to be adopted. To the extent the adoption of new accounting standards materially affects our financial condition, results of operations or liquidity, the impacts are discussed in the applicable section(s) of this discussion and Notes to the Consolidated Financial Statements.

## **RESULTS OF OPERATIONS**

### **Net Interest Income and Net Interest Margin**

Net interest income remains the most significant component of our earnings. It is the excess of interest and fees earned on total average earning assets (loans, investment securities, federal funds sold and interest-bearing deposits with other banks) over interest owed on average interest-bearing liabilities (deposits and borrowings). As shown in the table below, tax-equivalent net interest income for 2011 was \$40.0 million, a 6.8% decrease from 2010. The decrease was primarily due to lower yields earned on average earning assets and a decline in higher-yielding average loan balances. Tax-equivalent net interest income for 2010 was \$42.9 million, a 2.9% increase over 2009. The increase was primarily due to lower rates paid on interest-bearing liabilities offsetting the decline in yields on earning assets

Our net interest margin (*i.e.*, tax-equivalent net interest income divided by average earning assets) represents the net yield on earning assets. The net interest margin is managed through loan and deposit pricing and asset/liability strategies. The net interest margin was 3.74% for 2011, compared to 4.02% for 2010, representing a decline of 28 basis points due to the decrease in net interest income. The increase in net interest income in 2010 when compared to 2009 was enough to improve the net interest margin by 12 basis points. The net interest spread, which is the difference between the average yield on earning assets and the rate paid for interest-bearing liabilities, was 3.52% for 2011, 3.76% for 2010 and 3.52% for 2009.

The following table sets forth the major components of net interest income, on a tax-equivalent basis, for the years ended December 31, 2011, 2010, and 2009.

|  | 2011               |                 |               | 2010            |              |            | 2009            |              |            |
|--|--------------------|-----------------|---------------|-----------------|--------------|------------|-----------------|--------------|------------|
| (Dollars in thousands)                     | Average Balance    | Interest (1)    | Yield/Rate    | Average Balance | Interest (1) | Yield/Rate | Average Balance | Interest (1) | Yield/Rate |
| <b>Earning assets</b>                      |                    |                 |               |                 |              |            |                 |              |            |
| Loans (2) (3)                              | <b>\$873,155</b>   | <b>\$47,688</b> | <b>5.46 %</b> | \$906,732       | \$52,118     | 5.75 %     | \$913,631       | \$55,369     | 6.06 %     |
| Investment securities:                     |                    |                 |               |                 |              |            |                 |              |            |
| Taxable                                    | <b>109,059</b>     | <b>3,031</b>    | <b>2.78</b>   | 101,162         | 3,209        | 3.17       | 84,283          | 3,184        | 3.78       |
| Tax-exempt                                 | <b>4,509</b>       | <b>234</b>      | <b>5.19</b>   | 6,080           | 321          | 5.29       | 8,071           | 458          | 5.67       |
| Federal funds sold                         | <b>23,808</b>      | <b>25</b>       | <b>0.10</b>   | 39,770          | 60           | 0.15       | 59,416          | 84           | 0.14       |
| Interest-bearing deposits                  | <b>58,927</b>      | <b>93</b>       | <b>0.16</b>   | 14,520          | 18           | 0.12       | 3,200           | 11           | 0.35       |
| Total earning assets                       | <b>1,069,458</b>   | <b>51,071</b>   | <b>4.78 %</b> | 1,068,264       | 55,726       | 5.22 %     | 1,068,601       | 59,106       | 5.53 %     |
| Cash and due from banks                    | <b>19,198</b>      |                 |               | 16,567          |              |            | 17,049          |              |            |
| Other assets                               | <b>67,695</b>      |                 |               | 65,774          |              |            | 54,016          |              |            |
| Allowance for credit losses                | <b>(16,408 )</b>   |                 |               | (13,689 )       |              |            | (10,754 )       |              |            |
| Total assets                               | <b>\$1,139,943</b> |                 |               | \$1,136,916     |              |            | \$1,128,912     |              |            |
| <b>Interest-bearing liabilities</b>        |                    |                 |               |                 |              |            |                 |              |            |
| Demand deposits                            | <b>\$145,533</b>   | <b>300</b>      | <b>0.21 %</b> | \$130,297       | 315          | 0.24 %     | \$124,758       | 315          | 0.25 %     |
| Money market and savings deposits (4)      | <b>265,910</b>     | <b>2,654</b>    | <b>1.00</b>   | 258,650         | 1,970        | 0.76       | 218,125         | 1,354        | 0.62       |
| Certificates of deposit, \$100,000 or more | <b>245,214</b>     | <b>3,965</b>    | <b>1.62</b>   | 256,393         | 5,128        | 2.00       | 258,879         | 7,670        | 2.96       |
| Other time deposits                        | <b>205,154</b>     | <b>4,076</b>    | <b>1.99</b>   | 214,121         | 5,268        | 2.46       | 234,468         | 7,679        | 3.28       |
| Interest-bearing deposits                  | <b>861,811</b>     | <b>10,995</b>   | <b>1.28</b>   | 859,461         | 12,681       | 1.48       | 836,230         | 17,018       | 2.04       |
| Short-term borrowings                      | <b>15,319</b>      | <b>56</b>       | <b>0.37</b>   | 16,348          | 83           | 0.51       | 25,519          | 127          | 0.50       |
| Long-term debt                             | <b>814</b>         | <b>37</b>       | <b>4.50</b>   | 1,304           | 58           | 4.41       | 4,792           | 266          | 5.55       |
| Total interest-bearing liabilities         | <b>877,944</b>     | <b>11,088</b>   | <b>1.26 %</b> | 877,113         | 12,822       | 1.46 %     | 866,541         | 17,411       | 2.01 %     |
| Noninterest-bearing deposits               | <b>130,260</b>     |                 |               | 120,871         |              |            | 113,430         |              |            |
| Other liabilities                          | <b>10,243</b>      |                 |               | 13,346          |              |            | 13,963          |              |            |
| Stockholders' equity                       | <b>121,496</b>     |                 |               | 125,586         |              |            | 134,978         |              |            |



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|  |                    |               |             |        |             |        |
|--|--------------------|---------------|-------------|--------|-------------|--------|
| Total liabilities and stockholders' equity | <b>\$1,139,943</b> |               | \$1,136,916 |        | \$1,128,912 |        |
| Net interest spread                        | <b>\$39,983</b>    | <b>3.52 %</b> | \$42,904    | 3.76 % | \$41,695    | 3.52 % |
| Net interest margin                        |                    | <b>3.74 %</b> |             | 4.02 % |             | 3.90 % |

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0% for 2011 and 2010 and 34.2% for 2009, exclusive of the alternative minimum tax rate and nondeductible interest expense. The tax-equivalent adjustment amounts used in the above table to compute yields aggregated \$219 thousand in 2011, \$265 thousand in 2010 and \$317 thousand in 2009.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.

(4) Interest expense on money market and savings deposits includes expense on deposits related to the Promontory Insured Network Deposits Program. The interest expense for these deposits was \$1.3 million for 2011, \$429 thousand for 2010 and \$8 thousand for 2009.

On a tax-equivalent basis, total interest income was \$51.1 million for 2011, compared to \$55.7 million for 2010 and \$59.1 million for 2009. For 2011, average earning assets remained relatively unchanged but yields earned decreased 44 basis points, mainly due to loan activity, which reduced interest income by \$4.6 million when compared to 2010. During 2011, average loans decreased \$33.6 million and the yield earned on loans decreased 29 basis points. Interest income for 2010 also declined when compared to 2009 mainly due to a decrease of \$6.9 million in average loans and a decrease of 31 basis points in the yield on loans. Excluding average nonaccrual loans, the yield on loans would have been 5.78%, 5.97% and 6.15% for 2011, 2010, and 2009, respectively. The changes in all other average earning assets included increases in interest-bearing deposits with other banks and taxable investment securities of \$44.4 million and \$7.9 million, respectively, when compared to 2010 and decreases in federal funds sold and tax-exempt investment securities of \$16.0 million and \$1.6 million, respectively, when compared to 2010. During 2011, the investment of excess cash from customers' deposits shifted from federal funds sold to interest-bearing deposits in other banks, primarily with the Federal Reserve Bank, to take advantage of higher yields on these deposits. Similarly for 2010, average taxable investment securities and interest-bearing deposits increased while average federal funds sold and tax-exempt investment securities decreased. As a percentage of total average earning assets, loans, investment securities, federal funds sold and interest-bearing deposits were 81.7%, 10.6%, 2.2% and 5.5%, respectively, for 2011. The comparable percentages were 84.9%, 10.0%, 3.7%, and 1.4%, respectively, for 2010 and, 85.5%, 8.6%, 5.6% and 0.3%, respectively, for 2009. The yields on all other earning assets in 2011 declined when compared to 2010 except for the yield on interest-bearing deposits which increased four basis points. Likewise, the yields on all other earning assets decreased in 2010 when compared to yields in 2009 except for the yield on federal funds sold which increased one basis point. When comparing 2011 to 2010, the overall decrease in yields on earning assets produced \$3.0 million less in interest income and the decrease in average balances of earning assets produced \$1.7 million less in interest income, as seen in the Rate/Volume Variance Analysis below. Both rate and volume variances for interest income were primarily impacted by loan activity. In 2010, the \$3.4 million decrease in interest income was almost all due to lower rates.

Interest expense was \$11.1 million for 2011, compared to \$12.8 million for 2010 and \$17.4 million for 2009. Although overall volume increased slightly, lower rates paid for interest-bearing liabilities were the main reason for the decrease in interest expense in 2011. A similar situation prevailed during 2010, with overall volumes of interest-bearing liabilities increasing but rates decreasing enough to reduce interest expense. Interest expense on time deposits (certificates of deposit of \$100,000 or more and other time deposits) had the largest effect on the decrease in interest expense, declining \$2.4 million when compared to 2010. The decrease in interest expense was due to a decrease of \$20.1 million in average time deposits and a decrease of 42 basis points on rates paid on these deposits when compared to 2010. The decrease in average time deposits reflected a decrease in the Company's liquidity needs and the lower rates reflected current market conditions. For 2010, average time deposits decreased \$22.8 million and rates paid decreased 90 basis points when compared to 2009. During 2011, average interest-bearing demand deposits and money market and savings deposits increased \$22.5 million, offsetting the decline in average time deposits. The rates paid on average interest-bearing demand deposits decreased 3 basis points but the rates paid on money market and savings deposits increased 24 basis points. The changes in average balances and rates paid on these deposits increased interest expense by \$669 thousand when compared to 2010. Interest expense for money market deposits included \$881.5 thousand more in 2011 than in 2010 related to the Promontory Insured Network Deposits Program (the "IND Program"). See the section below entitled "Deposits" for additional information. In 2011, the movement from time deposits to interest-bearing demand and money market and other savings deposits reflected a shift in customer investment needs. For 2010, average interest-bearing demand deposits and money market and savings deposits increased \$46.1 million and the rates paid on these deposits increased 10 basis points. During 2011, lower rates on interest-bearing liabilities produced \$1.4 million less in interest expense and decreased volume produced \$372 thousand less in interest expense, as shown in the table below. Both rate and volume variances for interest expense were primarily impacted by time deposit activity. In 2010, lower rates produced \$4.8 million less in interest expense while increased volume produced \$211 thousand more in interest expense.

The following Rate/Volume Variance Analysis identifies the portion of the changes in tax-equivalent net interest income attributable to changes in volume of average balances or to changes in the yield on earning assets and rates paid on interest-bearing liabilities.

| (Dollars in thousands)                              | 2011 over (under) 2010 |                   |           | 2010 over (under) 2009 |                   |         |
|---|------------------------|-------------------|-----------|------------------------|-------------------|---------|
|   | Total<br>Variance      | Caused By<br>Rate | Volume    | Total<br>Variance      | Caused By<br>Rate | Volume  |
| Interest income from earning assets:                |                        |                   |           |                        |                   |         |
| Loans   | \$(4,430)              | \$(2,554)         | \$(1,876) | \$(3,251)              | \$(2,768)         | \$(483) |
| Taxable investment securities                       | (178)                  | (415)             | 237       | 25                     | (558)             | 583     |
| Tax-exempt investment securities                    | (87)                   | (6)               | (81)      | (137)                  | (29)              | (108)   |
| Federal funds sold                                  | (35)                   | (16)              | (19)      | (24)                   | 6                 | (30)    |
| Interest-bearing deposits                           | 75                     | 8                 | 67        | 7                      | (11)              | 18      |
| Total interest income                               | (4,655)                | (2,983)           | (1,672)   | (3,380)                | (3,360)           | (20)    |
| Interest expense on deposits<br>and borrowed funds: |                        |                   |           |                        |                   |         |
| Interest-bearing demand deposits                    | (15)                   | (46)              | 31        | -                      | (13)              | 13      |
| Money market and savings deposits                   | 684                    | 628               | 56        | 616                    | 90                | 526     |
| Time deposits                                       | (2,355)                | (1,923)           | (432)     | (4,953)                | (4,834)           | (119)   |

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|                        |           |           |           |         |         |           |
|------------------------|-----------|-----------|-----------|---------|---------|-----------|
| Short-term borrowings  | (27 )     | (22 )     | (5 )      | (44 )   | 3       | (47 )     |
| Long-term debt         | (21 )     | 1         | (22 )     | (208 )  | (46 )   | (162 )    |
| Total interest expense | (1,734)   | (1,362)   | (372 )    | (4,589) | (4,800) | 211       |
| Net interest income    | \$(2,921) | \$(1,621) | \$(1,300) | \$1,209 | \$1,440 | \$ (231 ) |

*The rate and volume variance for each category has been allocated on a consistent basis between rate and volume variances, based on a percentage of rate, or volume, variance to the sum of the absolute two variances.*

**Noninterest Income**

Noninterest income decreased \$723 thousand, or 4.0%, in 2011 when compared to 2010. This compared to a decrease of \$1.5 million, or 7.7%, in 2010 when compared to 2009. The decrease in noninterest income in 2011 when compared to 2010 was mainly due to declines in insurance agency commissions of \$755 thousand, service charges on deposit accounts of \$412 thousand and other noninterest income of \$179 thousand. The decline in insurance agency commissions reflected the ongoing soft market in the insurance industry and the decline in service charges on deposit accounts reflected a decrease in customer use of overdraft protection programs. The primary reasons for the lower amount in other noninterest income was a \$224 thousand gain relating to the surrender of directors' life insurance policies in 2010 and \$182 thousand less in mortgage broker fees in 2011. The Company terminated the operations of its mortgage subsidiary during 2010 and now conducts brokerage activities through a minority series investment in an unrelated Delaware limited liability company under the name "Wye Mortgage Group". During 2011 and 2010, Wye Mortgage Group generated income of \$169 thousand and a loss of \$6 thousand, respectively. In 2011, the decreases in noninterest income were partially offset by \$563 thousand in gains on sales of investment securities.

The decrease in noninterest income in 2010 when compared to 2009 was mainly due to a decline in insurance agency commissions of \$1.0 million, a decline in mortgage broker fees of \$666 thousand and a mark to market gain of \$420 thousand on interest rate swaps in 2009. The decline in insurance agency commissions reflected the continuing soft market in the insurance industry. Mortgage broker fees declined since the Company began conducting brokerage activities in 2010 through its unconsolidated subsidiary, Wye Mortgage Group, the results of which were reported in other noninterest income. The decrease in noninterest income was partially offset by increases in trust and investment fee income and other noninterest income of \$403 thousand and \$423 thousand, respectively. Other noninterest income included the \$224 thousand gain relating to the surrender of directors' life insurance policies.

The following table summarizes our noninterest income for the years ended December 31.

| (Dollars in thousands)                  | Years Ended |          |          | Change from Prior Year |          |           |         |
|---|-------------|----------|----------|------------------------|----------|-----------|---------|
|   | 2011        | 2010     | 2009     | 2011/10                |          | 2010/09   |         |
|   |             |          |          | Amount                 | Percent  | Amount    | Percent |
| Service charges on deposit accounts     | \$2,845     | \$3,257  | \$3,424  | \$(412)                | (12.6 )% | \$(167 )  | (4.9 )% |
| Trust and investment fee income         | 1,563       | 1,503    | 1,100    | 60                     | 4.0      | 403       | 36.6    |
| Gains on sales of investment securities | 563         | -        | 49       | 563                    | -        | (49 )     | (100.0) |
| Insurance agency commissions income     | 9,358       | 10,113   | 11,131   | (755)                  | (7.5 )   | (1,018)   | (9.1 )  |
| Other noninterest income:               |             |          |          |                        |          |           |         |
| Interest rate swaps                     | -           | -        | 420      | -                      | -        | (420 )    | (100.0) |
| Mortgage broker fees                    | -           | 182      | 848      | (182)                  | (100.0 ) | (666 )    | (78.5 ) |
| Earnings – unconsolidated subsidiary    | 169         | (6 )     | -        | 175                    | 2,916.7  | (6 )      | -       |
| Other                                   | 2,820       | 2,992    | 2,569    | (172)                  | (5.7 )   | 423       | 16.5    |
| Total other noninterest income          | 2,989       | 3,168    | 3,837    | (179)                  | (5.7 )   | (669 )    | (17.4 ) |
| Total                                   | \$17,318    | \$18,041 | \$19,541 | \$(723)                | (4.0 )   | \$(1,500) | (7.7 )  |

### Noninterest Expense

Total noninterest expense decreased \$2.6 million, or 6.1%, in 2011, compared to an increase of \$1.5 million, or 3.7%, in 2010. A significant portion of the decrease in 2011 was due to \$1.7 million less in goodwill and other intangible assets impairment charges when compared to 2010. As a result of the 2011 annual assessment for goodwill and other intangible assets impairment, it was determined that goodwill and other intangible assets were impaired primarily in our retail insurance business. The Company recorded goodwill impairment charges of \$1.2 million and other intangible assets impairment charges of \$120 thousand. See Note 7 to the Consolidated Financial Statements for further information regarding the impact of goodwill and other intangible assets on the financial statements. When comparing 2011 to 2010, in addition to the large decrease in impairment charges, salaries and wages declined \$652 thousand due to cost containment measures, FDIC insurance premium expense declined \$536 thousand due to regulatory changes in the calculation of the premium, and insurance agency commissions expense declined \$302 thousand. These decreases in expenses were somewhat offset by higher expenses related to other real estate owned activities (reported in other noninterest expense) and higher data processing charges related to the merger of The Felton Bank into CNB during the first quarter of 2011.

A significant portion of the increase in noninterest expense in 2010 when compared to 2009 was due to goodwill and other intangible assets impairment charges of \$3.1 million. As a result of the 2010 annual assessment for goodwill and other intangible assets impairment, it was determined that goodwill was impaired at one of the Banks and goodwill and other intangible assets were impaired in our wholesale insurance business. The Company recorded goodwill impairment charges of \$1.5 million at that Bank and goodwill impairment charges of \$1.5 million and other intangible assets impairment charges of \$51 thousand at the wholesale insurance business. Other noninterest expenses for 2010 increased \$723 thousand when compared to 2009, over half of which included expenses related to collection and other real estate owned activities. Partially offsetting these increases in expense were a decrease in salaries and wages of \$1.1 million and a decrease in employee benefits of \$802 thousand reflecting lower expenses accrued for bonus and profit sharing plans which are a part of overall cost containment measures taken by the Company. Insurance agency commissions expense and FDIC insurance premium expense decreased \$344 thousand and \$244 thousand, respectively.

We had 319 full-time equivalent employees at December 31, 2011, compared to 321 and 335 at December 31, 2010 and 2009, respectively.

The following table summarizes our noninterest expense for the years ended December 31.

| (Dollars in thousands)                          | Years Ended |          |          | Change from Prior Year |         |           |         |
|---|-------------|----------|----------|------------------------|---------|-----------|---------|
|   | 2011        | 2010     | 2009     | 2011/10                |         | 2010/09   |         |
|   |             |          |          | Amount                 | Percent | Amount    | Percent |
| Salaries and wages                              | \$16,825    | \$17,477 | \$18,488 | \$(652 )               | (3.7 )% | \$(1,011) | (5.5 )% |
| Employee benefits                               | 3,840       | 3,829    | 4,631    | 11                     | 0.3     | (802 )    | (17.3 ) |
| Occupancy expense                               | 2,312       | 2,328    | 2,324    | (16 )                  | (0.7 )  | 4         | 0.2     |
| Furniture and equipment expense                 | 1,059       | 1,200    | 1,183    | (141 )                 | (11.8 ) | 17        | 1.4     |
| Data processing                                 | 2,852       | 2,607    | 2,463    | 245                    | 9.4     | 144       | 5.8     |
| Directors' fees                                 | 500         | 412      | 478      | 88                     | 21.4    | (66 )     | (13.8 ) |
| Goodwill and other intangible assets impairment | 1,344       | 3,051    | -        | (1,707)                | (55.9 ) | 3,051     | -       |
| Amortization of intangible assets               | 512         | 515      | 515      | (3 )                   | (0.6 )  | -         | -       |
| Insurance agency commissions expense            | 1,267       | 1,569    | 1,913    | (302 )                 | (19.2 ) | (344 )    | (18.0 ) |
| FDIC insurance premium expense                  | 1,298       | 1,834    | 2,078    | (536 )                 | (29.2 ) | (244 )    | (11.7 ) |
| Other noninterest expense                       | 7,358       | 6,898    | 6,175    | 460                    | 6.7     | 723       | 11.7    |
| Total   | \$39,167    | \$41,720 | \$40,248 | \$(2,553)              | (6.1 )  | \$1,472   | 3.7     |

## Income Taxes

The Company reported an income tax benefit of \$658 thousand for 2011, compared to an income tax benefit of \$492 thousand for 2010 and an income tax expense of \$4.4 million for 2009. The effective tax rate was a 42.3% benefit for 2011, a 22.8% benefit for 2010 and a 37.8% expense for 2009. The higher tax rate for 2011 when compared to 2010 and the lower tax rate for 2010 when compared to 2009 reflected that \$1.5 million of the goodwill impairment charge recorded in 2010 was not tax deductible.

## REVIEW OF FINANCIAL CONDITION

Asset and liability composition, capital resources, asset quality, market risk, interest sensitivity and liquidity are all factors that affect our financial condition.

### Assets

Total assets increased 2.5% from \$1.130 billion at December 31, 2010 to \$1.158 billion at December 31, 2011. Total assets increased 2.3% from the end of 2009 to the end of 2010. Average total assets were \$1.140 billion, \$1.137 billion and \$1.129 billion for 2011, 2010 and 2009, respectively. The loan portfolio is the primary source of our income, and it represented 81.7%, 84.9% and 85.5% of average earning assets for 2011, 2010 and 2009, respectively.

Funding for loans is provided primarily by core deposits. Additional funding is obtained through short-term and long-term borrowings. Average total deposits increased 1.2% to \$992.1 million at December 31, 2011, compared to a 3.2% increase for 2010. Deposits provided funding for approximately 92.8%, 91.8% and 88.9% of average earning assets for 2011, 2010 and 2009, respectively.

