

FIDELITY D & D BANCORP INC  
Form 10-Q  
November 08, 2013  
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2013

OR

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

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

Commission file number: 333-90273

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

PENNSYLVANIA

23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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 subjected to such filing requirements for the past 90 days.  YES  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  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a 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

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on October 31, 2013, the latest practicable date, was 2,371,171 shares.

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FIDELITY D & D BANCORP, INC.

Form 10-Q September 30, 2013

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## PART I – Financial Information

## Item 1: Financial Statements

Fidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Balance Sheets  
(Unaudited)

(dollars in thousands)	September 30, 2013	December 31, 2012
Assets:		
Cash and due from banks	\$ 13,951	\$ 12,657
Interest-bearing deposits with financial institutions	21,934	9,189
 Total cash and cash equivalents	 35,885	 21,846
Available-for-sale securities	102,921	100,441
Held-to-maturity securities	190	289
Federal Home Loan Bank stock	2,160	2,624
Loans and leases, net (allowance for loan losses of \$8,405 in 2013; \$8,972 in 2012)	454,700	424,584
Loans held-for-sale (fair value \$920 in 2013, \$10,824 in 2012)	903	10,545
Foreclosed assets held-for-sale	2,966	1,607
Bank premises and equipment, net	13,709	14,127
Cash surrender value of bank owned life insurance	10,316	10,065
Accrued interest receivable	1,973	1,985
Other assets	14,571	13,412
 Total assets	 \$ 640,294	 \$ 601,525
Liabilities:		
Deposits:		
Interest-bearing	\$ 410,716	\$ 388,625
Non-interest-bearing	134,114	126,035
 Total deposits	 544,830	 514,660
Accrued interest payable and other liabilities	3,471	3,863
Short-term borrowings	14,197	8,056
Long-term debt	16,000	16,000
 Total liabilities	 578,498	 542,579
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-

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Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 2,371,171 in 2013; and 2,323,248 in 2012)	24,805	23,711
Retained earnings	37,644	34,999
Accumulated other comprehensive (loss) income	(653)	236
Total shareholders' equity	61,796	58,946
Total liabilities and shareholders' equity	\$ 640,294	\$ 601,525

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Statements of Income

(Unaudited)	Three months ended		Nine months ended	
(dollars in thousands except per share data)	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Interest income:				
Loans and leases:				
Taxable	\$ 5,329	\$ 5,313	\$ 16,034	\$ 15,885
Nontaxable	126	107	346	359
Interest-bearing deposits with financial institutions	5	12	19	55
Investment securities:				
U.S. government agency and corporations	167	226	483	747
States and political subdivisions (nontaxable)	303	298	893	917
Other securities	24	18	59	54
Total interest income	5,954	5,974	17,834	18,017
Interest expense:				
Deposits	525	585	1,551	1,886
Securities sold under repurchase agreements	5	4	18	27
Other short-term borrowings and other	3	-	8	-
Long-term debt	215	215	638	667
Total interest expense	748	804	2,215	2,580
Net interest income	5,206	5,170	15,619	15,437
Provision for loan losses	450	700	1,600	2,000
Net interest income after provision for loan losses	4,756	4,470	14,019	13,437
Other income:				
Service charges on deposit accounts	492	470	1,403	1,313
Interchange fees	319	276	899	798
Fees from trust fiduciary activities	139	140	480	447
Fees from financial services	148	155	444	441
Service charges on loans	162	195	744	846
Fees and other revenue	122	88	343	257
Earnings on bank-owned life insurance	85	83	251	244
Gain (loss) on sale, recovery, or disposal of:				
Loans	313	500	1,207	1,329
Investment securities	138	3	266	264
Premises and equipment	(10)	(16)	(10)	(17)
Impairment losses on investment securities:				
Other-than-temporary impairment on investment securities	-	(1)	(61)	(242)
Non-credit-related losses on investment securities not expected to be sold (recognized in other comprehensive income (loss))	-	1	61	106
Net impairment losses on investment securities	-	-	-	(136)
Total other income	1,908	1,894	6,027	5,786
Other expenses:				
Salaries and employee benefits	2,248	2,116	7,145	6,767
Premises and equipment	837	889	2,496	2,593
Advertising and marketing	513	552	980	947



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Professional services	314	292	891	963
FDIC assessment	105	130	353	379
Loan collection	84	197	447	498
Other real estate owned	40	67	224	226
Office supplies and postage	116	103	332	315
Automated transaction processing	186	105	426	286
Other	201	28	837	965
Total other expenses	4,644	4,479	14,131	13,939
Income before income taxes	2,020	1,885	5,915	5,284
Provision for income taxes	515	486	1,503	1,311
Net income	\$ 1,505	\$ 1,399	\$ 4,412	\$ 3,973
Per share data:				
Net income - basic	\$ 0.64	\$ 0.61	\$ 1.88	\$ 1.74
Net income - diluted	\$ 0.64	\$ 0.61	\$ 1.88	\$ 1.74
Dividends	\$ 0.25	\$ 0.25	\$ 0.75	\$ 0.75

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary				
Consolidated Statements of Comprehensive Income	Three months		Nine months	
(Unaudited)	ended		ended	
(dollars in thousands)	September 30,		September 30,	
	2013	2012	2013	2012
Net income	\$ 1,505	\$ 1,399	\$ 4,412	\$ 3,973
Other comprehensive income (loss), before tax:				
Unrealized holding gain (loss) on available-for-sale securities	925	1,182	(1,302)	2,195
Reclassification adjustment for net gains realized in income	(138)	(3)	(266)	(264)
Net impairment losses on investment securities	-	-	-	136
Net unrealized gain (loss)	787	1,179	(1,568)	2,067
Tax effect	(268)	(401)	533	(703)
Unrealized gain (loss), net of tax	519	778	(1,035)	1,364
Non-credit-related impairment gain on investment securities not expected to be sold	168	76	221	358
Tax effect	(57)	(26)	(75)	(122)
Net non-credit-related impairment gain on investment securities	111	50	146	236
Other comprehensive income (loss), net of tax	630	828	(889)	1,600
Total comprehensive income, net of tax	\$ 2,135	\$ 2,227	\$ 3,523	\$ 5,573

See notes to unaudited consolidated financial statements



Fidelity D & D Bancorp, Inc. and Subsidiary  
 Consolidated Statements of Changes in Shareholders' Equity  
 For the nine months ended September 30, 2013 and  
 2012  
 (Unaudited)

	Capital stock		Retained	Accumulated other comprehensive	Total
(dollars in thousands)	Shares	Amount	earnings	income (loss)	
Balance, December 31, 2011	2,254,542	\$ 22,354	\$ 32,380	\$ (1,110)	\$ 53,624
Net income			3,973		3,973
Other comprehensive income				1,600	1,600
Issuance of common stock through Employee Stock Purchase Plan	3,874	67			67
Issuance of common stock through Dividend Reinvestment Plan	49,190	980			980
Stock-based compensation expense		15			15
Cash dividends declared			(1,706)		(1,706)
Balance, September 30, 2012	2,307,606	\$ 23,416	\$ 34,647	\$ 490	\$ 58,553
Balance, December 31, 2012	2,323,248	\$ 23,711	\$ 34,999	\$ 236	\$ 58,946
Net income			4,412		4,412
Other comprehensive loss				(889)	(889)
Issuance of common stock through Employee Stock Purchase Plan	4,256	78			78
Issuance of common stock through Dividend Reinvestment Plan	43,533	928			928
Issuance of common stock from vested restricted share grants through stock compensation plans	134				
Stock-based compensation expense		88			88
Cash dividends declared			(1,767)		(1,767)
Balance, September 30, 2013	2,371,171	\$ 24,805	\$ 37,644	\$ (653)	\$ 61,796

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Statements of Cash Flows

(Unaudited)	Nine months ended September 30,	
(dollars in thousands)	2013	2012
Cash flows from operating activities:		
Net income	\$ 4,412	\$ 3,973
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	2,546	2,612
Provision for loan losses	1,600	2,000
Deferred income tax expense (benefit)	598	(253)
Stock-based compensation expense	88	15
Proceeds from sale of loans held-for-sale	72,449	64,605
Originations of loans held-for-sale	(59,848)	(58,395)
Earnings on bank-owned life insurance	(251)	(244)
Net gain from sales of loans	(1,207)	(1,329)
Net gain from sales of investment securities	(104)	(251)
Net loss on sale and write-down of foreclosed assets held-for-sale	97	107
Loss on disposal of equipment	10	17
Other-than-temporary impairment on securities	-	136
Change in:		
Accrued interest receivable	7	90
Other assets	(731)	(249)
Accrued interest payable and other liabilities	(351)	(4,086)
Net cash provided by operating activities	19,315	8,748
Cash flows from investing activities:		
Held-to-maturity securities:		
Proceeds from maturities, calls and principal pay-downs	100	88
Available-for-sale securities:		
Proceeds from sales	8,461	3,571
Proceeds from maturities, calls and principal pay-downs	21,771	24,029
Purchases	(35,098)	(20,891)
Decrease FHLB stock	464	680
Net increase in loans and leases	(36,430)	(28,898)
Acquisition of bank premises and equipment	(810)	(1,809)
Proceeds from sale of foreclosed assets held-for-sale	716	719
Net cash used by investing activities	(40,826)	(22,511)
Cash flows from financing activities:		
Net increase in deposits	30,170	8,318

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Net increase in short-term borrowings	6,141	4,561
Repayments of long-term debt	-	(5,000)
Proceeds from employee stock purchase plan participants	78	67
Dividends paid, net of dividends reinvested	(1,090)	(1,124)
Proceeds from dividend reinvestment plan participants	251	398
Net cash provided by financing activities	35,550	7,220
Net increase (decrease) in cash and cash equivalents	14,039	(6,543)
Cash and cash equivalents, beginning	21,846	52,165
Cash and cash equivalents, ending	\$ 35,885	\$ 45,622

See notes to unaudited consolidated financial statements

FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(Unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

Fidelity Deposit and Discount Bank (the Bank) is a commercial bank chartered in the Commonwealth of Pennsylvania and a wholly-owned subsidiary of Fidelity D & D Bancorp, Inc. (the Company or collectively, the Company). Having commenced operations in 1903, the Bank is committed to provide superior customer service, while offering a full range of banking products and financial and trust services to both our consumer and commercial customers from our main office located in Dunmore and other branches located throughout Lackawanna and Luzerne counties.

Principles of consolidation

The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Management is responsible for the fairness, integrity and objectivity of the unaudited financial statements included in this report. Management prepared the unaudited financial statements in accordance with GAAP. In meeting its responsibility for the financial statements, management depends on the Company's accounting systems and related internal controls. These systems and controls are designed to provide reasonable but not absolute assurance that the financial records accurately reflect the transactions of the Company, the Company's assets are safeguarded and that the financial statements present fairly the financial condition and results of operations of the Company.

In the opinion of management, the consolidated balance sheets as of September 30, 2013 and December 31, 2012 and the related consolidated statements of income and consolidated statements of comprehensive income for the three- and nine-months ended September 30, 2013 and 2012, and consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the nine months ended September 30, 2013 and 2012 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature. Certain reclassifications have been made to the

2012 financial statements to conform to the 2013 presentation.

In preparing these consolidated financial statements, the Company evaluated the events and transactions that occurred after September 30, 2013 through the date these consolidated financial statements were issued.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2012, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

#### Critical accounting policies

The presentation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect many of the reported amounts and disclosures. Actual results could differ from these estimates.

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at September 30, 2013 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions and could, therefore, calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.



Another material estimate is the calculation of fair values of the Company's investment securities. Except for the Company's investment in corporate bonds, consisting of pooled trust preferred securities, fair values of the other investment securities are determined by pricing provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. For the Company's investment in pooled trust preferred securities, management is unable to obtain readily attainable and realistic pricing from market traders due to a lack of active market participants and therefore management has determined the market for these securities to be inactive. In order to determine the fair value of the pooled trust preferred securities, management relied on the use of an income valuation approach (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs, the results of which are more representative of fair value than the market approach valuation technique used for the other investment securities.

Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. The majority of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (loss) (OCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells residential mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these circumstances, pricing may be obtained from other entities and the loans are transferred at the lower of cost or market value and simultaneously sold. As of September 30, 2013 and December 31, 2012, loans classified as HFS consisted of residential mortgage loans.

During the first quarter of 2013, the Company commenced its automobile leasing operations, a component of auto loans and leases in the consumer segment of the loan portfolio. Financing of automobiles, provided to customers under lease arrangements of varying terms, are accounted for as direct finance leases. Interest on automobile direct finance leasing is determined using the interest method. Generally, the interest method is used to arrive at a level effective yield over the life of the lease.

Foreclosed assets held-for-sale includes other real estate acquired through foreclosure (ORE) and may, from time-to-time, include repossessed assets such as automobiles. ORE is carried at the lower of cost (principal balance at date of foreclosure) or fair value less estimated cost to sell. Any write-downs at the date of foreclosure or within a reasonable period of time after foreclosure are charged to the allowance for loan losses. Expenses incurred to maintain ORE properties, subsequent write downs to the asset's fair value and gains or losses on disposal are included as components of other real estate owned expense in the consolidated statements of income.

For purposes of the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. For the nine months ended September 30, 2013 and 2012, the Company paid interest of \$2.2 million and \$2.6 million, respectively. The Company was required to pay income taxes of \$1.1 million and \$1.8 million during the first nine months of 2013 and 2012, respectively. Transfers from loans to foreclosed assets held-for-sale amounted to \$2.2 million and \$1.4 million during the nine months ended September 30, 2013 and 2012. During the same respective periods, transfers from loans to loans HFS amounted to \$2.9 million and \$2.8 million. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of bank premises and equipment.

## 2. New Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (FASB) issued the accounting update related to; Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The update requires entities to present information about reclassification adjustments from accumulated other comprehensive income in their annual financial statements in a single note or on the face of the financial statements. The new requirement is effective prospectively for interim and annual reporting periods beginning after December 15, 2012. The provisions of this accounting update require expanded financial reporting disclosures.

3. Accumulated other comprehensive income (loss)

The following tables illustrate the changes in accumulated other comprehensive income (loss) by component and the details about the components of accumulated comprehensive income (loss) as of and for the periods indicated:

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As of and for the nine months ended September 30, 2013

(dollars in thousands)	Unrealized gains on available-for- sale securities	Non-credit-related impairment losses on investment securities	Total
Beginning balance	\$ 1,905	\$ (1,669)	\$ 236
Other comprehensive (loss) income before reclassifications	(859)	146	(713)
Amounts reclassified from accumulated other comprehensive income	(176)	-	(176)
Net current-period other comprehensive (loss) income	(1,035)	146	(889)
Ending balance	\$ 870	\$ (1,523)	\$ (653)

As of and for the three months ended September 30, 2013

(dollars in thousands)	Unrealized gains on available-for- sale securities	Non-credit-related impairment losses on investment securities	Total
Beginning balance	\$ 351	\$ (1,634)	\$ (1,283)
Other comprehensive income before reclassifications	610	111	721
Amounts reclassified from accumulated other comprehensive income	(91)	-	(91)
Net current-period other comprehensive income	519	111	630
Ending balance	\$ 870	\$ (1,523)	\$ (653)

In the tables above, all amounts are net of tax at 34%. Amounts in parentheses indicate debits.

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Details about accumulated other comprehensive income components	Amount reclassified from accumulated other comprehensive income	Affected line item in the statement where net income is presented
(dollars in thousands)		
For the nine months ended September 30, 2013		
Unrealized gains on AFS securities	\$ 266	Gain on sale, recovery, or disposal of investment securities
	-	Net impairment losses on investment securities
	266	Income before income taxes
	(90)	Provision for income taxes
Total reclassifications for the period	\$ 176	Net income
For the three months ended September 30, 2013		
Unrealized gains on AFS securities	\$ 138	Gain on sale, recovery, or disposal of investment securities
	-	Net impairment losses on investment securities
	138	Income before income taxes
	(47)	Provision for income taxes
Total reclassifications for the period	\$ 91	Net income

## 4. Investment securities

The amortized cost and fair value of investment securities at September 30, 2013 and December 31, 2012 are summarized as follows:

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
September 30, 2013				
Held-to-maturity securities:				
MBS - GSE residential	\$ 190	\$ 17	\$ -	\$ 207
Available-for-sale securities:				
Agency - GSE	\$ 15,715	\$ 34	\$ 40	\$ 15,709
Obligations of states and political subdivisions	30,531	1,086	455	31,162
Corporate bonds:				
Pooled trust preferred securities	6,115	267	3,439	2,943
MBS - GSE residential	51,254	1,471	137	52,588
Total debt securities	103,615	2,858	4,071	102,402
Equity securities - financial services	295	224	-	519
Total available-for-sale securities	\$ 103,910	\$ 3,082	\$ 4,071	\$ 102,921

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2012				
Held-to-maturity securities:				
MBS - GSE residential	\$ 289	\$ 31	\$ -	\$ 320
Available-for-sale securities:				
Agency - GSE	\$ 17,651	\$ 102	\$ 13	\$ 17,740
Obligations of states and political subdivisions	26,979	2,879	1	29,857
Corporate bonds:				

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Pooled trust preferred securities	6,323	185	4,683	1,825
MBS - GSE residential	48,836	1,761	44	50,553
Total debt securities	99,789	4,927	4,741	99,975
Equity securities - financial services	295	171	-	466
Total available-for-sale securities	\$ 100,084	\$ 5,098	\$ 4,741	\$ 100,441

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The amortized cost and fair value of debt securities at September 30, 2013 by contractual maturity are summarized below:

(dollars in thousands)	Amortized cost	Fair value
Held-to-maturity securities:		
MBS - GSE residential	\$ 190	\$ 207
Available-for-sale securities:		
Debt securities:		
Due in one year or less	\$ 3,007	\$ 3,020
Due after one year through five years	5,127	5,111
Due after five years through ten years	9,579	9,683
Due after ten years	34,648	32,000
Total debt securities	52,361	49,814
MBS - GSE residential	51,254	52,588
Total available-for-sale debt securities	\$ 103,615	\$ 102,402

Actual maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Agency – GSE and municipal securities are included based on their original stated maturity. MBS – GSE residential, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total. Most of the securities have fixed rates or have predetermined scheduled rate changes, and many have call features that allow the issuer to call the security at par before its stated maturity, without penalty.

