

FIDELITY D & D BANCORP INC  
Form 10-Q  
May 07, 2014  
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 March 31, 2014

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 April 30, 2014, the latest practicable date, was 2,411,667 shares.

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FIDELITY D & D BANCORP, INC.

Form 10-Q March 31, 2014

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## PART I – Financial Information

## Item 1: Financial Statements

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

|                                                                                                                  | March 31,<br>2014 | December<br>31, 2013 |
|------------------------------------------------------------------------------------------------------------------|-------------------|----------------------|
| (dollars in thousands)                                                                                           |                   |                      |
| Assets:                                                                                                          |                   |                      |
| Cash and due from banks                                                                                          | \$ 15,462         | \$ 13,197            |
| Interest-bearing deposits with financial institutions                                                            | 16,637            | 21                   |
| Total cash and cash equivalents                                                                                  | 32,099            | 13,218               |
| Available-for-sale securities                                                                                    | 102,213           | 97,246               |
| Held-to-maturity securities (fair value of \$0 in 2014, \$195 in 2013)                                           | -                 | 177                  |
| Federal Home Loan Bank stock                                                                                     | 2,176             | 2,640                |
| Loans and leases, net (allowance for loan losses of \$8,899 in 2014; \$8,928 in 2013)                            | 474,665           | 469,216              |
| Loans held-for-sale (fair value \$458 in 2014, \$937 in 2013)                                                    | 451               | 917                  |
| Foreclosed assets held-for-sale                                                                                  | 2,511             | 2,086                |
| Bank premises and equipment, net                                                                                 | 14,410            | 13,602               |
| Cash surrender value of bank owned life insurance                                                                | 10,485            | 10,402               |
| Accrued interest receivable                                                                                      | 2,030             | 2,068                |
| Other assets                                                                                                     | 13,389            | 12,253               |
| Total assets                                                                                                     | \$ 654,429        | \$ 623,825           |
| Liabilities:                                                                                                     |                   |                      |
| Deposits:                                                                                                        |                   |                      |
| Interest-bearing                                                                                                 | \$ 422,670        | \$ 406,779           |
| Non-interest-bearing                                                                                             | 132,096           | 122,919              |
| Total deposits                                                                                                   | 554,766           | 529,698              |
| Accrued interest payable and other liabilities                                                                   | 3,487             | 3,425                |
| Short-term borrowings                                                                                            | 12,327            | 8,642                |
| Long-term debt                                                                                                   | 16,000            | 16,000               |
| Total liabilities                                                                                                | 586,580           | 557,765              |
| Shareholders' equity:                                                                                            |                   |                      |
| Preferred stock authorized 5,000,000 shares with no par value; none issued                                       | -                 | -                    |
| Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 2,411,667 in 2014; and |                   |                      |

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|                                            |            |            |
|--------------------------------------------|------------|------------|
| 2,391,617 in 2013)                         | 25,703     | 25,302     |
| Retained earnings                          | 40,373     | 39,519     |
| Accumulated other comprehensive income     | 1,773      | 1,239      |
| Total shareholders' equity                 | 67,849     | 66,060     |
| Total liabilities and shareholders' equity | \$ 654,429 | \$ 623,825 |

See notes to unaudited consolidated financial statements

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

(Unaudited)

(dollars in thousands except per share data)

|                                                                                                                              | Three months ended |                |
|------------------------------------------------------------------------------------------------------------------------------|--------------------|----------------|
|                                                                                                                              | March 31, 2014     | March 31, 2013 |
| Interest income:                                                                                                             |                    |                |
| Loans and leases:                                                                                                            |                    |                |
| Taxable                                                                                                                      | \$ 5,276           | \$ 5,370       |
| Nontaxable                                                                                                                   | 131                | 99             |
| Interest-bearing deposits with financial institutions                                                                        | 7                  | 12             |
| Investment securities:                                                                                                       |                    |                |
| U.S. government agency and corporations                                                                                      | 245                | 179            |
| States and political subdivisions (nontaxable)                                                                               | 321                | 290            |
| Other securities                                                                                                             | 22                 | 18             |
| Total interest income                                                                                                        | 6,002              | 5,968          |
| Interest expense:                                                                                                            |                    |                |
| Deposits                                                                                                                     | 489                | 515            |
| Securities sold under repurchase agreements                                                                                  | 8                  | 9              |
| Other short-term borrowings and other                                                                                        | -                  | 1              |
| Long-term debt                                                                                                               | 210                | 210            |
| Total interest expense                                                                                                       | 707                | 735            |
| Net interest income                                                                                                          | 5,295              | 5,233          |
| Provision for loan losses                                                                                                    | 300                | 550            |
| Net interest income after provision for loan losses                                                                          | 4,995              | 4,683          |
| Other income:                                                                                                                |                    |                |
| Service charges on deposit accounts                                                                                          | 423                | 452            |
| Interchange fees                                                                                                             | 305                | 272            |
| Fees from trust fiduciary activities                                                                                         | 164                | 149            |
| Fees from financial services                                                                                                 | 139                | 155            |
| Service charges on loans                                                                                                     | 117                | 234            |
| Fees and other revenue                                                                                                       | 171                | 102            |
| Earnings on bank-owned life insurance                                                                                        | 83                 | 81             |
| Gain on sale, recovery, or disposal of:                                                                                      |                    |                |
| Loans                                                                                                                        | 128                | 504            |
| Investment securities                                                                                                        | 207                | 119            |
| Premises and equipment                                                                                                       | 1                  | -              |
| Impairment losses on investment securities:                                                                                  |                    |                |
| Other-than-temporary impairment on investment securities                                                                     | -                  | (61)           |
| Non-credit-related losses on investment securities not expected to be sold (recognized in other comprehensive income (loss)) | -                  | 61             |
| Net impairment losses on investment securities                                                                               | -                  | -              |
| Total other income                                                                                                           | 1,738              | 2,068          |
| Other expenses:                                                                                                              |                    |                |
| Salaries and employee benefits                                                                                               | 2,476              | 2,474          |

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|                                  |          |          |
|----------------------------------|----------|----------|
| Premises and equipment           | 917      | 854      |
| Advertising and marketing        | 332      | 252      |
| Professional services            | 318      | 249      |
| FDIC assessment                  | 99       | 126      |
| Loan collection                  | 47       | 195      |
| Other real estate owned          | 65       | 123      |
| Office supplies and postage      | 107      | 102      |
| Automated transaction processing | 151      | 125      |
| Other                            | 273      | 380      |
| Total other expenses             | 4,785    | 4,880    |
| Income before income taxes       | 1,948    | 1,871    |
| Provision for income taxes       | 492      | 477      |
| Net income                       | \$ 1,456 | \$ 1,394 |
| Per share data:                  |          |          |
| Net income - basic               | \$ 0.61  | \$ 0.60  |
| Net income - diluted             | \$ 0.61  | \$ 0.60  |
| Dividends                        | \$ 0.25  | \$ 0.25  |

See notes to unaudited consolidated financial statements

|                                                                                     |                    |          |
|-------------------------------------------------------------------------------------|--------------------|----------|
| Fidelity D & D Bancorp, Inc. and Subsidiary                                         |                    |          |
| Consolidated Statements of Comprehensive Income                                     |                    |          |
| (Unaudited)                                                                         |                    |          |
| (dollars in thousands)                                                              |                    |          |
|                                                                                     | Three months ended |          |
|                                                                                     | March 31,          |          |
|                                                                                     | 2014               | 2013     |
| Net income                                                                          | \$ 1,456           | \$ 1,394 |
| Other comprehensive income, before tax:                                             |                    |          |
| Unrealized holding gain (loss) on available-for-sale securities                     | 1,015              | (417)    |
| Reclassification adjustment for net gains realized in income                        | (207)              | (119)    |
| Net unrealized gain (loss)                                                          | 808                | (536)    |
| Tax effect                                                                          | (274)              | 182      |
| Unrealized gain (loss), net of tax                                                  | 534                | (354)    |
| Non-credit-related impairment loss on investment securities not expected to be sold | -                  | (39)     |
| Reclassification adjustment for net gains realized in income                        | -                  | -        |
| Net non-credit-related impairment loss on investment securities                     | -                  | (39)     |
| Tax effect                                                                          | -                  | 13       |
| Non-credit-related impairment loss on investment securities, net of tax             | -                  | (26)     |
| Other comprehensive income (loss), net of tax                                       | 534                | (380)    |
| Total comprehensive income, net of tax                                              | \$ 1,990           | \$ 1,014 |