The following table sets forth the average balance of the components of average earning assets as a percentage of total average earning assets for the year ended December 31.

|  | 2011    | 2010    | 2009    | 2008    | 2007    |
|--|---------|---------|---------|---------|---------|
| Loans                                      | 81.7 %  | 84.9 %  | 85.5 %  | 87.8 %  | 81.6 %  |
| Investment securities                      | 10.6    | 10.0    | 8.6     | 10.1    | 14.1    |
| Federal funds sold                         | 2.2     | 3.7     | 5.6     | 1.7     | 2.4     |
| Interest-bearing deposits with other banks | 5.5     | 1.4     | 0.3     | 0.4     | 1.9     |
|  | 100.0 % | 100.0 % | 100.0 % | 100.0 % | 100.0 % |

#### **Interest-Bearing Deposits With Other Banks and Federal Funds Sold**

We invest excess cash balances (*i.e.*, the excess cash remaining after funding loans and investing in securities with deposits and borrowings) in interest-bearing accounts and federal funds sold offered by our correspondent banks. These liquid investments are maintained at a level necessary to meet immediate liquidity needs. Total interest-bearing deposits with other banks and federal funds sold increased \$46.5 million from \$58.3 million at December 31, 2010 to \$104.8 million at December 31, 2011. Average interest-bearing deposits with other banks and federal funds sold increased \$28.4 million to \$82.7 million for the year ended December 31, 2011. During 2011, the investment of excess cash from customers' deposits shifted from federal funds sold, which decreased \$16.0 million, to interest-bearing deposits in other banks, which increased \$44.4 million, to take advantage of higher yields on these deposits. Total interest-bearing deposits with other banks and federal funds sold decreased 4.8% from the end of 2009 to the end of 2010. Average interest-bearing deposits with other banks and federal funds sold decreased \$8.3 million in 2010. The fluctuations in these accounts reflected that there was less excess cash in 2010 than in 2009.

## Investment Securities

The investment portfolio is structured to provide us with liquidity and also plays an important role in the overall management of interest rate risk. Investment securities available for sale are stated at estimated fair value based on quoted market prices. They represent securities which may be sold as part of the asset/liability management strategy or which may be sold in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At December 31, 2011, 95% of the portfolio was classified as available for sale and 5% as held to maturity, compared to 94% and 6%, respectively, at December 31, 2010 and 92% and 8%, respectively, at December 31, 2009. The percentage of securities designated as available for sale reflects the amount needed to support our anticipated growth and liquidity needs. With the exception of municipal securities, our general practice is to classify all newly-purchased securities as available for sale.

Investment securities available for sale were \$129.8 million at the end of 2011 and \$99.1 million at the end of 2010. Investment securities available for sale increased \$30.7 million, or 31.0%, in 2011, much higher than the \$1.5 million, or 1.5%, in 2010. The larger increase in investment securities available for sale reflected that there were more funds available for investing in securities than were needed for funding loans during 2011 than in 2010. At year-end 2011, 32.5% of the securities in the portfolio were U.S. Government agencies and 67.1% of the securities were mortgage-backed securities, compared to 59.5% and 40.0%, respectively, at year-end 2010, reflecting a shift in the composition of the portfolio to higher-yielding mortgage-backed securities. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

Investment securities held to maturity, consisting primarily of tax-exempt municipal bonds, totaled \$6.5 million at December 31, 2011, compared to \$6.7 million at December 31, 2010 and \$8.9 million at December 31, 2009. The balance continues to decline because there were only maturities and no purchases of investment securities held to maturity during 2011 and 2010. We do not typically invest in structured notes or other derivative securities.

The following table sets forth the maturities and weighted average yields of the bond investment portfolio as of December 31, 2011.

| (Dollars in thousands)     | 1 Year or Less  |               | 1-5 Years       |               | 5-10 Years      |               | Over 10 Years   |               |
|----------------------------|-----------------|---------------|-----------------|---------------|-----------------|---------------|-----------------|---------------|
|                            | Carrying Amount | Average Yield | Carrying Amount | Average Yield | Carrying Amount | Average Yield | Carrying Amount | Average Yield |
| Available for sale:        |                 |               |                 |               |                 |               |                 |               |
| U.S. Government agencies   | \$7,123         | 3.70 %        | \$21,164        | 0.80 %        | \$1,713         | 2.68 %        | \$12,148        | 4.40 %        |
| Mortgage-backed securities | -               | -             | 609             | 4.86          | 3,688           | 2.43          | 82,736          | 2.56          |
| Total available for sale   | \$7,123         | 3.70          | \$21,773        | 0.91          | \$5,401         | 2.51          | \$94,884        | 2.79          |



Held to maturity:

|   |         |      |   |         |      |   |         |      |   |         |      |   |
|---|---------|------|---|---------|------|---|---------|------|---|---------|------|---|
| Obligations of states and political subdivisions <sup>1</sup> | \$2,583 | 4.91 | % | \$1,590 | 5.26 | % | \$1,297 | 5.20 | % | \$1,010 | 5.19 | % |
|---|---------|------|---|---------|------|---|---------|------|---|---------|------|---|

<sup>1</sup>Yields adjusted to reflect a tax equivalent basis assuming a federal tax rate of 34.0%.

## Loans

During 2011, loans declined when compared to the prior year because fewer high-quality loan opportunities and historically high levels of loan charge-offs continued to deter loan growth. Loans, net of unearned income, totaled \$841.1 million at December 31, 2011, a decrease of \$54.4 million, or 6.1%, from 2010. Loans decreased \$21.2 million, or 2.3%, in 2010 when compared to 2009. Most of our loans are secured by real estate. Real estate loans are classified as construction, residential or commercial real estate loans. Total real estate loans decreased \$39.5 million, or 5.0%, from year-end 2010 to year-end 2011. Most of the decrease in real estate loans was due to a decline in construction loans of \$24.1 million, or 16.7%. Commercial loans, which include financial and agricultural loans, decreased \$13.3 million, or 16.1%, and consumer loans, a small percentage of the overall loan portfolio, decreased \$1.6 million, or 9.6%, from the end of 2010 to the end of 2011. At the end of 2010, real estate loans decreased by \$8.9 million, or 1.1%, commercial loans decreased \$9.0 million, or 9.8%, and consumer loans decreased \$3.3 million or, 17.1%, when compared to the end of 2009. At December 31, 2011, 56.6% of the loan portfolio had fixed interest rates and 43.4% had adjustable interest rates. At December 31, 2011 and 2010, there were no loans held for sale. We do not engage in foreign or subprime lending activities.

The table below sets forth trends in the composition of the loan portfolio over the past five years (including net deferred loan fees/costs).

|                         | December 31, |            |            |            |            |
|-------------------------|--------------|------------|------------|------------|------------|
| (Dollars in thousands)  | 2011         | 2010       | 2009       | 2008       | 2007       |
| Construction            | \$ 119,883   | \$ 143,952 | \$ 161,437 | \$ 179,847 | \$ 155,513 |
| Residential real estate | 321,604      | 333,738    | 327,873    | 289,510    | 256,195    |
| Commercial real estate  | 315,439      | 318,726    | 315,930    | 304,396    | 248,953    |
| Commercial              | 69,485       | 82,787     | 91,783     | 91,644     | 92,258     |
| Consumer                | 14,639       | 16,201     | 19,534     | 23,131     | 23,431     |
| Total                   | \$ 841,050   | \$ 895,404 | \$ 916,557 | \$ 888,528 | \$ 776,350 |

The table below sets forth the maturities and interest rate sensitivity of the loan portfolio at December 31, 2011.

| (Dollars in thousands)         | Maturing within one year | Maturing after one but within five years | Maturing after five years | Total      |
|--------------------------------|--------------------------|--|---------------------------|------------|
| Construction                   | \$ 82,435                | \$ 34,917                                | \$ 2,531                  | \$ 119,883 |
| Residential real estate        | 118,291                  | 88,383                                   | 114,930                   | 321,604    |
| Commercial real estate         | 118,061                  | 175,351                                  | 22,027                    | 315,439    |
| Commercial                     | 37,804                   | 20,681                                   | 11,000                    | 69,485     |
| Consumer                       | 7,518                    | 6,054                                    | 1,067                     | 14,639     |
| Total                          | \$ 364,109               | \$ 325,386                               | \$ 151,555                | \$ 841,050 |
| Rate terms:                    |                          |  |                           |            |
| Fixed-interest rate loans      | \$ 164,438               | \$ 272,856                               | \$ 38,679                 | \$ 475,973 |
| Adjustable-interest rate loans | 199,671                  | 52,530                                   | 112,876                   | 365,077    |
| Total                          | \$ 364,109               | \$ 325,386                               | \$ 151,555                | \$ 841,050 |

## Deposits

We use core deposits primarily to fund loans and to purchase investment securities. Total deposits increased \$30.4 million from \$979.5 million at December 31, 2010 to \$1.010 billion at December 31, 2011. The increase in noninterest-bearing demand (\$9.6 million), interest-bearing demand (\$33.6 million), and money market and savings deposits (\$13.7 million) more than offset the decrease in time deposits (\$26.5 million), primarily in certificates of deposit of \$100,000 or more (\$20.1 million). Average deposits increased \$11.7 million, or 1.2%, in 2011, compared to a 3.2% increase in 2010. The majority of the average deposit growth was in interest-bearing demand deposits, followed by noninterest-bearing deposits, and money market and savings deposits which increased in aggregate by \$31.9 million, or 6.3%. Average time deposits decreased \$20.1 million, or 4.3%, during 2011 mainly due to a reduction in rates to reflect current market conditions, a reduction in the Company's liquidity needs, and a shift in customer investment needs. As with 2010, average time deposits also declined because some of our largest customers are local government municipalities and their deposits have decreased due to reduced tax revenues.

For 2010, the majority of the average deposit growth was in money market and savings deposits which increased \$40.5 million, or 18.6%. These deposits increased primarily from participation in the IND Program during all of 2010. The Company began participation in the IND program during the second quarter of 2009. The program has a five-year term and a guaranteed minimum funding level of \$70 million. Average time deposits decreased \$22.7 million, or 4.6%, during 2010 mainly due to a reduction in rates to reflect current market conditions and the Company's liquidity needs. Average time deposits also declined because the deposits of some of the local government municipalities have decreased due to reduced tax revenues. Average interest-bearing demand deposits increased \$5.5 million, or 4.4%, and noninterest-bearing deposits increased \$7.4 million, or 6.6%, during 2010 when compared to 2009.

The following table sets forth the average balances of deposits and the percentage of each category to total average deposits for the years ended December 31.

| (Dollars in thousands)                     | Average Balances |                |                  |                |                  |                |
|--|------------------|----------------|------------------|----------------|------------------|----------------|
|  | 2011             |                | 2010             |                | 2009             |                |
| Noninterest-bearing demand                 | \$ 130,260       | 13.1 %         | \$ 120,871       | 12.3 %         | \$ 113,430       | 11.9 %         |
| Interest-bearing deposits                  |                  |                |                  |                |                  |                |
| Demand                                     | 145,533          | 14.7           | 130,297          | 13.3           | 124,758          | 13.1           |
| Money market and savings                   | 265,910          | 26.8           | 258,650          | 26.4           | 218,125          | 23.0           |
| Certificates of deposit, \$100,000 or more | 245,214          | 24.7           | 256,393          | 26.2           | 258,879          | 27.3           |
| Other time deposits                        | 205,154          | 20.7           | 214,121          | 21.8           | 234,468          | 24.7           |
| Total                                      | <b>\$992,071</b> | <b>100.0 %</b> | <b>\$980,332</b> | <b>100.0 %</b> | <b>\$949,660</b> | <b>100.0 %</b> |

The following table sets forth the maturity ranges of certificates of deposit with balances of \$100,000 or more as of December 31, 2011.

|                              |           |
|------------------------------|-----------|
| (Dollars in thousands)       |           |
| Three months or less         | \$47,939  |
| Over three through 12 months | 96,538    |
| Over 12 months               | 99,070    |
| Total                        | \$243,547 |

### Short-Term Borrowings

Short-term borrowings generally consist of securities sold under agreements to repurchase and short-term borrowings from the FHLB. Securities sold under agreements to repurchase are issued in conjunction with cash management services for commercial depositors. We also borrow from the FHLB on a short-term basis and occasionally borrow from correspondent banks under federal fund lines of credit arrangements to meet short-term liquidity needs. At December 31, 2011 and 2010, short-term borrowings included only repurchase agreements.

The average balance of short-term borrowings decreased \$1.0 million, or 6.3%, in 2011, while the balance decreased \$9.2 million, or 35.9%, in 2010. The need for short-term borrowings declined due to increases in average deposits and fewer funding requirements for loans during 2011 and 2010.

The following table sets forth our position with respect to short-term borrowings.

| (Dollars in thousands)               | 2011     |               | 2010     |               | 2009     |               |
|--------------------------------------|----------|---------------|----------|---------------|----------|---------------|
|                                      | Balance  | Interest Rate | Balance  | Interest Rate | Balance  | Interest Rate |
| Average outstanding for the year     | \$15,319 | 0.37 %        | \$16,348 | 0.51 %        | \$25,519 | 0.50 %        |
| Outstanding at year end              | 17,817   | 0.34          | 16,041   | 0.35          | 20,404   | 0.82          |
| Maximum outstanding at any month end | 18,251   | -             | 18,447   | -             | 46,270   | -             |

### Long-Term Debt

We use long-term borrowings to meet longer term liquidity needs, specifically to fund loan growth where deposit growth is not sufficient. Average long-term debt declined \$490 thousand during 2011 and \$3.5 million during 2010 because deposit growth was sufficient to meet funding needs. All long-term debt at the end of 2011 and 2010 was related to the acquisition of TSGIA. Acquisition-related debt was \$455 thousand and \$932 thousand at year-end 2011 and 2010, respectively.

## Capital Management

Total stockholders' equity for the Company was \$121.2 million at December 31, 2011, 1.0% lower than in the previous year. Stockholders' equity at December 31, 2010 decreased 4.1% from December 31, 2009. The decrease in stockholders' equity in 2011 was due primarily to the \$897 thousand loss and \$760 thousand in dividends paid on shares of the common stock of the Company. The decrease in stockholders' equity in 2010 was due primarily to the \$1.7 million loss and \$2.0 million in dividends paid.

In 2011, the Company reduced the quarterly common stock dividend to \$0.01 from \$0.06 per share which was reduced in 2010 from \$0.16 per share. The reduction in dividends was intended primarily to mitigate declines in stockholders' equity and capital ratios. Even though stockholders' equity has decreased since the end of 2009, the Company and the Banks continued to maintain capital at levels in excess of the risk-based capital guidelines adopted by the federal banking agencies, as seen in the table below. At year-end 2011, the Company remained well in excess of regulatory requirements for well capitalized institutions.

We record unrealized holding gains (losses), net of tax, on investment securities available for sale and on cash flow hedging activities as accumulated other comprehensive income (loss), a separate component of stockholders' equity. At December 31, 2011, the portion of the investment portfolio designated as "available for sale" had net unrealized holding gains, net of tax, of \$1.4 million, compared to net unrealized holding gains, net of tax, of \$970 thousand at December 31, 2010 and net unrealized holding gains, net of tax, of \$728 thousand at December 31, 2009. There were \$3.1 million, \$2.8 million and \$568 thousand in net unrealized holding losses on cash flow hedging activities at the end of 2011, 2010 and 2009, respectively. See Note 21 to the Consolidated Financial Statements for further information on hedging activities.

On January 9, 2009, as a requirement of its participation in the TARP CPP, the Company issued a common stock purchase warrant covering 172,970 shares of common stock (the "Warrant") to the Treasury. On November 16, 2011, the Company paid \$25,000 to repurchase the Warrant from the Treasury. The repurchase price was based on the fair market value of the Warrant as agreed on by the Company and the Treasury. With the repurchase of the Warrant, the Company concluded its participation in the TARP CPP.

The following table compares the Company's capital ratios to the minimum regulatory requirements as of December 31.

| (Dollars in thousands)        | 2011       | 2010       | 2009       | Minimum<br>Regulatory<br>Requirements |
|-------------------------------|------------|------------|------------|---------------------------------------|
| Tier 1 capital                | \$ 106,276 | \$ 105,808 | \$ 106,391 |                                       |
| Tier 2 capital                | 10,641     | 11,249     | 10,537     |                                       |
| Total risk-based capital      | 116,917    | 117,057    | 116,928    |                                       |
| Net risk-weighted assets      | 846,936    | 895,581    | 928,933    |                                       |
| Adjusted average total assets | 1,143,990  | 1,109,999  | 1,148,077  |                                       |
| Risk-based capital ratios:    |            |            |            |                                       |
| Tier 1                        | 12.55      | % 11.81    | % 11.45    | % 4.0                                 |
| Total capital                 | 13.80      | 13.07      | 12.59      | 8.0                                   |
| Tier 1 leverage ratio         | 9.29       | 9.53       | 9.27       | 4.0                                   |

See Note 18 to the Consolidated Financial Statements for further information about the regulatory capital positions of the Company and the Banks.

### Provision for Credit Losses and Risk Management

Originating loans involves a degree of risk that credit losses will occur in varying amounts according to, among other factors, the types of loans being made, the credit-worthiness of the borrowers over the term of the loans, the quality of the collateral for the loan, if any, as well as general economic conditions. The Company's Board of Directors demands accountability of management, keeping the interests of shareholders in focus. Through the Company's and Banks' Asset/Liability Management Committees and the Company's Audit Committee, the Board actively reviews critical risk positions, including credit, market, liquidity and operational risk. The Company's goal in managing risk is to reduce earnings volatility, control exposure to unnecessary risk, and ensure appropriate returns for risk assumed. Senior members of management actively manage risk at the product level, supplemented with corporate level oversight through the Asset/Liability Management Committee and internal audit function. The risk management structure is designed to identify risk issues through a systematic process, enabling timely and appropriate action to avoid and mitigate risk.

Credit risk is mitigated through loan portfolio diversification, limiting exposure to any single industry or customer, collateral protection and standard lending policies and underwriting criteria. The following discussion provides information and statistics on the overall quality of the Company's loan portfolio. Note 1 to the Consolidated Financial Statements describes the accounting policies related to nonperforming loans (nonaccrual, delinquent 90 days or more and troubled debt restructurings) and loan charge-offs and describes the methodologies used to develop the allowance for credit losses, including the specific, formula and nonspecific components (also discussed below). Management believes the policies governing nonperforming loans and charge-offs are consistent with regulatory standards. The amount of the allowance for credit losses and the resulting provision are reviewed monthly by senior members of

management and approved quarterly by the Board of Directors.

The allowance is increased by provisions for credit losses charged to expense and recoveries of loans previously charged-off. It is decreased by loans charged-off in the current period. Loans, or portions thereof, are charged off when considered uncollectible. Provisions for credit losses are made to bring the allowance for credit losses within the range of balances that are considered appropriate based on the results of the allowance methodology and to reflect losses within the loan portfolio as of the balance sheet date.

The adequacy of the allowance for credit losses is determined based on management's estimate of the inherent risks associated with lending activities, estimated fair value of collateral, past experience and present indicators such as loan delinquency trends, nonaccrual loans and current market conditions. Management believes the allowance is adequate to provide for probable losses inherent in our loan portfolio; however, future changes in the composition of the loan portfolio and financial condition of borrowers may result in additions to the allowance. Examination of the portfolio and allowance by various regulatory agencies and consultants engaged by the Company may result in the need for additional provisions based on information available at the time of the examination. Each of the Banks maintains a separate allowance for credit losses, which is only available to absorb losses from their respective loan portfolios. The allowance set by each of the Banks is subject to regulatory examination and determination as to its adequacy.

The allowance for credit losses is comprised of three parts: the specific allowance, the formula allowance and the nonspecific allowance. The specific allowance is established against impaired loans until charge offs are made. Loans are considered impaired (i.e., nonaccrual loans and accruing troubled debt restructurings) when it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. The formula allowance is determined based on management's assessment of industry trends and economic factors in the markets in which we operate. The determination of the formula allowance involves a higher risk of uncertainty and considers current risk factors that may not have yet manifested themselves in our historical loss factors. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

The specific allowance is used to individually allocate an allowance to loans identified as impaired. An impaired loan may involve deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. If it is determined that there is a loss associated with an impaired loan, a specific allowance is established until a charge off is made. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans that are identified as special mention, substandard and doubtful are adversely rated. These loans are assigned higher allowance factors than favorably rated loans due to management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower. Loans that are favorably rated are grouped by type (commercial real estate and construction, residential real estate, commercial or consumer). Each loan type is assigned an allowance factor based on management's estimate of the risk, complexity and size of individual loans within a particular category.

The nonspecific allowance is used to estimate the loss on loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements.

The economic downturn has continued to materially impact our performance since the second half of 2009. Because most of our loans are secured by real estate, persistent weaknesses in our local real estate market and construction industry, and lack of improvement in general economic conditions have had a material adverse effect on the credit quality and performance of our loan portfolio. Factors affecting the loan portfolio performance and our overall financial performance included higher provisions for credit losses, loan charge-offs and nonperforming assets (nonperforming loans and other real estate and other assets owned).

As seen in the table below, the allowance for credit losses was \$14.3 million, or 1.64% of average outstanding loans and 28% of total nonaccrual loans at December 31, 2011, compared to an allowance of \$14.2 million, or 1.57% of average outstanding loans and 39% of nonaccrual loans at December 31, 2010. Although the allowance was relatively unchanged from year-end 2010 to year-end 2011, the allowance for credit losses as a percentage of average loans increased. At December 31, 2009, the allowance for credit losses was \$10.9 million, or 1.19% of average outstanding loans and 67% of nonaccrual loans. The ratio of net charge-offs to average loans was 2.22% in 2011, 1.96% in 2010 and 0.81% in 2009.

The allowance for credit losses as a percentage of nonaccrual loans has declined in each of the last three years as a result of the increased volume of impaired nonaccrual loans. When a loan is determined to be impaired, the uncollectible portion is charged-off. Impaired nonaccrual loans were reduced by partial charge-offs totaling \$13.5 million, or 20.8%, of the unpaid principal balance at December 31, 2011, compared to \$8.3 million, or 18.6%, at



December 31, 2010.

The provision for credit losses was \$19.5 million for 2011, compared to \$21.1 million and \$9.0 million for 2010 and 2009, respectively. Net loan charge-offs totaled \$19.4 million in 2011, \$17.8 million in 2010 and \$7.4 million in 2009. When comparing 2011 to 2010, residential and commercial real estate were the two loan categories that reflected increases in charge offs. When comparing 2010 to 2009, all loan categories reflected increases in charge offs except for commercial real estate. Construction loans had the largest amount of charge offs in 2010. These losses primarily related to two significant construction loan relationships.

Although credit quality has been negatively impacted by weak economic conditions, we continue to observe strong underwriting guidelines. However, as management identifies problem loans, it quantifies and attempts to minimize losses and pursues loan workouts, which result in either mutually acceptable resolutions or the disposal of the problem loans. In light of the impact that the recession has had on our loan quality over the past few years, we have been more focused in our efforts to dispose of existing problem loans in an attempt to improve our financial performance. The historically low real estate values that we are experiencing delay this process.