The following table presents the fair value and gross unrealized losses of investment securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of September 30, 2013 and December 31, 2012:

(dollars in thousands)	Less than 12 months		More than 12 months		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
September 30, 2013						
Agency - GSE	\$ 8,643	\$ 40	\$ -	\$ -	\$ 8,643	\$ 40
Obligations of states and political subdivisions	7,761	455	-	-	7,761	455
Corporate bonds:						

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Pooled trust preferred securities	-	-	2,264	3,439	2,264	3,439
MBS - GSE residential	12,253	137	-	-	12,253	137
Total temporarily impaired securities	\$ 28,657	\$ 632	\$ 2,264	\$ 3,439	\$ 30,921	\$ 4,071
Number of securities	31		7		38	
December 31, 2012						
Agency - GSE	\$ 1,017	\$ 13	\$ -	\$ -	\$ 1,017	\$ 13
Obligations of states and political subdivisions	281	1	-	-	281	1
Corporate bonds:						
Pooled trust preferred securities	-	-	1,639	4,683	1,639	4,683
MBS - GSE residential	6,214	44	-	-	6,214	44
Total temporarily impaired securities	\$ 7,512	\$ 58	\$ 1,639	\$ 4,683	\$ 9,151	\$ 4,741
Number of securities	5		8		13	



Management believes the cause of the unrealized losses is related to changes in interest rates, instability in the capital markets or the limited trading activity due to illiquid conditions in the debt market and is not directly related to credit quality. Quarterly, management conducts a formal review of investment securities for the presence of other-than-temporary impairment (OTTI). The accounting guidance related to OTTI requires the Company to assess whether OTTI is present when the fair value of a debt security is less than its amortized cost as of the balance sheet date. Under those circumstances, OTTI is considered to have occurred if: (1) the entity has intent to sell the security; (2) more likely than not the entity will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover the entire amortized cost.

The accounting guidance requires that credit-related OTTI be recognized in earnings while non-credit-related OTTI on securities not expected to be sold be recognized in other comprehensive income (loss) (OCI). Non-credit-related OTTI is based on other factors affecting market value, including illiquidity. Presentation of OTTI is made in the consolidated statements of income on a gross basis with an offset for the amount of non-credit-related OTTI recognized in OCI.

The Company's OTTI evaluation process also follows the guidance set forth in topics related to debt and equity securities. The guidance set forth in the pronouncements require the Company to take into consideration current market conditions, fair value in relationship to cost, extent and nature of changes in fair value, issuer rating changes and trends, volatility of earnings, current analysts' evaluations, all available information relevant to the collectability of debt securities, the ability and intent to hold investments until a recovery of fair value which may be to maturity and other factors when evaluating for the existence of OTTI. The guidance requires that credit-related OTTI be recognized as a realized loss through earnings when there has been an adverse change in the holder's expected cash flows such that the full amount (principal and interest) will probably not be received. This requirement is consistent with the impairment model in the guidance for accounting for debt and equity securities.

For all security types, as of September 30, 2013, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that more likely than not would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI in the Company's portfolios of Agency – Government Sponsored Enterprise (GSE), Mortgage-backed securities (MBS) – GSE residential and Obligations of states and political subdivisions. Following is a description of the security types within the Company's investment portfolio.

#### Agency - GSE and MBS - GSE residential

Agency – GSE and MBS – GSE residential securities consist of short- and medium-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), Federal Home Loan Bank (FHLB), Federal Farm Credit Bank (FFCB) and Government National Mortgage Association (GNMA). These securities have interest rates that are fixed and adjustable, have varying short- to mid-term maturity dates and have contractual cash flows guaranteed by the U.S. government or agencies of the U.S. government.

#### Obligations of states and political subdivisions

The municipal securities are bank qualified or bank eligible, general obligation and revenue bonds rated as investment grade by various credit rating agencies and have fixed rates of interest with mid- to long-term maturities. Fair values of these securities are highly driven by interest rates. Management performs ongoing credit quality reviews on these issues.

In the above security types, management believes the change in fair value is attributable to changes in interest rates and those instruments with unrealized losses were not caused by deterioration of credit quality. Accordingly, as of September 30, 2013, recognition of OTTI on these securities was unnecessary. Interest rates along the intermediate

and long end of the treasury yield curve have increased from year-end 2012 and while the intermediate term rates have ebbed slightly from the prior quarter, until rates stabilize, values of banks' investment securities will be somewhat volatile.

#### Pooled trust preferred securities

A Pooled Trust Preferred Collateralized Debt Obligation (CDO) is a type of investment security collateralized by trust preferred securities (TPS) issued by banks, insurance companies and real estate investment trusts. The primary collateral type is a TPS issued by a bank. A TPS is a hybrid security that consists of both debt and equity characteristics which includes the ability of the issuer to voluntarily defer interest payments for up to 20 consecutive quarters. A TPS is considered a junior security in the capital structure of the issuer.

There are various investment classes or tranches issued by the CDO. The most senior tranche has the lowest yield but the most protection from credit losses. Conversely, the most junior tranche has the highest yield but the most exposure to risk of credit losses. Junior tranches are subordinate to senior tranches and losses are generally allocated from the lowest tranche with the equity component holding the most risk of credit loss and then subordinate tranches in reverse order up to the most senior tranche. The allocation of losses is defined in the indenture when the CDO was formed.

Unrealized losses in the pooled trust preferred securities (PreTSLs) are caused mainly by: (1) collateral deterioration due to bank failures and credit concerns across the banking sector; (2) widening of credit spreads and (3) illiquidity in the market. The Company's review of its portfolio of pooled trust preferred securities determined that in 2012 credit-related OTTI be recorded on two holdings, both of which are contained in the Company's AFS securities portfolio. The losses were caused by credit quality downgrades on the underlying collateral, including the collateral of four banks deferring interest payments within these two

securities and one bank fully redeeming which removes all future earnings cash flow. There was no credit related OTTI required to be recognized during the three- or nine-months ended September 30, 2013.

The following table summarizes the amount of OTTI recognized in earnings, by security during the periods indicated:

(dollars in thousands)	Three months ended		Nine months ended	
	September 30, 2013	2012	September 30, 2013	2012
Pooled trust preferred securities:				
PreTSL IX, B1, B3	\$ -	\$ -	\$ -	\$ 18
PreTSL XVIII, C	-	-	-	118
Total	\$ -	\$ -	\$ -	\$ 136

The following is a tabular roll-forward of the cumulative amount of credit-related OTTI recognized in earnings:

(dollars in thousands)	Nine months ended		
	September 30, 2013		
	HTM	AFS	Total
Beginning balance of credit-related OTTI	\$ -	\$ (15,416)	\$ (15,416)
Additions for credit-related OTTI not previously recognized	-	-	-
Additional credit-related OTTI previously recognized when there is no intent to sell before recovery of amortized cost basis	-	-	-
Ending balance of credit-related OTTI	\$ -	\$ (15,416)	\$ (15,416)

To determine credit-related OTTI, the Company analyzes the collateral of each individual tranche within each of the individual pools in the Company's portfolio of PreTSLs that has a remaining book value. The Company engaged a third party structured finance firm to: review the underlying collateral of each PreTSL; research trustee reports to update relevant data and credit ratings of the underlying collateral; project default rates and cash flows of the collateral and simulate 10,000 Monte Carlo time-to-default scenarios to arrive at the single best estimate of future cash flow for each tranche. This analysis is performed quarterly.

The sub-topics of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 320 provide the scope, steps and accounting guidance for impairment: 1) determine whether an investment is impaired; 2)

evaluate whether impairment is other-than-temporary; then 3) recognition of OTTI. The guidance in ASC 320 retains and emphasizes the objective of OTTI assessment and the related disclosure requirements by aligning the OTTI methodology for certain securitizations. ASC 325 provides a scope exception for investments that were considered of high credit quality (i.e. rated "AA" or higher) at the time of acquisition. The application of the guidance contained in ASC 320 is used for two investments considered of high credit quality and ASC 325 is used for the remaining securities. In summary, the quarterly evaluations indicated there was no significant adverse change in cash flows in the securities. As a result, there was no credit related OTTI recorded during the three- and nine- months ended September 30, 2013.

The guidance prescribed in ASC 320 is used for investments that, upon purchase, were rated of high credit quality, "AA" or higher, by a nationally recognized statistical rating organization. The Company has two PreTSLs (XXIV and XXVII) that were of high credit quality, "AA" rated, upon acquisition. PreTSL XXVII evaluation proved a high probability that the Company will be able to collect all amounts due, both principal and interest, by maturity and thus, determined the impairment is temporary. PreTSL XXIV was evaluated under ASC 320 to determine if the Company expects to recover the remaining amortized cost basis and whether OTTI is deemed to have occurred. An adverse change or short-fall in the expected cash flows compared to the amortized cost would be recorded as credit-related OTTI. To assess the likelihood of recoverability, the present value of the best estimate of future cash flows is compared to the amortized cost. In this situation, the discount rate used was the interest rate implicit in the security at the date of acquisition. The application of the guidance on this security did not result in an adverse change in cash flows when compared to the previous measurement date and therefore, no credit related OTTI has been recorded during 2013.

The remaining six PreTSLs were rated "A" by a nationally recognized statistical rating organization at the date of acquisition and as such are considered beneficial interests of securitized financial assets. For these securities, the Company applies the guidance of ASC 325. Under this and other relevant guidance, if the fair value is below amortized cost and the present value of the best estimate of future cash flows declines significantly, evidencing a probable material adverse change in cash flows since the previous measurement date, credit-related OTTI is deemed to exist and written down to the determined present value through a charge to current earnings. The discount rate used under ASC 325 is the yield to accrete beneficial interest, which is representative

of the resulting interest from the total gross estimated future cash flows less the current amortized cost. In applying this guidance to the remaining securities, none of the securities measured an adverse change in cash flows and therefore no credit related OTTI has been recorded during 2013.

The following table is the composition of the Company's non-accrual PreTSL securities as of the period indicated:

(dollars in thousands)		September 30,		December 31,	
		2013		2012	
Deal	Class	Book value	Fair value	Book value	Fair value
Pre TSL V	Mezzanine	\$ -	\$ 23	\$ -	\$ 27
Pre TSL VII	Mezzanine	-	59	-	125
Pre TSL IX	B-1,B-3	1,450	616	1,507	630
Pre TSL XI	B-3	974	390	1,053	305
Pre TSL XV	B-1	-	52	-	33
Pre TSL XVIII	C	167	-	167	-
Pre TSL XIX	C	316	6	316	-
Pre TSL XXIV	B-1	407	20	407	12
		\$ 3,314	\$ 1,166	\$ 3,450	\$ 1,132

Non-accrual securities have experienced impairment of principal, and interest was "paid-in-kind". When these two conditions exist, the security is placed on non-accrual status. Quarterly, each of the other PreTSL issues is evaluated for the presence of these two conditions and if necessary placed on non-accrual status. For the nine months ended September 30, 2013, the Company recovered \$0.1 million of previously charged off PreTSLs compared to \$13 thousand for the same period in 2012 which are included in the consolidated statements of income as a component of gain (loss) on sale, recovery, or disposal of investment securities .

The following table provides additional information with respect to the Company's pooled trust preferred securities as of September 30, 2013:

(dollars in thousands)

Deal	Class	Book value	Fair value	Unrealized gain (loss)	Moody's / Fitch ratings (1)	Current	Actual	Excess	Effective
						number of banks / insurance companies	deferrals and defaults as a % of current collateral	subordinations as a % of current performing collateral	subordinations as a % of current performing collateral

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Pre				Caa2 /							
TSL IV Mezzanine	\$ 412	\$ 545	\$ 133	B	6 / -	\$ 12,000	18.0	\$ 16,467	28.4		38.7
Pre											
TSL V Mezzanine	-	23	23	C / D	3 / -	28,950	100.0	None	N/A		N/A
Pre											
TSL VII Mezzanine	-	59	59	Ca / C	14 / -	85,000	54.1	None	N/A		N/A
Pre				Caa1 /							
TSL IX B-1, B-3	1,450	616	(834)	C	45 / -	101,280	27.5	None	N/A		3.6
Pre				Caa3 /							
TSL XIB-3	974	390	(584)	C	60 / -	180,250	32.1	None	N/A		N/A
Pre											
TSL XV B-1	-	52	52	C / C	62 / 7	185,200	32.9	None	N/A		N/A
Pre											
TSL XVI C	-	-	-	C / C	48 / 7	217,390	39.0	None	N/A		N/A
Pre											
TSL XVII C	-	-	-	C / C	49 / 6	149,890	33.3	None	N/A		N/A
Pre											
TSL XVIII C	167	-	(167)	Ca / C	63 / 14	186,320	29.2	None	N/A		N/A
Pre											
TSL XIX C	316	6	(310)	C / C	51 / 14	137,650	22.6	None	N/A		1.7
Pre											
TSL XXIV B-1	407	20	(387)	Ca / CC	77 / 11	347,500	34.8	None	N/A		14.2
Pre											
TSL XXV C-1	-	-	-	C / C	61 / 7	257,000	33.5	None	N/A		0.1
Pre											
TSL XXVII B	2,389	1,232	(1,157)	Caa3 / CCC	40 / 7	81,800	26.1	10,519	4.5		29.5
	\$ 6,115	\$ 2,943	\$ (3,172)								

(1) All ratings have been updated through September 30, 2013.

(2) Excess subordination represents the excess (if any) of the amount of performing collateral over the given class of bonds.

(3) Effective subordination represents the estimated percentage of the performing collateral that would need to defer or default at the next payment in order to trigger a loss of principal or interest. This differs from excess subordination in that it considers the effect of excess interest earned on the performing collateral.

For a further discussion on the fair value determination of the Company's investment in PreTSLs and other financial instruments, see Note 8, "Fair value measurements".



## 5. Loans and leases

The classifications of loans and leases at September 30, 2013 and December 31, 2012 are summarized as follows:

(dollars in thousands)	September 30, 2013	December 31, 2012
Commercial and industrial	\$ 66,557	\$ 65,110
Commercial real estate:		
Non-owner occupied	89,268	81,998
Owner occupied	84,411	80,509
Construction	10,776	10,679
Consumer:		
Home equity installment	33,666	32,828
Home equity line of credit	35,305	34,169
Auto loans and leases	20,838	17,411
Other	5,587	6,139
Residential:		
Real estate	108,919	96,765
Construction	7,833	7,948
Total	463,160	433,556
Less:		
Allowance for loan losses	(8,405)	(8,972)
Unearned lease revenue	(55)	-
Loans and leases, net	\$ 454,700	\$ 424,584

Net deferred loan costs of \$1.1 million and \$1.0 million have been added to the carrying values of loans at September 30, 2013 and December 31, 2012, respectively.

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate amount of mortgages serviced amounted to \$245.2 million as of September 30, 2013 and \$214.7 million as of December 31, 2012.

The Company utilizes an external independent loan review firm that reviews and validates the credit risk program on at least an annual basis. Results of these reviews are presented to management and the board of directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

## Non-accrual loans

The decision to place loans on non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. Commercial and industrial and commercial real estate loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90



days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest and unsecured consumer loans are charged off when the loan is 90 days or more past due as to principal and interest. The Company considers all non-accrual loans to be impaired loans.

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Non-accrual loans, segregated by class, at September 30, 2013 and December 31, 2012, were as follows:

(dollars in thousands)	September 30, 2013	December 31, 2012
Commercial and industrial	\$ 99	\$ 18
Commercial real estate:		
Non-owner occupied	1,498	1,884
Owner occupied	1,630	5,031
Construction	779	1,123
Consumer:		
Home equity installment	299	1,306
Home equity line of credit	393	381
Auto loans and leases	12	-
Other	-	48
Residential:		
Real estate	1,438	2,330
Total	\$ 6,148	\$ 12,121

#### Troubled Debt Restructuring

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company considers all TDRs to be impaired loans. The Company offers various types of concessions when modifying a loan, however, forgiveness of principal is rarely granted. Commercial and industrial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial real estate loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Commercial real estate construction loans modified in a TDR may also involve extending the interest-only payment period. Residential mortgage loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers' financial needs for an extended period of time. After the lowered monthly payment period ends, the borrower would revert back to paying principal and interest pursuant to the original terms with the maturity date adjusted accordingly. Consumer loan modifications are typically not granted and therefore standard modification terms do not exist for loans of this type.

Loans modified in a TDR may or may not be placed on non-accrual status. As of September 30, 2013, total TDRs amounted to \$2.0 million, of which \$1.0 million were on non-accrual status. This was a slight reduction from the December 31, 2012 total of \$2.2 million of which \$1.1 million were on non-accrual status.

Loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment. There were no loans modified in a TDR during the three- or nine- months ended September 30, 2013 and 2012. There were no loans modified in a TDR during the twelve months ended September 30, 2013 that subsequently defaulted during the three or nine months ended September 30, 2013.

The allowance for loan loss (allowance) may be increased, adjustments may be made in the allocation of the allowance or partial charge offs may be taken to further write-down the carrying value of the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral, less any selling costs, is used to establish the allowance.

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Past due loans

Loans are considered past due when the contractual principal and/or interest are not received by the due date. An aging analysis of past due loans, segregated by class of loans, as of the period indicated is as follows (dollars in thousands):

	30 - 59 Days	60 - 89 Days	Past due		Current	Total loans receivables	Recorded investment past due ≥ 90 days and accruing
			90 days or more *	Total past due			
September 30, 2013	past due	past due	*	past due	Current	receivables	and accruing
Commercial and industrial	\$ 160	\$ 220	\$ 106	\$ 486	\$ 66,071	\$ 66,557	\$ 7
Commercial real estate:							
Non-owner occupied	908	-	1,631	2,539	86,729	89,268	133
Owner occupied	238	408	1,630	2,276	82,135	84,411	-
Construction	-	-	779	779	9,997	10,776	-
Consumer:							
Home equity installment	143	9	299	451	33,215	33,666	-
Home equity line of credit	-	4	415	419	34,886	35,305	22
Auto loans and leases	292	38	18	348	20,435	20,783	6
Other	20	33	-	53	5,534	5,587	-
Residential:							
Real estate	257	546	1,615	2,418	106,501	108,919	177
Construction	-	-	-	-	7,833	7,833	-
Total	\$ 2,018	\$ 1,258	\$ 6,493	\$ 9,769	\$ 453,336	\$ 463,105	\$ 345

\* Includes \$6.1 million of non-accrual loans.

	30 - 59 Days	60 - 89 Days	Past due		Current	Total loans receivables	Recorded investment past due ≥ 90 days and accruing
			90 days or more *	Total past due			
December 31, 2012	past due	past due	*	past due	Current	receivables	and accruing
Commercial and industrial	\$ 676	\$ 15	\$ 254	\$ 945	\$ 64,165	\$ 65,110	\$ 236
Commercial real estate:							
Non-owner occupied	-	141	1,884	2,025	79,973	81,998	-
Owner occupied	208	282	5,439	5,929	74,580	80,509	408
Construction	-	-	1,123	1,123	9,556	10,679	-

Consumer:							
Home equity installment	216	132	1,325	1,673	31,155	32,828	19
Home equity line of credit	-	66	381	447	33,722	34,169	-
Auto	459	30	16	505	16,906	17,411	16
Other	48	4	65	117	6,022	6,139	17
Residential:							
Real estate	99	544	3,357	4,000	92,765	96,765	1,027
Construction	-	-	-	-	7,948	7,948	-
Total	\$ 1,706	\$ 1,214	\$ 13,844	\$ 16,764	\$ 416,792	\$ 433,556	\$ 1,723

\* Includes \$12.1 million of non-accrual loans.