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Statements of Changes in Shareholders' Equity  
For the three months ended March 31, 2014 and 2013  
(Unaudited)

|                                                                                               | Capital stock |           | Retained  | Accumulated<br>other<br>comprehensive |           |
|-----------------------------------------------------------------------------------------------|---------------|-----------|-----------|---------------------------------------|-----------|
| (dollars in thousands)                                                                        | Shares        | Amount    | earnings  | income (loss)                         | Total     |
| Balance, December 31, 2012                                                                    | 2,323,248     | \$ 23,711 | \$ 34,999 | \$ 236                                | \$ 58,946 |
| Net income                                                                                    |               |           | 1,394     |                                       | 1,394     |
| Other comprehensive loss                                                                      |               |           |           | (380)                                 | (380)     |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 4,256         | 78        |           |                                       | 78        |
| Issuance of common stock through Dividend Reinvestment Plan                                   | 15,131        | 298       |           |                                       | 298       |
| Stock-based compensation expense                                                              |               | 29        |           |                                       | 29        |
| Cash dividends declared                                                                       |               |           | (586)     |                                       | (586)     |
| Balance, March 31, 2013                                                                       | 2,342,635     | \$ 24,116 | \$ 35,807 | \$ (144)                              | \$ 59,779 |
| Balance, December 31, 2013                                                                    | 2,391,617     | \$ 25,302 | \$ 39,519 | \$ 1,239                              | \$ 66,060 |
| Net income                                                                                    |               |           | 1,456     |                                       | 1,456     |
| Other comprehensive income                                                                    |               |           |           | 534                                   | 534       |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 4,373         | 80        |           |                                       | 80        |
| Issuance of common stock through Dividend Reinvestment Plan                                   | 10,427        | 249       |           |                                       | 249       |
| Issuance of common stock from vested restricted share grants through stock compensation plans | 5,250         |           |           |                                       |           |
| Stock-based compensation expense                                                              |               | 72        |           |                                       | 72        |
| Cash dividends declared                                                                       |               |           | (602)     |                                       | (602)     |
| Balance, March 31, 2014                                                                       | 2,411,667     | \$ 25,703 | \$ 40,373 | \$ 1,773                              | \$ 67,849 |

See notes to unaudited consolidated financial statements

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

| (Unaudited)<br>(dollars in thousands)                                             | Three months ended<br>March 31, |          |
|-----------------------------------------------------------------------------------|---------------------------------|----------|
|                                                                                   | 2014                            | 2013     |
| Cash flows from operating activities:                                             |                                 |          |
| Net income                                                                        | \$ 1,456                        | \$ 1,394 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |          |
| Depreciation, amortization and accretion                                          | 767                             | 853      |
| Provision for loan losses                                                         | 300                             | 550      |
| Deferred income tax (benefit) expense                                             | (16)                            | 387      |
| Stock-based compensation expense                                                  | 72                              | 29       |
| Proceeds from sale of loans held-for-sale                                         | 7,065                           | 27,951   |
| Originations of loans held-for-sale                                               | (6,563)                         | (18,573) |
| Earnings on bank-owned life insurance                                             | (83)                            | (81)     |
| Net gain from sales of loans                                                      | (128)                           | (504)    |
| Net gain from sales of investment securities                                      | (207)                           | (111)    |
| Net (gain) loss on sale and write-down of foreclosed assets held-for-sale         | (48)                            | 44       |
| Change in:                                                                        |                                 |          |
| Accrued interest receivable                                                       | 38                              | (8)      |
| Other assets                                                                      | (530)                           | (1,594)  |
| Accrued interest payable and other liabilities                                    | (535)                           | 512      |
| Net cash provided by operating activities                                         | 1,588                           | 10,849   |
| Cash flows from investing activities:                                             |                                 |          |
| Held-to-maturity securities:                                                      |                                 |          |
| Proceeds from sales                                                               | 187                             | -        |
| Proceeds from maturities, calls and principal pay-downs                           | 3                               | 16       |
| Available-for-sale securities:                                                    |                                 |          |
| Proceeds from sales                                                               | 2,751                           | 756      |
| Proceeds from maturities, calls and principal pay-downs                           | 3,580                           | 9,182    |
| Purchases                                                                         | (10,612)                        | (9,558)  |
| Decrease FHLB stock                                                               | 464                             | 386      |
| Net increase in loans and leases                                                  | (7,892)                         | (17,844) |
| Acquisition of bank premises and equipment                                        | (433)                           | (111)    |
| Proceeds from sale of foreclosed assets held-for-sale                             | 766                             | 76       |
| Net cash used by investing activities                                             | (11,186)                        | (17,097) |
| Cash flows from financing activities:                                             |                                 |          |
| Net increase (decrease) in deposits                                               | 25,067                          | (195)    |
| Net increase in short-term borrowings                                             | 3,685                           | 5,537    |
| Proceeds from employee stock purchase plan participants                           | 80                              | 78       |
| Dividends paid, net of dividends reinvested                                       | (395)                           | (367)    |

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|                                                       |           |           |
|-------------------------------------------------------|-----------|-----------|
| Proceeds from dividend reinvestment plan participants | 42        | 79        |
| Net cash provided by financing activities             | 28,479    | 5,132     |
| Net increase (decrease) in cash and cash equivalents  | 18,881    | (1,116)   |
| Cash and cash equivalents, beginning                  | 13,218    | 21,846    |
| Cash and cash equivalents, ending                     | \$ 32,099 | \$ 20,730 |

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, 2013.

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 March 31, 2014 and December 31, 2013 and the related consolidated statements of income, consolidated statements of comprehensive income, consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the three months ended March 31, 2014 and 2013 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 2013 financial statements to conform to the 2014

presentation.

In preparing these consolidated financial statements, the Company evaluated the events and transactions that occurred after March 31, 2014 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, 2013, 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 March 31, 2014 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. Fair values of 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. 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 March 31, 2014 and December 31, 2013, loans classified as HFS consisted of residential mortgage loans.

Financing of automobiles, provided to customers under lease arrangements of varying terms, are accounted for as direct finance leases. Interest income 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, any rental income received 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 each of the three months ended March 31, 2014 and 2013, the Company paid interest of \$0.7 million. The Company was not required to pay income taxes in the first quarters of 2014 and 2013. Transfers from loans to foreclosed assets held-for-sale amounted to \$1.2 million and \$0.8 million during the three months ended March 31, 2014 and 2013, respectively. During the same respective periods, transfers from loans to loans HFS amounted to \$0 and \$1.0 million and from loans to bank premises and equipment amounted to \$1.0 million and \$0. 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 January 2014, the Financial Accounting Standards Board (FASB) issued an accounting standard update (ASU 2014-04) related to; Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40) Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The update applies to all creditors who obtain physical possession of residential real estate property collateralizing a consumer mortgage loan in satisfaction of a receivable. The amendments in this update clarify when an in-substance repossession or foreclosure occurs and requires disclosure of both (1) the amount of foreclosed residential real estate property held by a creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in the update are effective for public business entities for fiscal years, and interim periods within those fiscal years,

beginning after December 15, 2014. Early adoption is permitted. The Company is currently analyzing the impact of the updated guidance on its financial statements.

### 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 other comprehensive income (loss) as of and for the periods indicated:

As of and for the three months ended March 31, 2014

| (dollars in thousands)                                              | Unrealized<br>gains<br>on<br>available-for-<br>sale securities | Non-credit-related<br>impairment losses |          |
|---------------------------------------------------------------------|----------------------------------------------------------------|-----------------------------------------|----------|
|                                                                     |                                                                | on investment<br>securities             | Total    |
| Beginning balance                                                   | \$ 1,239                                                       | \$ -                                    | \$ 1,239 |
| Other comprehensive income before reclassifications                 | 671                                                            | -                                       | 671      |
| Amounts reclassified from accumulated other<br>comprehensive income | (137)                                                          | -                                       | (137)    |
| Net current-period other comprehensive income                       | 534                                                            | -                                       | 534      |
| Ending balance                                                      | \$ 1,773                                                       | \$ -                                    | \$ 1,773 |

As of and for the three months ended March 31, 2013

| (dollars in thousands)                                              | Unrealized<br>gains<br>on<br>available-for-<br>sale securities | Non-credit-related<br>impairment losses |          |
|---------------------------------------------------------------------|----------------------------------------------------------------|-----------------------------------------|----------|
|                                                                     |                                                                | on investment<br>securities             | Total    |
| Beginning balance                                                   | \$ 1,905                                                       | \$ (1,669)                              | \$ 236   |
| Other comprehensive loss before reclassifications                   | (275)                                                          | (26)                                    | (301)    |
| Amounts reclassified from accumulated other<br>comprehensive income | (79)                                                           | -                                       | (79)     |
| Net current-period other comprehensive loss                         | (354)                                                          | (26)                                    | (380)    |
| Ending balance                                                      | \$ 1,551                                                       | \$ (1,695)                              | \$ (144) |