The following table sets forth a summary of our loan loss experience for the years ended December 31.

| (Dollars in thousands)   | 2011       | 2010       | 2009       | 2008       | 2007       |
|--|------------|------------|------------|------------|------------|
| Balance, beginning of year   | \$ 14,227  | \$ 10,876  | \$ 9,320   | \$ 7,551   | \$ 6,300   |
| Loans charged off  |            |            |            |            |            |
| Construction   | (4,236 )   | (7,910 )   | (674 )     | (536 )     | -          |
| Residential real estate  | (7,693 )   | (5,818 )   | (2,621 )   | (316 )     | (137 )     |
| Commercial real estate   | (5,037 )   | (492 )     | (1,695 )   | (238 )     | -          |
| Commercial   | (3,388 )   | (3,710 )   | (2,304 )   | (447 )     | (276 )     |
| Consumer   | (202 )     | (589 )     | (417 )     | (276 )     | (301 )     |
| Total  | (20,556 )  | (18,519 )  | (7,711 )   | (1,813 )   | (714 )     |
| Recoveries   |            |            |            |            |            |
| Construction   | 49         | 14         | 2          | -          | -          |
| Residential real estate  | 120        | 215        | 70         | 19         | -          |
| Commercial real estate   | 361        | 108        | 6          | -          | -          |
| Commercial   | 549        | 214        | 66         | 136        | 165        |
| Consumer   | 68         | 200        | 137        | 90         | 76         |
| Total  | 1,147      | 751        | 281        | 245        | 241        |
| Net loans charged off  | (19,409 )  | (17,768 )  | (7,430 )   | (1,568 )   | (473 )     |
| Provision for credit losses  | 19,470     | 21,119     | 8,986      | 3,337      | 1,724      |
| Balance, end of year   | \$ 14,288  | \$ 14,227  | \$ 10,876  | \$ 9,320   | \$ 7,551   |
| Average loans outstanding  | \$ 873,155 | \$ 906,732 | \$ 913,631 | \$ 837,739 | \$ 728,766 |
| Percentage of net charge-offs to average loans outstanding during the year | 2.22 %     | 1.96 %     | 0.81 %     | 0.19 %     | 0.06 %     |
| Percentage of allowance for credit losses at year end to average loans     | 1.64 %     | 1.57 %     | 1.19 %     | 1.11 %     | 1.04 %     |

During 2011, there was no significant change in the processes or assumptions affecting the allowance methodology. The amount of the provision is determined based on management's analysis of the portfolio, growth and changes in the condition of credits and their resultant specific loss allocations. Historically, we have experienced the majority of our losses in the commercial loan portfolio, which are typically not secured by real estate. However, beginning in 2008, the Company experienced significantly higher losses on real estate secured loans due to declining real estate values and the economic downturn.

Included in the balance of the allowance for credit losses were specific reserves of \$1.5 million, \$203 thousand and \$468 thousand at the end of 2011, 2010 and 2009, respectively. These specific reserves were primarily for residential

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real estate loans at year-end 2011 and 2010, and commercial loans at year-end 2009. As seen in the table below, the unallocated portion of the allowance for credit losses was a fairly small percent of the total allowance with \$22 thousand at December 31, 2011, \$343 thousand at December 31, 2010 and \$124 thousand at December 31, 2009. As stated previously, most of our loans are secured by real estate with the portfolio comprised of 14.3% construction, 38.2% residential real estate and 37.5% commercial real estate at December 31, 2011. That compares to 16.1%, 37.3% and 35.6%, respectively, at December 31, 2010 and 17.6%, 35.8% and 34.5 %, respectively, at December 31, 2009.

The following table sets forth the allocation of the allowance for credit losses and the percentage of loans in each category to total loans for the years ended December 31.

|                         | 2011     |            | 2010     |            | 2009     |            | 2008    |            | 2007    |            |
|-------------------------|----------|------------|----------|------------|----------|------------|---------|------------|---------|------------|
|                         | Amount   | % of Loans | Amount   | % of Loans | Amount   | % of Loans | Amount  | % of Loans | Amount  | % of Loans |
| (Dollars in thousands)  |          |            |          |            |          |            |         |            |         |            |
| Construction            | \$3,745  | 14.3 %     | \$3,327  | 16.1 %     | \$2,630  | 17.6 %     | \$2,749 | 20.2 %     | \$1,398 | 20.0 %     |
| Residential real estate | 5,014    | 38.2       | 4,833    | 37.3       | 1,528    | 35.8       | 644     | 32.6       | 538     | 33.0       |
| Commercial real estate  | 3,415    | 37.5       | 3,665    | 35.6       | 3,947    | 34.5       | 3,357   | 34.3       | 3,537   | 32.1       |
| Commercial              | 1,498    | 8.3        | 1,422    | 9.2        | 2,132    | 10.0       | 2,073   | 10.3       | 1,826   | 11.9       |
| Consumer                | 594      | 1.7        | 637      | 1.8        | 515      | 2.1        | 281     | 2.6        | 252     | 3.0        |
| Unallocated             | 22       | -          | 343      | -          | 124      | -          | 216     | -          | -       | -          |
| Total                   | \$14,288 | 100.0 %    | \$14,227 | 100.0 %    | \$10,876 | 100.0 %    | \$9,320 | 100.0 %    | \$7,551 | 100.0 %    |

Nonperforming assets were \$88.7 million, \$69.6 million and \$28.0 million at December 31, 2011, 2010 and 2009, respectively. For 2011, total nonperforming loans increased \$13.4 million, primarily in nonaccrual residential and commercial real estate loans, and other real estate and other assets owned increased \$5.7 million. See Note 20 to the Consolidated Financial Statements for further information about the changes in the balances of nonaccrual loans and troubled debt restructurings. For 2010, total nonperforming loans increased \$40.4 million, primarily in nonaccrual real estate loans and troubled debt restructurings, and other real estate and other assets owned increased \$1.1 million. From year-end 2009 to year-end 2010, the increase in nonaccrual loans was primarily in construction loans that related largely to two borrowing relationships while the increase in troubled debt restructurings reflected a rise in concessionary workouts relating to problem loans.

The following table summarizes our nonperforming and past due assets as of December 31.

| (Dollars in thousands)                                  | 2011     | 2010     | 2009     | 2008    | 2007    |
|---|----------|----------|----------|---------|---------|
| Nonperforming assets                                    |          |          |          |         |         |
| Nonaccrual loans  |          |          |          |         |         |
| Construction  | \$15,555 | \$17,261 | \$7,163  | \$5,277 | \$1,668 |
| Residential real estate                                 | 20,106   | 9,969    | 4,246    | 1,015   | 876     |
| Commercial real estate                                  | 14,012   | 5,133    | 2,828    | 1,682   | 877     |
| Commercial  | 1,669    | 3,845    | 2,028    | 137     | 114     |
| Consumer  | 28       | 30       | 37       | 4       | 5       |
| Total nonaccrual loans                                  | 51,370   | 36,238   | 16,302   | 8,115   | 3,540   |
| Loans 90 days or more past due and still accruing       |          |          |          |         |         |
| Construction  | 325      | -        | 5,096    | 64      | 637     |
| Residential real estate                                 | 2,331    | 3,454    | 2,274    | 583     | 473     |
| Commercial real estate                                  | -        | 986      | -        | 726     | 137     |
| Commercial  | 66       | 174      | -        | 3       | 337     |
| Consumer  | 1        | 88       | 55       | 5       | 22      |
| Total loans 90 days or more past due and still accruing | 2,723    | 4,702    | 7,425    | 1,381   | 1,606   |
| Accruing troubled debt restructurings                   |          |          |          |         |         |
| Construction  | 11,781   | 10,914   | -        | 237     | 267     |
| Residential real estate                                 | 3,792    | 5,367    | 1,722    | -       | -       |
| Commercial real estate                                  | 9,566    | 8,147    | -        | -       | -       |
| Commercial  | 69       | 529      | -        | -       | -       |
| Consumer  | -        | -        | -        | -       | -       |
| Total accruing troubled debt restructurings             | 25,208   | 24,957   | 1,722    | 237     | 267     |
| Total nonperforming loans                               | 79,301   | 65,897   | 25,449   | 9,733   | 5,413   |
| Other real estate and other assets owned                | 9,385    | 3,702    | 2,572    | 148     | 176     |
| Total nonperforming assets                              | \$88,686 | \$69,599 | \$28,021 | \$9,881 | \$5,589 |
| Nonaccrual loans to total loans                         | 6.11 %   | 4.05 %   | 1.78 %   | 0.91 %  | 0.46 %  |
| Nonaccrual loans to total assets                        | 4.44 %   | 3.21 %   | 1.41 %   | 0.78 %  | 0.37 %  |
|   | 10.43 %  | 7.74 %   | 3.05 %   | 1.11 %  | 0.72 %  |

Nonperforming assets to total loans and other real estate and other assets owned

Nonperforming assets to total assets 7.66 % 6.16 % 2.42 % 0.95 % 0.58 %

### Market Risk Management

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates or equity pricing. Our principal market risk is interest rate risk that arises from our lending, investing and deposit taking activities. Our profitability is largely dependent on the Banks' net interest income. Interest rate risk can significantly affect net interest income to the degree that interest-bearing liabilities mature or reprice at different intervals than interest-earning assets. The Company's and Banks' Asset/Liability Management Committees oversee the management of interest rate risk. The primary purpose of these committees is to manage the exposure of net interest margins to unexpected changes due to interest rate fluctuations. These efforts affect our loan pricing and deposit rate policies as well as asset mix, volume guidelines, and liquidity and capital planning.

During 2009, the Company began using derivative instruments to hedge its exposure to changes in interest rates. The Company does not use derivatives for any trading or other speculative purposes. See Note 21 to the Consolidated Financial Statements for further information on hedging activities.

Because we are not exposed to market risk from trading activities and do not use off-balance sheet management strategies, the Asset/Liability Management Committees of the Company and Banks rely on “gap” analysis as its primary tool in managing interest rate risk. Gap analysis summarizes the amount of interest sensitive assets and liabilities, which will reprice over various time intervals. The excess between the volume of assets and liabilities repricing in each interval is the interest sensitivity “gap”. “Positive gap” occurs when more assets reprice in a given time interval, while “negative gap” occurs when more liabilities reprice. At December 31, 2011, as seen in the table below, we had an overall negative gap position within the one-year repricing interval because the interest sensitive liabilities exceeded the interest sensitive assets within the one-year repricing interval by \$34.5 million, or 3.0% of total assets. The negative gap position within the one-year interval at December 31, 2010 totaled \$37.0 million, or 3.3% of total assets, similar to the negative gap position at the end of 2011. The negative gap position within the one-year interval at December 31, 2009, totaled \$150.8 million, or 13.0% of total assets. The \$113.8 million decrease in the one-year negative gap for 2010 when compared to 2009 was primarily due to fewer time deposits in the one-year interval gap at the end of 2010 than at the end of 2009 which was attributable to management reducing rates on time deposits.

The following table summarizes our interest sensitivity at December 31, 2011. Loans, federal funds sold, time deposits and short-term borrowings are classified based on contractual maturities if fixed rate or earliest repricing date if variable rate. Investment securities are classified by contractual maturities or, if they have call provisions, by the most likely repricing date.

|  | Within<br>3 Months | 3 Months<br>through<br>12<br>Months | 1 Year<br>through<br>3 Years | 3 Years<br>through<br>5 Years | After<br>5 Years | Non-<br>Sensitive<br>Funds | Total     |
|--|--------------------|-------------------------------------|------------------------------|-------------------------------|------------------|----------------------------|-----------|
| December 31, 2011                                |                    |                                     |                              |                               |                  |                            |           |
| (Dollars in thousands)                           |                    |                                     |                              |                               |                  |                            |           |
| <b>ASSETS</b>                                    |                    |                                     |                              |                               |                  |                            |           |
| Loans, net                                       | \$447,983          | \$78,723                            | \$180,627                    | \$91,358                      | \$42,359         | \$(14,288)                 | \$826,762 |
| Investment securities                            | 14,057             | 14,149                              | 31,679                       | 27,987                        | 47,789           | 599                        | 136,260   |
| Federal funds sold                               | 4,980              | -                                   | -                            | -                             | -                | -                          | 4,980     |
| Interest-bearing<br>deposits with other<br>banks | 99,776             | -                                   | -                            | -                             | -                | -                          | 99,776    |
| Other assets                                     | -                  | -                                   | -                            | -                             | -                | 90,415                     | 90,415    |
| Total assets                                     | 566,796            | 92,872                              | 212,306                      | 119,345                       | 90,148           | 76,726                     | 1,158,193 |
| <b>LIABILITIES</b>                               |                    |                                     |                              |                               |                  |                            |           |
| Noninterest-bearing<br>demand deposits           | -                  | -                                   | -                            | -                             | -                | 133,801                    | 133,801   |
| Interest-bearing<br>demand deposits              | 161,999            | -                                   | -                            | -                             | -                | -                          | 161,999   |
| Money market and<br>savings deposits             | 269,214            | -                                   | -                            | -                             | -                | -                          | 269,214   |
| Certificates of deposit,<br>\$100,000 or more    | 47,939             | 96,538                              | 52,775                       | 46,295                        | -                | -                          | 243,547   |
| Other time deposits                              | 26,321             | 73,917                              | 63,811                       | 37,309                        | -                | -                          | 201,358   |

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|  |          |             |          |          |           |              |           |    |
|--|----------|-------------|----------|----------|-----------|--------------|-----------|----|
| Short-term borrowings                                  | 17,817   | -           | -        | -        | -         | -            | 17,817    |    |
| Long-term debt   | -        | 455         | -        | -        | -         | -            | 455       |    |
| Other liabilities                                      | -        | -           | -        | -        | -         | 8,753        | 8,753     |    |
| STOCKHOLDERS' EQUITY                                   | -        | -           | -        | -        | -         | 121,249      | 121,249   |    |
| Total Liabilities and Stockholders' Equity             | 523,290  | 170,910     | 116,586  | 83,604   | -         | 263,803      | 1,158,193 |    |
| Excess (deficit)                                       | \$43,506 | \$(78,038 ) | \$95,720 | \$35,741 | \$90,148  | \$(187,077 ) | \$-       |    |
| Cumulative excess (deficit)                            | \$43,506 | \$(34,532 ) | \$61,188 | \$96,929 | \$187,077 | \$-          | \$-       |    |
| Cumulative excess (deficit) as percent of total assets | 3.8      | % (3.0 )%   | 5.3      | % 8.4    | % 16.2    | %            | -%        | -% |

In addition to gap analysis, the Banks use simulation models to quantify the effect a hypothetical immediate plus or minus 100, 200 and 300 basis point change in rates would have on their net interest income and the fair value of capital. The model takes into consideration the effect of call features of investment securities as well as prepayments of loans in periods of declining rates. The chart below summarizes the forecasted results provided by the simulation model for net interest income and the fair value of capital as of year-end 2011 and 2010. For example, the model projects that, compared with net interest income under stable rates, net interest income would increase 3.0% if interest rates increased 100 basis points. Conversely, net interest income would decrease 1.4% if interest rates decreased 100 basis points. When actual changes in interest rates occur, the changes in interest-earning assets and interest-bearing liabilities may differ from the assumptions used in the model. Due to the low interest-rate environment, we believe the results of the minus 300 basis point change in rates are not meaningful.

|                                 | Immediate Change in Rates |                      |                      |                      |                      |                      |
|---------------------------------|---------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
|                                 | -300<br>Basis<br>Points   | -200<br>Basis Points | -100<br>Basis Points | +100<br>Basis Points | +200<br>Basis Points | +300<br>Basis Points |
| <b>2011</b>                     |                           |                      |                      |                      |                      |                      |
| % Change in Net Interest Income | N/A                       | (6.6 )%              | (1.4 )%              | 3.0 %                | 8.0 %                | 14.6%                |
| % Change in Value of Capital    | N/A                       | 12.8 %               | 6.9 %                | 3.3 %                | 7.8 %                | 11.6%                |
| <b>2010</b>                     |                           |                      |                      |                      |                      |                      |
| % Change in Net Interest Income | N/A                       | (4.0 )%              | 0.9 %                | 1.1 %                | 3.2 %                | 7.9%                 |
| % Change in Value of Capital    | N/A                       | 8.4 %                | 3.9 %                | 4.4 %                | 7.4 %                | 9.3%                 |

### Off-Balance Sheet Arrangements

In the normal course of business, to meet the financing needs of its customers, the Banks are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. The Banks' exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Banks use the same credit policies in making commitments and conditional obligations as they use for on-balance sheet instruments. The Banks generally require collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Banks evaluate each customer's creditworthiness on a case-by-case basis.

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. Letters of credit are conditional commitments issued by the Banks to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. Further information about these arrangements is provided in Note 22 to the Consolidated Financial Statements.



Management does not believe that any of the foregoing arrangements have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

### **Liquidity Management**

Liquidity describes our ability to meet financial obligations that arise during the normal course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of customers and to fund current and planned expenditures. Liquidity is derived through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets. We have arrangements with correspondent banks whereby we have \$15.5 million available in federal funds lines of credit and a reverse repurchase agreement available to meet any short-term needs which may not otherwise be funded by the Banks' portfolio of readily marketable investments that can be converted to cash. The Banks are also members of the FHLB, which provides another source of liquidity, and had credit availability of approximately \$31.6 million from the FHLB as of December 31, 2011. Further information is provided in Note 19 to the Consolidated Financial Statements.

At December 31, 2011, our loan to deposit ratio was approximately 83.3%, which represents a more liquid position than the 91.4% and 92.5% at year-end 2010 and 2009, respectively. During 2009, we began participating in the IND program which increased liquidity. Investment securities available for sale totaling \$129.8 million at the end of 2011 were available for the management of liquidity and interest rate risk. The comparable amounts were \$99.1 million and \$97.6 million at December 31, 2010 and 2009, respectively. Cash and cash equivalents were \$127.7 million at December 31, 2011, compared to \$78.0 million at year-end 2010 and \$75.6 million at year-end 2009. Overall, we were in a more liquid position at the end of 2011 than we were at the end of 2010. Our liquidity position at the end of 2010 was similar to that at the end of 2009. Management is not aware of any demands, commitments, events or uncertainties that will materially affect our ability to maintain liquidity at satisfactory levels.

We have various financial obligations, including contractual obligations and commitments that may require future cash payments.

The following table presents significant fixed and determinable contractual obligations to third parties by payment date as of December 31, 2011.

| (Dollars in thousands) | Within<br>one<br>year | One to<br>three<br>years | Three<br>to<br>five<br>years | Over<br>five<br>years | Total    |
|------------------------|-----------------------|--------------------------|------------------------------|-----------------------|----------|
| Long-term debt         | \$455                 | \$-                      | \$-                          | \$-                   | \$455    |
| Operating leases       | 725                   | 865                      | 491                          | 1,387                 | 3,468    |
| Purchase obligations   | 2,736                 | 3,360                    | 2,771                        | 6,014                 | 14,881   |
| Total                  | \$3,916               | \$4,225                  | \$3,262                      | \$7,401               | \$18,804 |

#### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**

The information required by this item may be found in Item 7 of Part II of this annual report under the caption “Market Risk Management”, which is incorporated herein by reference.

#### **Item 8. Financial Statements and Supplementary Data.**

#### **INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Shore Bancshares, Inc. (the "Company") is responsible for the preparation, integrity and fair presentation of the consolidated financial statements included in this annual report. The Company's consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and, as such, include some amounts that are based on the best estimates and judgments of management.

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. This internal control system is designed to provide reasonable assurance to management and the Board of Directors regarding the reliability of the Company's financial reporting and the preparation and presentation of financial statements for external reporting purposes in conformity with accounting principles generally accepted in the United States of America, as well as to safeguard assets from unauthorized use or disposition. The system of internal control over financial reporting is evaluated for effectiveness by management and tested for reliability through a program of internal audit with actions taken to correct potential deficiencies as they are identified. Because of inherent limitations in any internal control system, no matter how well designed, misstatement due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2011 based upon criteria set forth in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on this assessment and on the foregoing criteria, management has concluded that, as of December 31, 2011, the Company's internal control over financial reporting is effective. Stegman & Company, the Company's independent registered public accounting firm that audited the financial statements included in this annual report, has issued a report on the Company's internal control over financial reporting, which appears on the following page.

March 14, 2012

|                          |                              |
|--------------------------|------------------------------|
| /s/ W. Moorhead Vermilye | /s/ Susan E. Leaverton       |
| W. Moorhead Vermilye     | Susan E. Leaverton, CPA      |
| Chief Executive Officer  | Principal Accounting Officer |



## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and

Stockholders of Shore Bancshares, Inc.

We have audited the accompanying consolidated balance sheets of Shore Bancshares, Inc. (the “Company”) as of December 31, 2011 and 2010, and the consolidated statements of (loss) income, comprehensive (loss) income, changes in stockholders’ equity and cash flows for each of the years in the three-year period ended December 31, 2011. We also have audited the Company’s internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company’s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management’s Report on Internal Control over Financial Reporting*. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company’s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Shore Bancshares, Inc. as of December 31, 2011 and 2010, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Shore Bancshares, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Baltimore, Maryland

March 14, 2012

**SHORE BANCSHARES, INC.****CONSOLIDATED BALANCE SHEETS**

December 31,

| (In thousands, except share data)  | 2011        | 2010        |
|--|-------------|-------------|
| <b>ASSETS</b>  |             |             |
| Cash and due from banks  | \$22,986    | \$19,680    |
| Interest-bearing deposits with other banks   | 99,776      | 21,593      |
| Federal funds sold   | 4,980       | 36,691      |
| Investment securities:   |             |             |
| Available for sale, at fair value  | 129,780     | 99,055      |
| Held to maturity, at amortized cost – fair value of \$6,732 (2011) and \$6,851 (2010)  | 6,480       | 6,727       |
| Loans  | 841,050     | 895,404     |
| Less: allowance for credit losses  | (14,288 )   | (14,227 )   |
| Loans, net   | 826,762     | 881,177     |
| Premises and equipment, net  | 14,662      | 14,483      |
| Goodwill   | 12,454      | 13,678      |
| Other intangible assets, net   | 4,208       | 4,840       |
| Other real estate and other assets owned, net  | 9,385       | 3,702       |
| Other assets   | 26,720      | 28,685      |
| Total assets   | \$1,158,193 | \$1,130,311 |
| <b>LIABILITIES</b>   |             |             |
| Deposits:  |             |             |
| Noninterest-bearing  | \$133,801   | \$124,188   |
| Interest-bearing   | 876,118     | 855,328     |
| Total deposits   | 1,009,919   | 979,516     |
| Short-term borrowings  | 17,817      | 16,041      |
| Other liabilities  | 8,753       | 11,309      |
| Long-term debt   | 455         | 932         |
| Total liabilities  | 1,036,944   | 1,007,798   |
| <b>STOCKHOLDERS' EQUITY</b>  |             |             |
| Common stock, par value \$.01, authorized 35,000,000 shares; shares issued and outstanding—8,457,359 (2011) and 8,443,436 (2010) | 85          | 84          |
| Warrant  | -           | 1,543       |
| Additional paid in capital   | 32,052      | 30,242      |
| Retained earnings  | 90,801      | 92,458      |
| Accumulated other comprehensive loss   | (1,689 )    | (1,814 )    |
| Total stockholders' equity   | 121,249     | 122,513     |

|  |             |             |
|--|-------------|-------------|
| Total liabilities and stockholders' equity | \$1,158,193 | \$1,130,311 |
|--|-------------|-------------|

The notes to the consolidated financial statements are an integral part of these statements.