#### Impaired loans

A loan is considered impaired when, based on current information and events; it is probable that the Company will be unable to collect the scheduled payments in accordance with the contractual terms of the loan. Factors considered in determining impairment include payment status, collateral value and the probability of collecting payments when due. The significance of payment delays and/or shortfalls is determined on a case-by-case basis. All circumstances surrounding the loan are taken into account. Such factors include the length of the delinquency, the underlying reasons and the borrower's prior payment record. Impairment is measured on these loans on a loan-by-loan basis. Impaired loans include non-accrual loans, TDRs and other loans deemed to be impaired based on the aforementioned factors. As of September 30, 2013 and December 31, 2012, impaired loans consisted of non-accrual loans and TDRs.

At September 30, 2013, impaired loans consisted of accruing TDRs totaling \$1.1 million and \$6.1 million of non-accrual loans. At December 31, 2012, impaired loans consisted of accruing TDRs totaling \$1.1 million and \$12.1 million of non-accrual loans. As of September 30, 2013 and December 31, 2012, the non-accrual loans included non-accruing TDRs of \$1.0 million and \$1.1 million, respectively. Payments received from impaired loans are first applied against the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income.

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Impaired loans, segregated by class, as of the period indicated are detailed below:

(dollars in thousands)	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance	Average recorded investment	Interest income recognized	Cash basis interest income recognized
September 30, 2013								
Commercial & industrial	\$ 136	\$ 102	\$ 34	\$ 136	\$ 40	\$ 81	\$ 2	\$ -
Commercial real estate:								
Non-owner occupied	1,962	410	1,572	1,982	37	2,319	25	59
Owner occupied	2,328	802	1,366	2,168	155	3,969	30	-
Construction	1,073	210	569	779	62	1,002	-	-
Consumer:								
Home equity installment	370	99	200	299	14	825	37	-
Home equity line of credit	528	103	290	393	14	381	-	-
Auto loans and leases	12	12	-	12	1	3	-	-
Other	-	-	-	-	-	43	-	-
Residential:								
Real Estate	1,593	582	856	1,438	73	1,903	54	-
Construction	-	-	-	-	-	-	-	-
Total	\$ 8,002	\$ 2,320	\$ 4,887	\$ 7,207	\$ 396	\$ 10,526	\$ 148	\$ 59

(dollars in thousands)	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance	Average recorded investment	Interest income recognized	Cash basis interest income recognized
December 31, 2012								
Commercial & industrial	\$ 52	\$ 8	\$ 52	\$ 60	\$ 4	\$ 275	\$ 4	\$ -
Commercial real estate:								
Non-owner occupied	2,431	957	1,420	2,377	233	4,172	152	20
Owner occupied	5,940	4,500	1,099	5,599	1,230	7,292	121	-
Construction	1,123	210	913	1,123	194	941	-	-
Consumer:								
Home equity installment	1,480	524	782	1,306	38	1,023	-	-

Home equity line of credit	435	144	237	381	31	482	-	-
Auto	-	-	-	-	-	1	-	-
Other	102	16	32	48	8	36	-	-
Residential:								
Real Estate	2,688	564	1,766	2,330	76	2,342	17	-
Construction	-	-	-	-	-	44	-	-
Total	\$ 14,251	\$ 6,923	\$ 6,301	\$ 13,224	\$ 1,814	\$ 16,608	\$ 294	\$ 20

## Credit Quality Indicators

### Commercial and industrial and commercial real estate

The Company utilizes a loan grading system and assigns a credit risk grade to its loans in the commercial and industrial and commercial real estate portfolios. The grading system provides a means to measure portfolio quality and aids in the monitoring of the credit quality of the overall loan portfolio. The credit risk grades are arrived at using a risk rating matrix to assign a grade to each of the loans in the commercial and industrial and commercial real estate portfolios.

The following is a description of each risk rating category the Company uses to classify each of its commercial and industrial and commercial real estate loans:

#### Pass

Loans in this category have an acceptable level of risk and are graded in a range of one to five. Secured loans generally have good collateral coverage. Current financial statements reflect acceptable balance sheet ratios, sales and earnings trends. Management is considered to be good, and there is some depth existing. Payment experience on the loans has been good with minor or no delinquency experience. Loans with a grade of one are of the highest quality in the range. Those graded five are of marginally acceptable quality.

#### Special Mention

Loans in this category are graded a six and may be protected but are potentially weak. They constitute a credit risk to the

Company, but have not yet reached the point of adverse classification. Some of the following conditions may exist: little or no collateral coverage; lack of current financial information; delinquency problems; highly leveraged; available financial information reflects poor balance sheet ratios and profit and loss statements reflect uncertain trends; and document exceptions. Cash flow may not be sufficient to support total debt service requirements. Loans in this category should not remain on the list for an inordinate period of time (no more than one year) and then the loan should be passed or classified appropriately.

#### Substandard

Loans in this category are graded a seven and have a well-defined weakness which may jeopardize the ultimate collectability of the debt. The collateral pledged may be lacking in quality or quantity. Financial statements may indicate insufficient cash flow to service the debt; and/or do not reflect a sound net worth. The payment history indicates chronic delinquency problems. Management is considered to be weak. There is a distinct possibility that the Company may sustain a loss. All loans on non-accrual are rated substandard. Other loans that are included in the substandard category can be accruing, as well as loans that are current or past due. Some borrowers may also have claimed bankruptcy or plan to claim bankruptcy some-time in the near future.

#### Doubtful

Loans in this category are graded an eight and have a better than 50% possibility of the Company sustaining a loss, but the loss cannot be determined because of specific reasonable factors which may strengthen credit in the near-term. Many of the weaknesses present in a substandard loan exist. Liquidation of collateral, if any, is likely. Any loan graded lower than an eight is considered to be uncollectible and charged-off.

#### Consumer and Residential

The consumer and residential loan segments are regarded as homogeneous loan pools and as such are not risk rated. For these portfolios, the Company utilizes payment activity, history and recency of payment. Non-performing loans are considered to be loans past due 90 days or more and accruing and non-accrual loans. All loans not classified as non-performing are considered performing.

The following table presents loans, segregated by class, categorized into the appropriate credit quality indicator category as of the period indicated:

#### Commercial credit exposure

#### Credit risk profile by creditworthiness category

(dollars in thousands)	Commercial and industrial		Commercial real estate - non-owner occupied		Commercial real estate - owner occupied		Commercial real estate - construction	
	9/30/2013	12/31/2012	9/30/2013	12/31/2012	9/30/2013	12/31/2012	9/30/2013	12/31/2012
Pass	\$ 63,568	\$ 61,821	\$ 80,246	\$ 72,738	\$ 80,900	\$ 73,922	\$ 8,361	\$ 8,094



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Special mention	2,322	2,221	4,071	3,520	200	222	1,575	1,422
Substandard	667	1,068	4,951	5,740	3,311	6,365	840	1,163
Doubtful	-	-	-	-	-	-	-	-
Total	\$ 66,557	\$ 65,110	\$ 89,268	\$ 81,998	\$ 84,411	\$ 80,509	\$ 10,776	\$ 10,679

Consumer credit exposure

Credit risk profile based on payment activity

(dollars in thousands)	Home equity installment		Home equity line of credit		Auto loans and leases		Other	
	9/30/2013	12/31/2012	9/30/2013	12/31/2012	9/30/2013	12/31/2012	9/30/2013	12/31/2012
Performing	\$ 33,367	\$ 31,503	\$ 34,890	\$ 33,788	\$ 20,765	\$ 17,395	\$ 5,587	\$ 6,074
Non-performing	299	1,325	415	381	18	16	-	65
Total	\$ 33,666	\$ 32,828	\$ 35,305	\$ 34,169	\$ 20,783	\$ 17,411	\$ 5,587	\$ 6,139

Mortgage lending credit exposure

Credit risk profile based on payment activity

(dollars in thousands)	Residential real estate		Residential construction	
	9/30/2013	12/31/2012	9/30/2013	12/31/2012
Performing	\$ 107,304	\$ 93,408	\$ 7,833	\$ 7,948
Non-performing	1,615	3,357	-	-
Total	\$ 108,919	\$ 96,765	\$ 7,833	\$ 7,948

#### Allowance for loan losses

Management continually evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance for loan losses (the allowance) on a quarterly basis. The allowance reflects management's best estimate of the amount of credit losses in the loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

Management applies two primary components during the loan review process to determine proper allowance levels. The two components are a specific loan loss allocation for loans that are deemed impaired and a general loan loss allocation for those loans not specifically allocated. The methodology to analyze the adequacy of the allowance for loan losses is as follows:

- § identification of specific impaired loans by loan category;
- § specific loans that are not impaired, but have an identified potential for loss;
- § calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- § determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;
- § application of historical loss percentages (two-year average) to pools to determine the allowance allocation;
- § application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio.
- § Qualitative factor adjustments include:
  - o levels of and trends in delinquencies and non-accrual loans;
  - o levels of and trends in charge-offs and recoveries;
  - o trends in volume and terms of loans;
  - o changes in risk selection and underwriting standards;
  - o changes in lending policies, procedures and practices;
  - o experience, ability and depth of lending management;
  - o national and local economic trends and conditions; and
  - o changes in credit concentrations.

Allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk grading of individual commercial and industrial and commercial real estate loans. Commercial and industrial and commercial real estate loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed as the case may be. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The credit risk grades for the commercial and industrial and commercial real estate loan portfolios are taken into account in the reserve methodology and loss factors are applied based upon the credit risk grades. The loss factors applied are based upon the Company's historical experience as well as what we believe to be best practices and common industry standards. Historical experience reveals there is a direct correlation between the credit risk grades and loan charge-offs. The changes in allocations in the commercial and industrial and commercial real estate loan portfolio from period to period are based upon the credit risk grading system and from periodic reviews of the loan portfolio.

Each quarter, management performs an assessment of the allowance for loan losses. The Company's Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered and the reserve amounts pursuant to the accounting principles are reasonable. The assessment process includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company's Credit Administration function have assigned a criticized or classified risk rating. In 2013, the Company did not change its policy or methodology in calculating the allowance for loan losses from the policy or methodology used in 2012.

The Company's policy is to charge off unsecured consumer loans when they become 90 days or more past due as to principal and interest. In the other portfolio segments, amounts are charged off at the point in time when the Company deems the balance, or a portion thereof, to be uncollectible.

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Information related to the change in the allowance for loan losses and the Company's recorded investment in loans by portfolio segment as of the period indicated is as follows:

As of and for the nine months ended  
September 30, 2013

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 922	\$ 4,908	\$ 1,639	\$ 1,503	\$ -	\$ 8,972
Charge-offs	56	1,815	274	158	-	2,303
Recoveries	8	28	99	1	-	136
Provision	32	702	189	335	342	1,600
Ending balance	\$ 906	\$ 3,823	\$ 1,653	\$ 1,681	\$ 342	\$ 8,405
Ending balance: individually evaluated for impairment	\$ 40	\$ 254	\$ 29	\$ 73		\$ 396
Ending balance: collectively evaluated for impairment	\$ 866	\$ 3,569	\$ 1,624	\$ 1,608		\$ 7,667
Loans Receivables:						
Ending balance	\$ 66,557	\$ 184,455	\$ 95,341	\$ 116,752		\$ 463,105
Ending balance: individually evaluated for impairment	\$ 136	\$ 4,929	\$ 704	\$ 1,438		\$ 7,207
Ending balance: collectively evaluated for impairment	\$ 66,421	\$ 179,526	\$ 94,637	\$ 115,314		\$ 455,898

As of and for the three months ended  
September 30, 2013

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 919	\$ 3,521	\$ 1,647	\$ 1,718	\$ 491	\$ 8,296
Charge-offs	8	188	94	94	-	384
Recoveries	2	16	24	1	-	43
Provision	(7)	474	76	56	(149)	450
Ending balance	\$ 906	\$ 3,823	\$ 1,653	\$ 1,681	\$ 342	\$ 8,405

As of and for the year ended December  
31, 2012

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,221	\$ 3,979	\$ 1,435	\$ 1,051	\$ 422	\$ 8,108
Charge-offs	185	1,335	737	231	-	2,488
Recoveries	26	46	30	-	-	102
Provision	(140)	2,218	911	683	(422)	3,250
Ending balance	\$ 922	\$ 4,908	\$ 1,639	\$ 1,503	\$ -	\$ 8,972
Ending balance: individually evaluated for impairment	\$ 4	\$ 1,657	\$ 77	\$ 76		\$ 1,814
Ending balance: collectively evaluated for impairment	\$ 918	\$ 3,251	\$ 1,562	\$ 1,427		\$ 7,158
Loans Receivables:						
Ending balance	\$ 65,110	\$ 173,186	\$ 90,547	\$ 104,713		\$ 433,556
Ending balance: individually evaluated for impairment	\$ 60	\$ 9,099	\$ 1,735	\$ 2,330		\$ 13,224
Ending balance: collectively evaluated for impairment	\$ 65,050	\$ 164,087	\$ 88,812	\$ 102,383		\$ 420,332

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Information related to the change in the allowance for loan losses as of and for the three- and nine- months ended September 30, 2012 is as follows:

As of and for the nine months ended  
September 30, 2012

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,221	\$ 3,979	\$ 1,435	\$ 1,051	\$ 422	\$ 8,108
Charge-offs	135	1,258	491	121	-	2,005
Recoveries	23	-	16	-	-	39
Provision	55	1,083	457	579	(174)	2,000
Ending balance	\$ 1,164	\$ 3,804	\$ 1,417	\$ 1,509	\$ 248	\$ 8,142

As of and for the three months ended  
September 30, 2012

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,195	\$ 4,143	\$ 1,425	\$ 1,333	\$ 55	\$ 8,151
Charge-offs	70	518	57	76	-	721
Recoveries	11	-	1	-	-	12
Provision	28	179	48	252	193	700
Ending balance	\$ 1,164	\$ 3,804	\$ 1,417	\$ 1,509	\$ 248	\$ 8,142

## 6. Earnings per share

Basic earnings per share (EPS) is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but also reflects the potential dilution that could occur from the grant of stock-based compensation awards. The Company maintains two active share-based compensation plans that may generate additional potentially dilutive common shares. For granted and unexercised stock options, dilution would occur if Company-issued stock options were exercised and converted into common stock. Since the average share market prices of the Company's

common stock, during the three- and nine- months ended September 30, 2013 and 2012, were below the strike prices of all unexercised outstanding options, there were no potentially dilutive shares outstanding in any of the reportable periods related to stock options. For restricted stock, dilution would occur from the Company's unvested shares. There were 14,000 and 151 unvested restricted share grants outstanding as of September 30, 2013 and 2012, respectively.

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options and unvested restricted stock. Under the treasury stock method, the assumed proceeds, as defined, received from shares issued in a hypothetical stock option exercise or restricted stock grant, are assumed to be used to purchase treasury stock. Proceeds include: amounts received from the exercise of outstanding stock options; compensation cost for future service that the Company has not yet recognized in earnings; and any windfall tax benefits that would be credited directly to shareholders' equity when the grant generates a tax deduction (or a reduction in proceeds if there is a charge to equity). The Company does not consider awards from share-based grants in the computation of basic EPS.

The following table illustrates the data used in computing basic and diluted EPS for the periods indicated:

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
(dollars in thousands except per share data)				
Basic EPS:				
Net income available to common shareholders	\$ 1,505	\$ 1,399	\$ 4,412	\$ 3,973
Weighted-average common shares outstanding	2,359,947	2,294,416	2,345,453	2,277,801
Basic EPS	\$ 0.64	\$ 0.61	\$ 1.88	\$ 1.74
Diluted EPS:				
Net income available to common shareholders	\$ 1,505	\$ 1,399	\$ 4,412	\$ 3,973
Weighted-average common shares outstanding	2,359,947	2,294,416	2,345,453	2,277,801
Potentially dilutive common shares	4,632	151	4,407	151
Weighted-average common and potentially dilutive shares outstanding	2,364,579	2,294,567	2,349,860	2,277,952
Diluted EPS	\$ 0.64	\$ 0.61	\$ 1.88	\$ 1.74

## 7. Stock plans

The Company has two stock-based compensation plans (the stock compensation plans) from which it can grant stock-based compensation awards, and applies the fair value method of accounting for stock-based compensation provided under current accounting guidance. The guidelines require the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. The Company's stock compensation plans were shareholder-approved and permit the grant of share-based compensation awards to its employees and directors. The Company believes that the stock-based compensation plans will advance the development, growth and financial condition of the Company by providing incentives through participation in the appreciation in the value of the common stock of the Company to secure, retain and motivate the Company's employees and directors who are responsible for the operation and the management of the affairs of the Company, thereby aligning the interest of its employees and directors with the interest of its shareholders. In the stock compensation plans, employees and directors are eligible to be awarded stock-based compensation grants which can consist of stock options (qualified and non-qualified), stock appreciation rights (SARs) and restricted stock.

At the annual shareholders' meeting held on May 1, 2012, the shareholders of the Company approved and the Company adopted the 2012 Omnibus Stock Incentive Plan and the 2012 Director Stock Incentive Plan (collectively, the 2012 stock incentive plans). The 2012 stock incentive plans replaced the 2000 Independent Directors Stock Option Plan and the 2000 Stock Incentive Plan (collectively, the 2000 stock incentive plans), both of which expired in 2011. Unless terminated by the Company's board of directors, the 2012 stock incentive plans will expire on, and no options shall be granted after the tenth anniversary – or in the year 2022. Previously issued and currently outstanding options under the 2000 stock incentive plans may be exercised pursuant to the terms of the stock option plans existing at the time of grant. However, the outstanding options under the 2000 stock incentive plans may be cancelled and replaced with grants under the 2012 stock incentive plans.

In the 2012 Omnibus Stock Incentive Plan, the Company has reserved 500,000 shares of its no-par common stock for future issuance. In the Omnibus Stock Incentive Plan, 6,000 and 151 restricted stock awards were granted to employees during the first quarter of 2013 and the second quarter of 2012, respectively. In the 2012 grant, 134 of the 151 shares became fully vested during the second quarter of 2013 with the remaining 17 grants forfeited. The 2013 stock grants will vest over a period of four years. The Company recognizes share-based compensation expense over the requisite service or vesting period. Due to immateriality however, the entire expense, or \$2 thousand, from the 2012 grant was recognized on the date of grant.

In the 2012 Director Stock Incentive Plan, the Company has reserved 500,000 shares of its no-par common stock for issuance under the plan. In the Director Stock Incentive Plan, 8,000 restricted stock awards were granted to the members of the board of directors during the first quarter of 2013. The grants will vest over a period of two years. Share-based compensation expense is included as a component of salaries and employee benefits in the consolidated statements of income.