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

| Details about accumulated other comprehensive income components<br><br>(dollars in thousands) | Amount reclassified from accumulated other comprehensive income |        | Affected line item in the statement where net income is presented |
|-----------------------------------------------------------------------------------------------|-----------------------------------------------------------------|--------|-------------------------------------------------------------------|
|                                                                                               | For the three months ended March 31, 2014                       | 2013   |                                                                   |
| Unrealized gains on AFS securities                                                            | \$ 207                                                          | \$ 119 | Gain on sale, recovery, or disposal of investment securities      |
|                                                                                               | (70)                                                            | (40)   | Provision for income taxes                                        |
| Total reclassifications for the period                                                        | \$ 137                                                          | \$ 79  | Net income                                                        |

## 4. Investment securities

The amortized cost and fair value of investment securities at March 31, 2014 and December 31, 2013 are summarized as follows:

| (dollars in thousands)                              | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|-----------------------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2014                                      |                   |                              |                               |               |
| Held-to-maturity securities:                        |                   |                              |                               |               |
| MBS - GSE residential                               | \$ -              | \$ -                         | \$ -                          | \$ -          |
| Available-for-sale securities:                      |                   |                              |                               |               |
| Agency - GSE                                        | \$ 15,634         | \$ 26                        | \$ 38                         | \$ 15,622     |
| Obligations of states and<br>political subdivisions | 34,402            | 1,448                        | 190                           | 35,660        |
| MBS - GSE residential                               | 49,196            | 1,271                        | 92                            | 50,375        |
| Total debt securities                               | 99,232            | 2,745                        | 320                           | 101,657       |
| Equity securities - financial services              | 295               | 261                          | -                             | 556           |
| Total available-for-sale securities                 | \$ 99,527         | \$ 3,006                     | \$ 320                        | \$ 102,213    |

| (dollars in thousands)                              | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|-----------------------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| December 31, 2013                                   |                   |                              |                               |               |
| Held-to-maturity securities:                        |                   |                              |                               |               |
| MBS - GSE residential                               | \$ 177            | \$ 18                        | \$ -                          | \$ 195        |
| Available-for-sale securities:                      |                   |                              |                               |               |
| Agency - GSE                                        | \$ 14,667         | \$ 8                         | \$ 74                         | \$ 14,601     |
| Obligations of states and<br>political subdivisions | 32,269            | 912                          | 570                           | 32,611        |
| MBS - GSE residential                               | 48,137            | 1,476                        | 104                           | 49,509        |
| Total debt securities                               | 95,073            | 2,396                        | 748                           | 96,721        |
| Equity securities - financial services              | 295               | 230                          | -                             | 525           |

|                                     |           |          |        |           |
|-------------------------------------|-----------|----------|--------|-----------|
| Total available-for-sale securities | \$ 95,368 | \$ 2,626 | \$ 748 | \$ 97,246 |
|-------------------------------------|-----------|----------|--------|-----------|

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The amortized cost and fair value of debt securities at March 31, 2014 by contractual maturity are summarized below:

| (dollars in thousands)                   | Amortized<br>cost | Fair<br>value |
|------------------------------------------|-------------------|---------------|
| Held-to-maturity securities:             |                   |               |
| MBS - GSE residential                    | \$ -              | \$ -          |
| Available-for-sale securities:           |                   |               |
| Debt securities:                         |                   |               |
| Due in one year or less                  | \$ 1,000          | \$ 1,004      |
| Due after one year through five years    | 7,116             | 7,090         |
| Due after five years through ten years   | 9,531             | 9,623         |
| Due after ten years                      | 32,389            | 33,565        |
| Total debt securities                    | 50,036            | 51,282        |
| MBS - GSE residential                    | 49,196            | 50,375        |
| Total available-for-sale debt securities | \$ 99,232         | \$ 101,657    |

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 March 31, 2014 and December 31, 2013:

| (dollars in thousands)                           | Less than 12 months |                      | More than 12 months |                      | Total         |                      |
|--------------------------------------------------|---------------------|----------------------|---------------------|----------------------|---------------|----------------------|
|                                                  | Fair<br>value       | Unrealized<br>losses | Fair<br>value       | Unrealized<br>losses | Fair<br>value | Unrealized<br>losses |
| March 31, 2014                                   |                     |                      |                     |                      |               |                      |
| Agency - GSE                                     | \$ 10,476           | \$ 38                | \$ -                | \$ -                 | \$ 10,476     | \$ 38                |
| Obligations of states and political subdivisions | 6,592               | 147                  | 867                 | 43                   | 7,459         | 190                  |
| MBS - GSE residential                            | 7,972               | 56                   | 4,853               | 36                   | 12,825        | 92                   |
| Total temporarily impaired securities            | \$ 25,040           | \$ 241               | \$ 5,720            | \$ 79                | \$ 30,760     | \$ 320               |

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|                                                  |           |        |          |       |           |        |
|--------------------------------------------------|-----------|--------|----------|-------|-----------|--------|
| Number of securities                             | 26        |        | 6        |       | 32        |        |
| December 31, 2013                                |           |        |          |       |           |        |
| Agency - GSE                                     | \$ 11,592 | \$ 74  | \$ -     | \$ -  | \$ 11,592 | \$ 74  |
| Obligations of states and political subdivisions | 10,148    | 570    | -        | -     | 10,148    | 570    |
| MBS - GSE residential                            | 11,703    | 83     | 3,052    | 21    | 14,755    | 104    |
| Total temporarily impaired securities            | \$ 33,443 | \$ 727 | \$ 3,052 | \$ 21 | \$ 36,495 | \$ 748 |
| Number of securities                             | 38        |        | 2        |       | 40        |        |

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 March 31, 2014, 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 security portfolio. In addition, 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 March 31, 2014, recognition of OTTI on these securities was unnecessary.

#### 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 long-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.

## 5. Loans and leases

The classifications of loans and leases at March 31, 2014 and December 31, 2013 are summarized as follows:

| (dollars in thousands)     | March 31,<br>2014 | December<br>31, 2013 |
|----------------------------|-------------------|----------------------|
| Commercial and industrial  | \$ 75,717         | \$ 74,551            |
| Commercial real estate:    |                   |                      |
| Non-owner occupied         | 90,647            | 89,255               |
| Owner occupied             | 89,373            | 86,294               |
| Construction               | 9,609             | 10,765               |
| Consumer:                  |                   |                      |
| Home equity installment    | 34,161            | 34,480               |
| Home equity line of credit | 37,202            | 36,836               |
| Auto loans and leases      | 23,725            | 22,261               |
| Other                      | 5,242             | 5,205                |
| Residential:               |                   |                      |
| Real estate                | 110,675           | 110,365              |
| Construction               | 7,292             | 8,188                |
| Total                      | 483,643           | 478,200              |
| Less:                      |                   |                      |
| Allowance for loan losses  | (8,899)           | (8,928)              |
| Unearned lease revenue     | (79)              | (56)                 |
| Loans and leases, net      | \$ 474,665        | \$ 469,216           |

Net deferred loan costs of \$1.2 million and \$1.1 million have been added to the carrying values of loans at March 31, 2014 and December 31, 2013, respectively.

Unearned lease revenue represents the difference between the lessor's investment in the property and the gross investment in the lease. Unearned revenue is accrued over the life of the lease using the effective income method.

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 \$251.8 million as of March 31, 2014 and \$250.2 million as of December 31, 2013.

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 March 31, 2014 and December 31, 2013, were as follows:

| (dollars in thousands)     | March<br>31, 2014 | December<br>31, 2013 |
|----------------------------|-------------------|----------------------|
| Commercial and industrial  | \$ 62             | \$ 62                |
| Commercial real estate:    |                   |                      |
| Non-owner occupied         | 640               | 1,518                |
| Owner occupied             | 1,567             | 1,422                |
| Construction               | 281               | 635                  |
| Consumer:                  |                   |                      |
| Home equity installment    | 211               | 393                  |
| Home equity line of credit | 138               | 254                  |
| Auto loans and leases      | -                 | 12                   |
| Other                      | 22                | 22                   |
| Residential:               |                   |                      |
| Real estate                | 788               | 1,350                |
| Total                      | \$ 3,709          | \$ 5,668             |

## 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 March 31, 2014, total TDRs amounted to \$1.8 million (5 loans), of which one loan with a balance of \$1.0 million was on non-accrual status, compared to \$2.0 million (7 loans) and \$1.0 million, respectively as of December 31, 2013. Of the TDRs outstanding as of March 31, 2014 and December 31, 2013, when modified, the concessions granted consisted of temporary interest-only payments or a reduction in the rate of interest to a below-market rate for a contractual period of time.