**SHORE BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF (LOSS) INCOME**

For the Years Ended December 31,

| (Dollars in thousands, except per share data)                | 2011     | 2010     | 2009     |
|--|----------|----------|----------|
| <b>INTEREST INCOME</b>                                       |          |          |          |
| Interest and fees on loans                                   | \$47,549 | \$51,962 | \$55,209 |
| Interest and dividends on investment securities:             |          |          |          |
| Taxable  | 3,031    | 3,209    | 3,184    |
| Tax-exempt   | 154      | 212      | 301      |
| Interest on federal funds sold                               | 25       | 60       | 84       |
| Interest on deposits with other banks                        | 93       | 18       | 11       |
| Total interest income  | 50,852   | 55,461   | 58,789   |
| <b>INTEREST EXPENSE</b>                                      |          |          |          |
| Interest on deposits   | 10,995   | 12,681   | 17,018   |
| Interest on short-term borrowings                            | 56       | 83       | 127      |
| Interest on long-term debt                                   | 37       | 58       | 266      |
| Total interest expense                                       | 11,088   | 12,822   | 17,411   |
| <b>NET INTEREST INCOME</b>                                   | 39,764   | 42,639   | 41,378   |
| Provision for credit losses                                  | 19,470   | 21,119   | 8,986    |
| <b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b> | 20,294   | 21,520   | 32,392   |
| <b>NONINTEREST INCOME</b>                                    |          |          |          |
| Service charges on deposit accounts                          | 2,845    | 3,257    | 3,424    |
| Trust and investment fee income                              | 1,563    | 1,503    | 1,100    |
| Gains on sales of investment securities                      | 563      | -        | 49       |
| Insurance agency commissions income                          | 9,358    | 10,113   | 11,131   |
| Other noninterest income                                     | 2,989    | 3,168    | 3,837    |
| Total noninterest income                                     | 17,318   | 18,041   | 19,541   |
| <b>NONINTEREST EXPENSE</b>                                   |          |          |          |
| Salaries and wages   | 16,825   | 17,477   | 18,488   |
| Employee benefits  | 3,840    | 3,829    | 4,631    |
| Occupancy expense  | 2,312    | 2,328    | 2,324    |
| Furniture and equipment expense                              | 1,059    | 1,200    | 1,183    |
| Data processing  | 2,852    | 2,607    | 2,463    |
| Directors' fees  | 500      | 412      | 478      |
| Goodwill and other intangible assets impairment              | 1,344    | 3,051    | -        |
| Amortization of other intangible assets                      | 512      | 515      | 515      |
| Insurance agency commissions expense                         | 1,267    | 1,569    | 1,913    |

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|  |           |            |         |
|--|-----------|------------|---------|
| FDIC insurance premium expense                     | 1,298     | 1,834      | 2,078   |
| Other noninterest expenses                         | 7,358     | 6,898      | 6,175   |
| Total noninterest expense                          | 39,167    | 41,720     | 40,248  |
| <br>   |           |            |         |
| (LOSS) INCOME BEFORE INCOME TAXES                  | (1,555 )  | (2,159 )   | 11,685  |
| Income tax (benefit) expense                       | (658 )    | (492 )     | 4,412   |
| <br>   |           |            |         |
| NET (LOSS) INCOME                                  | (897 )    | (1,667 )   | 7,273   |
| Preferred stock dividends and discount accretion   | -         | -          | 1,876   |
| Net (loss) income available to common shareholders | \$(897 )  | \$(1,667 ) | \$5,397 |
| <br>   |           |            |         |
| Basic (loss) earnings per common share             | \$(0.11 ) | \$(0.20 )  | \$0.64  |
| Diluted (loss) earnings per common share           | \$(0.11 ) | \$(0.20 )  | \$0.64  |
| Cash dividends paid per common share               | \$0.09    | \$0.24     | \$0.64  |

The notes to the consolidated financial statements are an integral part of these statements.

**SHORE BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME**

For the Years Ending December 31,

| (Dollars in thousands)   | 2011     | 2010      | 2009    |
|--|----------|-----------|---------|
| Net (loss) income  | \$(897 ) | \$(1,667) | \$7,273 |
| Other comprehensive (loss) income:                                 |          |           |         |
| Securities available for sale:                                     |          |           |         |
| Unrealized holding gains (losses) on available-for-sale securities | 1,241    | 406       | (1,061) |
| Tax effect   | (505 )   | (164 )    | 425     |
| Reclassification of gains recognized in net income                 | (563 )   | -         | (49 )   |
| Tax effect   | 227      | -         | 20      |
| Net of tax amount  | 400      | 242       | (665 )  |
| Cash flow hedging activities:                                      |          |           |         |
| Unrealized holding losses on cash flow hedging activities          | (460 )   | (3,717)   | (952 )  |
| Tax effect   | 185      | 1,501     | 384     |
| Net of tax amount  | (275 )   | (2,216)   | (568 )  |
| Total other comprehensive income (loss)                            | 125      | (1,974)   | (1,233) |
| Comprehensive (loss) income  | \$(772 ) | \$(3,641) | \$6,040 |

The notes to the consolidated financial statements are an integral part of these statements.

**SHORE BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

For the Years Ended December 31, 2011, 2010, and 2009

| (Dollars in thousands, except per share data)  | Preferred Stock | Common Stock | Warrant | Additional Paid In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Stockholders' Equity |
|--|-----------------|--------------|---------|----------------------------|-------------------|---|----------------------------|
| Balances, December 31, 2008  | \$-             | \$ 84        | \$-     | \$ 29,768                  | \$ 96,140         | \$ 1,393                                      | \$ 127,385                 |
| Comprehensive income:  |                 |              |         |                            |                   |   |                            |
| Net income   | -               | -            | -       | -                          | 7,273             | -   | 7,273                      |
| Unrealized losses on available-for-sale securities, net of reclassification adjustment, net of taxes | -               | -            | -       | -                          | -                 | (665 )  | (665 )                     |
| Unrealized losses on cash flow hedging activities, net of taxes                                      | -               | -            | -       | -                          | -                 | (568 )  | (568 )                     |
| Total comprehensive income   |                 |              |         |                            |                   |   | 6,040                      |
| Warrant issued   | -               | -            | 1,543   | -                          | -                 | -   | 1,543                      |
| Preferred shares issued pursuant to TARP   | 25,000          | -            | -       | -                          | -                 | -   | 25,000                     |
| Discount from issuance of preferred stock  | (1,543 )        | -            | -       | -                          | -                 | -   | (1,543 )                   |
| Discount accretion   | 68              | -            | -       | -                          | (68 )             | -   | -                          |
| Redemption of preferred stock  | (23,525)        | -            | -       | -                          | -                 | -   | (23,525 )                  |
| Shares issued for employee stock-based awards  | -               | -            | -       | 2                          | -                 | -   | 2                          |
| Stock-based compensation   | -               | -            | -       | 102                        | -                 | -   | 102                        |
| Preferred stock dividends  | -               | -            | -       | -                          | (1,808 )          | -   | (1,808 )                   |
| Cash dividends paid (\$0.64 per share)   | -               | -            | -       | -                          | (5,386 )          | -   | (5,386 )                   |
| Balances, December 31, 2009  | -               | 84           | 1,543   | 29,872                     | 96,151            | 160   | 127,810                    |
| Comprehensive loss:  |                 |              |         |                            |                   |   |                            |
| Net loss   | -               | -            | -       | -                          | (1,667 )          | -   | (1,667 )                   |
| Unrealized gains on available-for-sale securities, net of reclassification adjustment, net of taxes  | -               | -            | -       | -                          | -                 | 242   | 242                        |
| Unrealized losses on cash flow hedging activities, net of taxes                                      | -               | -            | -       | -                          | -                 | (2,216 )                                      | (2,216 )                   |

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|   |     |       |          |           |           |             |            |
|---|-----|-------|----------|-----------|-----------|-------------|------------|
| Total comprehensive loss  |     |       |          |           |           |             | (3,641 )   |
| Stock-based compensation expense  | -   | -     | -        | 370       | -         | -           | 370        |
| Cash dividends paid (\$0.24 per share)  | -   | -     | -        | -         | (2,026 )  | -           | (2,026 )   |
| Balances, December 31, 2010   | -   | 84    | 1,543    | 30,242    | 92,458    | (1,814 )    | 122,513    |
| Comprehensive loss:   |     |       |          |           |           |             |            |
| Net loss  | -   | -     | -        | -         | (897 )    | -           | (897 )     |
| Unrealized gains on available-for-sale securities, net of reclassification adjustment, net of taxes | -   | -     | -        | -         | -         | 400         | 400        |
| Unrealized losses on cash flow hedging activities, net of taxes                                     | -   | -     | -        | -         | -         | (275 )      | (275 )     |
| Total comprehensive loss  |     |       |          |           |           |             | (772 )     |
| Repurchase of warrant   | -   | -     | (1,543 ) | 1,518     | -         | -           | (25 )      |
| Shares issued for employee stock-based awards   | -   | 1     | -        | (1 )      | -         | -           | -          |
| Stock-based compensation expense  | -   | -     | -        | 293       | -         | -           | 293        |
| Cash dividends paid (\$0.09 per share)  | -   | -     | -        | -         | (760 )    | -           | (760 )     |
| Balances, December 31, 2011   | \$- | \$ 85 | \$-      | \$ 32,052 | \$ 90,801 | \$ (1,689 ) | \$ 121,249 |

The notes to the consolidated financial statements are an integral part of these statements.

**SHORE BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

For the Years Ended December 31,

| (Dollars in thousands)  | 2011      | 2010       | 2009      |
|---|-----------|------------|-----------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |           |            |           |
| Net (loss) income   | \$(897 )  | \$(1,667 ) | \$7,273   |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities:    |           |            |           |
| Provision for credit losses   | 19,470    | 21,119     | 8,986     |
| Goodwill and other intangible assets impairment   | 1,344     | 3,051      | -         |
| Depreciation and amortization   | 2,341     | 2,405      | 1,880     |
| Discount accretion on debt securities   | (156 )    | (128 )     | (226 )    |
| Stock-based compensation expense  | 338       | 390        | 102       |
| Excess tax expense from stock-based arrangements  | (45 )     | (20 )      | (5 )      |
| Deferred income tax benefit   | (1,550 )  | (2,905 )   | (928 )    |
| Gains on sales of investment securities   | (563 )    | -          | (49 )     |
| Losses on disposals of premises and equipment   | 36        | -          | -         |
| Losses on sales of other real estate owned  | 1,222     | 735        | 185       |
| Gains on interest rate swaps  | -         | -          | (420 )    |
| Net changes in:   |           |            |           |
| Accrued interest receivable   | 1,127     | (256 )     | (198 )    |
| Other assets  | 1,813     | 2,516      | (6,541 )  |
| Accrued interest payable  | (291 )    | (921 )     | (569 )    |
| Other liabilities   | (2,265 )  | (4,429 )   | 5,536     |
| Net cash provided by operating activities   | 21,924    | 19,890     | 15,026    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |           |            |           |
| Proceeds from maturities and principal payments of investment securities available for sale | 53,343    | 47,945     | 53,668    |
| Proceeds from sales of investment securities available for sale                             | 20,825    | -          | 2,048     |
| Purchases of investment securities available for sale                                       | (104,305) | (49,626)   | (78,376 ) |
| Proceeds from maturities and principal payments of investment securities held to maturity   | 226       | 2,195      | 3,934     |
| Purchases of investment securities held to maturity   | -         | -          | (2,623 )  |
| Net change in loans   | 24,233    | 264        | (38,190 ) |
| Purchases of premises and equipment   | (1,216 )  | (1,292 )   | (1,553 )  |
| Proceeds from sales of premises and equipment   | 4         | -          | -         |
| Proceeds from sales of other real estate owned  | 3,807     | 1,255      | 122       |
| Purchases of interest rate caps   | -         | -          | (6,475 )  |
| Investment in unconsolidated subsidiary   | (25 )     | (25 )      | -         |
| Net cash (used in) provided by investing activities   | (3,108 )  | 716        | (67,445 ) |

## CASH FLOWS FROM FINANCING ACTIVITIES:

Net changes in:

|   |        |          |           |
|---|--------|----------|-----------|
| Noninterest-bearing deposits                          | 9,613  | 1,696    | 19,908    |
| Interest-bearing deposits                             | 20,790 | (13,118) | 125,658   |
| Short-term borrowings                                 | 1,776  | (4,363 ) | (32,565 ) |
| Excess tax expense from stock-based arrangements      | 45     | 20       | 5         |
| Repayment of long-term debt                           | (477 ) | (497 )   | (6,518 )  |
| Proceeds from issuance of preferred stock and warrant | -      | -        | 25,000    |
| Redemption of preferred stock                         | -      | -        | (23,525 ) |
| Repurchase of warrant                                 | (25 )  | -        | -         |
| Proceeds from issuance of common stock                | -      | -        | 2         |
| Preferred stock dividends paid                        | -      | -        | (1,808 )  |
| Common stock dividends paid                           | (760 ) | (2,026 ) | (5,386 )  |
| Net cash provided by (used in) financing activities   | 30,962 | (18,288) | 100,771   |

**SHORE BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)**

For the Years Ended December 31,

| (Dollars in thousands)                          | 2011      | 2010     | 2009     |
|---|-----------|----------|----------|
| NET INCREASE IN CASH AND CASH EQUIVALENTS       | 49,778    | 2,318    | 48,352   |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR  | 77,964    | 75,646   | 27,294   |
| CASH AND CASH EQUIVALENTS AT END OF YEAR        | \$127,742 | \$77,964 | \$75,646 |
| Supplemental cash flow information:             |           |          |          |
| Interest paid                                   | \$11,379  | \$13,743 | \$17,980 |
| Income taxes paid                               | \$2,062   | \$1,193  | \$4,975  |
| Transfers from loans to other real estate owned | \$10,712  | \$3,140  | \$2,731  |

The notes to consolidated financial statements are an integral part of these statements.



**SHORE BANCSHARES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

For the Years Ended December 31, 2011, 2010, and 2009

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries (collectively referred to in these Notes as the “Company”), with all significant intercompany transactions eliminated. The investments in subsidiaries are recorded on the Company’s books (Parent only) on the basis of its equity in the net assets of the subsidiaries. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”). For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

In 2009, the Financial Accounting Standards Board (the “FASB”) established the Accounting Standards Codification (“ASC”) as the source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with generally accepted accounting principles. Rules and interpretive releases of the U.S. Securities and Exchange Commission (the “SEC”) under authority of federal securities laws are also sources of authoritative guidance for SEC registrants. All guidance contained in the ASC carries an equal level of authority. All non-grandfathered, non-SEC accounting literature not included in the ASC is superseded and deemed non-authoritative. The switch to the ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

**Nature of Operations**

The Company engages in the banking business through CNB, a Maryland commercial bank with trust powers, and The Talbot Bank of Easton, Maryland, a Maryland commercial bank (“Talbot Bank”). Through December 31, 2010, the Company also engaged in the banking business through The Felton Bank, a Delaware commercial bank (“Felton Bank” and, together with CNB and Talbot Bank, the “Banks”), which was merged into CNB on January 1, 2011. The Company’s primary source of revenue is interest earned on commercial, real estate and consumer loans made to customers located on the Delmarva Peninsula. The Company engages in the insurance business through two general insurance producer firms, The Avon-Dixon Agency, LLC, a Maryland limited liability company, and Elliott Wilson Insurance, LLC, a Maryland limited liability company; one marine insurance producer firm, Jack Martin & Associates, Inc., a Maryland corporation; three wholesale insurance firms, Tri-State General Insurance Agency, LTD, a Maryland corporation, Tri-State General Insurance Agency of New Jersey, Inc., a New Jersey corporation, and Tri-State General Insurance Agency of Virginia, Inc., a Virginia corporation (collectively, “TSGIA”); and two insurance

premium finance companies, Mubell Finance, LLC, a Maryland limited liability company, and ESFS, Inc., a Maryland corporation (all of the foregoing insurance entities are collectively referred to as the “Insurance Subsidiaries”). The Company engages in the mortgage brokerage business under the name “Wye Mortgage Group” through a minority series investment in an unrelated Delaware limited liability company.

### **Use of Estimates**

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

The allowance for credit losses is a material estimate that is particularly susceptible to significant changes in the near term. Management believes that the allowance for credit losses is sufficient to address the probable losses in the current portfolio. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination processes, periodically review the Company’s allowance for credit losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

### **Investment Securities Available for Sale**

Investment securities available for sale are stated at estimated fair value based on quoted market prices. They represent those securities which management may sell as part of its asset/liability management strategy or which may be sold in response to changing interest rates, changes in prepayment risk or other similar factors. The cost of securities sold is determined by the specific identification method. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Net unrealized holding gains and losses on these securities are reported as accumulated other comprehensive income, a separate component of stockholders’ equity, net of related income taxes. Declines in the fair value of individual available-for-sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value and are reflected in earnings as realized losses. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

### **Investment Securities Held to Maturity**

Investment securities held to maturity are stated at cost adjusted for amortization of premiums and accretion of discounts. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. The Company intends and has the ability to hold such securities until maturity. Declines in the fair value of individual held-to-maturity securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

### **Loans**

Loans are stated at their principal amount outstanding net of any deferred fees and costs. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed on nonaccrual when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired when it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding. The allowance for credit losses includes specific reserves related to impaired loans. Impaired loans do not include groups of smaller balance homogeneous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and are included in the formula portion of the allowance for credit losses.

A loan is considered a troubled debt restructuring if a concession is granted due to a deterioration in the borrower's financial condition. Troubled debt restructurings may include modifications of original loan terms, receipts of assets in partial or full satisfaction of loans or a combination thereof. The Company does not participate in any specific government or Company sponsored loan modification programs. All restructured loan agreements are contracts negotiated with each of the borrowers.

### **Allowance for Credit Losses**

The allowance for credit losses is maintained at a level believed adequate by management to absorb losses inherent in the loan portfolio as of the balance sheet date and is based on the size and current risk characteristics of the loan portfolio, an assessment of individual problem loans and actual loss experience, current economic events in specific industries and geographical areas, including unemployment levels, and other pertinent factors, including regulatory guidance and general economic conditions and other observable data. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows or collateral value of impaired loans, estimated losses on pools of homogeneous loans that are based on historical loss experience, and consideration of current economic trends, all of which may be susceptible to significant change. Loans, or portions thereof, that are considered uncollectible are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. A provision for credit losses is charged to operations based on management's periodic evaluation of the factors previously mentioned, as well as other pertinent factors. Evaluations are conducted at least quarterly and more often if deemed necessary.

The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) ASC Topic 450, "Contingencies", which requires that losses be accrued when they are probable of occurring and estimable; and (ii) ASC Topic 310, "Receivables," which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and our internal loan processes in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from management's estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.

The allowance for credit losses is comprised of three parts: the specific allowance, the formula allowance and the nonspecific allowance. The specific allowance is established against impaired loans until charge offs are made. The formula allowance, described below, is determined based on management's assessment of industry trends and economic factors in the markets in which we operate. The determination of the formula allowance involves a higher risk of uncertainty and considers current risk factors that may not have yet manifested themselves in our historical loss factors. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans that are identified as special mention, substandard and doubtful are adversely rated. A special mention loan has potential weaknesses that could result in a future loss to the Company if the weaknesses are realized. A substandard loan has certain deficiencies that could result in a future loss to the Company if these deficiencies are not corrected. A doubtful loan has enough risk that there is a high probability that the Company will sustain a loss. These loans are assigned higher allowance factors than favorably rated loans due to management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower. Loans that are favorably rated are grouped by type (commercial real estate and construction, residential real estate, commercial or consumer). Each loan type is assigned an allowance factor based on management's estimate of the risk, complexity and size of individual loans within a particular category.

#### Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are calculated using the straight-line method over the estimated useful lives of the assets. Useful lives range from three to 10 years for furniture, fixtures and equipment; three to five years for computer hardware and data handling equipment; and 10 to 40 years for buildings and building improvements. Land improvements are amortized over a period of 15 years and leasehold improvements are amortized over the term of the respective lease. Sale-leaseback transactions are considered normal leasebacks and any realized gains are deferred and amortized to other income on a straight-line basis over the initial lease term. Maintenance and repairs are charged to expense as incurred, while improvements which extend the useful life of an asset are capitalized and depreciated over the estimated remaining life of the asset.

Long-lived assets are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of a long-lived asset are less than its carrying value. In that event, the Company recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset.

#### Goodwill and Other Intangible Assets

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill

because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. The Company's other intangible assets that have finite lives are amortized on a straight-line basis over varying periods not exceeding 21 years.

Impairment testing requires that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. The Company's reporting units were identified based on an analysis of each of its individual operating segments. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss.

As a result of the 2011 annual assessment for goodwill and other intangible assets impairment, it was determined that goodwill and other intangible assets were impaired primarily in the Company's retail insurance business. The Company recorded goodwill impairment charges of \$1.2 million and other intangible assets impairment charges of \$120 thousand. In 2010, the annual assessment determined that goodwill was impaired at one of the Banks and goodwill and other intangible assets were impaired in the Company's wholesale insurance business. The Company recorded goodwill impairment charges of \$1.5 million at that Bank and goodwill impairment charges of \$1.5 million and other intangible assets impairment charges of \$51 thousand at the wholesale insurance business.

### **Other Real Estate Owned**

Other real estate owned represents assets acquired in satisfaction of loans either by foreclosure or deeds taken in lieu of foreclosure. Properties acquired are recorded at the lower of cost or fair value less estimated selling costs at the time of acquisition with any deficiency charged to the allowance for credit losses. Thereafter, costs incurred to operate or carry the properties as well as reductions in value as determined by periodic appraisals are charged to operating expense. Gains and losses resulting from the final disposition of the properties are included in noninterest income.

### **Short-Term Borrowings**

Short-term borrowings are comprised primarily of repurchase agreements. The repurchase agreements are securities sold to the Company's customers, at the customers' request, under a continuing "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated from the Company's other investment securities by its safekeeping agents.

## **Income Taxes**

Shore Bancshares, Inc. and its subsidiaries file a consolidated federal income tax return. The Company accounts for income taxes using the liability method in accordance with required accounting guidance. Under this method, deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes result from such temporary differences.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date. The Company recognizes accrued interest and penalties as a component of tax expense. The Company does not have any uncertain tax positions and did not recognize any adjustments for unrecognized tax benefits. The Company remains subject to examination for income tax returns ending after December 31, 2007.

## **Basic and Diluted Earnings Per Common Share**

Basic earnings (loss) per share is calculated by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding and does not include the effect of any potentially dilutive common stock equivalents. Diluted earnings (loss) per share is calculated by dividing net income (loss) by the weighted-average number of shares outstanding, adjusted for the effect of any potentially dilutive common stock equivalents. There is no dilutive effect on the loss per share during loss periods. See Note 16 for further information.

## **Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (i) the assets have been isolated from the Company, (ii) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (iii) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

## **Statement of Cash Flows**

Cash and due from banks, interest-bearing deposits with other banks and federal funds sold are considered “cash and cash equivalents” for financial reporting purposes.

### **Stock-Based Compensation**

Accounting guidance for stock-based compensation requires that expense relating to such transactions be recognized as compensation cost in the income statement. Stock-based compensation expense is recognized ratably over the requisite service period for all awards and is based on the grant date fair value. See Note 14 for a further discussion.

### **Derivative Instruments and Hedging Activities**

Under accounting guidance for derivative instruments and hedging activities, all derivatives are recorded as other assets or other liabilities on the balance sheet at their respective fair values. When the purpose of a derivative is to hedge the variability of a floating rate asset or liability, the derivative is considered a “cash flow” hedge. To account for the effective portion of a cash flow hedge, unrealized gains and losses due to changes in the fair value of the derivative designated as a cash flow hedge are recorded in other comprehensive income. Ineffectiveness resulting from differences between the cash flows of the hedged item and changes in fair value of the derivative is recognized as other noninterest income. The net interest settlement on a derivative designated as a cash flow hedge is treated as an adjustment of the interest income or interest expense of the hedged asset or liability.