The following table summarizes the weighted-average fair value and vesting of restricted stock grants awarded during 2013 and 2012 under the 2012 stock incentive plans:



	2013			2012		
	Shares	Weighted- average grant date fair value	Vesting period	Shares granted	Weighted- average grant date fair value	Vesting period
Director plan	8,000	\$ 21.20	2 yrs - 50% per year	-	\$ -	
Omnibus plan	6,000	21.20	4 yrs - 25% per year	151	21.50	1 year
Total	14,000	\$ 21.20		151	\$ 21.50	

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The following tables illustrate stock-based compensation expense recognized during the three- and nine- months ended September 30, 2013 and 2012 and the unrecognized stock-based compensation expense as of September 30, 2013. There was no unrecognized stock-based compensation expense as of December 31, 2012:

	Three months ended September 30,		Nine months ended September 30,	
(dollars in thousands)	2013	2012	2013	2012
Stock-based compensation expense:				
Director plan	\$ 22	\$ -	\$ 57	\$ -
Omnibus plan	7	2	21	2
Total stock-based compensation expense	\$ 29	\$ 2	\$ 78	\$ 2

(dollars in thousands)	As of September 30, 2013
Unrecognized stock-based compensation expense:	
Director plan	\$ 113
Omnibus plan	106
Total unrecognized stock-based compensation expense	\$ 219

The unrecognized stock-based compensation expense as of September 30, 2013 will be recognized ratably over the periods ended January 2015 and January 2017 for the Director Plan and the Omnibus Plan, respectively.

For restricted stock, intrinsic value represents the closing price of the underlying stock at the end of the period. As of September 30, 2013, the intrinsic value of the Company's restricted stock under the Director and Omnibus plans was \$27.00 per share.

In addition to the 2012 stock incentive plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance under the plan. The ESPP was designed to promote broad-based employee ownership of the Company's stock and to motivate employees to improve job performance and enhance the financial results of the Company. Under the ESPP, participation is voluntary whereby employees use automatic payroll withholdings to purchase the Company's capital stock at a discounted price based on the fair market value of the capital stock as measured on either the commencement or termination dates, as defined. As of September 30, 2013, 29,956 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and is required to comply with the provisions of current accounting guidance. Therefore, the Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the nine months ended September 30, 2013 and 2012, compensation expense related to the ESPP approximated \$10 thousand and \$12 thousand, respectively, and is included as a component of salaries and employee benefits in the consolidated statements of income. There was no compensation expense related to the ESPP for the three months ended September

30, 2013 and 2012.

#### 8. Fair value measurements

The accounting guidelines establish a framework for measuring and disclosing information about fair value measurements. The guidelines of fair value reporting instituted a valuation hierarchy for disclosure of the inputs used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 - inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 - inputs are quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument;

Level 3 - inputs are unobservable and are based on the Company's own assumptions to measure assets and liabilities at fair value. Level 3 pricing for securities may also include unobservable inputs based upon broker-traded transactions.

A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The Company uses fair value to measure certain assets and, if necessary, liabilities on a recurring basis when fair value is the primary measure for accounting. Thus, the Company uses fair value for AFS securities. Fair value is used on a non-recurring basis to measure certain assets when adjusting carrying values to market values, such as impaired loans and other real estate owned.

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The following table represents the carrying amount and estimated fair value of the Company's financial instruments as of the periods indicated:

September 30, 2013

(dollars in thousands)	Carrying amount	Estimated fair value	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Financial assets:					
Cash and cash equivalents	\$ 35,885	\$ 35,885	\$ 35,885	\$ -	\$ -
Held-to-maturity securities	190	207	-	207	-
Available-for-sale securities	102,921	102,921	519	99,459	2,943
FHLB Stock	2,160	2,160	-	2,160	-
Loans and leases, net	454,700	455,351	-	-	455,351
Loans held-for-sale	903	920	-	920	-
Financial liabilities:					
Deposit liabilities	544,830	545,242	-	545,242	-
Short-term borrowings	14,197	14,197	-	14,197	-
Long-term debt	16,000	18,092	-	18,092	-

December 31, 2012

(dollars in thousands)	Carrying amount	Estimated fair value	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Financial assets:					
Cash and cash equivalents	\$ 21,846	\$ 21,846	\$ 21,846	\$ -	\$ -
Held-to-maturity securities	289	320	-	320	-
Available-for-sale securities	100,441	100,441	466	98,150	1,825
FHLB Stock	2,624	2,624	-	2,624	-
Loans, net	424,584	430,861	-	-	430,861
Loans held-for-sale	10,545	10,824	-	10,824	-
Financial liabilities:					

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Deposit liabilities	514,660	515,869	-	515,869	-
Short-term borrowings	8,056	8,056	-	8,056	-
Long-term debt	16,000	18,691	-	18,691	-

The carrying value of short-term financial instruments, as listed below, approximates their fair value. These instruments generally have limited credit exposure, no stated or short-term maturities, carry interest rates that approximate market and generally are recorded at amounts that are payable on demand :

- Cash and cash equivalents;
- Non-interest bearing deposit accounts;
- Savings, NOW and money market accounts and
- Short-term borrowings.

Securities: With the exception of pooled trust preferred securities, fair values on investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. The fair values of pooled trust preferred securities are determined based on a present value technique (income valuation).

FHLB stock: The Company considers the fair value of FHLB stock is equal to its carrying value or cost since there is no market value available and investments in and transactions for the stock are restricted and limited to the FHLB and its member-banks.

Loans: The fair value of loans is estimated by the net present value of the future expected cash flows discounted at current offering rates for similar loans. Current offering rates consider, among other things, credit risk. The carrying value that fair value is compared to is net of the allowance for loan losses and since there is significant judgment included in evaluating credit quality, loans are classified within Level 3 of the fair value hierarchy.

Loans held-for-sale: The fair value of loans held-for-sale is estimated using rates currently offered for similar loans and is typically obtained from FNMA or the FHLB.

Certificates of deposit: The fair value of certificates of deposit is based on discounted cash flows using rates which approximate market rates for deposits of similar maturities.

Long-term debt: Fair value is estimated using the rates currently offered for similar borrowings.

The following tables illustrate the financial instruments measured at fair value on a recurring basis segregated by hierarchy fair value levels as of the period indicated:

	Total carrying value September 30, 2013	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
(dollars in thousands)				
Available-for-sale securities:				
Agency - GSE	\$ 15,709	\$ -	\$ 15,709	\$ -
Obligations of states and political subdivisions	31,162	-	31,162	-
Corporate bonds:				
Pooled trust preferred securities	2,943	-	-	2,943
MBS - GSE residential	52,588	-	52,588	-
Equity securities - financial services	519	519	-	-
Total available-for-sale securities	\$ 102,921	\$ 519	\$ 99,459	\$ 2,943

	Total carrying value	Quoted prices in active markets	Significant other observable inputs	Significant other unobservable inputs

(dollars in thousands)	December 31, 2012	(Level 1)	(Level 2)	(Level 3)
Available-for-sale securities:				
Agency - GSE	\$ 17,740	\$ -	\$ 17,740	\$ -
Obligations of states and political subdivisions	29,857	-	29,857	-
Corporate bonds:				
Pooled trust preferred securities	1,825	-	-	1,825
MBS - GSE residential	50,553	-	50,553	-
Equity securities - financial services	466	466	-	-
Total available-for-sale securities	\$ 100,441	\$ 466	\$ 98,150	\$ 1,825

Equity securities in the AFS portfolio are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Other than the Company's investment in corporate bonds, consisting of pooled trust preferred securities, other debt securities in the AFS portfolio are measured at fair value using market quotations provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Assets classified as Level 2 use valuation techniques that are common to bond valuations. That is, in active markets whereby bonds of similar characteristics frequently trade, quotes for similar assets are obtained. For the nine months ended September 30, 2013, there were no transfers to or from Level 1 and Level 2 fair value measurements for financial assets measured on a recurring basis.

The Company's pooled trust preferred securities include both observable and unobservable inputs to determine fair value and, therefore, are considered Level 3 inputs. The accounting pronouncement related to fair value measurement provides guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity such as is the case with the Company's investment in pooled trust preferred securities.

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The following table presents and summarizes quantitative information about assets measured at fair value on a recurring basis whereby the Company uses Level 3 inputs to determine fair value:

Quantitative information about Level 3 fair value measurements as of the periods indicated:

(dollars in thousands)	Valuation technique	September 30, 2013	December 31, 2012	Unobservable input	September 30, 2013	December 31, 2012
		Fair value	Fair value		Input utilized	Input utilized
Available-for-sale securities:						
Pooled trust preferred securities						
	discounted cash flow	\$ 2,943	\$ 1,825	- structural behavior estimated probability of default	issuer specific	issuer specific
				- correlation analysis among issuers	2.19% - 2.76%	4.11% - 4.17%
				- loss given default rate	50% - 30%	50% - 30%
				- prepayment rate	100%	100%
				- recovery rate	0%	0%
				- credit adjusted cash flow discount rate	0%	0%
					0% - 75.0%	0% - 36.3%

The Company owns 13 issues of \$22.3 million, original par value, pooled trust preferred securities. As of September 30, 2013, the amortized cost and fair values amounted to \$6.1 million and \$2.9 million, respectively. The market for these securities is inactive – no new issues since 2007, financial institutions with less than \$10 billion in assets qualify for new issue Tier 1 capital treatment which further limits the already low probability of a new issue coming to market, trading is sparse and consummated mostly by speculative hedge funds. Observable pricing market inputs such as broker models, S&P pricing based on interpolated available market activity and Bloomberg fair value models for corporate issues are available, however, such inputs to be used as indicators of fair value would require significant adjustments. Therefore, management has determined that a fair value modeled income approach (discounted cash flow) is more representative of fair value than the market approach. This technique strives to maximize the use of observable inputs and minimizes the use of unobservable inputs. The Company uses the Moody’s Wall Street Analytics methodology of valuation and analysis of collateralized “TruPS”, and their proprietary software to help analyze and value the Company’s pooled trust preferred securities portfolio. The major unobservable input assumptions used in the cash flow analysis include:

- Credit quality estimated using issuer specific probability of default;
- Correlation analysis or the potential for the tendency of companies to default once other companies in the same industry default: 50% for same industry and 30% for across industries;
- Loss given default or cash lost to investor. Assumed to be 100% with no recovery;
- Cash flows were forecast for the underlying collateral and applied to each tranche to determine the resulting distribution among securities, capturing the credit risk element of the collateral, and to determine the estimated fundamental value of the security. No prepayments are assumed and the tranche coupon rate is used as the discount rate; and
- Finally, the orderly liquid exit values (OLEV) are calculated for valuation purposes. The OLEV estimates a new issuance spread as if the market was both liquid and active utilizing the current risk profile of the security and regression analysis across a large sample of tranches based on historical data. The discount rates determined on an



overall basis ranged from 0% to 75% as of September 30, 2013 and are applied to the fundamental cash flow value (as determined above) of the security to determine fair value.

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The following table illustrates the changes in Level 3 financial instruments, consisting of the Company's investment in pooled trust preferred securities, measured at fair value on a recurring basis for the periods indicated:

(dollars in thousands)	As of and for the nine months ended September 30,	
	2013	2012
Balance at beginning of period	\$ 1,825	\$ 1,466
Realized losses in earnings	-	(136)
Unrealized gains (losses) in OCI:		
Gains	1,519	518
Losses	(193)	(113)
Pay down / settlement	(216)	(96)
Interest paid-in-kind	6	21
Accretion	2	3
Balance at end of period	\$ 2,943	\$ 1,663

The following table illustrates the financial instruments measured at fair value on a non-recurring basis segregated by hierarchy fair value levels as of the periods indicated:

(dollars in thousands)	Total carrying value at September 30, 2013	Quoted	Significant	Significant
		prices in active markets (Level 1)	other observable inputs (Level 2)	other unobservable inputs (Level 3)
Impaired loans	\$ 1,924	\$ -	\$ -	\$ 1,924
Other real estate owned	1,987	-	-	1,987
Total	\$ 3,911	\$ -	\$ -	\$ 3,911

Total carrying	Quoted prices in active markets	Significant other observable inputs	Significant other unobservable inputs
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(dollars in thousands)	value at December 31, 2012 (Level			
	1)	(Level 2)	(Level 3)	
Impaired loans	\$ 5,109	\$ -	\$ -	\$ 5,109
Other real estate owned	1,448	-	-	1,448
Other repossessed assets	6	-	-	6
Total	\$ 6,563	\$ -	\$ -	\$ 6,563

From time-to-time, the Company may be required to record at fair value financial instruments on a non-recurring basis, such as impaired loans and other real estate owned (ORE) and other repossessed assets. These non-recurring fair value adjustments involve the application of lower-of-cost-or-market accounting on write downs of individual assets. The following describes valuation methodologies used for financial instruments measured at fair value on a non-recurring basis.

A loan is considered impaired when, based upon current information and events; it is probable that the Company will be unable to collect all scheduled payments in accordance with the contractual terms of the loan. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves, a component of the allowance for loan losses, and as such are carried at the lower of net recorded investment or the estimated fair value.

Estimates of fair value of the collateral are determined based on a variety of information, including available valuations from certified appraisers for similar assets, present value of discounted cash flows and inputs that are estimated based on commonly used and generally accepted industry liquidation advance rates and other estimates and assumptions developed by management.

Valuation techniques for impaired loans are typically determined through independent appraisals of the underlying collateral or may be determined through present value of discounted cash flows. Both techniques include various Level 3 inputs which are not identifiable. The valuation technique may be adjusted by management for estimated liquidation expenses and qualitative factors such as economic conditions. If real estate is not the primary source of repayment, present value of discounted cash flows and estimates using generally accepted industry liquidation advance rates and other factors may be utilized to determine fair value. For example, from time-to-time, the Company may refer to the National Automobile Dealers Association (NADA) guide to estimate vehicle's fair value for an impaired auto loan. At September 30, 2013, the range of liquidation expenses and other valuation adjustments applied to impaired loans ranged from -16.00% to -95.37% (weighted-average -39.48%). Due to the multitude of

assumptions, many of which are subjective in nature, and the varying inputs and techniques used to determine fair value, the Company recognizes that valuations could differ across a wide spectrum of techniques employed. Accordingly, fair value estimates for impaired loans are classified as Level 3.

For other real estate owned, fair value is generally determined through independent appraisals of the underlying properties which generally include various Level 3 inputs which are not identifiable. The appraisals may be adjusted by management for qualitative reasons and estimated liquidation expenses. Management's assumptions may include consideration of the location and occupancy of the property, along with current economic conditions. Subsequently, as these properties are actively marketed, the estimated fair values may be periodically adjusted through incremental subsequent write-downs. These write-downs usually reflect decreases in estimated values resulting from sales price observations as well as changing economic and market conditions. At September 30, 2013, adjustments to the appraisal values for other real estate owned ranged from -1.72% to -60.90% (weighted average -26.76%).

For repossessed assets, consisting of one automobile as of December 31, 2012, the Company refers to the NADA guide to determine a vehicle's fair value. There were no other repossessed assets at September 30, 2013.

## Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of September 30, 2013 compared to December 31, 2012 and a comparison of the results of operations for the three- and nine- months ended September 30, 2013 and 2012. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2012 Annual Report filed on Form 10-K.

### Forward-looking statements

Certain of the matters discussed in this Quarterly Report on Form 10-Q may constitute forward-looking statements for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, and as such may involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. The words "expect," "anticipate," "intend," "plan," "believe," "estimate," and similar expressions are intended to identify such forward-looking statements.

The Company's actual results may differ materially from the results anticipated in these forward-looking statements due to a variety of factors, including, without limitation:

- § the effects of economic deterioration and the prolonged economic malaise on current customers, specifically the effect of the economy on loan customers' ability to repay loans;
- § the costs and effects of litigation and of unexpected or adverse outcomes in such litigation;
- § the impact of new laws and regulations, including the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the regulations promulgated thereunder;
- § impacts of the new capital and liquidity requirements of the Basel III standards and other regulatory pronouncements, regulations and rules;
- § governmental monetary and fiscal policies, as well as legislative and regulatory changes;
- § the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;
- § the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks;
- §

the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet;

§ technological changes;

§ acquisitions and integration of acquired businesses;

§ the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities;

§ volatilities in the securities markets;

§ slow economic conditions;

§ acts of war or terrorism; and

§ disruption of credit and equity markets.

The Company cautions readers not to place undue reliance on forward-looking statements, which reflect analyses only as of the date of this document. The Company has no obligation to update any forward-looking statements to reflect events or circumstances after the date of this document.

Readers should review the risk factors described in other documents that we file or furnish, from time to time, with the Securities and Exchange Commission, including Annual Reports to Shareholders, Annual Reports filed on Form 10-K and other current reports filed or furnished on Form 8-K.

## General

Nationally, the unemployment rate declined slightly from 7.8% at December 31, 2012 to 7.2% at September 30, 2013, remaining at the lowest level since 2008. While the unemployment rate has been declining nationally, the unemployment rate in the Scranton-Wilkes-Barre Metropolitan Statistical Area (local) still remains above national and state levels. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at August 31, 2013 was 9.4%, unchanged from December 31, 2012 and down 0.4 percentage points from August 31, 2012. Local economists and state labor analysts predict that unemployment rates will decline as the national economy improves. However, this economic improvement is anticipated to be slow-moving. The number of foreclosures has been declining on a national level, but was up nearly 26% in our local metropolitan area in the third quarter of 2013 compared to the same period in 2012. This is the third straight quarter the region has seen increases in home repossessions, property auction warnings and mortgage default notifications. Pennsylvania and the region generally dodged the explosion of foreclosures that battered many states from 2009 to 2012. Now the effect of prolonged high rates of unemployment is beginning to catch up. The increase can also be attributed to inventory built up during the downturn that is just coming to the market now. Notwithstanding these issues, high levels of unemployment and the prolonged weakness in the local housing and real estate markets may negatively impact the performance and condition of the Company's loan portfolios.

The Company's earnings depend primarily on net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields earned on interest-earning assets, which consist principally of loans and investment securities. Interest expense is incurred from rates paid on interest-bearing liabilities, which consist of deposits and borrowings. Net interest income is determined by the Company's interest rate spread (the difference between the yields earned on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. Interest rate spread is significantly impacted by: changes in interest rates and market yield curves and their related impact on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in the marketplace.

The Company's earnings are also affected by the level of its non-interest income and expenses and by the provisions for loan losses and income taxes. Non-interest income consists of service charges on the Company's loan and deposit products, interchange fees, trust and asset management service fees, increases in the cash surrender value of the bank owned life insurance, net gains or losses from sales of loans, securities and from credit related other-than-temporary impairment (OTTI) charges on investment securities. Non-interest expense consists of: compensation and related employee benefit costs; occupancy; equipment; data processing; advertising and marketing; FDIC insurance premiums; professional fees; loan collection; net other real estate owned (ORE) expenses; supplies and other operating overhead.