Other than the TDR that was on non-accrual status, the TDRs were performing in accordance with their modified terms.

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 and twelve months ended March 31, 2014.

The allowance for loan losses (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 is 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):

|                            |          |          | Past due |          |            | Total       | Recorded investment past |
|----------------------------|----------|----------|----------|----------|------------|-------------|--------------------------|
|                            | 30 - 59  | 60 - 89  | 90 days  | Total    |            | loans       | due ≥ 90 days            |
|                            | Days     | Days     | or more  |          |            |             |                          |
| March 31, 2014             | past due | past due | *        | past due | Current    | receivables | and accruing             |
| Commercial and industrial  | \$ 247   | \$ 2     | \$ 62    | \$ 311   | \$ 75,406  | \$ 75,717   | \$ -                     |
| Commercial real estate:    |          |          |          |          |            |             |                          |
| Non-owner occupied         | 326      | -        | 640      | 966      | 89,681     | 90,647      | -                        |
| Owner occupied             | 948      | 354      | 1,567    | 2,869    | 86,504     | 89,373      | -                        |
| Construction               | -        | -        | 281      | 281      | 9,328      | 9,609       | -                        |
| Consumer:                  |          |          |          |          |            |             |                          |
| Home equity installment    | 105      | 74       | 211      | 390      | 33,771     | 34,161      | -                        |
| Home equity line of credit | 22       | -        | 138      | 160      | 37,042     | 37,202      | -                        |
| Auto loans and leases      | 255      | -        | 20       | 275      | 23,371     | 23,646      | 20                       |
| Other                      | 82       | -        | 22       | 104      | 5,138      | 5,242       | -                        |
| Residential:               |          |          |          |          |            |             |                          |
| Real estate                | 287      | -        | 788      | 1,075    | 109,600    | 110,675     | -                        |
| Construction               | -        | -        | -        | -        | 7,292      | 7,292       | -                        |
| Total                      | \$ 2,272 | \$ 430   | \$ 3,729 | \$ 6,431 | \$ 477,133 | \$ 483,564  | \$ 20                    |

\* Includes \$3.7 million of non-accrual loans.

|                           |          |          | Past due |          |           | Total       | Recorded investment past |
|---------------------------|----------|----------|----------|----------|-----------|-------------|--------------------------|
|                           | 30 - 59  | 60 - 89  | 90 days  | Total    |           | loans       | due ≥ 90 days            |
|                           | Days     | Days     | or more  |          |           |             |                          |
| December 31, 2013         | past due | past due | *        | past due | Current   | receivables | and accruing             |
| Commercial and industrial | \$ 111   | \$ 212   | \$ 69    | \$ 392   | \$ 74,159 | \$ 74,551   | \$ 7                     |
| Commercial real estate:   |          |          |          |          |           |             |                          |
| Non-owner occupied        | 484      | 35       | 1,518    | 2,037    | 87,218    | 89,255      | -                        |
| Owner occupied            | 1,714    | 545      | 1,422    | 3,681    | 82,613    | 86,294      | -                        |
| Construction              | -        | -        | 635      | 635      | 10,130    | 10,765      | -                        |

## Consumer:

|                            |          |          |          |           |            |            |        |
|----------------------------|----------|----------|----------|-----------|------------|------------|--------|
| Home equity installment    | 229      | 72       | 393      | 694       | 33,786     | 34,480     | -      |
| Home equity line of credit | -        | 114      | 275      | 389       | 36,447     | 36,836     | 21     |
| Auto loans and leases      | 165      | 14       | 23       | 202       | 22,003     | 22,205     | 11     |
| Other                      | 52       | 23       | 22       | 97        | 5,108      | 5,205      | -      |
| Residential:               |          |          |          |           |            |            |        |
| Real estate                | 158      | 1,340    | 1,466    | 2,964     | 107,401    | 110,365    | 116    |
| Construction               | -        | -        | -        | -         | 8,188      | 8,188      | -      |
| Total                      | \$ 2,913 | \$ 2,355 | \$ 5,823 | \$ 11,091 | \$ 467,053 | \$ 478,144 | \$ 155 |

\* Includes \$5.7 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 March 31, 2014 and December 31, 2013, impaired loans consisted of non-accrual loans and TDRs.

At March 31, 2014, impaired loans consisted of accruing TDRs totaling \$0.8 million and \$3.7 million of non-accrual loans. At December 31, 2013, impaired loans consisted of accruing TDRs totaling \$1.0 million and \$5.7 million of non-accrual loans. As of March 31, 2014 and December 31, 2013, the non-accrual loans included non-accruing TDRs of \$1.0 million. 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 |
|----------------------------|--------------------------|------------------------------------|---------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|---------------------------------------|
| March 31, 2014             |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Commercial & industrial    | \$ 141                   | \$ 18                              | \$ 69                                 | \$ 87                     | \$ 5              | \$ 85                       | \$ 1                       | \$ -                                  |
| Commercial real estate:    |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Non-owner occupied         | 1,289                    | 728                                | 392                                   | 1,120                     | 56                | 1,922                       | 7                          | -                                     |
| Owner occupied             | 2,226                    | 213                                | 1,612                                 | 1,825                     | 29                | 2,449                       | 4                          | -                                     |
| Construction               | 355                      | -                                  | 281                                   | 281                       | -                 | 734                         | -                          | -                                     |
| Consumer:                  |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Home equity installment    | 300                      | 36                                 | 175                                   | 211                       | 3                 | 504                         | -                          | -                                     |
| Home equity line of credit | 154                      | -                                  | 138                                   | 138                       | -                 | 307                         | 20                         | -                                     |
| Auto loans and leases      | -                        | -                                  | -                                     | -                         | -                 | 5                           | -                          | -                                     |
| Other                      | 22                       | -                                  | 22                                    | 22                        | -                 | 23                          | -                          | -                                     |
| Residential:               |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Real estate                | 883                      | 203                                | 585                                   | 788                       | 53                | 1,374                       | -                          | -                                     |
| Construction               | -                        | -                                  | -                                     | -                         | -                 | -                           | -                          | -                                     |
| Total                      | \$ 5,370                 | \$ 1,198                           | \$ 3,274                              | \$ 4,472                  | \$ 146            | \$ 7,403                    | \$ 32                      | \$ -                                  |

| (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, 2013       |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Commercial & industrial | \$ 134                   | \$ 64                              | \$ 33                                 | \$ 97                     | \$ 31             | \$ 80                       | \$ 2                       | \$ -                                  |
| Commercial real estate: |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Non-owner occupied      | 2,146                    | 174                                | 1,827                                 | 2,001                     | 27                | 2,173                       | 31                         | 78                                    |
| Owner occupied          | 2,136                    | 622                                | 1,327                                 | 1,949                     | 90                | 3,203                       | 36                         | -                                     |
| Construction            | 1,024                    | -                                  | 635                                   | 635                       | -                 | 903                         | -                          | -                                     |
| Consumer:               |                          |                                    |                                       |                           |                   |                             |                            |                                       |
| Home equity installment | 501                      | 125                                | 268                                   | 393                       | 23                | 723                         | 37                         | -                                     |

|                            |          |          |          |          |        |          |        |       |
|----------------------------|----------|----------|----------|----------|--------|----------|--------|-------|
| Home equity line of credit | 340      | -        | 254      | 254      | -      | 355      | 2      | -     |
| Auto                       | 12       | 12       | -        | 12       | 1      | 5        | -      | -     |
| Other                      | 22       | -        | 22       | 22       | -      | 29       | -      | -     |
| Residential:               |          |          |          |          |        |          |        |       |
| Real estate                | 1,511    | 437      | 913      | 1,350    | 110    | 1,682    | 71     | -     |
| Construction               | -        | -        | -        | -        | -      | -        | -      | -     |
| Total                      | \$ 7,826 | \$ 1,434 | \$ 5,279 | \$ 6,713 | \$ 282 | \$ 9,153 | \$ 179 | \$ 78 |

## 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. Loans 90 days or more past due, unless otherwise fully supported, are classified substandard. Also, borrowers that are bankrupt or have loans categorized as troubled debt restructures can be graded substandard.