### **Fair Value**

The Company measures certain financial assets and liabilities at fair value. Significant financial instruments measured at fair value on a recurring basis are investment securities and interest rate caps. Impaired loans and other real estate and other assets owned are significant financial instruments measured at fair value on a nonrecurring basis. See Note 20 for a further discussion of fair value.

### **Advertising Costs**

Advertising costs are generally expensed as incurred. The Company incurred advertising costs of approximately \$296 thousand, \$347 thousand and \$383 thousand for the years ended December 31, 2011, 2010 and 2009, respectively.



## New Accounting Pronouncements

*Accounting Standards Update (“ASU”) No. 2010-28, “Intangibles - Goodwill and Other (Topic 350) - When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts.”* ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist such as if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. ASU 2010-28 became effective for the Company on January 1, 2011 and did not have a significant impact on the Company’s financial statements.

*ASU No. 2011-02, “Receivables (Topic 310) - A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring.”* ASU 2011-02 clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-02, that both of the following exist: (i) the restructuring constitutes a concession; and (ii) the debtor is experiencing financial difficulties. ASU 2011-02 became effective for the Company on July 1, 2011, and applies retrospectively to restructurings occurring on or after January 1, 2011. See Note 4 for further information.

*ASU No. 2011-03, “Reconsideration of Effective Control for Repurchase Agreements.”* ASU No. 2011-03 affects all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The amendments in ASU No. 2011-03 remove from the assessment of effective control the criterion relating to the transferor’s ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU No. 2011-03 also eliminates the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. The guidance is effective for the Company on January 1, 2012 and is not expected to have a significant impact on the Company’s financial statements.

*ASU No. 2011-04, “Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.”* ASU No. 2011-04 results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards (“IFRS”). As a result of ASU No. 2011-04, the following changes were made to U.S. GAAP. First, the concepts of highest and best use and valuation premise are relevant only when measuring the fair value of nonfinancial assets (that is, they do not apply to financial assets or any liabilities). Second, whereas U.S. GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets, ASU No. 2011-04 extends that prohibition to all fair value measurements. Third, an exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market

risks or counterparty credit risk that are managed on the basis of the entity's net exposure to either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position. Fourth, the fair value measurement of instruments classified within an entity's stockholders' equity has been aligned with the guidance for liabilities. Fifth, disclosure requirements have been enhanced for recurring Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to describe the sensitivity of fair value measurements to changes in unobservable inputs and interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. The provisions of ASU No. 2011-04 are effective for the Company's interim reporting period beginning on or after December 15, 2011. The adoption of ASU No. 2011-04 is not expected to have a material impact on the Company's financial statements.

*ASU 2011-08, "Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment."* ASU 2011-08 amends Topic 350, "Intangibles – Goodwill and Other," to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 is effective for annual and interim impairment tests beginning after December 15, 2011, and is not expected to have a significant impact on the Company's financial statements.

## **NOTE 2. CASH AND DUE FROM BANKS**

The Board of Governors of the Federal Reserve System (the "FRB") requires banks to maintain certain minimum cash balances consisting of vault cash and deposits in the appropriate Federal Reserve Bank or in other commercial banks. Such balances for the Banks averaged approximately \$2.1 million and \$1.9 million during 2011 and 2010, respectively.

**NOTE 3. INVESTMENT SECURITIES**

The following table provides information on the amortized cost and estimated fair values of investment securities.

| (Dollars in thousands)                                   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| Available-for-sale securities:                           |                   |                              |                               |                            |
| December 31, 2011:                                       |                   |                              |                               |                            |
| Obligations of U.S. Government agencies and corporations | \$ 41,360         | \$ 803                       | \$ 15                         | \$ 42,148                  |
| Mortgage-backed securities                               | 85,545            | 1,587                        | 99                            | 87,033                     |
| Equity securities  | 577               | 22                           | -                             | 599                        |
| Total  | \$ 127,482        | \$ 2,412                     | \$ 114                        | \$ 129,780                 |
| December 31, 2010:                                       |                   |                              |                               |                            |
| Obligations of U.S. Government agencies and corporations | \$ 58,052         | \$ 921                       | \$ 69                         | \$ 58,904                  |
| Mortgage-backed securities                               | 38,817            | 933                          | 173                           | 39,577                     |
| Equity securities  | 566               | 8                            | -                             | 574                        |
| Total  | \$ 97,435         | \$ 1,862                     | \$ 242                        | \$ 99,055                  |
| Held-to-maturity securities:                             |                   |                              |                               |                            |
| December 31, 2011:                                       |                   |                              |                               |                            |
| Obligations of states and political subdivisions         | \$ 6,480          | \$ 252                       | \$ -                          | \$ 6,732                   |
| December 31, 2010:                                       |                   |                              |                               |                            |
| Obligations of states and political subdivisions         | \$ 6,727          | \$ 143                       | \$ 19                         | \$ 6,851                   |

The following table provides information about gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at December 31, 2011.

| (Dollars in thousands)               | Less than<br>12 Months |                      | More than<br>12 Months |                      | Total         |                      |
|--------------------------------------|------------------------|----------------------|------------------------|----------------------|---------------|----------------------|
|                                      | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| Available-for-sale securities:       |                        |                      |                        |                      |               |                      |
| U.S. Gov't agencies and corporations | \$ 13,114              | \$ 15                | \$ -                   | \$ -                 | \$ 13,114     | \$ 15                |
| Mortgage-backed securities           | 16,085                 | 67                   | 3,856                  | 32                   | 19,941        | 99                   |
| Total                                | \$ 29,199              | \$ 82                | \$ 3,856               | \$ 32                | \$ 33,055     | \$ 114               |

The available-for-sale securities have a fair value of approximately \$129.8 million, of which approximately \$33.1 million have unrealized losses when compared to their amortized cost. The securities with the unrealized losses in the available-for-sale portfolio all have modest duration risk, low credit risk, and minimal losses (approximately 0.09%) when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since the original purchase. Because the Company does not intend to sell these debt securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers the unrealized losses in the available-for-sale portfolio to be temporary. There were no unrealized losses in the held-to-maturity securities portfolio at December 31, 2011.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at December 31, 2011.

| (Dollars in thousands)                 | Available for sale |            | Held to maturity |            |
|--|--------------------|------------|------------------|------------|
|  | Amortized          | Estimated  | Amortized        | Estimated  |
|  | Cost               | Fair Value | Cost             | Fair Value |
| Due in one year or less                | \$7,004            | \$7,123    | \$2,583          | \$2,626    |
| Due after one year through five years  | 21,722             | 21,773     | 1,590            | 1,648      |
| Due after five years through ten years | 5,297              | 5,401      | 1,297            | 1,373      |
| Due after ten years                    | 92,882             | 94,884     | 1,010            | 1,085      |
|  | 126,905            | 129,181    | 6,480            | 6,732      |
| Equity securities                      | 577                | 599        | -                | -          |
| Total                                  | \$127,482          | \$129,780  | \$6,480          | \$6,732    |

The maturity dates for debt securities are determined using contractual maturity dates.

The following table sets forth the amortized cost and estimated fair values of securities which have been pledged as collateral for obligations to federal, state and local government agencies, and other purposes as required or permitted by law, or sold under agreements to repurchase. All pledged securities are in the available-for-sale investment portfolio.

| (Dollars in thousands)                | December 31, 2011 |            | December 31, 2010 |            |
|---------------------------------------|-------------------|------------|-------------------|------------|
|                                       | Amortized         | Estimated  | Amortized         | Estimated  |
|                                       | Cost              | Fair Value | Cost              | Fair Value |
| Pledged available-for-sale securities | \$77,762          | \$79,358   | \$63,097          | \$64,651   |

There were no obligations of states or political subdivisions with carrying values, as to any issuer, exceeding 10% of stockholders' equity at December 31, 2011 or 2010.

Proceeds from sales of investment securities were \$20.8 million, \$0, and \$2.0 million for the years ended December 31, 2011, 2010, and 2009, respectively. Gross gains from sales of investment securities were \$595 thousand, \$0 and \$49 thousand for the years ended December 31, 2011, 2010, and 2009, respectively. Gross losses were \$32 thousand for 2011. There were no gross losses for 2010 or 2009.

#### NOTE 4. LOANS AND ALLOWANCE FOR CREDIT LOSSES

The Company makes residential mortgage, commercial and consumer loans to customers primarily in the Maryland counties of Talbot, Queen Anne's, Kent, Caroline and Dorchester and in Kent County, Delaware. The following table provides information about the principal classes of the loan portfolio at December 31, 2011 and 2010.

| (Dollars in thousands)      | 2011       | 2010       |
|-----------------------------|------------|------------|
| Construction                | \$ 119,883 | \$ 143,952 |
| Residential real estate     | 321,604    | 333,738    |
| Commercial real estate      | 315,439    | 318,726    |
| Commercial                  | 69,485     | 82,787     |
| Consumer                    | 14,639     | 16,201     |
| Total loans                 | 841,050    | 895,404    |
| Allowance for credit losses | (14,288 )  | (14,227 )  |
| Total loans, net            | \$ 826,762 | \$ 881,177 |

Loans include deferred costs net of deferred fees of \$188 thousand at year-end 2011 and \$38 thousand at year-end 2010.

In the normal course of banking business, loans are made to officers and directors and their affiliated interests. These loans are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with persons who are not related to the Company and are not considered to involve more than the normal risk of collectibility. As of December 31, 2011, and 2010, such loans outstanding, both direct and indirect (including guarantees), to directors, their associates and policy-making officers, totaled approximately \$22.4 million and \$20.0 million, respectively. During 2011 and 2010, loan additions were approximately \$4.4 million and \$2.1 million, respectively, and loan repayments were approximately \$2.0 million and \$1.3 million, respectively.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and are included in the formula portion of the allowance for credit losses.

Loans are evaluated on a case-by-case basis for impairment. Once the amount of impairment has been determined, the uncollectible portion is charged off. In some cases, a specific allocation within the allowance for credit losses is made until such time as a charge off is made. Impaired nonaccrual loans were \$51.4 million and \$36.2 million at the end of 2011 and 2010, respectively. At December 31, 2011, impaired nonaccrual loans had been reduced by partial charge-offs totaling \$13.5 million, or 20.8%, of the aggregate unpaid principal balance. In addition, \$1.5 million in specific reserves were established against \$4.7 million of impaired nonaccrual loans. At December 31, 2010, impaired nonaccrual loans had been reduced by partial charge-offs totaling \$8.3 million, or 18.6%, of the aggregate unpaid principal balance. In addition, \$203 thousand in specific reserves were established against \$837 thousand of impaired nonaccrual loans.

A loan is considered a troubled debt restructuring if a concession is granted due to a deterioration in a borrower's financial condition. At both December 31, 2011 and 2010, the Company had impaired accruing troubled debt restructurings of \$25.2 million.

Gross interest income of \$2.6 million, \$2.1 million and \$859 thousand would have been recorded in 2011, 2010 and 2009, respectively, if impaired loans had been current and performing in accordance with their original terms. There was no interest recorded on such loans during 2011 or 2010. There was \$4 thousand in interest recorded during 2009.

The following tables provide information on impaired loans by loan class as of December 31, 2011 and 2010.

| (Dollars in thousands)     | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment |
|----------------------------|--------------------------|---------------------------------------|---------------------------------------|-------------------|-----------------------------|
| December 31, 2011          |                          |                                       |                                       |                   |                             |
| Impaired nonaccrual loans: |                          |                                       |                                       |                   |                             |

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|                                       |           |           |          |          |           |
|---------------------------------------|-----------|-----------|----------|----------|-----------|
| Construction                          | \$ 22,883 | \$ 14,005 | \$ 1,550 | \$ 170   | \$ 16,555 |
| Residential real estate               | 22,431    | 16,925    | 3,181    | 1,296    | 15,430    |
| Commercial real estate                | 17,372    | 14,012    | -        | -        | 14,624    |
| Commercial                            | 2,119     | 1,669     | -        | -        | 2,539     |
| Consumer                              | 30        | 28        | -        | -        | 32        |
| Total                                 | 64,835    | 46,639    | 4,731    | 1,466    | 49,180    |
| Impaired accruing restructured loans: |           |           |          |          |           |
| Construction                          | 11,781    | 11,781    | -        | -        | 10,663    |
| Residential real estate               | 3,792     | 3,792     | -        | -        | 6,093     |
| Commercial real estate                | 9,566     | 9,566     | -        | -        | 7,960     |
| Commercial                            | 69        | 69        | -        | -        | 111       |
| Consumer                              | -         | -         | -        | -        | -         |
| Total                                 | 25,208    | 25,208    | -        | -        | 24,827    |
| Total impaired loans:                 |           |           |          |          |           |
| Construction                          | 34,664    | 25,786    | 1,550    | 170      | 27,218    |
| Residential real estate               | 26,223    | 20,717    | 3,181    | 1,296    | 21,523    |
| Commercial real estate                | 26,938    | 23,578    | -        | -        | 22,584    |
| Commercial                            | 2,188     | 1,738     | -        | -        | 2,650     |
| Consumer                              | 30        | 28        | -        | -        | 32        |
| Total                                 | \$ 90,043 | \$ 71,847 | \$ 4,731 | \$ 1,466 | \$ 74,007 |



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| (Dollars in thousands)                | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment |
|---------------------------------------|--------------------------|---------------------------------------|---------------------------------------|-------------------|-----------------------------|
| December 31, 2010                     |                          |                                       |                                       |                   |                             |
| Impaired nonaccrual loans:            |                          |                                       |                                       |                   |                             |
| Construction                          | \$ 22,643                | \$ 17,261                             | \$ -                                  | \$ -              | \$ 19,380                   |
| Residential real estate               | 11,983                   | 9,132                                 | 837                                   | 203               | 8,788                       |
| Commercial real estate                | 5,558                    | 5,133                                 | -                                     | -                 | 3,827                       |
| Commercial                            | 4,305                    | 3,845                                 | -                                     | -                 | 3,191                       |
| Consumer                              | 30                       | 30                                    | -                                     | -                 | 56                          |
| Total                                 | 44,519                   | 35,401                                | 837                                   | 203               | 35,242                      |
| Impaired accruing restructured loans: |                          |                                       |                                       |                   |                             |
| Construction                          | 10,914                   | 10,914                                | -                                     | -                 | 3,110                       |
| Residential real estate               | 5,561                    | 5,561                                 | -                                     | -                 | 4,658                       |
| Commercial real estate                | 8,147                    | 8,147                                 | -                                     | -                 | 2,129                       |
| Commercial                            | 529                      | 529                                   | -                                     | -                 | 171                         |
| Consumer                              | -                        | -                                     | -                                     | -                 | -                           |
| Total                                 | 25,151                   | 25,151                                | -                                     | -                 | 10,068                      |
| Total impaired loans:                 |                          |                                       |                                       |                   |                             |
| Construction                          | 33,557                   | 28,175                                | -                                     | -                 | 22,490                      |
| Residential real estate               | 17,544                   | 14,693                                | 837                                   | 203               | 13,446                      |
| Commercial real estate                | 13,705                   | 13,280                                | -                                     | -                 | 5,956                       |
| Commercial                            | 4,834                    | 4,374                                 | -                                     | -                 | 3,362                       |
| Consumer                              | 30                       | 30                                    | -                                     | -                 | 56                          |
| Total                                 | \$ 69,670                | \$ 60,552                             | \$ 837                                | \$ 203            | \$ 45,310                   |

The following tables provide information on troubled debt restructurings by loan class as of December 30, 2011 and 2010. The amounts include nonaccrual troubled debt restructurings.

| (Dollars in thousands)        | Number of contracts | Premodification outstanding recorded investment | Postmodification outstanding recorded investment |
|-------------------------------|---------------------|---|--|
| Troubled debt restructurings: |                     |   |  |
| December 31, 2011             |                     |   |  |
| Construction                  | 9                   | \$ 12,981                                       | \$ 12,539  |
| Residential real estate       | 20                  | 11,471  | 10,359   |
| Commercial real estate        | 20                  | 15,874  | 14,175   |
| Commercial                    | 1                   | 69  | 69   |
| Consumer                      | -                   | -   | -  |
| Total                         | 50                  | \$ 40,395                                       | \$ 37,142  |

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December 31, 2010

|                         |    |           |           |
|-------------------------|----|-----------|-----------|
| Construction            | 5  | \$ 11,075 | \$ 10,926 |
| Residential real estate | 31 | 7,986     | 7,388     |
| Commercial real estate  | 16 | 9,424     | 9,417     |
| Commercial              | 3  | 529       | 529       |
| Consumer                | -  | -         | -         |
| Total                   | 55 | \$ 29,014 | \$ 28,260 |

| (Dollars in thousands)                                    | Number of contracts | Recorded investment |
|---|---------------------|---------------------|
| Troubled debt restructurings that subsequently defaulted: |                     |                     |
| December 31, 2011   |                     |                     |
| Construction  | 3                   | \$ 758              |
| Residential real estate                                   | 10                  | 7,353               |
| Commercial real estate                                    | 5                   | 6,751               |
| Commercial  | -                   | -                   |
| Consumer  | -                   | -                   |
| Total   | 18                  | \$ 14,862           |
| December 31, 2010   |                     |                     |
| Construction  | 1                   | \$ 12               |
| Residential real estate                                   | 13                  | 2,752               |
| Commercial real estate                                    | 6                   | 4,103               |
| Commercial  | -                   | -                   |
| Consumer  | -                   | -                   |
| Total   | 20                  | \$ 6,867            |

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. Loans that are identified as special mention, substandard and doubtful are adversely rated and are assigned higher risk ratings than favorably rated loans.

The following tables provide information on loan risk ratings as of December 31, 2011 and 2010.

| (Dollars in thousands)  | Pass/Performing | Special mention | Substandard | Doubtful | Nonaccrual | Total      |
|-------------------------|-----------------|-----------------|-------------|----------|------------|------------|
| December 31, 2011       |                 |                 |             |          |            |            |
| Construction            | \$ 50,403       | \$ 30,373       | \$ 23,552   | \$ -     | \$ 15,555  | \$ 119,883 |
| Residential real estate | 261,910         | 13,467          | 25,676      | 445      | 20,106     | 321,604    |
| Commercial real estate  | 257,247         | 16,001          | 28,179      | -        | 14,012     | 315,439    |
| Commercial              | 59,178          | 3,813           | 4,748       | 77       | 1,669      | 69,485     |
| Consumer                | 14,520          | 32              | 59          | -        | 28         | 14,639     |
| Total                   | \$ 643,258      | \$ 63,686       | \$ 82,214   | \$ 522   | \$ 51,370  | \$ 841,050 |

| (Dollars in thousands)  | Pass/Performing | Special mention | Substandard | Doubtful | Nonaccrual | Total      |
|-------------------------|-----------------|-----------------|-------------|----------|------------|------------|
| December 31, 2010       |                 |                 |             |          |            |            |
| Construction            | \$ 83,344       | \$ 23,090       | \$ 20,257   | \$ -     | \$ 17,261  | \$ 143,952 |
| Residential real estate | 283,895         | 23,847          | 13,752      | 2,275    | 9,969      | 333,738    |
| Commercial real estate  | 260,040         | 17,821          | 35,732      | -        | 5,133      | 318,726    |
| Commercial              | 73,502          | 2,249           | 3,088       | 103      | 3,845      | 82,787     |

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|          |            |          |           |          |           |           |
|----------|------------|----------|-----------|----------|-----------|-----------|
| Consumer | 16,043     | -        | 128       | -        | 30        | 16,201    |
| Total    | \$ 716,824 | \$67,007 | \$ 72,957 | \$ 2,378 | \$ 36,238 | \$895,404 |

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The following tables provide information on the aging of the loan portfolio as of December 31, 2011 and 2010.

| (Dollars in thousands)  | Accruing  |                     |                     |                          | Total past due | Non-accrual | Total     |
|-------------------------|-----------|---------------------|---------------------|--------------------------|----------------|-------------|-----------|
|                         | Current   | 30-59 days past due | 60-89 days past due | 90 days or more past due |                |             |           |
| December 31, 2011       |           |                     |                     |                          |                |             |           |
| Construction            | \$102,441 | \$1,246             | \$316               | \$325                    | \$1,887        | \$15,555    | \$119,883 |
| Residential real estate | 289,459   | 4,417               | 5,291               | 2,331                    | 12,039         | 20,106      | 321,604   |
| Commercial real estate  | 289,760   | 10,073              | 1,594               | -                        | 11,667         | 14,012      | 315,439   |
| Commercial              | 64,581    | 1,350               | 1,819               | 66                       | 3,235          | 1,669       | 69,485    |
| Consumer                | 14,492    | 112                 | 6                   | 1                        | 119            | 28          | 14,639    |
| Total                   | \$760,733 | \$17,198            | \$9,026             | \$2,723                  | \$28,947       | \$51,370    | \$841,050 |

| (Dollars in thousands)  | Accruing  |                     |                     |                          | Total past due | Non-accrual | Total     |
|-------------------------|-----------|---------------------|---------------------|--------------------------|----------------|-------------|-----------|
|                         | Current   | 30-59 days past due | 60-89 days past due | 90 days or more past due |                |             |           |
| December 31, 2010       |           |                     |                     |                          |                |             |           |
| Construction            | \$124,892 | \$1,691             | \$108               | \$-                      | \$1,799        | \$17,261    | \$143,952 |
| Residential real estate | 314,914   | 4,046               | 1,355               | 3,454                    | 8,855          | 9,969       | 333,738   |
| Commercial real estate  | 306,497   | 3,393               | 2,717               | 986                      | 7,096          | 5,133       | 318,726   |
| Commercial              | 77,833    | 470                 | 465                 | 174                      | 1,109          | 3,845       | 82,787    |
| Consumer                | 15,572    | 486                 | 25                  | 88                       | 599            | 30          | 16,201    |
| Total                   | \$839,708 | \$10,086            | \$4,670             | \$4,702                  | \$19,458       | \$36,238    | \$895,404 |

|                         | Accruing |                     |                     |                          | Total past due | Non-accrual |
|-------------------------|----------|---------------------|---------------------|--------------------------|----------------|-------------|
|                         | Current  | 30-59 days past due | 60-89 days past due | 90 days or more past due |                |             |
| December 31, 2011       |          |                     |                     |                          |                |             |
| Construction            | 85.4%    | 1.0%                | 0.3%                | 0.3%                     | 1.6%           | 13.0%       |
| Residential real estate | 90.0     | 1.4                 | 1.6                 | 0.7                      | 3.7            | 6.3         |
| Commercial real estate  | 91.9     | 3.2                 | 0.5                 | -                        | 3.7            | 4.4         |
| Commercial              | 93.0     | 1.9                 | 2.6                 | 0.1                      | 4.6            | 2.4         |
| Consumer                | 99.0     | 0.8                 | -                   | -                        | 0.8            | 0.2         |
| Total                   | 90.5     | 2.0                 | 1.1                 | 0.3                      | 3.4            | 6.1         |

|                   | Accruing |                     |                     |                          | Total past due | Non-accrual |
|-------------------|----------|---------------------|---------------------|--------------------------|----------------|-------------|
|                   | Current  | 30-59 days past due | 60-89 days past due | 90 days or more past due |                |             |
| December 31, 2010 |          |                     |                     |                          |                |             |

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|                         |       |     |   |     |   |     |     |   |      |   |
|-------------------------|-------|-----|---|-----|---|-----|-----|---|------|---|
| Construction            | 86.8% | 1.1 | % | 0.1 | % | -%  | 1.2 | % | 12.0 | % |
| Residential real estate | 94.4  | 1.2 |   | 0.4 |   | 1.0 | 2.6 |   | 3.0  |   |
| Commercial real estate  | 96.2  | 1.0 |   | 0.9 |   | 0.3 | 2.2 |   | 1.6  |   |
| Commercial              | 94.0  | 0.6 |   | 0.6 |   | 0.2 | 1.4 |   | 4.6  |   |
| Consumer                | 96.1  | 3.0 |   | 0.2 |   | 0.5 | 3.7 |   | 0.2  |   |
| Total                   | 93.8  | 1.2 |   | 0.5 |   | 0.5 | 2.2 |   | 4.0  |   |

Management has established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts and is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based on this analysis. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for 2011 and 2010.

| (Dollars in thousands)       | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer | Unallocated | Total    |
|------------------------------|--------------|----------------------------|---------------------------|------------|----------|-------------|----------|
| 2011                         |              |                            |                           |            |          |             |          |
| Allowance for credit losses: |              |                            |                           |            |          |             |          |
| Beginning balance            | \$ 3,327     | \$ 4,833                   | \$ 3,665                  | \$ 1,422   | \$ 637   | \$ 343      | \$14,227 |
| Charge-offs                  | (4,236 )     | (7,693 )                   | (5,037 )                  | (3,388 )   | (202 )   | -           | (20,556) |
| Recoveries                   | 49           | 120                        | 361                       | 549        | 68       | -           | 1,147    |
| Net charge-offs              | (4,187 )     | (7,573 )                   | (4,676 )                  | (2,839 )   | (134 )   | -           | (19,409) |
| Provision                    | 4,605        | 7,754                      | 4,426                     | 2,915      | 91       | (321 )      | 19,470   |
| Ending balance               | \$ 3,745     | \$ 5,014                   | \$ 3,415                  | \$ 1,498   | \$ 594   | \$ 22       | \$14,288 |

| (Dollars in thousands)       | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer | Unallocated | Total    |
|------------------------------|--------------|----------------------------|---------------------------|------------|----------|-------------|----------|
| 2010                         |              |                            |                           |            |          |             |          |
| Allowance for credit losses: |              |                            |                           |            |          |             |          |
| Beginning balance            | \$ 2,630     | \$ 1,528                   | \$ 3,947                  | \$ 2,132   | \$ 515   | \$ 124      | \$10,876 |
| Charge-offs                  | (7,910 )     | (5,818 )                   | (492 )                    | (3,710 )   | (589 )   | -           | (18,519) |
| Recoveries                   | 14           | 215                        | 108                       | 214        | 200      | -           | 751      |
| Net charge-offs              | (7,896 )     | (5,603 )                   | (384 )                    | (3,496 )   | (389 )   | -           | (17,768) |
| Provision                    | 8,593        | 8,908                      | 102                       | 2,786      | 511      | 219         | 21,119   |
| Ending balance               | \$ 3,327     | \$ 4,833                   | \$ 3,665                  | \$ 1,422   | \$ 637   | \$ 343      | \$14,227 |

The following tables include impairment information relating to loans and the allowance for credit losses as of December 31, 2011 and 2010.