## Comparison of the results of operations

Three- and nine- months ended September 30, 2013 and 2012

## Overview

Net income for the third quarter of 2013 increased \$0.1 million, or 8%, to \$1.5 million or \$0.64 per diluted share, compared to \$1.4 million or \$0.61 per diluted share in the same 2012 quarter. For the nine months ended September 30, 2013, net income increased \$0.4 million, or 11%, to \$4.4 million or \$1.88 per diluted share, compared to \$4.0 million, or \$1.74 per diluted share, recorded for the nine months ended September 30, 2012. In the quarterly comparison, net income increased \$0.1 million due mostly to a decrease in the provision for loan losses offset by an increase in non-interest expense. Similarly, net income in the year-to-date comparison increased due to higher net interest and non-interest income and also included a lower provision for loan loss requirement. The increase in other non-interest expense offset the growth in net interest income and non-interest income.

Return on average assets (ROA) and return on average shareholders' equity (ROE) were 0.96% and 9.85%, respectively, for the three months ended September 30, 2013 compared to 0.92% and 9.67%, respectively, for the three months ended September 30, 2012. For the nine months ended September 30, 2013, ROA and ROE were 0.96% and 9.78%, respectively, compared to 0.87% and 9.46% for the same period in 2012. The improvement in ROA and ROE in both the three- and nine- month comparisons was caused predominantly by the increase in net income.

#### Net interest income and interest sensitive assets / liabilities

Net interest income increased \$36 thousand, or 0.7%, in the third quarter of 2013 to \$5.2 million. The fully-taxable equivalent (FTE) net interest rate spread fell five basis points to 3.57% for the three months ended September 30, 2013 from 3.62% for the three months ended September 30, 2012. During the same period, the FTE net interest margin decreased to 3.74% from 3.79%.

The rise in net interest income can be attributed to lower rates paid on smaller average interest-bearing deposits and was bolstered further by a \$13.0 million increase in non-interest bearing deposits – an interest-free funding source for interest-earning asset growth. Though net interest income increased marginally, the interest rate spread declined primarily because the yield earned from interest-earning assets declined more rapidly than the decline in rates paid on interest-bearing liabilities. The decline in the net interest margin is due to a \$12.4 million increase in interest-earning assets producing a lower amount of interest income. Somewhat offsetting the rapid pace of the rate decline in earning assets was the shift of interest-earning assets from the relatively lower yielding cash and investment securities to higher yielding loans as well as higher balances of interest-earning assets. The average interest-bearing cash and securities portfolios declined \$19.7 million while the average balances of the loan portfolio increased by approximately \$33.4 million funded with net interest income-enhancing non-interest bearing deposits.

Net interest income for the nine months ended September 30, 2013 increased \$0.2 million, or 1%, from \$15.4 million in the first nine months of 2012 to \$15.6 million in the first nine months of 2013. During the same period, the FTE interest rate spread and margin increased two basis points and three basis points, to 3.63% and 3.81%, respectively. Rates paid on interest-bearing liabilities declined 8 basis points– mostly from a 24 basis point decline in certificates of deposit rates, and coupled with an increase in average non-interest bearing deposits of \$16.5 million more than offset the impact of a 6 basis point decline in yields earned from interest-earning assets. In addition, the Company shifted its emphasis from the lower yielding investment portfolio to higher yielding loans – particularly in the commercial and residential mortgage loan portfolios where average loan volume increases of \$32.9 million helped boost interest income by \$0.3 million despite a decline in yield of 20 basis points in commercial loans and 42 basis points in residential mortgage loans.

The low interest rate environment caused yields from earning assets to further decline and will most likely continue to do so throughout 2013 and therefore may further constrict the Company's asset yields and possibly the net interest margin. At 69 basis points, the Company's cost of interest-bearing liabilities for the quarter ended September 30, 2013 is five basis points lower than the cost in the third quarter of 2012. Other than retaining maturing long-term CDs, reducing deposit rates further would have a minor cost-savings effect. Lately, interest rates along the treasury yield curve have been slowly but steadily rising and, because of market competition, could potentially pressure banks to increase deposit rates to help prevent deposit outflow. On the asset side, the prime interest rate, the benchmark rate that banks use as a base rate for adjustable rate loans, is not expected to rise in tandem with the treasury yield curve thereby further pressuring net interest income should deposit market rates begin to steadily rise. To help combat the impending change to the economic landscape, the Company has successfully developed and will continue to strengthen its association with existing customers and develop new business relationships to retain and generate higher levels of average non-interest bearing DDA balances thereby reducing the Company's overall cost of funds and the potential drag on earnings. Strategically deploying these funds into interest earning-assets such as in the retail and commercial loan portfolios is an effective margin-enhancing strategy that the Company expects to pursue and expand upon to help stabilize net interest margin.

The Company's Asset Liability Management (ALM) team meets regularly to discuss among other things, interest rate risk and when deemed necessary adjusts interest rates and to discuss and seek revenue enhancing strategies to combat the trend in declining interest income. The Company's marketing department, in concert with ALM, lenders and deposit gatherers, continues to develop prudent strategies that will grow the loan portfolio and accumulate low-cost deposits in order to contain the Company's interest rate margin.

The tables that follow set forth a comparison of average balances and their corresponding FTE interest income and expense and annualized tax-equivalent yield and cost for the periods indicated. Within each of the tables, interest income was adjusted to a tax-equivalent basis, using the corporate federal tax rate of 34%, to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. This treatment allows a uniform comparison between yields on interest-earning assets. Loans include loans HFS and non-accrual loans but exclude the allowance for loan losses. Net deferred loan cost amortization of \$73.6 thousand and \$59.1 thousand for the third quarters of 2013 and 2012, respectively, and \$0.2 million and \$0.1 million for the first nine months of 2013 and 2012,



respectively, are included in interest income from loans. Securities include non-accrual securities. Average balances are based on amortized cost and do not reflect net unrealized gains or losses. Net interest margin is calculated by dividing annualized net interest income by total average interest-earning assets. Cost of funds includes the effect of average non-interest bearing deposits as a funding source:

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(dollars in thousands)	Three months ended			September 30, 2012		
	September 30, 2013		Yield /	September 30, 2012		Yield /
Assets	Average balance	Interest	rate	Average balance	Interest	rate
Interest-earning assets						
Interest-bearing deposits	\$ 6,540	\$ 5	0.29 %	\$ 19,924	\$ 13	0.25 %
Investments:						
Agency - GSE	16,184	40	0.98	24,327	65	1.06
MBS - GSE residential	48,242	126	1.04	49,685	162	1.29
State and municipal	30,932	471	6.04	27,084	447	6.57
Other	9,249	26	1.11	9,805	19	0.79
Total investments	104,607	663	2.47	110,901	693	2.49
Loans and leases:						
Commercial	251,341	3,097	4.89	237,896	3,052	5.10
Consumer	60,357	871	5.73	56,648	930	6.53
Residential real estate	153,279	1,553	4.02	137,049	1,492	4.33
Total loans and leases	464,977	5,521	4.71	431,593	5,474	5.05
Federal funds sold	241	-	0.25	1,530	1	0.26
Total interest-earning assets	576,365	6,189	4.26 %	563,948	6,181	4.36 %
Non-interest earning assets	44,490			43,738		
Total Assets	\$ 620,855			\$ 607,686		
Liabilities and shareholders' equity						
Interest-bearing liabilities						
Deposits:						
Savings	\$ 108,684	\$ 56	0.21 %	\$ 106,924	\$ 58	0.22 %
Interest-bearing checking	90,245	34	0.15	84,395	28	0.13
MMDA	79,904	108	0.54	94,363	119	0.50
CDs < \$100,000	77,172	198	1.01	76,929	227	1.17
CDs > \$100,000	42,081	129	1.21	42,523	152	1.43
Clubs	2,219	1	0.14	2,201	1	0.13
Total interest-bearing deposits	400,305	526	0.52	407,335	585	0.57
Repurchase agreements	10,648	5	0.17	11,614	4	0.17
Borrowed funds	20,615	218	4.20	16,002	215	5.35
Total interest-bearing liabilities	431,568	749	0.69 %	434,951	804	0.74 %

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Non-interest bearing deposits	124,794	111,781
Non-interest bearing liabilities	3,892	3,390
Total liabilities	560,254	550,122
Shareholders' equity	60,601	57,564
Total liabilities and shareholders' equity	\$ 620,855	\$ 607,686
Net interest income	\$ 5,440	\$ 5,377
Net interest spread	3.57 %	3.62 %
Net interest margin	3.74 %	3.79 %
Cost of funds	0.53 %	0.59 %

(dollars in thousands)	Nine months ended September 30, 2013			September 30, 2012		
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
<b>Assets</b>						
Interest-earning assets						
Interest-bearing deposits	\$ 8,768	\$ 19	0.29 %	\$ 28,829	\$ 55	0.25 %
Investments:						
Agency - GSE	16,277	98	0.80	25,997	218	1.12
MBS - GSE residential	48,968	385	1.05	51,015	529	1.39
State and municipal	29,276	1,365	6.23	27,964	1,378	6.58
Other	9,167	64	0.94	10,133	59	0.78
Total investments	103,688	1,912	2.47	115,109	2,184	2.53
Loans and leases:						
Commercial	247,022	9,207	4.98	237,066	9,195	5.18
Consumer	57,793	2,655	6.14	56,435	2,830	6.70
Residential real estate	153,510	4,697	4.09	130,549	4,404	4.51
Total loans and leases	458,325	16,559	4.83	424,050	16,429	5.18
Federal funds sold	234	-	0.25	665	1	0.26
Total interest-earning assets	571,015	18,490	4.33 %	568,653	18,669	4.39 %
Non-interest earning assets	44,883			42,124		
Total Assets	\$ 615,898			\$ 610,777		
<b>Liabilities and shareholders' equity</b>						
<b>Interest-bearing liabilities</b>						
<b>Deposits:</b>						
Savings	\$ 108,990	\$ 168	0.21 %	\$ 108,012	\$ 175	0.22 %
Interest-bearing checking	84,534	80	0.13	81,588	82	0.13
MMDA	80,392	317	0.53	99,066	394	0.53
CDs < \$100,000	76,328	595	1.04	79,369	755	1.27
CDs > \$100,000	41,572	389	1.25	41,677	478	1.53
Clubs	1,824	2	0.15	1,811	2	0.15
Total interest-bearing deposits	393,640	1,551	0.53	411,523	1,886	0.61
Repurchase agreements	12,253	18	0.19	13,195	27	0.28
Borrowed funds	19,765	646	4.37	17,025	667	5.23
Total interest-bearing liabilities	425,658	2,215	0.70 %	441,743	2,580	0.78 %

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Non-interest bearing deposits	126,132	109,589
Non-interest bearing liabilities	3,787	3,337
Total liabilities	555,577	554,669
Shareholders' equity	60,321	56,108
Total liabilities and shareholders' equity	\$ 615,898	\$ 610,777
Net interest income	\$ 16,275	\$ 16,089
Net interest spread	3.63 %	3.61 %
Net interest margin	3.81 %	3.78 %
Cost of funds	0.54 %	0.63 %

#### Provision for loan losses

The provision for loan losses represents the necessary amount to charge against current earnings, the purpose of which is to increase the allowance for loan losses (the allowance) to a level that represents management's best estimate of known and inherent losses in the Company's loan portfolio. Loans determined to be uncollectible are charged off against the allowance. The required amount of the provision for loan losses, based upon the adequate level of the allowance, is subject to the ongoing analysis of the loan portfolio. The Company's Special Assets Committee meets periodically to review problem loans. The committee is comprised of management, including the senior loan officer, credit administration officers, loan officers, loan workout officers and collection personnel. The committee reports quarterly to the Credit Administration Committee of the Board of Directors.

Management continuously reviews the risks inherent in the loan portfolio. Specific factors used to evaluate the adequacy of the loan loss provision during the formal process include:

- specific loans that could have loss potential;
- levels of and trends in delinquencies and non-accrual loans;
- levels of and trends in charge-offs and recoveries;
- trends in volume and terms of loans;
- changes in risk selection and underwriting standards;
- changes in lending policies, procedures and practices;
- experience, ability and depth of lending management;
- national and local economic trends and conditions; and
- changes in credit concentrations.

Provisions for loan losses of \$1.6 million were recorded for the first nine months of 2013, compared to \$2.0 million during the first nine months of 2012. Provisions for loan losses were \$0.5 million for the three months ending September 30, 2013, with \$0.7 million in provisions recorded during the three months ending September 30, 2012. The Company's non-performing loans declined to \$6.5 million as of September 30, 2013, a \$7.4 million decrease from year-end 2012. Though credit quality is improving, the additional provision in the third quarter of 2013 was necessary to fund the allowance to support growth in the loan portfolio and to reinforce the allowance for the potential credit risks that still exist from an uncertain local economic climate. The allowance for loan losses was \$8.4 million as of September 30, 2013, compared to \$9.0 million for December 31, 2012. The decrease in the allowance reflects the charge down of a large commercial real estate loan in the first quarter, coupled with additional charge downs in the other segments of the commercial loan portfolio as well as the mortgage and consumer loan portfolios over the first nine months of 2013.

#### Other income

For the three months ended September 30, 2013, non-interest income amounted to \$1.9 million, essentially unchanged from the same 2012 quarter. Reductions in gains recognized on loan sales in 2013 were offset by larger gains on investment securities and an increase in interchange fees.

For the nine months ended September 30, 2013, non-interest income amounted to \$6.0 million, an increase of \$0.2 million, or 4%, from \$5.8 million recorded in the first nine months of 2012. Additional fees from growth in trust, deposit and interchange services and the absence of \$0.1 million in credit OTTI charges in the current year helped boost non-interest related revenue. Growth in other service related fees was offset by a decline in service, late and other loan fee income in the first nine months of 2013 compared to the same 2012 period. In addition, a slowdown in mortgage loan origination activity and the decision to hold intermediate-term mortgage loans for portfolio has resulted in \$0.1 million less in gains recognized from the sales of mortgage loans into the secondary market during the nine months ended September 30, 2013 compared to the same period in 2012.

#### Other operating expenses

Total other operating expenses increased \$0.1 million, or 4%, from \$4.5 million in the third quarter of 2012 to \$4.6 million in the third quarter of 2013. Salary and employee benefits increased \$0.1 million, or 6%, due to normal salary merit increases, three additional full-time equivalents (FTEs) employees, including the hiring of a chief operating officer in the third quarter of 2012, a new director of trust services, increased group insurance and higher employee incentive costs. The \$81 thousand increase in automated transaction processing expense was due to the effect of the new regulation that allows the Company's card processors the right to bill for services related to point-of-sale transactions. In addition, the Company's rollout of a new debit card rewards program required implementation and program expenses in the third quarter of 2013 that did not exist in the 2012 quarter. The \$0.2 million increase in the other expense category was caused by the timing of the receipt of state tax credits increasing the third quarter shares tax expense by \$52 thousand compared to the third quarter of 2012. The Company typically receives tax credits, in three phases, based on contributions to qualifying educational organizations through the "Educational Improvement Tax Credit" (EITC) program administered by the state of Pennsylvania. The Company is waiting for the final application phase of the program to be approved by the state. Also contributing to the increase in other expenses was a lower level of residential mortgage originations resulting in less overhead being deferred as well as higher mortgage and commercial loan appraisal costs associated with the cost of second appraisals for construction loans migrating to permanent financing and for the cost of appraisals for withdrawn and denied loan applications. Advertising and marketing expenses declined \$39 thousand, or 7%, in the third quarter of

2013 compared to the third quarter of 2012. The decline was due to the \$0.1 million lower EITC donations made to date, a component of advertising and marketing, in the current year quarter compared to the third quarter of 2012. Related to the shares tax credits as noted above, the state has encountered a backlog in processing applications for the EITC program which has delayed our program contributions. Collections expense declined \$0.1 million due to the Company's continued aggressive and varied methods of gaining control of real estate collateral. These methods include more sharply focused efforts to reduce loan payment delinquencies, moving swiftly through the foreclosure litigation processes and other types of legal actions that achieved positive results more efficiently.

For the nine months ended September 30, 2013, total other operating expenses increased \$0.2 million compared to the nine months ended September 30, 2012. Salary and employee benefits increased \$0.4 million, or 6%, due to annual merit increases, internal promotions, the hiring of new senior staff positions, the related increase in payroll expenses and employee incentive related costs. Advertising and marketing expenses increased \$33 thousand, or 4%, during the nine months ended September 30, 2013 compared to the same period in 2012. The net increase was caused by a new branding initiative with expenses including a multi-media marketing campaign consisting of television, billboard, and social media, along with a very visible public relations initiative partially offset by the decrease in educational contributions as noted in the quarterly comparison, above. The decrease in professional services of \$72 thousand was due to less need and therefore lower legal service related expenses, non-recurring 2012 SBA examination fees and other lower ancillary professional service costs. Due to the reasons specified in the quarterly comparison, automated transaction processing expense increased \$0.1 million, or 49%, in the nine months ended September 30, 2013 compared to the same 2012 period. The non-recurring prepayment fee of \$0.2 million from the payoff of the \$5.0 million, 3.61%, FHLB loan in the first quarter of 2012 caused the decrease in the other expense category.

Comparison of financial condition at

September 30, 2013 and December 31, 2012

#### Overview

Consolidated assets increased \$38.8 million, or 6%, to \$640.3 million as of September 30, 2013 from \$601.5 million at December 31, 2012. The increase in assets was funded through growth in deposits of \$30.2 million, short-term borrowings of \$6.1 million, consisting of repurchase agreements and a \$2.9 million increase in shareholders' equity, the latter from \$4.4 million of net income partially offset by \$0.8 million of dividends declared net of activity in the Company's dividend reinvestment plan and \$0.9 million in other comprehensive loss. The growth in deposits and repurchase agreements was used to finance growth in the loan portfolio with the excess available for future liquidity needs.

Funds Deployed:

#### Investment securities

At the time of purchase, management classifies investment securities into one of three categories: trading, available-for-sale (AFS) or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. Most of the securities the Company purchases are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at fair value in the consolidated balance sheet with an adjustment to shareholders' equity, net of deferred taxes, presented under the caption "Accumulated other comprehensive income (loss)." Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity.



As of September 30, 2013, the carrying value of investment securities amounted to \$103.1 million, or 16% of total assets, compared to \$100.7 million, or 17% of total assets, at December 31, 2012. On September 30, 2013, approximately 51% of the carrying value of the investment portfolio was comprised of U.S. Government Sponsored Enterprise residential mortgage-backed securities (MBS – GSE residential or mortgage-backed securities) that amortize and provide monthly cash flow that the Company can use for reinvestment, unexpected deposit outflow, facility expansion or operations.

As of September 30, 2013, investment securities were comprised of HTM and AFS securities with carrying values of \$0.2 million and \$102.9 million, respectively. The AFS debt and equity securities were recorded with a combined net unrealized loss in the amount of \$1.0 million as of September 30, 2013 compared to an unrealized gain of \$0.4 million as of December 31, 2012, respectively, or a net decline of \$1.4 million during the first nine months of 2013. Interest rates along the intermediate and long end of the treasury yield curve have increased from year-end 2012 and while the intermediate term rates have ebbed slightly from the prior quarter, until rates stabilize, values of banks' investment securities will be somewhat volatile.