## 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

|                           |                                             |                                         |                                       |
|---------------------------|---------------------------------------------|-----------------------------------------|---------------------------------------|
| Commercial and industrial | Commercial real estate - non-owner occupied | Commercial real estate - owner occupied | Commercial real estate - construction |
|---------------------------|---------------------------------------------|-----------------------------------------|---------------------------------------|

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| (dollars in thousands) | 3/31/2014 | 12/31/2013 | 3/31/2014 | 12/31/2013 | 3/31/2014 | 12/31/2013 | 3/31/2014 | 12/31/2013 |
|------------------------|-----------|------------|-----------|------------|-----------|------------|-----------|------------|
| Pass                   | \$ 72,221 | \$ 71,122  | \$ 80,565 | \$ 78,069  | \$ 86,172 | \$ 82,975  | \$ 8,129  | \$ 9,026   |
| Special mention        | 2,322     | 2,244      | 3,204     | 2,734      | 654       | 656        | 1,144     | 1,037      |
| Substandard            | 1,174     | 1,185      | 6,878     | 8,452      | 2,547     | 2,663      | 336       | 702        |
| Doubtful               | -         | -          | -         | -          | -         | -          | -         | -          |
| Total                  | \$ 75,717 | \$ 74,551  | \$ 90,647 | \$ 89,255  | \$ 89,373 | \$ 86,294  | \$ 9,609  | \$ 10,765  |

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     |            |
|------------------------|-------------------------|------------|----------------------------|------------|-----------------------|------------|-----------|------------|
|                        | 3/31/2014               | 12/31/2013 | 3/31/2014                  | 12/31/2013 | 3/31/2014             | 12/31/2013 | 3/31/2014 | 12/31/2013 |
| Performing             | \$ 33,950               | \$ 34,087  | \$ 37,064                  | \$ 36,561  | \$ 23,626             | \$ 22,182  | \$ 5,220  | \$ 5,183   |
| Non-performing         | 211                     | 393        | 138                        | 275        | 20                    | 23         | 22        | 22         |
| Total                  | \$ 34,161               | \$ 34,480  | \$ 37,202                  | \$ 36,836  | \$ 23,646             | \$ 22,205  | \$ 5,242  | \$ 5,205   |

## Mortgage lending credit exposure

Credit risk profile based on payment activity

|                        | Residential real estate |            | Residential construction |            |
|------------------------|-------------------------|------------|--------------------------|------------|
| (dollars in thousands) | 3/31/2014               | 12/31/2013 | 3/31/2014                | 12/31/2013 |
| Performing             | \$ 109,887              | \$ 108,899 | \$ 7,292                 | \$ 8,188   |
| Non-performing         | 788                     | 1,466      | -                        | -          |
| Total                  | \$ 110,675              | \$ 110,365 | \$ 7,292                 | \$ 8,188   |

## 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;
- § identification of 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 (trailing twelve-quarter 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. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies.

Each quarter, management performs an assessment of the allowance for loan losses. The Company's Special Assets Committee meets monthly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount, if applicable, based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered regarding not only loans considered for specific reserves, but also the collectability of loans that may be past due in payment. The assessment process also 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.

During the fourth quarter of 2013, the Company changed its methodology to determine historical loss percentages – from a two-year average, calculated annually, to a trailing twelve-quarter average. Management determined that utilizing a trailing twelve-quarter average minimizes the impact of certain anomalies caused by irregular occurrences such as infrequent large loan charge offs. Analyzing historical loss data over a longer period provides a more accurate measurement of factors to be used in estimating future loan loss estimates.

In addition, during the fourth quarter of 2013, the Company changed its methodology used to calculate the allowance for loan losses from the methodology used in the first three quarters of 2013. Beginning in the fourth quarter of 2013, certain loans were eliminated from the allowance for loan loss calculation. The loans eliminated include the following: the guaranteed portion of all commercial loans that carry a guarantee by the Small Business Administration and loans in all loan categories that are fully secured by cash collateral. Management has determined that these loans have very little risk of not being fully collected. Therefore, upon origination, these loans have been eliminated from allowance for loan loss calculations.

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.

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 three months ended  
March 31, 2014

| (dollars in thousands)                                   | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer   | Residential<br>real estate | Unallocated | Total      |
|----------------------------------------------------------|-------------------------------|---------------------------|------------|----------------------------|-------------|------------|
| Allowance for Loan Losses:                               |                               |                           |            |                            |             |            |
| Beginning balance                                        | \$ 944                        | \$ 4,253                  | \$ 1,482   | \$ 1,613                   | \$ 636      | \$ 8,928   |
| Charge-offs                                              | 28                            | 152                       | 118        | 59                         | -           | 357        |
| Recoveries                                               | 11                            | 1                         | 16         | -                          | -           | 28         |
| Provision                                                | 35                            | 215                       | 137        | (30)                       | (57)        | 300        |
| Ending balance                                           | \$ 962                        | \$ 4,317                  | \$ 1,517   | \$ 1,524                   | \$ 579      | \$ 8,899   |
| Ending balance: individually<br>evaluated for impairment | \$ 5                          | \$ 85                     | \$ 3       | \$ 53                      |             | \$ 146     |
| Ending balance: collectively<br>evaluated for impairment | \$ 957                        | \$ 4,232                  | \$ 1,514   | \$ 1,471                   |             | \$ 8,174   |
| Loans Receivables:                                       |                               |                           |            |                            |             |            |
| Ending balance                                           | \$ 75,717                     | \$ 189,629                | \$ 100,251 | \$ 117,967                 |             | \$ 483,564 |
| Ending balance: individually<br>evaluated for impairment | \$ 87                         | \$ 3,226                  | \$ 371     | \$ 788                     |             | \$ 4,472   |
| Ending balance: collectively<br>evaluated for impairment | \$ 75,630                     | \$ 186,403                | \$ 99,880  | \$ 117,179                 |             | \$ 479,092 |

As of and for the year ended December  
31, 2013

| (dollars in thousands)                                   | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer  | Residential<br>real estate | Unallocated | Total      |
|----------------------------------------------------------|-------------------------------|---------------------------|-----------|----------------------------|-------------|------------|
| Allowance for Loan Losses:                               |                               |                           |           |                            |             |            |
| Beginning balance                                        | \$ 922                        | \$ 4,908                  | \$ 1,639  | \$ 1,503                   | \$ -        | \$ 8,972   |
| Charge-offs                                              | 56                            | 2,091                     | 400       | 218                        | -           | 2,765      |
| Recoveries                                               | 30                            | 30                        | 110       | 1                          | -           | 171        |
| Provision                                                | 48                            | 1,406                     | 133       | 327                        | 636         | 2,550      |
| Ending balance                                           | \$ 944                        | \$ 4,253                  | \$ 1,482  | \$ 1,613                   | \$ 636      | \$ 8,928   |
| Ending balance: individually<br>evaluated for impairment | \$ 31                         | \$ 117                    | \$ 24     | \$ 110                     |             | \$ 282     |
| Ending balance: collectively<br>evaluated for impairment | \$ 913                        | \$ 4,136                  | \$ 1,458  | \$ 1,503                   |             | \$ 8,010   |
| Loans Receivables:                                       |                               |                           |           |                            |             |            |
| Ending balance                                           | \$ 74,551                     | \$ 186,314                | \$ 98,726 | \$ 118,553                 |             | \$ 478,144 |
| Ending balance: individually<br>evaluated for impairment | \$ 97                         | \$ 4,585                  | \$ 681    | \$ 1,350                   |             | \$ 6,713   |
| Ending balance: collectively<br>evaluated for impairment | \$ 74,454                     | \$ 181,729                | \$ 98,045 | \$ 117,203                 |             | \$ 471,431 |

Information related to the change in the allowance for loan losses as of and for the three months ended March 31,  
2013 is as

follows:

As of and for the three months ended March  
31, 2013

| (dollars in thousands)     | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer | Residential<br>real estate | Unallocated | Total    |
|----------------------------|-------------------------------|---------------------------|----------|----------------------------|-------------|----------|
| Allowance for Loan Losses: |                               |                           |          |                            |             |          |
| Beginning balance          | \$ 922                        | \$ 4,908                  | \$ 1,639 | \$ 1,503                   | \$ -        | \$ 8,972 |
| Charge-offs                | 44                            | 1,244                     | 39       | 39                         | -           | 1,366    |
| Recoveries                 | 4                             | 3                         | 73       | -                          | -           | 80       |
| Provision                  | (28)                          | 62                        | (92)     | 194                        | 414         | 550      |
| Ending balance             | \$ 854                        | \$ 3,729                  | \$ 1,581 | \$ 1,658                   | \$ 414      | \$ 8,236 |