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| (Dollars in thousands)                      | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer  | Unallocated | Total      |
|---|--------------|----------------------------|---------------------------|------------|-----------|-------------|------------|
| December 31, 2011                           |              |                            |                           |            |           |             |            |
| Loans individually evaluated for impairment | \$ 27,336    | \$ 23,898                  | \$ 23,578                 | \$ 1,738   | \$ 28     | \$ -        | \$ 76,578  |
| Loans collectively evaluated for impairment | 92,547       | 297,706                    | 291,861                   | 67,747     | 14,611    | -           | 764,472    |
| Total loans                                 | \$ 119,883   | \$ 321,604                 | \$ 315,439                | \$ 69,485  | \$ 14,639 | \$ -        | \$ 841,050 |
| Allowance for credit losses allocated to:   |              |                            |                           |            |           |             |            |
| Loans individually evaluated for impairment | \$ 170       | \$ 1,296                   | \$ -                      | \$ -       | \$ -      | \$ -        | \$ 1,466   |
| Loans collectively evaluated for impairment | 3,575        | 3,718                      | 3,415                     | 1,498      | 594       | 22          | 12,822     |
| Total allowance for credit losses           | \$ 3,745     | \$ 5,014                   | \$ 3,415                  | \$ 1,498   | \$ 594    | \$ 22       | \$ 14,288  |



| (Dollars in thousands)                      | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer  | Unallocated | Total      |
|---|--------------|----------------------------|---------------------------|------------|-----------|-------------|------------|
| December 31, 2010                           |              |                            |                           |            |           |             |            |
| Loans individually evaluated for impairment | \$ 28,175    | \$ 15,530                  | \$ 13,280                 | \$ 4,374   | \$ 30     | \$ -        | \$ 61,389  |
| Loans collectively evaluated for impairment | 115,777      | 318,208                    | 305,446                   | 78,413     | 16,171    | -           | 834,015    |
| Total loans                                 | \$ 143,952   | \$ 333,738                 | \$ 318,726                | \$ 82,787  | \$ 16,201 | \$ -        | \$ 895,404 |
| Allowance for credit losses allocated to:   |              |                            |                           |            |           |             |            |
| Loans individually evaluated for impairment | \$ -         | \$ 203                     | \$ -                      | \$ -       | \$ -      | \$ -        | \$ 203     |
| Loans collectively evaluated for impairment | 3,327        | 4,630                      | 3,665                     | 1,422      | 637       | 343         | 14,024     |
| Total allowance for credit losses           | \$ 3,327     | \$ 4,833                   | \$ 3,665                  | \$ 1,422   | \$ 637    | \$ 343      | \$ 14,227  |

#### NOTE 5. PREMISES AND EQUIPMENT

The following table provides information on premises and equipment at December 31, 2011 and 2010.

| (Dollars in thousands)          | 2011     | 2010     |
|---------------------------------|----------|----------|
| Land                            | \$4,902  | \$4,902  |
| Buildings and land improvements | 13,404   | 12,290   |
| Furniture and equipment         | 7,390    | 8,322    |
|                                 | 25,696   | 25,514   |
| Accumulated depreciation        | (11,034) | (11,031) |
| Total                           | \$14,662 | \$14,483 |

Depreciation expense totaled \$996 thousand for 2011 and \$1.1 million for both 2010 and 2009. The increase in buildings and land improvements was primarily from the purchases associated with the relocation of a branch of one of the Banks.

The Company leases facilities under operating leases. Rental expense for the years ended December 31, 2011, 2010, and 2009 was \$753 thousand, \$770 thousand and \$774 thousand, respectively. Future minimum annual rental payments are approximately as follows:

(Dollars in thousands)

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|                              |         |
|------------------------------|---------|
| 2012                         | \$725   |
| 2013                         | 494     |
| 2014                         | 371     |
| 2015                         | 245     |
| 2016                         | 246     |
| Thereafter                   | 1,387   |
| Total minimum lease payments | \$3,468 |

**NOTE 6. INVESTMENT IN UNCONSOLIDATED SUBSIDIARY**

During 2010, the Company terminated the operations of its mortgage brokerage subsidiary and now conducts brokerage activities through a minority series investment in an unrelated Delaware limited liability company under the name “Wye Mortgage Group”. This investment is carried at cost, adjusted for the Company’s 49.0% equity ownership in Wye Mortgage Group’s undistributed income or loss. The following table provides a summary of the activity related to our investment in Wye Mortgage Group for 2011 and 2010.

|   |        |         |
|---|--------|---------|
| (Dollars in thousands)                  | 2011   | 2010    |
| Beginning balance                       | \$ 19  | \$ -    |
| Investment in unconsolidated subsidiary | 25     | 25      |
| Equity in undistributed income (loss)   | 45     | (6 )    |
| Ending balance                          | \$ 89  | \$ 19   |
| Income (loss)                           | \$ 169 | \$ (6 ) |

**NOTE 7. GOODWILL AND OTHER INTANGIBLE ASSETS**

Goodwill totaled \$12.5 million at December 31, 2011 and \$13.7 million at December 31, 2010. Under the provisions of FASB ASC Topic 350, “Intangibles – Goodwill and Other”, goodwill was subjected to an annual assessment for impairment during the third quarter of 2011. As a result of the annual assessment, it was determined that no goodwill impairment existed in the Company’s Community Banking segment. In 2010, the annual assessment determined that goodwill impairment existed at one of the Banks in the Community Banking segment and the Company recorded goodwill impairment charges of \$1.5 million. The Community Banking segment had \$2.6 million in goodwill at the end of both 2011 and 2010. See Note 26 for further information regarding the Company’s business segments.

During the testing for goodwill and other intangible assets impairment in the third quarter of 2011, it was determined that goodwill and other intangible assets were impaired in the Insurance Products and Services segment, primarily relating to the Company’s retail insurance business. The Company recorded goodwill impairment charges of \$1.2 million and other intangible assets impairment charges of \$120 thousand. In 2010, the annual assessment determined that goodwill impairment existed in the Company’s wholesale insurance business in the Insurance Products and Services segment. The Company recorded goodwill impairment charges of \$1.5 million and other intangible assets impairment charges of \$51 thousand in the third quarter of 2010. During the fourth quarter of 2010, goodwill increased \$724 thousand for the Insurance Products and Services segment. The increase reflected a contingent payment to be made to one of the Company’s retail insurance producer firms for meeting performance criteria outlined in its acquisition agreement. As of December 31, 2011, the Insurance Products and Services segment had \$9.9 million in goodwill compared to \$11.1 million at the end of 2010.

The Company will continue to review goodwill and other intangible assets on an annual basis for impairment and as events occur or circumstances change.

The significant components of goodwill and acquired intangible assets are as follows:

| (Dollars in thousands)           | December 31, 2011           |                       |                             |                           | Weighted<br>Average<br>Remaining<br>Life | December 31, 2010           |                       |                             |                           | Weighted<br>Average<br>Remaining<br>Life |
|----------------------------------|-----------------------------|-----------------------|-----------------------------|---------------------------|--|-----------------------------|-----------------------|-----------------------------|---------------------------|--|
|                                  | Gross<br>Carrying<br>Amount | Impairment<br>Charges | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |  | Gross<br>Carrying<br>Amount | Impairment<br>Charges | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |  |
| Goodwill                         | \$17,345                    | \$(4,224)             | \$(667)                     | \$12,454                  | -  | \$17,345                    | \$(3,000)             | \$(667)                     | \$13,678                  | -  |
| Other intangible<br>assets       |                             |                       |                             |                           |  |                             |                       |                             |                           |  |
| Amortizable                      |                             |                       |                             |                           |  |                             |                       |                             |                           |  |
| Employment<br>agreements         | \$1,730                     | \$-                   | \$(1,059)                   | \$671                     | 2.7                                      | \$1,730                     | \$-                   | \$(810)                     | \$920                     | 3.7                                      |
| Insurance expirations            | 1,270                       | -                     | (809)                       | 461                       | 5.4                                      | 1,270                       | -                     | (725)                       | 545                       | 6.4                                      |
| Core deposits                    | 968                         | -                     | (938)                       | 30                        | 0.3                                      | 968                         | -                     | (817)                       | 151                       | 1.3                                      |
| Customer<br>relationships        | 960                         | (126)                 | (253)                       | 581                       | 11.6                                     | 960                         | (6)                   | (195)                       | 759                       | 12.6                                     |
|                                  | 4,928                       | (126)                 | (3,059)                     | 1,743                     |  | 4,928                       | (6)                   | (2,547)                     | 2,375                     |  |
| Unamortizable                    |                             |                       |                             |                           |  |                             |                       |                             |                           |  |
| Carrier relationships            | 1,300                       | (45)                  | -                           | 1,255                     | -  | 1,300                       | (45)                  | -                           | 1,255                     | -  |
| Trade name                       | 1,210                       | -                     | -                           | 1,210                     | -  | 1,210                       | -                     | -                           | 1,210                     | -  |
|                                  | 2,510                       | (45)                  | -                           | 2,465                     |  | 2,510                       | (45)                  | -                           | 2,465                     |  |
| Total other intangible<br>assets | \$7,438                     | \$(171)               | \$(3,059)                   | \$4,208                   |  | \$7,438                     | \$(51)                | \$(2,547)                   | \$4,840                   |  |

The current period and estimated future amortization expense for amortizable other intangible assets is as follows:

| (Dollars in thousands)                | Amortization<br>Expense |     |
|---------------------------------------|-------------------------|-----|
| Year ended December 31, 2011          | \$ 512                  |     |
| Estimate for years ended December 31, | 2012                    | 392 |
|                                       | 2013                    | 296 |
|                                       | 2014                    | 296 |
|                                       | 2015                    | 255 |
|                                       | 2016                    | 134 |

**NOTE 8. OTHER ASSETS**

The Company had the following other assets at December 31, 2011 and 2010.

| (Dollars in thousands)              | 2011     | 2010     |
|-------------------------------------|----------|----------|
| Nonmarketable investment securities | \$2,866  | \$2,949  |
| Insurance premiums receivable       | 876      | 741      |
| Accrued interest receivable         | 3,933    | 5,060    |
| Deferred income taxes (1)           | 9,036    | 7,578    |
| Interest rate caps (2)              | 250      | 2,022    |
| Prepaid FDIC premium expense        | 2,864    | 4,073    |
| Other assets                        | 6,895    | 6,262    |
| Total                               | \$26,720 | \$28,685 |

(1) See Note 16 for further discussion.

(2) See Note 21 for further discussion.

#### **NOTE 9. OTHER LIABILITIES**

The Company had the following other liabilities at December 31 2011 and 2010.

| (Dollars in thousands)                           | 2011    | 2010     |
|--|---------|----------|
| Accrued interest payable                         | \$569   | \$860    |
| Counterparty collateral - interest rate caps (1) | 428     | 1,390    |
| Other liabilities                                | 7,756   | 9,059    |
| Total  | \$8,753 | \$11,309 |

(1) See Note 21 for further discussion.

**NOTE 10. DEPOSITS**

The approximate amount of certificates of deposit of \$100,000 or more was \$243.5 million and \$263.7 million at December 31, 2011 and 2010, respectively.

The following table provides information on the approximate maturities of total time deposits at December 31, 2011 and 2010.

| (Dollars in thousands)     | 2011      | 2010      |
|----------------------------|-----------|-----------|
| Due in one year or less    | \$244,715 | \$295,361 |
| Due in one to three years  | 116,586   | 109,632   |
| Due in three to five years | 83,604    | 66,394    |
| Total                      | \$444,905 | \$471,387 |

**NOTE 11. SHORT-TERM BORROWINGS**

The following table summarizes certain information for short-term borrowings for the years ended December 31, 2011 and 2010.

| (Dollars in thousands)       | 2011            |               | 2010     |        |
|------------------------------|-----------------|---------------|----------|--------|
|                              | Amount          | Rate          | Amount   | Rate   |
| Average for the Year         |                 |               |          |        |
| Retail repurchase agreements | <b>\$15,319</b> | <b>0.37 %</b> | \$15,824 | 0.44 % |
| Other short-term borrowings  | -               | -             | 524      | 2.53   |
| Total                        | <b>\$15,319</b> | <b>0.37</b>   | \$16,348 | 0.51   |
| At Year End                  |                 |               |          |        |
| Retail repurchase agreements | <b>\$17,817</b> | <b>0.34 %</b> | \$16,041 | 0.35 % |
| Maximum Month-End Balance    |                 |               |          |        |
| Retail repurchase agreements | <b>\$18,251</b> |               | \$17,864 |        |
| Other short-term borrowings  | -               |               | 3,378    |        |

Securities sold under agreements to repurchase are securities sold to customers, at the customers' request, under a "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated in the Company's custodial accounts from other investment securities.

The Company may periodically borrow from a correspondent federal funds line of credit arrangement, under a secured reverse repurchase agreement, or from the Federal Home Loan Bank to meet short-term liquidity needs.

**NOTE 12. LONG-TERM DEBT**

The Company had the following long-term debt as of December 31, 2011 and 2010.

| (Dollars in thousands)  | 2011  | 2010  |
|---|-------|-------|
| Acquisition-related debt, 4.08% interest, annual payments over five years | \$455 | \$932 |

The acquisition-related debt was incurred as part of the purchase price of TSGIA and is payable to the seller thereof, who remains the President of that subsidiary. The final payment is due on October 1, 2012.

**NOTE 13. BENEFIT PLANS**

**401(k) and Profit Sharing Plan**

The Company has a 401(k) and profit sharing plan covering substantially all full-time employees. The plan calls for matching contributions by the Company, and the Company makes discretionary contributions based on profits. Company contributions to this plan included in expense totaled \$430 thousand, \$501 thousand, and \$1.1 million for 2011, 2010, and 2009, respectively. The expense decreased in 2011 when compared to 2010 because forfeitures were used to reduce 401(k) costs during 2011. The expense decreased in 2010 when compared to 2009 due to a decline in the amounts accrued for the profit sharing portion of the plan based on lower profits.



**NOTE 14. STOCK-BASED COMPENSATION**

At December 31, 2011, Shore Bancshares, Inc. maintained two equity compensation plans under which it may issue shares of common stock or grant other equity-based awards: (i) the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (“2006 Equity Plan”); and (ii) the Shore Bancshares, Inc. 1998 Stock Option Plan (the “1998 Option Plan”). The ability to grant options under the 1998 Option Plan expired on March 3, 2008 pursuant to the terms of that plan, but stock options granted thereunder were outstanding as of December 31, 2011.

Stock-based compensation expense totaled \$338 thousand, \$390 thousand and \$102 thousand in 2011, 2010, and 2009, respectively. Stock-based compensation expense is recognized ratably over the requisite service period for all awards, is based on the grant date fair value and reflects forfeitures as they occur. The excess tax expense recognized in the accompanying consolidated statements of income related to stock-based compensation was \$45 thousand, \$20 thousand, and \$5 thousand in 2011, 2010, and 2009, respectively. Unrecognized stock-based compensation expense related to stock-based awards totaled \$167 thousand at December 31, 2011. At such date, the weighted-average period over which this unrecognized expense was expected to be recognized was 8.5 months.

Under the 2006 Equity Plan, stock-based awards may be granted periodically to directors, executive officers, and key employees at the discretion of the Compensation Committee of the Board of Shore Bancshares, Inc. Stock-based awards granted to date under the 2006 Equity Plan are generally time-based, vesting on each anniversary of the grant date over a three- to five-year period of time and, in the case of stock options, expiring 10 years from the grant date. The 2006 Equity Plan originally reserved 631,972 shares of common stock for grant, and 561,294 shares remained available for grant at December 31, 2011.

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the two years ended December 31, 2011.

|                                | Year Ended December 31, 2011 |  | Year Ended December 31, 2010 |  |
|--------------------------------|------------------------------|--|------------------------------|--|
|                                | Number of Shares             | Weighted Average Grant Date Fair Value | Number of Shares             | Weighted Average Grant Date Fair Value |
| Nonvested at beginning of year | 44,127                       | \$ 16.76                               | 27,405                       | \$ 20.23                               |
| Granted                        | 13,923                       | 6.99                                   | 24,473                       | 13.41                                  |
| Vested                         | (12,271 )                    | 18.95                                  | (7,751 )                     | 18.47                                  |
| Cancelled                      | -                            | -                                      | -                            | -                                      |
| Nonvested at end of year       | 45,779                       | 13.20                                  | 44,127                       | 16.76                                  |

The total fair value of restricted stock awards that vested was \$119 thousand in 2011 and \$163 thousand in 2010.

The Company estimates the fair value of stock options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. No options were granted during 2011 or 2010.

There was no aggregate intrinsic value of the options outstanding and exercisable based on the \$5.15 market value per share of the Company's common stock at December 31, 2011. Since there were no options exercised during 2011 or 2010, there was no intrinsic value of stock options exercised and no cash received on exercise of options. No stock options vested in 2011 or 2010.

The following is a summary of stock option activity for the 1998 Option Plan for 2011 and 2010.

|                                  | Year Ended December 31, 2011 |                                 | Year Ended December 31, 2010 |                                 |
|----------------------------------|------------------------------|---------------------------------|------------------------------|---------------------------------|
|                                  | Number of Shares             | Weighted Average Exercise Price | Number of Shares             | Weighted Average Exercise Price |
| Outstanding at beginning of year | 8,420                        | \$ 13.17                        | 10,850                       | \$ 13.36                        |
| Granted                          | -                            | -                               | -                            | -                               |
| Exercised                        | -                            | -                               | -                            | -                               |
| Expired/Cancelled                | (1,295 )                     | 13.17                           | (2,430 )                     | 14.00                           |
| Outstanding at end of year       | 7,125                        | 13.17                           | 8,420                        | 13.17                           |

At December 31, 2011, all 7,125 outstanding options were exercisable, had a weighted average exercise price of \$13.17 per share, and expire on May 9, 2012.

**NOTE 15. DEFERRED COMPENSATION**

The Shore Bancshares, Inc. Executive Deferred Compensation Plan (the “Plan”) is for members of management and highly compensated employees of Shore Bancshares, Inc. and its subsidiaries. The Plan permits a participant to elect, each year, to defer receipt of up to 100% of his or her salary and bonus to be earned in the following year. The Plan also permits the participant to defer the receipt of performance-based compensation not later than six months before the end of the period for which it is to be earned. The deferred amounts are credited to an account maintained on behalf of the participant and are invested at the discretion of each participant in certain deemed investment options selected from time to time by the Compensation Committee of the Board of Shore Bancshares, Inc. The Company may also make matching, mandatory and discretionary contributions for certain participants. A participant is fully vested at all times in the amounts that he or she elects to defer. Any contributions by the Company will vest over a five-year period. The Company made contributions to the Plan totaling \$65 thousand, \$94 thousand, and \$85 thousand for 2011, 2010, and 2009, respectively. There were no elective deferrals made by plan participants during 2011 or 2010. One plan participant made elective deferrals during 2009.

Shore Bancshares, Inc. has a supplemental deferred compensation plan to provide retirement benefits to its Chief Executive Officer. The participant is 100% vested in amounts credited to his account. No contributions have been made to this plan since the adoption of the Plan described above.