The Company's investment policy is designed to complement its lending activity. During the nine months ended September 30, 2013, the carrying value of total investments increased \$2.4 million, or 2% during the same period the loan portfolio increased \$30.1 million, or 7%. With the loan portfolio currently offering better returns than can be obtained in the capital markets, growth in investments will be considered after loan demand, facility expansion and deposit outflow. The Company will however, maintain a diverse investment portfolio to help mitigate overall risk and maintain a strong balance sheet.

A comparison of investment securities at September 30, 2013 and December 31, 2012 is as follows:

(dollars in thousands)	September 30, 2013		December 31, 2012	
	Amount	%	Amount	%
MBS - GSE residential	\$ 52,778	51.2 %	\$ 50,842	50.5 %
State & municipal subdivisions	31,162	30.2	29,857	29.6
Agency - GSE	15,709	15.2	17,740	17.6
Pooled trust preferred securities	2,943	2.9	1,825	1.8
Equity securities - financial services	519	0.5	466	0.5
Total	\$ 103,111	100.0 %	\$ 100,730	100.0 %

Quarterly, management performs a review of the investment portfolio to determine the causes of declines in the fair value of each security. The Company uses inputs provided by independent third parties to determine the fair value of its investment securities portfolio. Inputs provided by the third parties are reviewed and corroborated by management. Evaluations of the causes of the unrealized losses are performed to determine whether impairment exists and whether the impairment is temporary or other-than-temporary. Considerations such as the Company's intent and ability to hold the securities to maturity, recoverability of the invested amounts over the intended holding period, the length of time and the severity in pricing decline below cost, the interest rate environment, the receipt of amounts contractually due and whether or not there is an active market for the securities, for example, are applied, along with an analysis of the financial condition of the issuer for management to make a realistic judgment of the probability that the Company will be unable to collect all amounts (principal and interest) due in determining whether a security is other-than-temporarily impaired. If a decline in value is deemed to be other-than-temporary, the amortized cost of the security is reduced by the credit impairment amount and a corresponding charge to current earnings is recognized. If at the time of sale, call or maturity, the proceeds exceed the security's amortized cost, previous credit impairment charges may be fully or partially recovered.

The Company owns 13 tranches of pooled trust preferred securities (PreTSLs). As of September 30, 2013, the market for these securities and other issues of PreTSLs remained inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which PreTSLs trade, then by a significant decrease in the volume of trades relative to historical levels. There has not been a new PreTSL issue since 2007. Newly imposed restrictions for institutions to qualify and receive favorable capital treatment have lessened the likelihood of new issues coming to market. There are currently very few market participants who are willing and/or able to transact for these securities. The Company has determined that the volume of trading activity in PreTSLs is minor, restricted mostly to speculative hedge fund traders, transacted on a bid basis and can take as long as weeks to fill orders and for the transactions to settle. Therefore, the Company has concluded that the market for these securities is inactive where pricing quotes are sparse, incorporate large illiquidity premiums, and exist with dislocation between spreads and default activity resulting in difficulties in assessing relative observable market inputs to determine fair value. To determine PreTSL valuations, the Company uses an independent third party that employs Moody's Wall Street Analytics. Therefore, in lieu of a market-quote approach to determine fair value of the PreTSL portfolio, a fair value "Level 3" modeled income approach is utilized. The income approach maximizes the use of observable inputs and minimizes the use of unobservable inputs and is more representative of fair value than the market-quote approach in markets that are inactive. Core assumption categories are: probability of default; loss given defaults; industry-wide correlations, discount rate and structural behavior. Discounted cash flows are modeled via Monte Carlo simulation to

determine the orderly liquidation value as an indication of fair value of all tranches of each PreTSL.

For the nine months ended September 30, 2013, the Company engaged a structured finance products specialist firm to analyze the seven securities (eight tranches) in the portfolio that have an amortized cost basis. The analysis establishes a base of fundamental cash flow values to determine whether the Company will receive all of its principal and interest. One security (PreTSL XXVII) was deemed to have a high probability of receiving all principal and interest payments and thus impairment was considered temporary. The firm applied the following steps and assumptions to the remaining six securities to arrive at a single best estimate of cash flow that is used as a basis to determine the presence of OTTI:

- o Data about the transaction structure, as defined in the offering indenture and the underlying collateral, was collected;
- o The credit quality of the collateral was estimated using issuer specific probability of default for each security. Deferral of interest payments are treated as defaults. Once an issuer defaults, the potential for the tendency is correlated among other issuers. The loss given default, or the amount of cash lost to the investor is assumed to be 100% with no recovery of principal and no prepayments;
- o The analysis uses a Monte Carlo simulation framework to simulate the time-to-default on a portfolio of obligors based on individual obligor default probabilities and inter-obligor correlations;

- o Cash flow modeling was performed using the output from the simulation engine to arrive at the single best estimate of cash flow for each tranche;
- o Present value techniques as prescribed in the accounting guidance are used to determine the expected cash flows of each of the tranches. The present value technique for one of the OTTI securities is based upon a discount rate determined at the time of acquisition. For the other six OTTI securities, the discount rate used in the present value calculation is the yield to accrete beneficial interest;
- o The present value results are then compared to the present value cash flow results from the immediately prior measurement date. An adverse change in estimated cash flow from the previous measurement date is indicative of credit-related OTTI. If the present value of the cash flow is less than the amortized cost basis, the difference is charged to current earnings as an impairment loss on investment securities.

The results of the OTTI analysis (refer to Note 4, "Investment securities", within the notes to the consolidated financial statements for a description of the analysis performed) determined as of and for the nine months ended September 30, 2013, the estimated value, based on the expected discounted cash flow, of all securities was sufficient to recover the amortized cost basis, and therefore no credit-related OTTI was needed for the three- and nine- months ended September 30, 2013 compared to none for the three months and \$0.1 million for the nine months ended September 30, 2012. Credit-related OTTI is charged to current earnings as a component of other income in the consolidated statements of income. Future analyses could yield results that may be indicative of further impairment and may therefore require additional write-downs and corresponding credit related OTTI charges to current earnings.

#### Federal Home Loan Bank Stock

Investment in FHLB stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB of Pittsburgh. Excess stock is typically repurchased from the Company at par if the amount of borrowings decline to a predetermined level. In addition, the Company typically earns a return or dividend based on the amount invested. The \$0.5 million decrease in FHLB stock as of September 30, 2013 compared to year-end 2012 was due to the lower amount required based in part to lower balances of advances and also due to the lifting of the FHLB self-imposed temporary redemption suspension declared at the end of 2008. The suspension was declared until the health and performance of the FHLB strengthened to a level that it was prudent to resume stock redemptions and dividend payments.

#### Loans held-for-sale (HFS)

Upon origination, residential mortgages and certain small business administration (SBA) guaranteed loans may be classified as HFS. In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In low interest rate environments, the Company would be exposed to prepayment risk and, as rates on adjustable-rate loans decrease, interest income would be negatively affected. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as HFS. The carrying value of loans HFS is based on the lower of cost or estimated fair value. If the fair values of these loans decline below their original cost, the difference is written down and charged to current earnings. Subsequent appreciation in the portfolio is credited to current earnings but only to the extent of previous write-downs. As of September 30, 2013 and December 31, 2012, loans HFS consisted of residential mortgage loans.

At September 30, 2013, loans HFS had a carrying amount of \$0.9 million which approximated fair value, compared to \$10.5 million carrying value and \$10.8 million fair value, respectively, at December 31, 2012. During the nine months ended September 30, 2013, residential mortgage loans with principal balances of \$72.0 million were sold into the secondary market and the Company recognized net gains of approximately \$1.2 million, compared to \$63.9 million and \$1.3 million, respectively during the nine months ended September 30, 2012. In comparing the nine months ended September 30, 2013 and 2012, gains of \$41 thousand, deferred from sales of SBA loans in the fourth quarter of 2012, were recognized in the first quarter of 2013 compared to \$18 thousand in gains deferred from sales in

the second quarter of 2012.

The Company retains mortgage servicing rights (MSRs) on loans sold into the secondary market. MSRs are retained so that the Company can foster personal relationships with its loyal customer base. At September 30, 2013 and December 31, 2012, the servicing portfolio balance of sold residential mortgage loans was \$245.2 million and \$214.7 million, respectively.

#### Loans and leases

Asset quality continues to be the underlying consideration as our Company remains focused on managing, expanding and developing new relationships. We have found that our growth has been from the expansion of existing proven relationships as well as our referral sources such as attorneys and accountants who practice in our primary market of Luzerne and Lackawanna counties. The volume of activity is driven by demand, credit culture and anticipated interest rate levels. Our local economy although showing signs of improvement, continues to be plagued by poor performance in residential construction and the financial uncertainties of some municipalities. As a preferred lender under the Small Business Administration (SBA) we have opportunities to provide credit facilities to the business community. We will continue our efforts to be part of the growth of our local economy by providing financial services to our customers while at the same time having a conservative approach. We continue to enhance

our risk exposure through loan participations, utilizing various government guaranty programs and structuring the transaction accordingly.

#### Commercial and industrial

Comparing the commercial and industrial (C&I) loan portfolio at December 31, 2012 of \$65.1 million and \$66.6 million at September 30, 2013, there was a nominal increase of \$1.5 million, or 2%. The continued effort by branch personnel and their relationship manager partners has allowed us to maintain and expand our relationships.

#### Commercial real estate

The commercial real estate loan portfolio increased \$11.3 million, or 7%, from \$173.2 million at December 31, 2012 to \$184.5 million as of September 30, 2013. Our focus has been and will continue in the foreseeable future to be to provide funding in owner occupied and non-owner occupied real estate. The growth in commercial real estate is shared by both owner and non-owner occupied by \$3.9 million and \$7.3 million, respectively. Our underwriting in this area remains conservative and is cash flow driven. The real estate value is determined by an objective third party licensed appraiser and when appropriate, reviewed by an outside consultant. Our sales activity has and will continue to be focused on owner occupied real estate.

#### Consumer

The consumer loan portfolio increased by \$4.8 million, or 5%, from \$90.6 million at December 31, 2012 to \$95.4 million at September 30, 2013. The increase was primarily attributed to auto loans and leases which increased \$3.4 million or 20%. Home equity activity continues to be strong as well, showing increases in home equity installment and home equity lines of credit of \$0.8 million or 3% and \$1.1 million or 3%, respectively. The growth is the result of continued business development efforts focused on expanding dealer relationships and promotional activity targeting the home equity area.

#### Residential

The residential loan portfolio increased \$12.0 million, or 11%, from \$104.7 million at December 31, 2012 to \$116.7 million at September 30, 2013. The Company reintroduced a mortgage loan modification program with the focus on retaining mortgage loans with maturities of 10 years or less. The program attributed primarily to the increase in the residential loan portfolio in 2013. The minor variance in the construction portion of the residential loan portfolio includes loans of \$2.3 million that migrated to permanent financing during the current year third quarter.

The composition of the loan portfolio at September 30, 2013 and December 31, 2012, is summarized as follows:

(dollars in thousands)	September 30, 2013		December 31, 2012	
	Amount	%	Amount	%
Commercial and industrial	\$ 66,557	14.4 %	\$ 65,110	15.0 %
Commercial real estate:				
Non-owner occupied	89,268	19.3	81,998	18.9
Owner occupied	84,411	18.2	80,509	18.6
Construction	10,776	2.3	10,679	2.5
Consumer:				

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Home equity installment	33,666	7.3	32,828	7.6
Home equity line of credit	35,305	7.6	34,169	7.9
Auto loans and leases	20,838	4.5	17,411	4.0
Other	5,587	1.2	6,139	1.4
Residential:				
Real estate	108,919	23.5	96,765	22.3
Construction	7,833	1.7	7,948	1.8
Gross loans	463,160	100.0 %	433,556	100.0 %
Less:				
Allowance for loan losses	(8,405)		(8,972)	
Unearned lease revenue	(55)		-	
Net loans	\$ 454,700		\$ 424,584	
Loans held-for-sale	\$ 903		\$ 10,545	

Allowance for loan losses

Management evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance for loan losses (the allowance) on a quarterly basis. The allowance reflects management's best estimate of the amount

of credit losses in the loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. The provision for loan losses represents the amount necessary to maintain an appropriate allowance. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

Management applies two primary components during the loan review process to determine proper allowance levels. The two components are a specific loan loss allocation for loans that are deemed impaired and a general loan loss allocation for those loans not specifically allocated. The methodology to analyze the adequacy of the allowance for loan losses is as follows:

- identification of specific impaired loans by loan category;
- calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;
- application of historical loss percentages (two-year average) to pools to determine the allowance allocation;
- application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio, and/or current economic conditions.

Allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk grading of individual commercial loans. Commercial loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed. The credit risk grades may be changed at any time management determines an upgrade or downgrade may be warranted. The credit risk grades for the commercial loan portfolio are taken into account in the reserve methodology and loss factors are applied based upon the credit risk grades. The loss factors applied are based upon the Company's historical experience as well as what management believes to be best practices and within common industry standards. Historical experience reveals there is a direct correlation between the credit risk grades and loan charge-offs. The changes in allocations in the commercial loan portfolio from period-to-period are based upon the credit risk grading system and from periodic reviews of the loan portfolio.

Each quarter, management performs an assessment of the allowance and the provision for loan losses. The Company's Special Assets Committee meets formally on a quarterly basis, or more frequently if necessary, and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based on current accounting guidelines. The Special Assets Committee's focus is on ensuring the pertinent facts are considered and the reserve amounts pursuant to the accounting principles are reasonable. The assessment process includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company's Credit Administration function have assigned a criticized or classified risk rating.

Total net charge-offs for the nine months ended September 30, 2013 were \$2.2 million compared to \$2.0 million for the nine months ended September 30, 2012. This increase is related, in part, to the charge down on one owner-occupied commercial real estate non-accrual loan in the first quarter of 2013. This loan carried a specific



reserve as of December 31, 2012, based on the estimated net realizable value of the loan's collateral. This collateral was sold on May 10, 2013 and no material charge offs or expenses were subsequently incurred. For a discussion on the provision for loan losses, see the "Provision for loan losses," located in the results of operations section of management's discussion and analysis contained herein.

The allowance for loan losses was \$8.4 million as of September 30, 2013, compared to \$9.0 million at December 31, 2012. Management believes that the current balance in the allowance for loan losses is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but inherent to the portfolio. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status nor past due 90 days or more. There could be additional instances which become identified in future periods that may require additional charge-offs and/or increases to the allowance due to continued sluggishness in the economy and pressure on property values.

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The following tables set forth the activity in the allowance for loan losses and certain key ratios for the period indicated:

(dollars in thousands)	As of and for the nine months ended September 30, 2013	As of and for the twelve months ended December 31, 2012	As of and for the nine months ended September 30, 2012			
Balance at beginning of period	\$ 8,972	\$ 8,108	\$ 8,108			
Charge-offs:						
Commercial and industrial	56	185	135			
Commercial real estate	1,815	1,335	1,258			
Consumer	274	737	491			
Residential	158	231	121			
Total	2,303	2,488	2,005			
Recoveries:						
Commercial and industrial	8	26	23			
Commercial real estate	28	46	-			
Consumer	99	30	16			
Residential	1	-	-			
Total	136	102	39			
Net charge-offs	2,167	2,386	1,966			
Provision for loan losses	1,600	3,250	2,000			
Balance at end of period	\$ 8,405	\$ 8,972	\$ 8,142			
Net charge-offs (annualized) to average total loans outstanding	0.95	%	0.56	%	0.62	%
Allowance for loan losses to net charge-offs (annualized)	1.94	x	3.76	x	3.11	x
Allowance for loan losses to total loans	1.81	%	2.02	%	1.89	%
Loans 30 - 89 days past due and accruing	\$ 3,276		\$ 2,920		\$ 6,551	
Loans 90 days or more past due and accruing	\$ 345		\$ 1,723		\$ 604	
Non-accrual loans	\$ 6,148		\$ 12,121		\$ 12,466	
Allowance for loan losses to loans 90 days or more past due and accruing	24.36	x	5.21	x	13.48	x
Allowance for loan losses to non-accrual loans	1.37	x	0.74	x	0.65	x
Allowance for loan losses to non-performing loans	1.29	x	0.65	x	0.62	x
Average total loans	\$ 458,325		\$ 426,636		\$ 424,050	

The allowance for loan losses can generally absorb losses throughout the loan portfolio. However, in some instances an allocation is made for specific loans or groups of loans. Allocation of the allowance for loan losses for different categories of loans is based on the methodology used by the Company, as previously explained. The changes in the allocations from period-to-period are based upon year-end reviews of the loan portfolio.

## Non-performing assets

The Company defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, troubled debt restructured loans (TDRs), other real estate owned (ORE), repossessed assets and non-accrual investment securities. As of September 30, 2013, non-performing assets represented 1.82% of total assets reduced from 2.94% at December 31, 2012, mainly resulting from the reduction of residential and commercial loans 90 days or more past due and accruing, coupled with a reduction in residential, consumer and commercial loans on non-accrual status. Most of the non-performing loans are collateralized, thereby mitigating the Company's potential for loss. At September 30, 2013, \$1.2 million of corporate bonds consisting of pooled trust preferred securities were on non-accrual status, compared to \$1.1 million at December 31, 2012. For a further discussion on the Company's securities portfolio, see Note 4, "Investment securities", within the notes to the consolidated financial statements and the section entitled "Investments", contained within this management's discussion and analysis section.

The following table sets forth non-performing assets data as of the period indicated:

(dollars in thousands)	September 30, 2013	December 31, 2012	September 30, 2012
Loans past due 90 days or more and accruing	\$ 345	\$ 1,723	\$ 604
Non-accrual loans *	6,148	12,121	12,466
Total non-performing loans	6,493	13,844	13,070
Troubled debt restructurings	1,059	1,103	1,108
Other real estate owned and repossessed assets	2,966	1,607	1,610
Non-accrual securities	1,166	1,132	965
Total non-performing assets	\$ 11,684	\$ 17,686	\$ 16,753
Total loans, including loans held-for-sale	\$ 464,008	\$ 444,101	\$ 430,914
Total assets	\$ 640,294	\$ 601,525	\$ 615,447
Non-accrual loans to total loans	1.32%	2.73%	2.89%
Non-performing loans to total loans	1.40%	3.12%	3.03%
Non-performing assets to total assets	1.82%	2.94%	2.72%

\* In the table above, the amount includes non-accrual TDRs of \$1.0 million as of September 30, 2013 and \$1.1 million as of December 31, 2012 and September 30, 2012, respectively.

In the review of loans for both delinquency and collateral sufficiency, management concluded that there were a number of loans that lacked the ability to repay in accordance with contractual terms. The decision to place loans on non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. Generally, commercial loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by residential real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest, and unsecured consumer loans are charged-off when the loan is 90 days or more past due as to principal and interest. Uncollected interest income accrued on all loans placed on non-accrual is reversed and charged to interest income.