## 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. As of March 31, 2014, there were 15 potentially dilutive shares related to issued and unexercised stock options. There were no potentially dilutive shares related to stock options as of March 31, 2013. For restricted stock, dilution would occur from the Company's previously granted but unvested shares. There were 3,283 and 5,453 potentially dilutive shares related to unvested restricted share grants as of March 31, 2014 and 2013, 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 March<br>31, |      |
| 2014                            | 2013 |

(dollars in thousands except per share data)

Basic EPS:

|                                             |           |           |
|---------------------------------------------|-----------|-----------|
| Net income available to common shareholders | \$ 1,456  | \$ 1,394  |
| Weighted-average common shares outstanding  | 2,398,731 | 2,330,325 |
| Basic EPS                                   | \$ 0.61   | \$ 0.60   |

Diluted EPS:

|                                                                     |           |           |
|---------------------------------------------------------------------|-----------|-----------|
| Net income available to common shareholders                         | \$ 1,456  | \$ 1,394  |
| Weighted-average common shares outstanding                          | 2,398,731 | 2,330,325 |
| Potentially dilutive common shares                                  | 3,298     | 5,453     |
| Weighted-average common and potentially dilutive shares outstanding | 2,402,029 | 2,335,778 |
| Diluted EPS                                                         | \$ 0.61   | \$ 0.60   |

## 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 Company's common stock. In return, the Company hopes to secure, retain and motivate the employees and directors who are responsible for the operation and the management of the affairs of the Company by 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 2012 annual shareholders' meeting, the Company's shareholders 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 both the expired 2000 Independent Directors Stock Option Plan and the 2000 Stock Incentive Plan (collectively, the 2000 stock incentive plans). Unless terminated by the Company's board of directors, the 2012 stock incentive plans will expire on, and no stock-based awards shall be granted after the plans' tenth anniversary – or in the year 2022. As of March 31, 2014, the Company had 19,500 of previously issued and unexercised stock options outstanding from the 2000 stock incentive plans. No stock options have been issued since 2008 under any share-based plan. As of March 31, 2014, the intrinsic value for outstanding stock options with market prices that exceeded their strike price amounted to \$1,500.

In each of the 2012 stock incentive plans, the Company has reserved 500,000 shares of its no-par common stock for future issuance. The Company recognizes share-based compensation expense over the requisite service or vesting period.

The following table summarizes the weighted-average fair value and vesting of restricted stock grants awarded during the three months ended March 31, 2014 and 2013 under the 2012 stock incentive plans:

|               | 2014    |                                        |                      | 2013    |                                        |                      |
|---------------|---------|----------------------------------------|----------------------|---------|----------------------------------------|----------------------|
|               | Shares  | Weighted-average grant date fair value | Vesting period       | Shares  | Weighted-average grant date fair value | Vesting period       |
|               | granted |                                        |                      | granted |                                        |                      |
| Director plan | 2,000   | \$ 27.00                               | 1 year               | 8,000   | \$ 21.20                               | 2 yrs - 50% per year |
| Omnibus plan  | 2,120   | 27.00                                  | 4 yrs - 25% per year | 6,000   | 21.20                                  | 4 yrs - 25% per year |
| Total         | 4,120   | \$ 27.00                               |                      | 14,000  | \$ 21.20                               |                      |

A summary of the status of the Company's restricted stock grants as of and changes during the periods indicated are presented in the following table:

|                              | 2012 Stock incentive plans |         |         |
|------------------------------|----------------------------|---------|---------|
|                              | Director                   | Omnibus | Total   |
| Balance at December 31, 2013 | 8,000                      | 5,000   | 13,000  |
| Granted                      | 2,000                      | 2,120   | 4,120   |
| Forfeited                    | -                          | -       | -       |
| Vested                       | (4,000)                    | (1,250) | (5,250) |
| Balance at March 31, 2014    | 6,000                      | 5,870   | 11,870  |

For restricted stock, intrinsic value represents the closing price of the underlying stock at the end of the period. As of March 31, 2014, the intrinsic value of the Company's restricted stock under the Director and Omnibus plans was \$27.55 per share.

Share-based compensation is included as a component of salaries and employee benefits in the consolidated statements of income. The following tables illustrate stock-based compensation expense recognized during the three months ended March 31, 2014 and 2013 and the unrecognized stock-based compensation expense as of March 31, 2014:

| (dollars in thousands)                 | Three<br>months<br>ended March<br>31, |       |
|----------------------------------------|---------------------------------------|-------|
|                                        | 2014                                  | 2013  |
| Stock-based compensation expense:      |                                       |       |
| Director plan                          | \$ 30                                 | \$ 14 |
| Omnibus plan                           | 9                                     | 5     |
| Total stock-based compensation expense | \$ 39                                 | \$ 19 |

|                                                |                               |
|------------------------------------------------|-------------------------------|
|                                                | As of<br>March<br>31,<br>2014 |
| (dollars in thousands)                         |                               |
| Unrecognized stock-based compensation expense: |                               |
| Director plan                                  | \$ 116                        |
| Omnibus plan                                   | 130                           |

Total unrecognized stock-based compensation expense \$ 246

The unrecognized stock-based compensation expense as of March 31, 2014 will be recognized ratably over the periods ended January 2015 and January 2018 for the Director Plan and the Omnibus Plan, respectively.

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 March 31, 2014, 34,329 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 three months ended March 31, 2014 and 2013, compensation expense related to the ESPP approximated \$33 thousand and \$10 thousand, respectively, and is included as a component of salaries and employee benefits in the consolidated statements of income.

## 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:

March 31, 2014

| (dollars in thousands)        | Carrying<br>amount | Estimated<br>fair value | Quoted<br>prices<br>in active<br>markets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|-------------------------------|--------------------|-------------------------|-------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------|
| Financial assets:             |                    |                         |                                                       |                                                           |                                                             |
| Cash and cash equivalents     | \$ 32,099          | \$ 32,099               | \$ 32,099                                             | \$ -                                                      | \$ -                                                        |
| Available-for-sale securities | 102,213            | 102,213                 | 556                                                   | 101,657                                                   | -                                                           |
| FHLB Stock                    | 2,176              | 2,176                   | -                                                     | 2,176                                                     | -                                                           |
| Loans and leases, net         | 474,665            | 474,604                 | -                                                     | -                                                         | 474,604                                                     |
| Loans held-for-sale           | 451                | 458                     | -                                                     | 458                                                       | -                                                           |
| Financial liabilities:        |                    |                         |                                                       |                                                           |                                                             |
| Deposit liabilities           | 554,766            | 554,969                 | -                                                     | 554,969                                                   | -                                                           |
| Short-term borrowings         | 12,327             | 12,327                  | -                                                     | 12,327                                                    | -                                                           |
| Long-term debt                | 16,000             | 17,737                  | -                                                     | 17,737                                                    | -                                                           |

December 31, 2013

| (dollars in thousands)        | Carrying<br>amount | Estimated<br>fair value | Quoted<br>prices<br>in active<br>markets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|-------------------------------|--------------------|-------------------------|-------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------|
| Financial assets:             |                    |                         |                                                       |                                                           |                                                             |
| Cash and cash equivalents     | \$ 13,218          | \$ 13,218               | \$ 13,218                                             | \$ -                                                      | \$ -                                                        |
| Held-to-maturity securities   | 177                | 195                     | -                                                     | 195                                                       | -                                                           |
| Available-for-sale securities | 97,246             | 97,246                  | 525                                                   | 96,721                                                    | -                                                           |
| FHLB Stock                    | 2,640              | 2,640                   | -                                                     | 2,640                                                     | -                                                           |
| Loans, net                    | 469,216            | 467,381                 | -                                                     | -                                                         | 467,381                                                     |
| Loans held-for-sale           | 917                | 937                     | -                                                     | 937                                                       | -                                                           |
| Financial liabilities:        |                    |                         |                                                       |                                                           |                                                             |
| Deposit liabilities           | 529,698            | 529,968                 | -                                                     | 529,968                                                   | -                                                           |
| Short-term borrowings         | 8,642              | 8,642                   | -                                                     | 8,642                                                     | -                                                           |
| Long-term debt                | 16,000             | 17,904                  | -                                                     | 17,904                                                    | -                                                           |

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, interest-bearing checking and money market accounts and
- Short-term borrowings.

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.