CNB has agreements with certain of its directors under which they have deferred part of their fees and compensation. The amounts deferred are invested in insurance policies, owned by CNB, on the lives of the respective individuals. Amounts available under the policies are to be paid to the individuals as retirement benefits over future years. The following table includes information on the cash surrender value and the accrued benefit obligation included in other assets and other liabilities at December 31, 2011 and 2010.

| (Dollars in thousands)     | <b>2011</b>    | 2010    |
|----------------------------|----------------|---------|
| Cash surrender value       | <b>\$3,006</b> | \$3,191 |
| Accrued benefit obligation | <b>1,158</b>   | 1,037   |

**NOTE 16. INCOME TAXES**

The following table provides information on income taxes receivable/payable and deferred taxes included in the balance sheets as of December 31, 2011 and 2010.

| (Dollars in thousands) | <b>2011</b> | 2010 |
|------------------------|-------------|------|
|------------------------|-------------|------|

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|   |              |          |
|---|--------------|----------|
| Federal income taxes currently receivable (payable) | <b>\$454</b> | \$(512 ) |
| State income taxes currently receivable (payable)   | <b>265</b>   | 111      |
| Net deferred tax asset                              | <b>9,036</b> | 7,578    |

The following table provides information on components of income tax expense for each of the three years ended December 31.

| (Dollars in thousands)             | <b>2011</b>     | 2010     | 2009    |
|------------------------------------|-----------------|----------|---------|
| Current tax expense:               |                 |          |         |
| Federal                            | <b>\$656</b>    | \$1,940  | \$4,078 |
| State                              | <b>236</b>      | 473      | 1,262   |
|                                    | <b>892</b>      | 2,413    | 5,340   |
| Deferred income tax benefit:       |                 |          |         |
| Federal                            | <b>(1,233)</b>  | (2,350)  | (708 )  |
| State                              | <b>(317 )</b>   | (555 )   | (220 )  |
|                                    | <b>(1,550)</b>  | (2,905)  | (928 )  |
| Total income tax (benefit) expense | <b>\$(658 )</b> | \$(492 ) | \$4,412 |

The following table provides a reconciliation of tax computed at the statutory federal tax rate of 34.0% for both 2011 and 2010, and 34.2% for 2009 to the actual tax expense for the three years ended December 31.

| (Dollars in thousands)                     | 2011          | 2010   | 2009   |
|--|---------------|--------|--------|
| Tax at federal statutory rate              | <b>34.0 %</b> | 34.0 % | 34.2 % |
| Tax effect of:                             |               |        |        |
| Tax-exempt income                          | <b>8.8</b>    | 7.6    | (1.6)  |
| Non-deductible goodwill impairment charges | <b>(6.0)</b>  | (24.3) | -      |
| Other non-deductible expenses              | <b>(2.1)</b>  | (1.3)  | 0.2    |
| State income taxes, net of federal benefit | <b>3.6</b>    | 2.4    | 5.9    |
| Other                                      | <b>4.0</b>    | 4.4    | (0.9)  |
| Actual income tax expense rate             | <b>42.3 %</b> | 22.8 % | 37.8 % |

The following table provides information on significant components of the Company's deferred tax assets and liabilities as of December 31.

| (Dollars in thousands)                            | 2011           | 2010    |
|---|----------------|---------|
| Deferred tax assets:                              |                |         |
| Allowance for credit losses                       | <b>\$5,640</b> | \$5,652 |
| Reserve for off-balance sheet commitments         | <b>137</b>     | 198     |
| Write-downs of other real estate owned            | <b>346</b>     | 163     |
| Net operating loss carry forward                  | <b>212</b>     | 258     |
| Deferred income                                   | <b>2,055</b>   | 1,244   |
| Accrued employee benefits                         | <b>1,187</b>   | 1,049   |
| Accrued data processing expenses                  | <b>263</b>     | 298     |
| Unrealized losses on interest rate caps           | <b>2,070</b>   | 1,884   |
| Other   | <b>54</b>      | 60      |
| Total deferred tax assets                         | <b>11,964</b>  | 10,806  |
| Deferred tax liabilities:                         |                |         |
| Depreciation                                      | <b>612</b>     | 550     |
| Purchase accounting adjustments                   | <b>680</b>     | 1,047   |
| Deferred capital gain on branch sale              | <b>473</b>     | 486     |
| Deferred gains on interest rate swaps             | <b>169</b>     | 169     |
| Deferred loan costs                               | <b>-</b>       | 256     |
| Unrealized gains on available-for-sale securities | <b>928</b>     | 650     |
| Other   | <b>66</b>      | 70      |
| Total deferred tax liabilities                    | <b>2,928</b>   | 3,228   |
| Net deferred tax assets                           | <b>\$9,036</b> | \$7,578 |

**NOTE 17. EARNINGS/(LOSS) PER COMMON SHARE**

Basic earnings/(loss) per common share are calculated by dividing net income/(loss) available to (allocable to) common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings/(loss) per common share are calculated by dividing net income/(loss) available to (allocable to) common stockholders by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of stock-based awards and the warrant. There is no dilutive effect on the loss per share during loss periods. The following table provides information relating to the calculation of earnings/(loss) per common share.

| (In thousands, except per share data)             | 2011      | 2010      | 2009    |
|---|-----------|-----------|---------|
| Net (loss) income                                 | \$(897 )  | \$(1,667) | \$5,397 |
| Weighted average shares outstanding – basic       | 8,451     | 8,442     | 8,414   |
| Dilutive effect of stock-based awards and warrant | -         | -         | 3       |
| Weighted average shares outstanding – diluted     | 8,451     | 8,442     | 8,417   |
| (Loss) earnings per common share – basic          | \$(0.11 ) | \$(0.20 ) | \$0.64  |
| (Loss) earnings per common share – diluted        | \$(0.11 ) | \$(0.20 ) | \$0.64  |

The calculations of diluted earnings/(loss) per share excluded weighted average stock-based awards of 7,201 for 2011, 8,626 for 2010 and 438 for 2009 and that portion of a warrant to purchase weighted average shares of common stock of 152 thousand for 2011, 173 thousand for 2010 and 169 thousand for 2009 because the effect of including them would have been antidilutive.

**NOTE 18. REGULATORY CAPITAL REQUIREMENTS**

Shore Bancshares, Inc. and each of the Banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Banks must meet specific capital guidelines that involve quantitative measures of the Banks' assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Banks' capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Banks to maintain amounts and ratios (set forth in the table below) of Tier 1 and total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (leverage ratio). Management believes, as of December 31, 2011, that Shore Bancshares, Inc. and the Banks met all capital adequacy requirements to which they are subject.

As of December 31, 2011 and 2010, the most recent notification from the Federal Deposit Insurance Corporation categorized the Banks as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Banks must maintain minimum Tier 1 risk-based and total risk-based capital ratios, and Tier 1 leverage ratios. Management believes that there are no conditions or events since that notification that have changed the well-capitalized category of Shore Bancshares, Inc. or either of the Banks.

The minimum ratios for capital adequacy purposes are 4.00%, 8.00% and 4.00% for the Tier 1 risk-based capital, total risk-based capital and leverage ratios, respectively. To be categorized as well capitalized, a bank must maintain minimum ratios of 6.00%, 10.00% and 5.00% for its Tier 1 risk-based capital, total risk-based capital and leverage ratios, respectively. Shore Bancshares, Inc., as a financial holding company, is subject to the well-capitalized requirement.

The following tables present the capital amounts and ratios for Shore Bancshares, Inc., Talbot Bank and CNB as of December 31, 2011 and 2010. Also presented below are the capital amounts and ratios for Felton Bank as of December 31, 2010.

| <b>December 31, 2011</b> |                  | Total            | Net              | Adjusted           | Tier 1       | Total          | Tier 1        |
|--------------------------|------------------|------------------|------------------|--------------------|--------------|----------------|---------------|
| (Dollars in thousands)   |                  | Risk-            | Risk-            | Average            | Risk-Based   | Risk-Based     | Leverage      |
| <b>Company</b>           | Tier 1           | Based            | Weighted         | Total Assets       | Capital      | Capital        | Ratio         |
|                          | Capital          | Capital          | Assets           |                    | Ratio        | Ratio          |               |
|                          | <b>\$106,276</b> | <b>\$116,917</b> | <b>\$846,936</b> | <b>\$1,143,990</b> | <b>12.55</b> | <b>% 13.80</b> | <b>% 9.29</b> |
| Talbot Bank              | 63,667           | 70,604           | 551,202          | 706,984            | 11.55        | 12.81          | 9.01          |
| CNB                      | 41,542           | 45,246           | 295,232          | 431,968            | 14.07        | 15.33          | 9.62          |

| <b>December 31, 2010</b> |                  | Total            | Net              | Adjusted           | Tier 1       | Total          | Tier 1        |
|--------------------------|------------------|------------------|------------------|--------------------|--------------|----------------|---------------|
| (Dollars in thousands)   |                  | Risk-            | Risk-            | Average            | Risk-Based   | Risk-Based     | Leverage      |
| <b>Company</b>           | Tier 1           | Based            | Weighted         | Total Assets       | Capital      | Capital        | Ratio         |
|                          | Capital          | Capital          | Assets           |                    | Ratio        | Ratio          |               |
|                          | <b>\$105,808</b> | <b>\$117,057</b> | <b>\$895,581</b> | <b>\$1,109,999</b> | <b>11.81</b> | <b>% 13.07</b> | <b>% 9.53</b> |
| Talbot Bank              | 65,736           | 73,133           | 589,533          | 682,493            | 11.15        | 12.41          | 9.63          |
| CNB                      | 32,813           | 35,893           | 246,056          | 342,771            | 13.34        | 14.59          | 9.57          |
| Felton Bank              | 7,683            | 8,459            | 61,086           | 81,621             | 12.58        | 13.85          | 9.41          |

Federal and state laws and regulations applicable to banks and their holding companies impose certain restrictions on dividend payments by the Banks, as well as restricting extensions of credit and transfers of assets between the Banks and Shore Bancshares, Inc. The Banks paid dividends of \$989 thousand to Shore Bancshares, Inc. during 2011. At December 31, 2011, the Banks could have paid dividends to Shore Bancshares, Inc. of approximately \$8.9 million without the prior consent and approval of the regulatory agencies. Shore Bancshares, Inc. had no outstanding receivables from subsidiaries at December 31, 2011 or 2010.

#### **NOTE 19. LINES OF CREDIT**

The Banks had \$15.5 million in unsecured federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at December 31, 2011. The comparable amount was \$24.5 million at December 31, 2010. In addition, the Banks had credit availability of approximately \$31.6 million and \$29.1 million from the Federal Home Loan Bank at December 31, 2011 and 2010, respectively. The Banks have pledged as collateral, under a blanket lien, all qualifying residential loans under borrowing agreements with the Federal Home Loan Bank. At December 31, 2011 and 2010, the Federal Home Loan Bank had issued letters of credit of \$63 million and \$71.0 million, respectively, on behalf of the Banks to local government entities as collateral for their deposits. The Banks had no short-term borrowings from the Federal Home Loan Bank at December 31, 2011 or 2010.



## NOTE 20. FAIR VALUE MEASUREMENTS

ASC 820, “*Fair Value Measurements and Disclosures*” provides a framework for measuring and disclosing fair value under GAAP. This accounting guidance requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis or on a nonrecurring basis.

ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale and derivative assets and liabilities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as impaired loans and other real estate and other assets owned (foreclosed assets). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Under ASC 820, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine their fair values. These hierarchy levels are:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity’s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

The following is a description of valuation methodologies used for the Company’s assets and liabilities recorded at fair value.

#### Investment Securities Available for Sale

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security’s credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

#### Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and a valuation allowance may be established if there are losses associated with the loan. Loans are considered impaired if it is probable that payment of interest and principle will not be made in accordance with contractual terms. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. At December 31, 2011 and 2010, substantially all impaired loans were evaluated based on the fair value of the collateral and were classified as Level 3 in the fair value hierarchy.

#### Other Real Estate and Other Assets Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management’s estimation of the value of the collateral. At December 31, 2011 and 2010, foreclosed assets were classified as Level 3 in the fair value hierarchy.

#### Derivative Assets and Liabilities

Derivative instruments held or issued by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Company measures fair value

using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. The Company classifies derivative instruments held or issued for risk management purposes as recurring Level 2. As of December 31, 2011 and 2010, the Company's derivative instruments consisted solely of interest rate caps. Derivative assets and liabilities are included in other assets and liabilities, respectively, in the accompanying consolidated balance sheets.

Assets Recorded at Fair Value on a Recurring Basis

The tables below present the recorded amount of assets measured at fair value on a recurring basis at December 31, 2011 and 2010. No assets were transferred from one hierarchy level to another during 2011 and 2010.

| (Dollars in thousands)         | Fair Value | Quoted Prices<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
|--------------------------------|------------|----------------------------|---|---|
| December 31, 2011              |            |                            |   |   |
| Securities available for sale: |            |                            |   |   |
| U.S. Government agencies       | \$ 42,148  | \$ -                       | \$ 42,148   | \$ -  |
| Mortgage-backed securities     | 87,033     | -                          | 87,033  | -   |
| Other equity securities        | 599        | -                          | 599   | -   |
| Total                          | \$ 129,780 | \$ -                       | \$ 129,780  | \$ -  |
| Interest rate caps             | \$ 250     | \$ -                       | \$ 250  | \$ -  |

| (Dollars in thousands)         | Fair Value | Quoted Prices<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
|--------------------------------|------------|----------------------------|---|---|
| December 31, 2010              |            |                            |   |   |
| Securities available for sale: |            |                            |   |   |
| U.S. Government agencies       | \$ 58,904  | \$ -                       | \$ 58,904   | \$ -  |
| Mortgage-backed securities     | 39,577     | -                          | 39,577  | -   |
| Other equity securities        | 574        | -                          | 574   | -   |
| Total                          | \$ 99,055  | \$ -                       | \$ 99,055   | \$ -  |
| Interest rate caps             | \$ 2,022   | \$ -                       | \$ 2,022  | \$ -  |

Assets Recorded at Fair Value on a Nonrecurring Basis

The tables below summarize the changes in the recorded amount of assets measured at fair value on a nonrecurring basis for 2011 and 2010. All assets measured at fair value on a nonrecurring basis were classified as Level 3 in the fair value hierarchy for the periods presented.

| (Dollars in thousands) | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer | Total    |
|------------------------|--------------|----------------------------|---------------------------|------------|----------|----------|
| 2011                   |              |                            |                           |            |          |          |
| Impaired loans:        |              |                            |                           |            |          |          |
| Beginning balance      | \$ 28,175    | \$ 15,327                  | \$ 13,280                 | \$ 4,374   | \$ 30    | \$61,186 |
| Charge-offs            | (4,313)      | ) (7,082)                  | ) (4,643)                 | ) (2,600)  | ) -      | (18,638) |
| Payments               | (1,555)      | ) (7,557)                  | ) (2,364)                 | ) (550)    | ) (13)   | (12,039) |

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|                                      |           |           |           |          |       |          |
|--------------------------------------|-----------|-----------|-----------|----------|-------|----------|
| Transfers to other real estate owned | (2,317 )  | (1,642 )  | (4,920 )  | (388 )   | -     | (9,267 ) |
| Return to performing status          | -         | (1,907 )  | -         | -        | -     | (1,907 ) |
| Changed to nonaccrual status         | (419 )    | (3,120 )  | (1,825 )  | -        | -     | (5,364 ) |
| Additions                            | 7,765     | 29,879    | 24,050    | 902      | 11    | 62,607   |
| Changes in allowance                 | (170 )    | (1,296 )  | -         | -        | -     | (1,466 ) |
| Ending balance                       | \$ 27,166 | \$ 22,602 | \$ 23,578 | \$ 1,738 | \$ 28 | \$75,112 |

| (Dollars in thousands)               | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer | Total     |
|--------------------------------------|--------------|----------------------------|---------------------------|------------|----------|-----------|
| 2010                                 |              |                            |                           |            |          |           |
| Impaired loans:                      |              |                            |                           |            |          |           |
| Beginning balance                    | \$ 7,163     | \$ 5,968                   | \$ 2,828                  | \$ 1,560   | \$ 37    | \$17,556  |
| Charge-offs                          | (7,765 )     | (5,809 )                   | (76 )                     | (2,258 )   | (94 )    | (16,002 ) |
| Payments                             | (2,209 )     | (4,146 )                   | (1,099 )                  | (220 )     | (2 )     | (7,676 )  |
| Transfers to other real estate owned | (157 )       | (1,233 )                   | (208 )                    | -          | -        | (1,598 )  |
| Return to performing status          | (462 )       | (655 )                     | -                         | (582 )     | -        | (1,699 )  |
| Changed to nonaccrual status         | -            | -                          | -                         | -          | -        | -         |
| Additions                            | 31,605       | 21,405                     | 11,835                    | 5,874      | 89       | 70,808    |
| Changes in allowance                 | -            | (203 )                     | -                         | -          | -        | (203 )    |
| Ending balance                       | \$ 28,175    | \$ 15,327                  | \$ 13,280                 | \$ 4,374   | \$ 30    | \$61,186  |

| (Dollars in thousands)   | 2011     | 2010     |
|--------------------------|----------|----------|
| Other real estate owned: |          |          |
| Beginning balance        | \$3,702  | \$2,572  |
| Sales                    | (3,978 ) | (1,353 ) |
| Write-downs              | (1,051 ) | (657 )   |
| Additions                | 10,712   | 3,140    |
| Ending balance           | \$9,385  | \$3,702  |

The following disclosures relate to the fair value of the Company's financial instruments and include the methods and assumptions used to estimate the fair value of each class of financial instrument for which it is practicable to estimate that value:

### Cash and Cash Equivalents

Cash equivalents include interest-bearing deposits with other banks and federal funds sold. For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

### Investment Securities

For all investments in debt securities, fair values are based on quoted market prices. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

### Loans

The fair values of categories of fixed rate loans, such as commercial loans, residential mortgage, and other consumer loans are estimated by discounting the future cash flows using the current rates at which similar loans would be made

to borrowers with similar credit ratings and for the same remaining maturities. Other loans, including variable rate loans, are adjusted for differences in loan characteristics.

### Financial Liabilities

The fair values of demand deposits, savings accounts, and certain money market deposits are the amounts payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. These estimates do not take into consideration the value of core deposit intangibles. Generally, the carrying amount of short-term borrowings is a reasonable estimate of fair value. The fair values of securities sold under agreements to repurchase (included in short-term borrowings) and long-term debt are estimated using the rates offered for similar borrowings.

### Commitments to Extend Credit and Standby Letters of Credit

The majority of the Company's commitments to grant loans and standby letters of credit are written to carry current market interest rates if converted to loans. In general, commitments to extend credit and letters of credit are not assignable by the Company or the borrower, so they generally have value only to the Company and the borrower. Therefore, it is impractical to assign any value to these commitments.

The following table provides information on the estimated fair values of the Company's financial instruments as of December 31, 2011 and 2010.

| (Dollars in thousands)            | 2011                |                      | 2010                |                      |
|-----------------------------------|---------------------|----------------------|---------------------|----------------------|
|                                   | Carrying Amount     | Estimated Fair Value | Carrying Amount     | Estimated Fair Value |
| <b>Financial assets</b>           |                     |                      |                     |                      |
| Cash and cash equivalents         | \$ 127,742          | \$ 127,742           | \$ 77,964           | \$ 77,964            |
| Investment securities             | 136,260             | 136,512              | 105,782             | 105,906              |
| Loans                             | 841,050             | 856,917              | 895,404             | 908,745              |
| Less: allowance for credit losses | (14,288 )           | -                    | (14,227 )           | -                    |
| <b>Total</b>                      | <b>\$ 1,090,764</b> | <b>\$ 1,121,171</b>  | <b>\$ 1,064,923</b> | <b>\$ 1,092,615</b>  |
| <b>Financial liabilities</b>      |                     |                      |                     |                      |
| Deposits                          | \$ 1,009,919        | \$ 1,013,964         | \$ 979,516          | \$ 983,257           |
| Short-term borrowings             | 17,817              | 17,817               | 16,041              | 16,041               |
| Long-term debt                    | 455                 | 470                  | 932                 | 982                  |
| <b>Total</b>                      | <b>\$ 1,028,191</b> | <b>\$ 1,032,251</b>  | <b>\$ 996,489</b>   | <b>\$ 1,000,280</b>  |

#### NOTE 21. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

ASC 815, "*Derivatives and Hedging*", defines derivatives, requires that derivatives be carried at fair value on the balance sheet and provides for hedge accounting when certain conditions are met. Changes in the fair values of derivative instruments designated as "cash flow" hedges, to the extent the hedges are highly effective, are recorded in other comprehensive income, net of taxes. Ineffective portions of cash flow hedges, if any, are recognized in current period earnings. The net interest settlement on cash flow hedges is treated as an adjustment of the interest income or interest expense of the hedged assets or liabilities. As part of its overall interest rate risk management strategy, the Company uses derivative instruments to hedge its exposure to changes in interest rates. The Company does not use derivatives for any trading or other speculative purposes.

During the second quarter of 2009, the Company entered into five-year interest rate swap agreements with notional amounts of \$70 million to effectively fix the interest rate on \$70 million of the Company's money market deposit accounts at 2.97%. Because the interest rate swaps did not qualify for hedge accounting, the Company restructured the original transactions and purchased interest rate caps for \$7.2 million during the third quarter of 2009. The interest rate caps qualified for hedge accounting. At December 31, 2011 and 2010, the aggregate fair value of these derivatives was an asset of \$250 thousand and \$2.0 million, respectively. The change in fair value included a \$460 thousand adjustment to record unrealized holding losses on the interest rate caps and a \$1.3 million charge to interest expense associated with the hedged money market deposit accounts. For 2010 and 2009, unrealized holding losses on the interest rate caps were \$3.7 million and \$952 thousand, respectively, and interest expense associated with the hedged money market deposit accounts was \$429 thousand and \$8 thousand, respectively. The Company expects that the



charge to interest expense associated with the hedged deposits over the next 12 months will be approximately \$2.0 million. For 2009, other noninterest income included a gain relating to the swap transactions of \$420 thousand which was recorded in the second quarter of 2009.

By entering into derivative instrument contracts, the Company exposes itself, from time to time, to counterparty credit risk. Counterparty credit risk is the risk that the counterparty will fail to perform under the terms of the derivative contract. When the fair value of a derivative contract is in an asset position, the counterparty has a liability to the Company, which creates credit risk for the Company. The Company attempts to minimize this risk by selecting counterparties with investment grade credit ratings, limiting its exposure to any single counterparty and regularly monitoring its market position with each counterparty. Also to minimize risk associated with the interest rate caps, the Company obtained counterparty collateral which was recorded in other liabilities. At December 31, 2011 and 2010, the counterparty collateral was \$428 thousand and \$1.4 million, respectively.

#### NOTE 22. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

In the normal course of business, to meet the financing needs of its customers, the Banks are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. The Banks' exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Banks use the same credit policies in making commitments and conditional obligations as they do for on-balance sheet instruments. The Banks generally require collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Banks evaluate each customer's creditworthiness on a case-by-case basis.

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. Letters of credit are conditional commitments issued by the Banks to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The following table provides information on commitments outstanding as of December 31, 2011 and 2010.

| (Dollars in thousands)       | 2011             | 2010      |
|------------------------------|------------------|-----------|
| Commitments to extend credit | <b>\$136,222</b> | \$137,078 |
| Letters of credit            | <b>11,311</b>    | 15,586    |
| Total                        | <b>\$147,533</b> | \$152,664 |

#### NOTE 23. CONTINGENCIES

In the normal course of business, Shore Bancshares, Inc. and its subsidiaries may become involved in litigation arising from banking, financial, and other activities. Management, after consultation with legal counsel, does not anticipate that the future liability, if any, arising out of current proceedings will have a material effect on the Company's financial condition, operating results, or liquidity.

#### NOTE 24. PARENT COMPANY FINANCIAL INFORMATION

The following tables provide condensed financial information for Shore Bancshares, Inc. (Parent Company Only).