Non-performing loans decreased \$7.3 million, or 53%, from \$13.8 million on December 31, 2012 to \$6.5 million at September 30, 2013. Non-performing loans consist of loans over 90 days past due and accruing and non-accrual loans. As of year-end 2012, there were seventeen loans to sixteen unrelated borrowers aggregating \$1.7 million in the over 90 day category ranging from less than \$1 thousand to \$0.6 million. At September 30, 2013, the over 90 days past due portion was \$0.3 million and was comprised of five loans to five unrelated borrowers, ranging from \$6 thousand to \$177 thousand. Of the five loans past due over 90 days, one loan, totaling \$0.2 million was a residential mortgage and two loans were secured commercial loans aggregating \$0.1 million, to unrelated borrowers. The Company seeks payments from all past due customers through an aggressive customer communication process. However, these loans remained past due after the quarter ended.

A past due loan will be placed on non-accrual at the 90-day point when it is deemed that a customer is non-responsive and uncooperative to collection efforts. At December 31, 2012, there were 65 loans to 57 unrelated borrowers ranging from less than \$1 thousand to \$3.2 million in the non-accrual category. At September 30, 2013, there were 45 loans to 34 unrelated borrowers ranging from less than \$1 thousand to \$1.0 million in the non-accrual category. The decrease

in non-accrual loans during the nine months ended September 30, 2013 was related to loans that were charged off, paid off, transferred to ORE or moved back to accrual status.

At September 30, 2013, the non-accrual loans aggregated \$6.1 million as compared to \$12.1 million at December 31, 2012. The net decrease in the level of non-accrual loans during the period ending September 30, 2013 occurred as follows: additions to the non-accrual loan component of the non-performing assets totaling \$1.8 million were made during the period; these were offset by reductions or payoffs of \$3.1 million, charge-offs of \$2.1 million, \$2.0 million of transfers to ORE and \$0.6 million of loans that returned to performing status. Loans past due 90 days or more and accruing were \$0.3 million at September 30, 2013, compared to \$1.7 million as of December 31, 2012. The ratio of non-performing loans to total loans was 1.40% at September 30, 2013 compared to 3.12% at December 31, 2012.

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The composition of non-performing loans as of September 30, 2013 is as follows:

	Gross loan balances	Past due 90 days or more accruing and still	Non- accrual loans	Total non- performing loans	% of gross loans
(dollars in thousands)					
Commercial and industrial	\$ 66,557	\$ 7	\$ 99	\$ 106	0.16%
Commercial real estate:					
Non-owner occupied	89,268	133	1,498	1,631	1.83%
Owner occupied	84,411	-	1,630	1,630	1.93%
Construction	10,776	-	779	779	7.23%
Consumer:					
Home equity installment	33,666	-	299	299	0.89%
Home equity line of credit	35,305	22	393	415	1.18%
Auto loans and leases	20,783	6	12	18	0.09%
Other	5,587	-	-	-	-
Residential:					
Real estate	108,919	177	1,438	1,615	1.48%
Construction	7,833	-	-	-	-
Loans held-for-sale	903	-	-	-	-
Total	\$ 464,008	\$ 345	\$ 6,148	\$ 6,493	1.40%

Payments received from non-accrual loans are recognized on a cash method. Payments are first applied against the outstanding principal balance, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of interest income. For the first nine months of 2013, \$59 thousand in cash basis interest income was recognized. If the non-accrual loans that were outstanding as of September 30, 2013 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of \$0.2 million during the nine months ended September 30, 2013.

The Company, on a regular basis, reviews changes to loans to determine if they meet the definition of a TDR. TDRs arise when a borrower experiences financial difficulty and the Company grants a concession that it would not otherwise grant based on current underwriting standards in order to maximize the Company's recovery. TDRs aggregated \$2.0 million at September 30, 2013, which was a slight decrease from the December 31, 2012 total of \$2.2 million.

The following tables set forth the activity in TDRs as and for the periods indicated:

As of and for the nine months  
ended September 30, 2013

(dollars in thousands)	Accruing Commercial & Commercial industrial estate	Non-accruing Commercial real estate	Total
Troubled Debt Restructures:			
Beginning balance	\$ 42 \$ 1,061	\$ 1,066	\$ 2,169
Pay downs / payoffs	5 39	87	131
Ending balance	\$ 37 \$ 1,022	\$ 979	\$ 2,038

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As of and for the year ended December 31, 2012

(dollars in thousands)	Accruing Commercial & Commercial industrial real estate	Non-accruing Commercial real estate	Total
Troubled Debt Restructures:			
Beginning balance	\$ 44 \$ 5,270	\$ 1,395	\$ 6,709
Pay downs / payoffs	2 4,998	129	5,129
Advance on balance	- 789	-	789
Charge offs	- -	200	200
Ending balance	\$ 42 \$ 1,061	\$ 1,066	\$ 2,169

If applicable, a TDR loan classified as non-accrual would require a minimum of six months of payments before consideration for a return to accrual status. Concessions made to borrowers typically involve an extension of the loan's maturity date or a change in the loan's amortization period. The Company believes concessions have been made in the best interests of the borrower and the Company. The Company has not reduced interest rates or forgiven principal with respect to these loans. If loans characterized as a TDR perform according to the restructured terms for a satisfactory period of time, the TDR designation may be removed in a new calendar year if the loan yields a market rate of interest.

#### Foreclosed assets held-for-sale

Foreclosed assets held-for-sale aggregated \$3.0 million at September 30, 2013 and \$1.6 million at December 31, 2012. The following table sets forth the activity in the ORE component of foreclosed assets held-for-sale:

(dollars in thousands)	September 30, 2013 Amount #	December 31, 2012 Amount #
Balance at beginning of period	\$ 1,600 12	\$ 1,169 6
Additions	2,180 13	1,778 14
Pay downs	(34)	(92)
Write downs	(109)	(86)
Sold	(671) (7)	(1,169) (8)
Balance at end of period	\$ 2,966 18	\$ 1,600 12



As of December 31, 2012, the ORE balance consisted of: nine properties totaling \$0.8 million from 2012 additions; two properties aggregating \$0.2 million acquired in 2011 and one property acquired in 2010 for \$0.6 million. As of September 30, 2013, thirteen properties were added to ORE and seven were sold, bringing the total to eighteen, which contributed an additional \$2.2 million to ORE for the first nine months of 2013. Four of the properties that were sold were added to ORE in 2012 and three were added in 2013. Of these thirteen properties added in the first nine months of 2013, three were commercial real estate and ten were residential real estate. Of the eighteen ORE properties as of September 30, 2013, which stemmed from seventeen unrelated borrowers, thirteen are listed for sale, two have signed sales agreements, three are in litigation.

#### Other assets

The increase in other assets of \$1.2 million, or 9%, consisted principally of \$0.9 million for automobile lease residual values and \$0.3 million each for a larger mortgage servicing portfolio and expenditures for construction in process.

#### Funds Provided:

#### Deposits

The Company is a community based commercial depository financial institution, member FDIC, which offers a variety of deposit products with varying ranges of interest rates and terms. Deposit products include transaction accounts such as: savings; clubs; interest-bearing checking (NOW); money market and non-interest bearing checking (DDA). The Company also offers short- and long-term deposit accounts such as certificates of deposit. Certificates of deposit, or CDs, are deposits with stated maturities which can range from seven days to ten years. The flow of deposits is influenced by economic conditions, changes in the interest rate environment, pricing and competition. To determine interest rates on its deposit products, the Company considers local competition, spreads to earning-asset yields, liquidity position and rates charged for alternative sources of funding such as short-

term borrowings and FHLB advances.

The following table represents the components of deposits as of the date indicated:

(dollars in thousands)	September 30, 2013		December 31, 2012	
	Amount	%	Amount	%
Money market	\$ 80,973	14.9 %	\$ 76,571	14.9 %
Interest-bearing checking	102,098	18.7	87,981	17.1
Savings and clubs	110,092	20.2	107,447	20.8
Certificates of deposit	117,553	21.6	116,626	22.7
Total interest-bearing	410,716	75.4	388,625	75.5
Non-interest bearing	134,114	24.6	126,035	24.5
Total deposits	\$ 544,830	100.0 %	\$ 514,660	100.0 %

Total deposits increased \$30.1 million, or 6%, from \$514.7 million at December 31, 2012 to \$544.8 million at September 30, 2013. Interest-bearing checking had the most significant growth at \$14.1 million or 16%, however all deposit categories displayed growth. Generally, deposits are obtained from consumers, businesses and public entities within the communities that surround the Company's 11 branch offices and all deposits are insured by the FDIC up to the full extent permitted by law.

Though the rates along the treasury yield curve have begun to slowly rise, the relatively low interest rate environment continues to cause business and retail customers to seek short-term alternatives for their deposits. Business interest-bearing checking accounts benefited the most from this strategy followed by retail savings and money market accounts as customers continued to move cash into non-maturing, readily available deposit accounts. The Company's focus continues to be on the acquisition and retention of retail and business households with a strong emphasis on deepening and broadening those relationships. The increase in non-interest bearing checking accounts was due to the continued development of the relationship within our business community.

The Company uses the Certificate of Deposit Account Registry Service (CDARS) reciprocal program to obtain FDIC insurance protection for customers who have large deposits that at times may exceed the FDIC maximum amount of \$250,000. In the CDARS program, deposits with varying terms and interest rates, originated in the Company's own markets, are exchanged for deposits of other financial institutions that are members in the CDARS network. By placing these deposits in other participating institutions, the deposits of our customers are fully insured by the FDIC. In return for deposits placed with network institutions, the Company receives from network institutions deposits that are approximately equal in amount and are comprised of terms similar to those placed for our customers. Deposits the Company receives, or reciprocal deposits, from other institutions are considered brokered deposits by regulatory definitions. As of September 30, 2013 and December 31, 2012, CDARS represented \$11.8 million and \$10.2 million, respectively, or 2%, of total deposits.

Excluding CDARS, certificates of deposit accounts of \$100,000 or more amounted to \$41.2 million and \$41.8 million at September 30, 2013 and December 31, 2012, respectively. Certificates of deposit of \$250,000 or more amounted to \$15.4 million and \$16.2 million as of September 30, 2013 and December 31, 2012, respectively.

Including CDARS, approximately 20% of the CDs, with a weighted-average interest rate of 0.76%, are scheduled to mature in 2013 and an additional 36%, with a weighted-average interest rate of 0.93%, are scheduled to mature in

2014. Renewing CDs may re-price to lower or higher market rates depending on the rate on the maturing CD, the direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative, non-term products. In this current low interest rate environment, a widespread preference has been for customers with maturing CDs to hold their deposits in readily available transaction accounts. Though the CD portfolio has increased slightly since year-end 2012, when interest rates begin to rise the Company expects CDs to trend back toward historical levels.

#### Borrowings

Borrowings are used as a complement to deposit generation as an alternative funding source whereby the Company will borrow under customer repurchase agreements in the local market, advances from the Federal Home Loan Bank of Pittsburgh (FHLB) and other correspondent banks for asset growth and liquidity needs.

Repurchase agreements are non-insured interest-bearing liabilities that have a perfected security interest in qualified investments of the Company. The FDIC Depositor Protection Act of 2009 requires banks to provide a perfected security interest to the purchasers of uninsured repurchase agreements. Repurchase agreements are offered through a sweep product. A sweep account is designed to ensure that on a daily basis, an attached DDA is adequately funded and excess funds are transferred, or swept, into an interest-bearing overnight repurchase agreement account. Due to the constant inflow and outflow of funds of the sweep product, their balances tend to be somewhat volatile, similar to a DDA. Customer liquidity is the typical cause for variances in repurchase agreements, which during the first nine months of 2013 increased \$6.1 million, or 76%, from year-end December 31, 2012. In addition, short-term borrowings may include overnight balances which the Company may require to fund daily liquidity needs such as deposit and repurchase agreement cash outflow, loan demand and operations. At September 30, 2013 and December 31,

2012, the Company did not have a balance in overnight borrowings.

The following table represents the components of borrowings as of the date indicated:

(dollars in thousands)	September 30, 2013		December 31, 2012	
	Amount	%	Amount	%
Securities sold under repurchase agreements	\$ 14,197	47.0 %	\$ 8,056	33.5 %
Long-term FHLB advances	16,000	53.0	16,000	66.5
Total	\$ 30,197	100.0 %	\$ 24,056	100.0 %

### Item 3. Quantitative and Qualitative Disclosure About Market Risk

Management of interest rate risk and market risk analysis.

The adequacy and effectiveness of an institution's interest rate risk management process and the level of its exposures are critical factors in the regulatory evaluation of an institution's sensitivity to changes in interest rates and capital adequacy. Management believes the Company's interest rate risk measurement framework is sound and provides an effective means to measure, monitor, analyze, identify and control interest rate risk in the balance sheet.

The Company is subject to the interest rate risks inherent in its lending, investing and financing activities. Fluctuations of interest rates will impact interest income and interest expense along with affecting market values of all interest-earning assets and interest-bearing liabilities, except for those assets or liabilities with a short term remaining to maturity. Interest rate risk management is an integral part of the asset/liability management process. The Company has instituted certain procedures and policy guidelines to manage the interest rate risk position. Those internal policies enable the Company to react to changes in market rates to protect net interest income from significant fluctuations. The primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on net interest income along with creating an asset/liability structure that maximizes earnings.

**Asset/Liability Management.** One major objective of the Company when managing the rate sensitivity of its assets and liabilities is to stabilize net interest income. The management of and authority to assume interest rate risk is the responsibility of the Company's Asset/Liability Committee (ALCO), which is comprised of senior management and members of the board of directors. ALCO meets quarterly to monitor the relationship of interest sensitive assets to interest sensitive liabilities. The process to review interest rate risk is a regular part of managing the Company. Consistent policies and practices of measuring and reporting interest rate risk exposure, particularly regarding the treatment of non-contractual assets and liabilities, are in effect. In addition, there is an annual process to review the interest rate risk policy with the board of directors which includes limits on the impact to earnings from shifts in interest rates.

**Interest Rate Risk Measurement.** Interest rate risk is monitored through the use of three complementary measures: static gap analysis, earnings at risk simulation and economic value at risk simulation. While each of the interest rate

risk measurements has limitations, collectively, they represent a reasonably comprehensive view of the magnitude of interest rate risk in the Company and the distribution of risk along the yield curve, the level of risk through time and the amount of exposure to changes in certain interest rate relationships.

**Static Gap.** The ratio between assets and liabilities re-pricing in specific time intervals is referred to as an interest rate sensitivity gap. Interest rate sensitivity gaps can be managed to take advantage of the slope of the yield curve as well as forecasted changes in the level of interest rate changes.

To manage this interest rate sensitivity gap position, an asset/liability model commonly known as cumulative gap analysis is used to monitor the difference in the volume of the Company's interest sensitive assets and liabilities that mature or re-price within given time intervals. A positive gap (asset sensitive) indicates that more assets will re-price during a given period compared to liabilities, while a negative gap (liability sensitive) has the opposite effect. The Company employs computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest-sensitive assets and liabilities in order to determine what impact these rate changes will have upon the net interest spread. At September 30, 2013, the Company maintained a one-year cumulative gap of positive (asset sensitive) \$69.4 million, or 11%, of total assets. The effect of this positive gap position provided a mismatch of assets and liabilities which may expose the Company to interest rate risk during periods of falling interest rates. Conversely, in an increasing interest rate environment, net interest income could be positively impacted because more assets than liabilities will re-price upward during the one-year period.

Certain shortcomings are inherent in the method of analysis discussed above and presented in the next table. Although certain assets and liabilities may have similar maturities or periods of re-pricing, they may react in different degrees to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. Certain assets,

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such as adjustable-rate mortgages, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the table amounts. The ability of many borrowers to service their adjustable-rate debt may decrease in the event of an interest rate increase.

The following table illustrates the Company's interest sensitivity gap position at September 30, 2013:

(dollars in thousands)	Three months or less	More than three months to twelve months	More than one year to three years	More than three years	Total
Cash and cash equivalents	\$ 21,954	\$ -	\$ -	\$ 13,931	\$ 35,885
Investment securities <sup>(1)(2)</sup>	3,299	8,505	22,053	71,414	105,271
Loans and leases <sup>(2)</sup>	170,055	64,036	112,629	108,883	455,603
Fixed and other assets	-	10,316	-	33,219	43,535
Total assets	\$ 195,308	\$ 82,857	\$ 134,682	\$ 227,447	\$ 640,294
Total cumulative assets	\$ 195,308	\$ 278,165	\$ 412,847	\$ 640,294	
Non-interest-bearing transaction deposits <sup>(3)</sup>	\$ -	\$ 13,425	\$ 36,854	\$ 83,835	\$ 134,114
Interest-bearing transaction deposits <sup>(3)</sup>	102,348	17,967	117,588	55,260	293,163
Certificates of deposit	23,629	37,165	48,140	8,619	117,553
Repurchase agreements	14,197	-	-	-	14,197
Short-term borrowings	-	-	-	-	-
Long-term debt	-	-	16,000	-	16,000
Other liabilities	-	-	-	3,471	3,471
Total liabilities	\$ 140,174	\$ 68,557	\$ 218,582	\$ 151,185	\$ 578,498
Total cumulative liabilities	\$ 140,174	\$ 208,731	\$ 427,313	\$ 578,498	
Interest sensitivity gap	\$ 55,134	\$ 14,300	\$ (83,900)	\$ 76,262	
Cumulative gap	\$ 55,134	\$ 69,434	\$ (14,466)	\$ 61,796	
Cumulative gap to total assets	8.6%	10.8%	-2.3%	9.7%	

(1) Includes FHLB stock and the net unrealized gains/losses on available-for-sale securities.

(2) Investments and loans are included in the earlier of the period in which interest rates were next scheduled to adjust or the period in which they are due. In addition, loans were included in the periods in which they are scheduled to be repaid based on scheduled amortization. For amortizing loans and MBS – GSE residential, annual prepayment rates are assumed reflecting historical experience as well as management's knowledge and experience of its loan products.

(3) The Company's demand and savings accounts were generally subject to immediate withdrawal. However, management considers a certain amount of such accounts to be core accounts having significantly longer effective maturities based on the retention experiences of such deposits in changing interest rate environments. The effective maturities presented are the recommended maturity distribution limits for non-maturing deposits based on historical deposit studies.

Earnings at Risk and Economic Value at Risk Simulations. The Company recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet that extend beyond static re-pricing gap analysis. Although it will continue to measure its re-pricing gap position, the Company utilizes additional modeling for identifying and measuring the interest rate risk in the overall balance sheet. The ALCO is responsible for focusing on “earnings at risk” and “economic value at risk”, and how both relate to the risk-based capital position when analyzing the interest rate risk.