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

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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 the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank of Pittsburgh (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<br>carrying<br>value<br>March 31,<br>2014 | Quoted<br>prices<br>in active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|--------------------------------------------------|-------------------------------------------------|----------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------|
| (dollars in thousands)                           |                                                 |                                                          |                                                           |                                                             |
| Available-for-sale securities:                   |                                                 |                                                          |                                                           |                                                             |
| Agency - GSE                                     | \$ 15,622                                       | \$ -                                                     | \$ 15,622                                                 | \$ -                                                        |
| Obligations of states and political subdivisions | 35,660                                          | -                                                        | 35,660                                                    | -                                                           |
| MBS - GSE residential                            | 50,375                                          | -                                                        | 50,375                                                    | -                                                           |
| Equity securities - financial services           | 556                                             | 556                                                      | -                                                         | -                                                           |
| Total available-for-sale securities              | \$ 102,213                                      | \$ 556                                                   | \$ 101,657                                                | \$ -                                                        |

|                                | Total<br>carrying<br>value<br>December<br>31, 2013 | Quoted<br>prices<br>in active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|--------------------------------|----------------------------------------------------|----------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------|
| (dollars in thousands)         |                                                    |                                                          |                                                           |                                                             |
| Available-for-sale securities: |                                                    |                                                          |                                                           |                                                             |

|                                                  |           |        |           |      |
|--------------------------------------------------|-----------|--------|-----------|------|
| Agency - GSE                                     | \$ 14,601 | \$ -   | \$ 14,601 | \$ - |
| Obligations of states and political subdivisions | 32,611    | -      | 32,611    | -    |
| MBS - GSE residential                            | 49,509    | -      | 49,509    | -    |
| Equity securities - financial services           | 525       | 525    | -         | -    |
| Total available-for-sale securities              | \$ 97,246 | \$ 525 | \$ 96,721 | \$ - |

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. 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 three months ended March 31, 2014 and the year ended December 31, 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 following table illustrates the changes in Level 3 financial instruments measured at fair value on a recurring basis during the first quarter of 2013. Prior to December 31, 2013, Level 3 financial instruments measured at fair value consisted of the Company's investment in pooled trust preferred securities. The Company sold its entire portfolio of pooled trust preferred securities in the fourth quarter of 2013. See Note 4, "Investment Securities", and Note 13, "Fair Value Measurements" within the notes to the audited consolidated financial statements, incorporated by reference to the Company's 2013 Annual Report on Form 10-K, filed with the SEC on March 19, 2014 for an expanded discussion on the Company's investment, fair value determination and activity of its portfolio of pooled trust preferred securities:

(dollars in thousands)

As of and for the three months ended March  
31, 2013

|                                     |          |
|-------------------------------------|----------|
| Balance at beginning of period      | \$ 1,825 |
| Realized gains (losses) in earnings | -        |
| Unrealized gains (losses) in OCI:   |          |
| Gains                               | 98       |
| Losses                              | (78)     |
| Pay down / settlement               | (52)     |
| Interest paid-in-kind               | 5        |
| Accretion                           | 1        |
| Balance at end of period            | \$ 1,799 |

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:

|                          |                                                    | Quoted<br>prices in               | Significant<br>other              | Significant<br>other                |
|--------------------------|----------------------------------------------------|-----------------------------------|-----------------------------------|-------------------------------------|
|                          | Total<br>carrying<br>value<br>at March<br>31, 2014 | active<br>markets<br>(Level<br>1) | observable<br>inputs<br>(Level 2) | unobservable<br>inputs<br>(Level 3) |
| (dollars in thousands)   |                                                    |                                   |                                   |                                     |
| Impaired loans           | \$ 1,052                                           | \$ -                              | \$ -                              | \$ 1,052                            |
| Other real estate owned  | 2,061                                              | -                                 | -                                 | 2,061                               |
| Other repossessed assets | 13                                                 | -                                 | -                                 | 13                                  |
| Total                    | \$ 3,126                                           | \$ -                              | \$ -                              | \$ 3,126                            |

|                        |                                                          | Quoted<br>prices in               | Significant<br>other              | Significant<br>other                |
|------------------------|----------------------------------------------------------|-----------------------------------|-----------------------------------|-------------------------------------|
|                        | Total<br>carrying<br>value<br>at<br>December<br>31, 2013 | active<br>markets<br>(Level<br>1) | observable<br>inputs<br>(Level 2) | unobservable<br>inputs<br>(Level 3) |
| (dollars in thousands) |                                                          |                                   |                                   |                                     |

|                          |          |      |      |          |
|--------------------------|----------|------|------|----------|
| Impaired loans           | \$ 1,152 | \$ - | \$ - | \$ 1,152 |
| Other real estate owned  | 1,642    | -    | -    | 1,642    |
| Other repossessed assets | 8        | -    | -    | 8        |
| Total                    | \$ 2,802 | \$ - | \$ - | \$ 2,802 |

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, 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 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 a vehicle's fair value for an impaired auto loan. At March 31, 2014 and December

31, 2013, the range of liquidation expenses and other valuation adjustments applied to impaired loans ranged from -9.00% to -34.71% (weighted-average -26.56%) and from -16.00% to -36.15% (weighted average -24.84%), respectively. 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 March 31, 2014 and December 31, 2013, adjustments to the appraisal values for other real estate owned ranged from -18.22 % to -41.50% (weighted average -30.26%) and from -18.22% to -72.17% (weighted average -30.79% ), respectively.

For repossessed assets, consisting of one automobile as of March 31, 2014 and December 31, 2013, the Company refers to the NADA guide to determine a vehicle's fair value.

## 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 March 31, 2014 compared to December 31, 2013 and a comparison of the results of operations for the three months ended March 31, 2014 and 2013. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2013 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 conditions 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;
  - § effects of short- and long-term federal budget and tax negotiations and their effect on economic and business conditions;
- § 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;

§ 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 was unchanged at 6.7% at both March 31, 2014 and December 31, 2013, remaining at the lowest level since 2008, and down from 7.5% a year earlier. 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 March 31, 2014 was 8.0%, an increase of 0.3 percentage points from 7.7% at December 31, 2013. The unemployment rate was driven up by a smaller labor force and less jobs. In a recent study in the “Metro Monitor” by the Brookings Institution that tracked the economic performance of 100 metropolitan areas, the Scranton/Wilkes-Barre metropolitan is last in the race to climb out of the recession. The study is based on four indicators: jobs, unemployment, output (gross product) and house prices. The area has experienced a slow recovery and hasn’t experienced the bounce back yet that other cities did. 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 and from net gains or losses from sales of loans and 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 months ended March 31, 2014 and 2013

### Overview

For the three months ended March 31, 2014, the Company generated net income of \$1.5 million, or \$0.61 per diluted share, compared to \$1.4 million, or \$0.60 per diluted share, for the three months ended March 31, 2013. The 4% increase in earnings was due to higher net interest income, lower non-interest expense and a \$0.3 million, or 45%,

lower provision for loan loss requirement, offset partially by a decrease in non-interest income. Non-interest income decreased mostly because of lower total net gains on sales of fewer loans. Other non-interest expenses decreased \$0.1 million, or 2%, in the current quarter compared to the 2013 like period from lower expenses related to loan collections and foreclosed assets held-for-sale.

Return on average assets (ROA) and return on average shareholders' equity (ROE) were 0.92% and 8.80%, respectively, for the three months ended March 31, 2014 compared to 0.91% and 9.49% for the same period in 2013.

The slight improvement in ROA was caused by the increase in net income and the decrease in ROE was caused by an increase in shareholders' equity that was boosted by 2013 earnings.