##### Condensed Balance Sheets

December 31,

| (Dollars in thousands)      | 2011    | 2010    |
|-----------------------------|---------|---------|
| Assets                      |         |         |
| Cash                        | \$1,316 | \$1,344 |
| Investment in subsidiaries  | 121,567 | 123,570 |
| Premises and equipment, net | 2,711   | 2,877   |

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|  |            |            |
|--|------------|------------|
| Other assets                               | 1,519      | 1,422      |
| Total assets                               | \$ 127,113 | \$ 129,213 |
| Liabilities                                |            |            |
| Accrued interest payable                   | \$91       | \$139      |
| Deferred tax liability                     | 1,383      | 1,458      |
| Other liabilities                          | 1,040      | 971        |
| Long-term debt                             | 3,350      | 4,132      |
| Total liabilities                          | 5,864      | 6,700      |
| Stockholders' equity                       |            |            |
| Common stock                               | 85         | 84         |
| Warrant                                    | -          | 1,543      |
| Additional paid in capital                 | 32,052     | 30,242     |
| Retained earnings                          | 90,801     | 92,458     |
| Accumulated other comprehensive loss       | (1,689 )   | (1,814 )   |
| Total stockholders' equity                 | 121,249    | 122,513    |
| Total liabilities and stockholders' equity | \$ 127,113 | \$ 129,213 |

## Condensed Statements of (Loss) Income

For the Years Ended December 31,

| (Dollars in thousands)  | 2011     | 2010      | 2009    |
|---|----------|-----------|---------|
| Income  |          |           |         |
| Dividends from subsidiaries   | \$1,519  | \$2,786   | \$5,725 |
| Management and other fees from subsidiaries   | 5,783    | 6,095     | 5,952   |
| Other income  | 245      | 70        | 76      |
| Interest income   | 6        | 1         | 68      |
| Total income  | 7,553    | 8,952     | 11,821  |
| Expenses  |          |           |         |
| Interest expense  | 154      | 172       | 87      |
| Salaries and employee benefits  | 3,977    | 4,120     | 4,351   |
| Occupancy and equipment expense   | 471      | 494       | 427     |
| Other operating expenses  | 1,360    | 1,499     | 1,476   |
| Total expenses  | 5,962    | 6,285     | 6,341   |
| Income before income tax expense and equity in undistributed net income of subsidiaries | 1,591    | 2,667     | 5,480   |
| Income tax (benefit) expense  | (190 )   | 151       | 125     |
| Income before equity in undistributed net income of subsidiaries                        | 1,781    | 2,516     | 5,355   |
| Equity in undistributed net (loss) income of subsidiaries                               | (2,678)  | (4,183)   | 1,918   |
| Net (loss) income   | (897 )   | (1,667)   | 7,273   |
| Preferred stock dividends and discount accretion  | -        | -         | 1,876   |
| Net (loss) income available to common stockholders                                      | \$(897 ) | \$(1,667) | \$5,397 |

## Condensed Statements of Cash Flows

For the Years Ended December 31,

| (Dollars in thousands)   | 2011     | 2010       | 2009     |
|--|----------|------------|----------|
| Cash flows from operating activities:  |          |            |          |
| Net (loss) income  | \$(897 ) | \$(1,667 ) | \$7,273  |
| Adjustments to reconcile net (loss) income to cash provided by operating activities: |          |            |          |
| Equity in undistributed net loss (income) of subsidiaries                            | 2,678    | 4,183      | (1,918 ) |
| Depreciation   | 223      | 235        | 215      |
| Stock-based compensation expense   | 338      | 390        | 102      |
| Excess tax expense from stock-based arrangements                                     | (45 )    | (20 )      | (5 )     |
| Net (increase) decrease in other assets  | (72 )    | 308        | (808 )   |
| Net (decrease) increase in other liabilities   | (99 )    | 406        | 114      |
| Net cash provided by operating activities  | 2,126    | 3,835      | 4,973    |
| Cash flows from investing activities:  |          |            |          |
| Purchases of premises and equipment  | (57 )    | (109 )     | (333 )   |
| Investment in unconsolidated subsidiary  | (25 )    | (25 )      | -        |
| Investment in subsidiaries   | (550 )   | -          | (3,400 ) |
| Net cash used by investing activities  | (632 )   | (134 )     | (3,733 ) |
| Cash flows from financing activities:  |          |            |          |
| Net (decrease) increase in short-term borrowings                                     | -        | (3,378)    | 3,378    |
| Proceeds from long-term debt   | -        | 3,200      | -        |
| Repayment of long-term debt  | (782 )   | (497 )     | (518 )   |
| Excess tax expense from stock-based arrangements                                     | 45       | 20         | 5        |
| Proceeds from issuance of preferred stock and warrant                                | -        | -          | 25,000   |
| Redemption of preferred stock  | -        | -          | (23,525) |
| Repurchase of warrant  | (25 )    | -          | -        |
| Proceeds from issuance of common stock   | -        | -          | 2        |
| Preferred stock dividends paid   | -        | -          | (1,808 ) |
| Common stock dividends paid  | (760 )   | (2,026)    | (5,386 ) |
| Net cash used by financing activities  | (1,522)  | (2,681)    | (2,852 ) |
| Net (decrease) increase in cash and cash equivalents                                 | (28 )    | 1,020      | (1,612 ) |
| Cash and cash equivalents at beginning of year                                       | 1,344    | 324        | 1,936    |
| Cash and cash equivalents at end of year   | \$1,316  | \$1,344    | \$324    |

## NOTE 25. QUARTERLY FINANCIAL RESULTS (unaudited)

The following table provides a summary of selected consolidated quarterly financial data for the two years ended December 31, 2011.

| (In thousands, except per share data)    | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
|--|------------------|-------------------|------------------|-------------------|
| 2011                                     |                  |                   |                  |                   |
| Interest income                          | \$12,718         | \$12,735          | \$12,868         | \$12,531          |
| Net interest income                      | 9,862            | 9,942             | 10,123           | 9,837             |
| Provision for credit losses              | 6,390            | 5,395             | 3,650            | 4,035             |
| (Loss) income before income taxes        | (2,024 )         | (266 )            | 319              | 416               |
| Net (loss) income                        | (1,083 )         | (233 )            | 94               | 325               |
| Basic (loss) earnings per common share   | \$(0.13 )        | \$(0.03 )         | \$0.01           | \$0.04            |
| Diluted (loss) earnings per common share | \$(0.13 )        | \$(0.03 )         | \$0.01           | \$0.04            |
| 2010                                     |                  |                   |                  |                   |
| Interest income                          | \$13,828         | \$13,967          | \$13,837         | \$13,829          |
| Net interest income                      | 10,395           | 10,691            | 10,687           | 10,866            |
| Provision for credit losses              | 7,617            | 4,917             | 4,193            | 4,392             |
| (Loss) income before income taxes        | (2,661 )         | 654               | (1,492 )         | 1,340             |
| Net (loss) income                        | (1,562 )         | 445               | (1,400 )         | 850               |
| Basic (loss) earnings per common share   | \$(0.19 )        | \$0.05            | \$(0.17 )        | \$0.10            |
| Diluted (loss) earnings per common share | \$(0.19 )        | \$0.05            | \$(0.17 )        | \$0.10            |

Earnings per share are based on quarterly results and may not be additive to the annual earnings per share amounts.

## NOTE 26. SEGMENT REPORTING

The Company operates two primary business segments: Community Banking and Insurance Products and Services. The Community Banking business provides services to consumers and small businesses on the Eastern Shore of Maryland and in Delaware through its 18-branch network. Community banking activities include small business services, retail brokerage, trust services and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards, accounts receivable financing arrangements, and merchant card services.

Through the Insurance Products and Services business, the Company provides a full range of insurance products and services to businesses and consumers in the Company's market areas. Products include property and casualty, life, marine, individual health and long-term care insurance. Pension and profit sharing plans and retirement plans for executives and employees are available to suit the needs of individual businesses.

During the third quarter of 2011, goodwill and other intangible assets were tested for impairment. It was determined that goodwill and other intangible assets were impaired in the Company's Insurance Products and Services segment, primarily relating to the Company's retail insurance business. The Company recorded goodwill impairment charges of \$1.2 million and other intangible assets impairment charges of \$120 thousand reflected in the table below in noninterest expense.

During the third quarter of 2010, when goodwill and other intangible assets were tested for impairment, it was determined that goodwill and other intangible assets were impaired in the Company's Community Banking segment at one of the Banks, and in the Insurance Products and Services segment, specifically relating to the Company's wholesale insurance business. The Company recorded goodwill impairment charges of \$1.5 million in both segments, and other intangible assets impairment charges of \$51 thousand in the Insurance Products and Services segment.

Selected financial information by business segments is included in the following table.

| (Dollars in thousands)            | Community<br>Banking | Insurance Products<br>and Services | Parent<br>Company | Total        |
|-----------------------------------|----------------------|------------------------------------|-------------------|--------------|
| 2011                              |                      |                                    |                   |              |
| Interest income                   | \$50,721             | \$ 131                             | \$ -              | \$50,852     |
| Interest expense                  | (11,051 )            | -                                  | (37 )             | (11,088 )    |
| Provision for credit losses       | (19,470 )            | -                                  | -                 | (19,470 )    |
| Noninterest income                | 7,269                | 9,881                              | 168               | 17,318       |
| Noninterest expense               | (22,738 )            | (10,766 )                          | (5,663 )          | (39,167 )    |
| Net intersegment (expense) income | (5,148 )             | (455 )                             | 5,603             | -            |
| (Loss) income before taxes        | (417 )               | (1,209 )                           | 71                | (1,555 )     |
| Income tax benefit (expense)      | 176                  | 512                                | (30 )             | 658          |
| Net (loss) income                 | \$(241 )             | \$ (697 )                          | \$ 41             | \$(897 )     |
| Total assets                      | \$ 1,138,576         | \$ 17,354                          | \$ 2,263          | \$ 1,158,193 |
| 2010                              |                      |                                    |                   |              |
| Interest income                   | \$55,293             | \$ 168                             | \$ -              | \$55,461     |
| Interest expense                  | (12,752 )            | -                                  | (70 )             | (12,822 )    |
| Provision for credit losses       | (21,119 )            | -                                  | -                 | (21,119 )    |
| Noninterest income                | 7,308                | 10,739                             | (6 )              | 18,041       |
| Noninterest expense               | (24,328 )            | (11,410 )                          | (5,982 )          | (41,720 )    |
| Net intersegment (expense) income | (5,418 )             | (521 )                             | 5,939             | -            |
| Loss before tax benefit           | (1,016 )             | (1,024 )                           | (119 )            | (2,159 )     |
| Income tax benefit                | 232                  | 233                                | 27                | 492          |
| Net loss                          | \$(784 )             | \$ (791 )                          | \$ (92 )          | \$(1,667 )   |
| Total assets                      | \$ 1,108,712         | \$ 18,759                          | \$ 2,840          | \$ 1,130,311 |
| 2009                              |                      |                                    |                   |              |
| Interest income                   | \$58,722             | \$ 67                              | \$ -              | \$58,789     |
| Interest expense                  | (17,324 )            | -                                  | (87 )             | (17,411 )    |
| Provision for credit losses       | (8,986 )             | -                                  | -                 | (8,986 )     |
| Noninterest income                | 7,774                | 11,767                             | -                 | 19,541       |
| Noninterest expense               | (23,256 )            | (10,882 )                          | (6,110 )          | (40,248 )    |
| Net intersegment (expense) income | (5,481 )             | (470 )                             | 5,951             | -            |
| Income (loss) before taxes        | 11,449               | 482                                | (246 )            | 11,685       |
| Income tax (expense) benefit      | (4,323 )             | (182 )                             | 93                | (4,412 )     |
| Net income (loss)                 | \$7,126              | \$ 300                             | \$(153 )          | \$7,273      |
| Total assets                      | \$ 1,133,673         | \$ 19,390                          | \$ 3,453          | \$ 1,156,516 |

## NOTE 27. PREFERRED STOCK



On January 9, 2009, Shore Bancshares, Inc. participated in the Troubled Asset Relief Program Capital Purchase Program (the "TARP CPP") of the United States Department of the Treasury (the "Treasury") by issuing 25,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the "Preferred Stock") and a common stock purchase warrant covering 172,970 shares of common stock (the "Warrant") to the Treasury for a total sales price of \$25 million. On April 15, 2009, Shore Bancshares, Inc. redeemed all 25,000 shares of the Preferred Stock from Treasury for \$25 million, plus accrued dividends of \$208 thousand. At the time of the redemption, the Preferred Stock had a carrying value of \$23.5 million. The difference between the redemption price and carrying value represented an additional accelerated deemed dividend of \$1.5 million. Total dividends paid on the Preferred Stock was \$1.8 million for 2009.

On November 16, 2011, Shore Bancshares, Inc. paid \$25,000 to repurchase the Warrant from the Treasury. The repurchase price was based on the fair market value of the Warrant as agreed on by Shore Bancshares, Inc. and the Treasury. With the repurchase of the Warrant, Shore Bancshares, Inc. concluded its participation in the TARP CPP.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports filed under the Exchange Act with the SEC, such as this annual report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to the Company's management, including the principal executive officer (the "PEO") and the principal accounting officer ("PAO"), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of December 31, 2011 was carried out under the supervision and with the participation of the Company's management, including the PEO and the PAO. Based on that evaluation, the Company's management, including the CEO and the PAO, has concluded that the Company's disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the fourth quarter of 2011, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

As required by Section 404 of the Sarbanes-Oxley Act of 2002, management has performed an evaluation and testing of the Company's internal control over financial reporting as of December 31, 2011. Management's report on the Company's internal control over financial reporting and the related attestation report of the Company's independent registered public accounting firm are included in Item 8 of Part II of this annual report, and each such report is incorporated into this Item 9A by reference thereto.

**Item 9B. Other Information.**

None.

**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance.**

The Company has adopted a Code of Ethics that applies to all of its directors, officers, and employees, including its principal executive officer, principal financial officer, principal accounting officer, or controller, or persons performing similar functions. A written copy of the Company's Code of Ethics will be provided to stockholders, free of charge, upon request to: W. David Morse, Secretary, Shore Bancshares, Inc., 18 E. Dover Street, Easton, Maryland 21601 or (410) 822-1400.

All other information required by this item is incorporated herein by reference to the following sections of the Company's definitive proxy statement to be filed in connection with the 2012 Annual Meeting of Stockholders:

Election of Directors (Proposal 1);  
Continuing Directors;  
Executive Officers;  
Qualifications of Director Nominees and Continuing Directors;  
Section 16(a) Beneficial Ownership Reporting Compliance; and  
Corporate Governance Matters (under the heading, "Board Committees").

**Item 11. Executive Compensation.**

The information required by this item is incorporated herein by reference to the following sections of the Company's definitive proxy statement to be filed in connection with the 2012 Annual Meeting of Stockholders:

Compensation Discussion and Analysis;  
 Executive Compensation;  
 Director Compensation;  
 Compensation Committee Interlocks and Insider Participation; and  
 Compensation Committee Report.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The Company maintains two equity compensation plans under which it may issue shares of common stock or grant other equity-based awards to employees, officers, and/or directors of the Company and its subsidiaries: (i) the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (the "2006 Plan"), which authorizes the grant of stock options, stock appreciation rights, stock awards, stock units, and performance units; and (ii) the Shore Bancshares, Inc. 1998 Stock Option Plan, which authorizes the grant of stock options (the "1998 Option Plan"). The Company's ability to grant options under the 1998 Option Plan expired on March 3, 2008 pursuant to the terms of that plan, but stock options granted under that plan were outstanding as of December 31, 2011. Each of these plans was approved by the Company's Board of Directors and its stockholders.

The following table contains information about these equity compensation plans as of December 31, 2011.

| Plan Category  | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants, and rights | Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)] |
|--|---|--|---|
|  | (a)   | (b)  | (c)   |
| Equity compensation plans approved by security holders (1) | 7,125   | \$ 13.17   | 561,294   |
| Equity compensation plans not approved by security holders | -   | -  | -   |

|       |       |          |         |
|-------|-------|----------|---------|
| Total | 7,125 | \$ 13.17 | 561,294 |
|-------|-------|----------|---------|

In addition to stock options and stock appreciation rights, the 2006 Plan permits the grant of stock awards, stock units, and performance units, and the shares available for issuance shown in column (c) may be granted pursuant to such awards. Subject to the anti-dilution provisions of the Omnibus Plan, the maximum number of shares of restricted stock that may be granted to any participant in any calendar year is 45,000; the maximum number of (1) restricted stock units that may be granted to any one participant in any calendar year is 45,000; and the maximum dollar value of performance units that may be granted to any one participant in any calendar year is \$1,500,000. As of December 31, 2011, the Company has granted 70,678 shares of restricted stock that are not reflected in column (a) of this table.

All other information required by this item is incorporated herein by reference to the section of the Company's definitive proxy statement to be filed in connection with the 2012 Annual Meeting of Stockholders entitled "Beneficial Ownership of Common Stock".

### **Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information required by this item is incorporated herein by reference to the sections of the Company's definitive proxy statement to be filed in connection with the 2012 Annual Meeting of Stockholders entitled "Certain Relationships and Related Transactions" and "Corporate Governance Matters" (under the heading, "Director Independence").

### **Item 14. Principal Accountant Fees and Services.**

The information required by this item is incorporated herein by reference to the section of the Company's definitive proxy statement to be filed in connection with the 2012 Annual Meeting of Stockholders entitled "Audit Fees and Services".

## **PART IV**

### **Item 15. Exhibits and Financial Statement Schedules.**

(a)(1), (2) and (c) Financial statements and schedules:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets at December 31, 2011 and 2010

Consolidated Statements of (Loss) Income — Years Ended December 31, 2011, 2010, and 2009

Consolidated Statements of Changes in Stockholders' Equity — Years Ended December 31, 2011, 2010, and 2009

Consolidated Statements of Comprehensive (Loss) Income — Years Ended December 31, 2011, 2010, and 2009

Consolidated Statements of Cash Flows — Years Ended December 31, 2011, 2010, and 2009

Notes to Consolidated Financial Statements for the years ended December 31, 2011, 2010, and 2009

(a)(3) and (b) Exhibits required to be filed by Item 601 of Regulation S-K:

The exhibits filed or furnished with this annual report are shown on the Exhibit Index that follows the signatures to this annual report, which index is incorporated herein by reference.

## SIGNATURES

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

Shore Bancshares, Inc.

Date: March 14, 2012 By: /s/ W. Moorhead Vermilye  
W. Moorhead Vermilye  
Chief Executive Officer

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

|  |  |
|--|--|
| /s/ Herbert L. Andrew, III<br>Herbert L. Andrew, III, Director<br>March 14, 2012 | /s/ Blenda W. Armistead<br>Blenda W. Armistead, Director<br>March 14, 2012 |
|--|--|

|  |  |
|--|--|
| /s/ Lloyd L. Beatty, Jr.<br>Lloyd L. Beatty, Jr., Director<br>March 14, 2012 | /s/ William W. Duncan<br>William W. Duncan, Director<br>March 14, 2012 |
|--|--|

|  |  |
|--|--|
| /s/ James A. Judge<br>James A. Judge, Director<br>March 14, 2012 | /s/ Neil R. LeCompte<br>Neil R. LeCompte, Director<br>March 14, 2012 |
|--|--|

|  |  |
|--|--|
| /s/ Frank E. Mason, III<br>Frank E. Mason, III, Director<br>March 14, 2012 | /s/ Jerry F. Pierson<br>Jerry F. Pierson, Director<br>March 14, 2012 |
|--|--|

|  |  |
|--|--|
| /s/ Christopher F. Spurry<br>Christopher F. Spurry, Director<br>March 14, 2012 | /s/ F. Winfield Trice, Jr.<br>F. Winfield Trice, Jr., Director<br>March 14, 2012 |
|--|--|

|  |   |
|--|---|
| /s/ John H. Wilson<br>John H. Wilson, Director<br>March 14, 2012 | /s/ W. Moorhead Vermilye<br>W. Moorhead Vermilye, Director<br>Chief Executive Officer<br>March 14, 2012 |
|--|---|

/s/ Susan E. Leaverton  
Susan E. Leaverton, Treasurer

Principal Accounting Officer  
March 14, 2012

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**EXHIBIT LIST**

Exhibit No. Description

- 3.1(i) Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000)
- 3.1(ii) Articles Supplementary relating to the Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference Exhibit 4.1 of the Company's Form 8-K filed on January 13, 2009)
- 3.1(iii) Articles Supplementary relating to the reclassification of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, as common stock (incorporated by reference Exhibit 3.1(i) of the Company's Form 8-K filed on June 17, 2009)
- 3.2(i) Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(i) of the Company's Form 10-K for the year ended December 31, 2010)
- 3.2(ii) First Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(ii) of the Company's Form 10-K for the year ended December 31, 2010)
- 3.2(iii) Second Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iii) of the Company's Form 10-K for the year ended December 31, 2010)
- 3.2(iv) Third Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iv) of the Company's Form 10-K for the year ended December 31, 2010)
- 4.1 Letter Agreement, including the related Securities Purchase Agreement – Standard Terms, dated January 9, 2009 by and between the Company and the U.S. Department of Treasury (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on January 13, 2009)
- 4.2 Letter Agreement dated as of April 15, 2009 between the Company and the U.S. Department of the Treasury (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 16, 2009)
- 4.3 Substitute Common Stock Purchase Warrant dated January 9, 2009 issued to the U.S. Department of Treasury (incorporated by reference to Exhibit 4.1 of the Company's Form 8-K filed on June 4, 2009)
- 4.4 Letter Agreement dated as of November 16, 2011 between the Company and the U.S. Department of the Treasury relating to the repurchase of the Common Stock Purchase Warrant (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on November 17, 2011)
- 10.1 Amended and Restated Employment Agreement, dated June 16, 2011, between the Company and W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q/A for the quarter ended June 30, 2011 filed on November 14, 2011).
- 10.2 Employment Agreement, dated June 16, 2011, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.2 of the Company's Form 10-Q/A for the quarter ended June 30,

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2011 filed on November 14, 2011)

- 10.3 Amended Summary of Compensation Arrangement for William W. Duncan, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on February 14, 2007, as amended by Form 8-K/A filed on May 3, 2007)
- 10.4 Summary of Compensation Arrangement between Centreville National Bank and F. Winfield Trice, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on August 13, 2007)
- 10.5 Employment Agreement between The Avon-Dixon Agency, LLC and Mark M. Freestate (incorporated by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006)
- 10.6 Shore Bancshares, Inc. Management Incentive Plan (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on April 21, 2010)
- 10.7 Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated by reference to Exhibit 10.2 of the Company's Form 8-K filed on February 14, 2007)

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- 10.8 Deferral Election, Investment Designation, and Beneficiary Designation Forms under the Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on October 2, 2006)
- 10.9 Form of Centreville National Bank of Maryland Director Indexed Fee Continuation Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on December 12, 2006)
- 10.10 Form of Amended and Restated Director Indexed Fee Continuation Plan Agreement between Centreville National Bank and Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed on January 7, 2009)
- 10.11 Form of Centreville National Bank Life Insurance Endorsement Split Dollar Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on December 12, 2006)
- 10.12 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005)
- 10.13 First Amendment to The Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan for the benefit of W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on January 7, 2009)
- 10.14 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan Trust Agreement (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005)
- 10.15 1998 Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed with the SEC on September 25, 1998 (Registration No. 333-64319))
- 10.16 Talbot Bancshares, Inc. Employee Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed May 4, 2001 (Registration No. 333-60214))
- 10.17 Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (incorporated by reference to Appendix A of the Company's 2006 definitive proxy statement filed on March 24, 2006)
- 10.18 Form of Restricted Stock Award Agreement under the 2006 Stock and Incentive Compensation Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 11, 2007)
- 21 Subsidiaries of the Company (included in the "BUSINESS—General" section of Item 1 of Part I of this Annual Report on Form 10-K)
- 23 Consent of Stegman & Company (filed herewith)
- 31.1 Certifications of the PEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 31.2 Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)

32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith)

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