Earnings at Risk. An earnings at risk simulation measures the change in net interest income and net income should interest rates rise and fall. The simulation recognizes that not all assets and liabilities re-price one-for-one with market rates (e.g., savings rate). The ALCO looks at “earnings at risk” to determine income changes from a base case scenario under an increase and decrease of 200 basis points in interest rate simulation models.

Economic Value at Risk. An earnings at risk simulation measures the short-term risk in the balance sheet. Economic value (or portfolio equity) at risk measures the long-term risk by finding the net present value of the future cash flows from the Company’s existing assets and liabilities. The ALCO examines this ratio quarterly utilizing an increase and decrease of 200 basis points in interest rate simulation models. The ALCO recognizes that, in some instances, this ratio may contradict the “earnings at risk” ratio.

The following table illustrates the simulated impact of an immediate 200 basis points upward or downward movement in interest rates on net interest income, net income and the change in the economic value (portfolio equity). This analysis assumed that interest-earning asset and interest-bearing liability levels at September 30, 2013 remained constant. The impact of the rate

movements was developed by simulating the effect of the rate change over a twelve-month period from the September 30, 2013 levels:

	% change	
	Rates +200	Rates -200
Earnings at risk:		
Net interest income	7.6	(3.2)%
Net income	23.9	(9.5)
Economic value at risk:		
Economic value of equity	(12.8)	(8.4)
Economic value of equity as a percent of total assets	(1.4)	(0.9)

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may normally change beyond the Company's policy guideline for a short period of time as long as the risk-based capital ratio (after adjusting for the excess equity exposure) is greater than 10%. At September 30, 2013, the Company's risk-based capital ratio was 13.9%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning October 1, 2013, under alternate interest rate scenarios using the income simulation model described above:

(dollars in thousands)	Net		
	interest income	\$ variance	% variance
Simulated change in interest rates			
+200 basis points	\$ 22,305	\$ 1,585	7.6 %
+100 basis points	21,351	631	3.0
Flat rate	20,720	-	-
-100 basis points	20,559	(161)	(0.8)
-200 basis points	20,066	(654)	(3.2)

Simulation models require assumptions about certain categories of assets and liabilities. The models schedule existing assets and liabilities by their contractual maturity, estimated likely call date or earliest re-pricing opportunity. MBS – GSE residential securities and amortizing loans are scheduled based on their anticipated cash flow including estimated prepayments. For investment securities, the Company uses a third-party service to provide cash flow estimates in the various rate environments. Savings, money market and interest-bearing checking accounts do not have stated maturities or re-pricing terms and can be withdrawn or re-price at any time. This may impact the margin if more expensive alternative sources of deposits are required to fund loans or deposit runoff. Management projects the re-pricing characteristics of these accounts based on historical performance and assumptions that it believes reflect their rate sensitivity. The model reinvests all maturities, repayments and prepayments for each type of asset or liability into the same product for a new like term at current product interest rates. As a result, the mix of



interest-earning assets and interest bearing-liabilities is held constant.

## Liquidity

Liquidity management ensures that adequate funds will be available to meet customers' needs for borrowings, deposit withdrawals and maturities, facility expansion and normal operating expenses of the Company. Sources of liquidity are cash and cash equivalents, asset maturities and pay-downs within one year, loans HFS, investments AFS, growth of core deposits and repurchase agreements, utilization of borrowing capacities from the FHLB, correspondent banks, CDARs, the Discount Window of the Federal Reserve Bank of Philadelphia (FRB) and proceeds from the issuance of capital stock. Though regularly scheduled investment and loan payments are dependable sources of daily liquidity, sales of both loans HFS and investments AFS, deposit activity and investment and loan prepayments are significantly influenced by general economic conditions and the interest rate environment. During low and declining interest rate environments, prepayments from interest-sensitive assets tend to accelerate and provide significant liquidity that can be used to invest in other interest-earning assets but at lower market rates. Conversely, in periods of high or rising interest rates, prepayments from interest-sensitive assets tend to decelerate causing cash flow from mortgage loans and mortgage-backed securities to decrease. Rising interest rates may also cause deposit inflow to accelerate but priced at higher market interest rates. Rising rates may also cause deposit outflow due to higher rates offered by the Company's competition for similar products. The Company closely monitors activity in the capital markets and takes appropriate action to ensure that the liquidity levels are adequate for funding, investing and operating activities.

The Company utilizes a contingency funding plan (CFP) that sets a framework for handling liquidity issues in the event circumstances arise which the Company deems to be less than normal. To accomplish this, the Company established guidelines for identifying, measuring, monitoring and managing the resolution of potentially serious liquidity crises. The Company's CFP outlines required monitoring tools, acceptable alternative funding sources and required actions during various liquidity scenarios.

Thus, the Company has implemented a proactive means for the measurement and resolution for handling potentially significant adverse liquidity conditions. At least quarterly, the CFP monitoring tools, current liquidity position and monthly projected liquidity sources and uses are presented and reviewed by the Company's ALCO. As of September 30, 2013 the Company had not experienced any adverse liquidity issues that would give rise to its inability to raise liquidity in an emergency situation.

During the nine months ended September 30, 2013, the Company generated \$14.0 million of cash. During the period, the Company's operations provided approximately \$19.3 million, mostly from \$12.6 million of net cash inflow from originating and selling residential mortgage loans, \$15.6 million of net cash inflow from the components of net interest income partially offset from net non-interest expense/income related payments. Liquidity generated from operations, deposit inflow and short-term borrowings were used to fund growth in the loan portfolio, dividend payments and premises and equipment acquisition, including construction in process. The \$35.9 million of cash on hand as of September 30, 2013 is expected to be used to fund deposit outflow and to grow interest-earning assets - mostly in the loan portfolio and also for facility and technology upgrades. The seasonal nature of deposit balances from municipalities and other public funding sources requires the Company to be prepared for the inherent volatility and the unpredictable timing of cash outflow from this loyal customer base.

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers and in connection with the overall interest rate management strategy. These instruments involve, to a varying degree, elements of credit, interest rate and liquidity risk. In accordance with GAAP, these instruments are either not recorded in the consolidated financial statements or are recorded in amounts that differ from the notional amounts. Such instruments primarily include lending commitments and lease obligations.

Lending commitments include commitments to originate loans and commitments to fund unused lines of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

In addition to lending commitments, the Company has contractual obligations related to operating lease commitments. Operating lease commitments are obligations under various non-cancelable operating leases on buildings and land used for office space and banking purposes. The Company's position with respect to lending commitments and significant contractual obligations, both on a short- and long-term basis has not changed materially from December 31, 2012.

As of September 30, 2013, the Company maintained \$35.9 million in cash and cash equivalents and \$103.8 million of investments AFS and loans HFS. Also as of September 30, 2013, the Company had approximately \$155.7 million available to borrow from the FHLB, \$21.0 million from correspondent banks, \$26.1 million from the FRB and \$32.0 million from the CDARS program. The combined total of \$374.5 million represented 58% of total assets at September 30, 2013. Management believes this level of liquidity to be strong and adequate to support current operations.

## Capital

During the nine months ended September 30, 2013, total shareholders' equity increased \$2.9 million, or 5%, due principally from \$4.4 million in net income, \$1.0 million of capital contributions from activities in the Company's dividend reinvestment and employee stock purchase plans (DRP and ESPP, respectively), partially offset by \$1.8 million of dividends declared and by \$0.9 million of other comprehensive losses from the decline in the fair value of the Company's AFS investment portfolio.

As of September 30, 2013, the Company reported a net unrealized loss position of \$0.7 million, net of tax, from the securities AFS portfolio compared to a net unrealized gain of \$0.2 million as of December 31, 2012. During the past several years, the sluggish economy has created uncertainty and illiquidity in the financial and capital markets and has created unpredictable volatility on the fair value estimates for securities in banks' investment portfolios. Management believes that most of the volatility in fair value of securities is due to changes in interest rates, which have begun to slowly rise, and liquidity complications in the financial markets and to a lesser extent to the deterioration in the creditworthiness of the issuers. When U.S. Treasury rates rise, investment securities' pricing will decline and fair values of investment securities will also decline. Bond prices tend to move inversely to the movement of interest rates. During the nine months ended September 30, 2013, the fair value of the Company's pooled trust preferred securities increased \$1.1 million, or 61%, as the net unrealized loss declined by \$1.3 million including \$0.2 million in cash payments. The Company did not incur credit related impairment charges for the nine months ended September 30, 2013 nor did the Company incur non-credit related impairment losses in the nine months ended September 30, 2013. The remainder of the AFS investment portfolio is recorded at an unrealized gain of \$2.2 million. Nonetheless, given the fragile condition of the capital markets, especially in the pooled trust preferred segment, and the prospects that rates will continue to rise, there is no assurance that future realized and unrealized losses will not be recognized from the Company's investment portfolio. To help maintain a healthy capital position, the Company expects to continue to issue stock to participants in the DRP and ESPP plans, a consistent source of capital from the Company's loyal employees and shareholders.

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company

and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets. The appropriate risk-weighting pursuant to regulatory guidelines, requires a gross-up in the risk-weighting of securities that are rated below investment grade, thus significantly inflating the total risk-weighted assets. This requirement had an adverse impact on the total capital and Tier I capital ratios in both 2013 and 2012. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I capital to total risk-weighted assets (Tier I Capital) of 4% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. As of September 30, 2013, the Company and the Bank exceeded all capital adequacy requirements to which it was subject.

The Company continues to closely monitor and evaluate alternatives to enhance its capital ratios as the regulatory and economic environments change. The following table depicts the capital amounts and ratios of the Company and the Bank as of September 30, 2013:

(dollars in thousands)	Actual		For capital adequacy purposes		To be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of September 30, 2013:						
Total capital (to risk-weighted assets)						
Consolidated	\$ 68,629	13.9%	≥ \$ 39,468	≥ 8.0%	N/A	N/A
Bank	\$ 68,324	13.9%	≥ \$ 39,463	≥ 8.0%	≥ \$ 49,329	≥10.0%
Tier I capital (to risk-weighted assets)						
Consolidated	\$ 62,333	12.6%	≥ \$ 19,734	≥ 4.0%	N/A	N/A
Bank	\$ 62,129	12.6%	≥ \$ 19,732	≥ 4.0%	≥ \$ 29,597	≥6.0%
Tier I capital (to average assets)						
Consolidated	\$ 62,333	10.0%	≥ \$ 24,830	≥ 4.0%	N/A	N/A
Bank	\$ 62,129	10.0%	≥ \$ 24,814	≥ 4.0%	≥ \$ 31,018	≥5.0%

The Company advises readers to refer to the Supervision and Regulation section of Management's Discussion and Analysis of Financial Condition and Results of Operation, of its 2012 Form 10-K for a discussion on the regulatory environment and recent legislation and rulemaking.

#### Regulatory Capital Changes

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations begins January 1, 2015, while larger institutions (generally those with assets of \$250 billion or more) must begin compliance on January 1, 2014. The final rules call for the following capital requirements:

- A minimum ratio of common tier 1 capital to risk-weighted assets of 4.5%.
- A minimum ratio of tier 1 capital to risk-weighted assets of 6%.
- A minimum ratio of total capital to risk-weighted assets of 8% (no change from current rule).
- A minimum leverage ratio of 4%.

In addition, the final rules establishes a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation and countercyclical capital buffers for all banking organizations will begin on January 1, 2016.

Under the proposed rules, accumulated other comprehensive income (AOCI) would have been included in a banking organization's common equity tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The opt-out election must be made in the first call

report or FR Y-9 series report that is filed after the financial institution becomes subject to the final rule.

The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010 for inclusion in the tier 1 capital of banking organizations with total consolidated assets less than \$15 billion as of December 31, 2009 and banking organizations that were mutual holding companies as of May 19, 2010.

The proposed rules would have modified the risk-weight framework applicable to residential mortgage exposures to require banking organizations to divide residential mortgage exposures into two categories in order to determine the applicable risk weight. In response to commenter concerns about the burden of calculating the risk weights and the potential negative effect on credit availability, the final rules do not adopt the proposed risk weights but retain the current risk weights for mortgage exposures under the general risk-based capital rules.

Consistent with the Dodd-Frank Act, the new rules replace the ratings-based approach to securitization exposures, which is based on external credit ratings, with the simplified supervisory formula approach in order to determine the appropriate risk weights for these exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

Under the new rules, mortgage servicing assets (MSAs) and certain deferred tax assets (DTAs) are subject to stricter limitations than those applicable under the current general risk-based capital rule. The new rules also increase the risk weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

The Company is in the process of assessing the impact of these changes on the regulatory ratios of the Company and the bank on the capital, operations, liquidity and earnings of the Company and the bank.

#### Item 4. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out by the Company's management, with the participation of its President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934. Based on such evaluation, the President and Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports the Company files or furnishes under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations, and are effective. The Company made no changes in its internal controls over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, these controls during the last fiscal quarter ended September 30, 2013.

## PART II - Other Information

#### Item 1. Legal Proceedings

The nature of the Company's business generates some litigation involving matters arising in the ordinary course of business. However, in the opinion of the Company after consultation with legal counsel, no legal proceedings are pending, which, if determined adversely to the Company or the Bank, would have a material adverse effect on the

Company's undivided profits or financial condition. No legal proceedings are pending other than ordinary routine litigation incidental to the business of the Company and the Bank. In addition, to management's knowledge, no governmental authorities have initiated or contemplated any material legal actions against the Company or the Bank.

Item 1A. Risk Factors

Management of the Company does not believe there have been any material changes to the risk factors that were disclosed in the 2012 Form 10-K filed with the Securities and Exchange Commission on March 26, 2013.

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

None

Item 3. Default Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

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Item 6. Exhibits

The following exhibits are filed herewith or incorporated by reference as a part of this Form 10-Q:

3(i) Amended and Restated Articles of Incorporation of Registrant. Incorporated by reference to Annex B of the Proxy Statement/Prospectus included in Registrant's Amendment 4 to its Registration Statement No. 333-90273 on Form S-4, filed with the SEC on April 6, 2000.

3(ii) Amended and Restated Bylaws of Registrant. Incorporated by reference to Exhibit 3(ii) to Registrant's Form 8-K filed with the SEC on November 21, 2007.

\*10.1 1998 Independent Directors Stock Option Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.1 to Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.

\*10.2 1998 Stock Incentive Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.2 of Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.

\*10.3 Registrant's 2012 Dividend Reinvestment and Stock Repurchase Plan. Incorporated by reference to Exhibit 4.1 to Registrant's Registration Statement No. 333-183216 on Form S-3 filed with the SEC on August 10, 2012.

\*10.4 Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

\*10.5 Amendment, dated October 2, 2007, to the Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 10.2 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

\*10.6 Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

\*10.7 Amendment, dated October 2, 2007, to the Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 10.1 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

\*10.8 Registrant's 2002 Employee Stock Purchase Plan. Incorporated by reference to Appendix A to Definitive proxy Statement filed with the SEC on March 28, 2002.

\*10.9 Change of Control Agreement with Salvatore R. DeFrancesco, the Registrant and The Fidelity Deposit and Discount Bank, dated March 21, 2006. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 27, 2006.

\*10.10 Amended and Restated Executive Employment Agreement between the Registrant, The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated March 23, 2011. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

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\*10.12 2012 Omnibus Stock Incentive Plan. Incorporated by reference to Appendix A to Registrant's Definitive Proxy Statement filed with the SEC on March 30, 2012.



\*10.13 2012 Director Stock Incentive Plan. Incorporated by reference to Appendix B to Registrant's Definitive Proxy Statement filed with the SEC on March 30, 2012.

\*10.14 Change in Control and Severance Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Raymond J. Fox, dated January 14, 2013. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on January 14, 2013.

11 Statement regarding computation of earnings per share. Included herein in Note No. 6, "Earnings per share," contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.

31.1 Rule 13a-14(a) Certification of Principal Executive Officer, filed herewith.

31.2 Rule 13a-14(a) Certification of Principal Financial Officer, filed herewith.

32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350,  
as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350,  
as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

101 Interactive data files: The following, from Fidelity D&D Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2013, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012; Consolidated Statements of Income for the three- and nine-months ended September 30, 2013 and 2012; Consolidated Statements of Comprehensive Income for the three- and nine-months ended September 30, 2013 and 2012; Consolidated Statements of Changes in Shareholders' Equity for the nine months ended September 30, 2013 and 2012, Consolidated Statements of Cash Flows for the nine months ended September 30, 2013 and 2012 and the Notes to the Consolidated Financial Statements.

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\* Management contract or compensatory plan or arrangement.

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Signatures

FIDELITY D & D BANCORP, INC.

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Fidelity D & D Bancorp, Inc.

Date: November 8, 2013 /s/Daniel J. Santaniello  
Daniel J. Santaniello,  
President and Chief Executive Officer

Fidelity D & D Bancorp, Inc.

Date: November 8, 2013 /s/Salvatore R. DeFrancesco, Jr.  
Salvatore R. DeFrancesco, Jr.,  
Treasurer and Chief Financial Officer



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\* Incorporated by Reference

\*\* Pursuant to Rule 406T of Regulation S-T, the interactive data files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

Exhibit 31.1

CERTIFICATION

I, Daniel J. Santaniello, certify that:

1.I have reviewed this quarterly report on Form 10-Q of Fidelity D & D Bancorp, Inc.;

2.Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a)Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b)Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c)Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d)Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5.The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions);

(a)All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b)Any fraud, whether or not material, that involves management or other employees, who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2013

/s/Daniel J. Santaniello  
Daniel J. Santaniello,  
President and Chief Executive Officer



Exhibit 31.2

CERTIFICATION

I, Salvatore R. DeFrancesco, Jr., certify that:

1.I have reviewed this quarterly report on Form 10-Q of Fidelity D & D Bancorp, Inc.;

2.Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a)Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b)Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c)Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d)Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5.The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions);

(a)All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b)Any fraud, whether or not material, that involves management or other employees, who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2013 /s/Salvatore R. DeFrancesco, Jr.  
Salvatore R. DeFrancesco, Jr.,  
Treasurer and Chief Financial Officer

Exhibit 32.1

CERTIFICATION PURSUANT TO

18 U.S.C. SECTION 1350

AS ADDED BY

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Fidelity D & D Bancorp, Inc. (the "Company") for the period ended September 30, 2013, as filed with the Securities and Exchange Commission (the "Report"), I, Daniel J. Santaniello, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as added by §906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. To my knowledge, the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

Date: November 8, 2013    By: /s/ Daniel J. Santaniello  
Daniel J. Santaniello  
President and Chief Executive Officer

Exhibit 32.2

CERTIFICATION PURSUANT TO

18 U.S.C. SECTION 1350

AS ADDED BY

SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Fidelity D & D Bancorp, Inc. (the "Company") for the period ended September 30, 2013, as filed with the Securities and Exchange Commission (the "Report"), I, Salvatore R. DeFrancesco, Jr., Treasurer and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as added by §906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. To my knowledge, the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

Date: November 8, 2013 By: /s/ Salvatore R. DeFrancesco, Jr.

Salvatore R. DeFrancesco, Jr.,  
Treasurer and Chief Financial