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

Net interest income increased \$0.1 million, or 1%, from \$5.2 million for the quarter ended March 31, 2013 to \$5.3 million for the quarter ended March 31, 2014, with increased interest income and reduced interest expense combining for the increase. The Company experienced a \$20.1 million net increase in average interest-bearing deposits, but a six basis point decline on average rates paid due to a 15 basis point decline on rates paid on certificates of deposit, or CDs. The lower rates paid on CDs in conjunction with a \$4.4 million decline in their average balances resulted in a \$51 thousand decrease in interest expense from time deposits. Interest expense from interest-bearing transaction deposits increased \$26

thousand mostly due to higher average balances, from successful efforts in generating business deposits and also from rates paid on promotional deposit-gathering offerings and negotiated rates. The portfolio of interest-earning assets increased \$20.4 million and helped offset the negative impact of a nine basis point net reduction in the yields earned from loans and investments. The increase in interest income was driven by a 62 basis point increase in the yield earned on investment securities that more than offset the lower interest earned from the loan portfolio. Though average balances of the security portfolio decreased \$3.6 million, its overall performance was bolstered by the Company's fourth quarter 2013 sale of its entire portfolio of corporate bonds. The corporate bond portfolio consisted of pooled trust preferred securities that were essentially non-performing. The proceeds of the sale were re-deployed into earning-assets. The loan portfolio increased \$30.1 million on average, but its earning's performance was negatively impacted by a 35 basis point reduction in yield. Average loan volume increases of \$23.3 million in the commercial and residential mortgage loans helped boost interest income despite a decline in yield of 39 basis points in commercial loans and four basis points in residential mortgage loans. The positive earnings performance of the commercial and residential loan portfolios, however, was not enough to offset the 111 basis points in lower yields earned on a \$6.8 million larger average balance of consumer loans, which generated \$60 thousand less interest income for the three months ended March 31, 2014 compared to March 31, 2013. The increase in interest income of \$34 thousand combined with lower interest expense caused the net interest income growth in the current year quarter compared to the 2013 quarter.

The fully-taxable equivalent (FTE) net interest rate spread and margin decreased by four and five basis points, respectively, for the three months ended March 31, 2014 compared to the three months ended March 31, 2013. The decline in the interest rate spread was caused by a more rapid decline in earning-asset yields compared to the rates paid on their funding sources, while the margin declined due to a lower yielding larger average portfolio of interest-earning assets. The overall cost of funds, which includes the impact of non-interest bearing deposits, was reduced by four basis points for the quarter ended March 31, 2014 compared to the first quarter of 2013 because of lower rates paid on a higher balance of average interest-bearing liabilities.

In 2014, the Company expects to continue to operate in a low, but steeping yield curve environment— increasing at the mid- to long-end of the curve and stable, but near zero at the shortest end. A rate environment with rising long-term interest rates positions the Company to improve its interest income performance from new and maturing long-term earning assets. For 2014, the Company anticipates net interest income to stabilize or improve marginally. The FOMC has not adjusted the short-term federal funds rate upward and is not expected to do so well into 2015, helping contain funding costs. Growth in the commercial loan portfolio and growth in certain targeted segments of the consumer loan portfolio will be the Company's strategy for 2014, and when coupled with historically low funding costs, should help contain the interest rate margin.

At 65 basis points, the Company's cost of interest-bearing liabilities for the three months ended March 31, 2014 is five basis points lower than the cost for the first three months of 2013. Other than retaining maturing long-term CDs, reducing deposit rates from all-time lows would have a minor cost-savings impact. As noted, interest rates along the treasury yield curve have been slowly rising. Competition could potentially pressure banks to increase term deposit rates. 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 the near term thereby further pressuring net interest income should deposit rates begin to steadily rise. To help combat the imminent change to the economic landscape, the Company has successfully developed and will continue to strengthen its association with existing customers, develop new business relationships, generate new loan volumes, retain and generate higher levels of average non-interest bearing deposit balances. 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, together with ALM, lenders and deposit

gatherers, continues to develop prudent strategies that will grow the loan portfolio and accumulate low-cost deposits to improve net interest income performance.

The table that follows sets forth a comparison of average balances of assets and liabilities and their related net tax equivalent yields and rates for the years indicated. Interest income was adjusted to a tax-equivalent basis (FTE), 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 among 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 \$64.3 thousand and \$65.7 thousand for the first quarters of 2014 and 2013, respectively, are included in interest income from loans. In 2013, 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 - FTE by total average interest-earning assets. Cost of funds includes the effect of average non-interest bearing deposits as a funding source:

| (dollars in thousands)               | Three months ended |          |              |                 |          |              |
|--------------------------------------|--------------------|----------|--------------|-----------------|----------|--------------|
|                                      | March 31, 2014     |          |              | March 31, 2013  |          |              |
|                                      | Average balance    | Interest | Yield / rate | Average balance | Interest | Yield / rate |
| Assets                               |                    |          |              |                 |          |              |
| Interest-earning assets              |                    |          |              |                 |          |              |
| Interest-bearing deposits            | \$ 11,792          | \$ 7     | 0.25 %       | \$ 17,419       | \$ 12    | 0.29 %       |
| Investments:                         |                    |          |              |                 |          |              |
| Agency - GSE                         | 15,597             | 54       | 1.40         | 17,472          | 45       | 1.04         |
| MBS - GSE residential                | 49,080             | 191      | 1.58         | 50,452          | 135      | 1.08         |
| State and municipal                  | 33,456             | 499      | 6.05         | 27,342          | 436      | 6.46         |
| Other                                | 2,551              | 24       | 3.86         | 9,059           | 20       | 0.88         |
| Total investments                    | 100,684            | 768      | 3.09         | 104,325         | 636      | 2.47         |
| Loans and leases:                    |                    |          |              |                 |          |              |
| Commercial                           | 262,673            | 3,033    | 4.68         | 241,763         | 3,023    | 5.07         |
| Consumer                             | 62,197             | 848      | 5.53         | 55,447          | 908      | 6.64         |
| Residential real estate              | 156,005            | 1,595    | 4.15         | 153,611         | 1,588    | 4.19         |
| Total loans and leases               | 480,875            | 5,476    | 4.62         | 450,821         | 5,519    | 4.97         |
| Federal funds sold                   | 40                 | -        | 0.30         | 441             | -        | 0.26         |
| Total interest-earning assets        | 593,391            | 6,251    | 4.27 %       | 573,006         | 6,167    | 4.36 %       |
| Non-interest earning assets          | 47,700             |          |              | 44,950          |          |              |
| Total Assets                         | \$ 641,091         |          |              | \$ 617,956      |          |              |
| Liabilities and shareholders' equity |                    |          |              |                 |          |              |
| Interest-bearing liabilities         |                    |          |              |                 |          |              |
| Deposits:                            |                    |          |              |                 |          |              |
| Savings                              | \$ 109,496         | \$ 55    | 0.20 %       | \$ 108,875      | \$ 56    | 0.21 %       |
| Interest-bearing checking            | 101,162            | 42       | 0.17         | 83,170          | 26       | 0.13         |
| MMDA                                 | 86,412             | 115      | 0.54         | 80,543          | 104      | 0.52         |
| CDs < \$100,000                      | 71,193             | 166      | 0.95         | 74,874          | 198      | 1.07         |
| CDs > \$100,000                      | 40,534             | 111      | 1.11         | 41,271          | 130      | 1.28         |
| Clubs                                | 1,388              | 0        | 0.14         | 1,380           | 1        | 0.15         |
| Total interest-bearing deposits      | 410,185            | 489      | 0.48         | 390,113         | 515      | 0.54         |
| Repurchase agreements                | 16,104             | 8        | 0.21         | 17,377          | 9        | 0.21         |
| Borrowed funds                       | 16,399             | 211      | 5.21         | 16,239          | 211      | 5.26         |
| Total interest-bearing liabilities   | 442,688            | 708      | 0.65 %       | 423,729         | 735      | 0.70 %       |
| Non-interest bearing deposits        | 127,736            |          |              | 130,864         |          |              |
| Non-interest bearing liabilities     | 3,595              |          |              | 3,811           |          |              |

|                                            |            |            |
|--------------------------------------------|------------|------------|
| Total liabilities                          | 574,019    | 558,404    |
| Shareholders' equity                       | 67,072     | 59,552     |
| Total liabilities and shareholders' equity | \$ 641,091 | \$ 617,956 |
| Net interest income - FTE                  | \$ 5,543   | \$ 5,432   |
| Net interest spread                        | 3.62 %     | 3.66 %     |
| Net interest margin                        | 3.79 %     | 3.84 %     |
| Cost of funds                              | 0.50 %     | 0.54 %     |

## 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 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 \$0.3 million were recorded during the first quarter of 2014, compared to \$0.6 million as of March 31, 2013. The Company's non-performing loans declined to \$3.7 million as of March 31, 2014, a \$2.1 million decrease from year-end 2013. Although credit quality is improving, additions to the provision in the first quarter of 2014 were required to reserve in connection with loan growth in the period, protect against inherent losses that existed in the portfolio, and reinforce the allowance for the potential credit risks that still existed from an uncertain local economic climate. The allowance for loan losses was \$8.9 million as of both March 31, 2014 and December 31, 2013. For a discussion on the allowance for loan losses, see "Allowance for loan losses," located in the comparison of financial condition section of management's discussion and analysis contained herein.

## Other income

For the three months ended March 31, 2014, non-interest income amounted to \$1.7 million, a \$0.3 million, or 16%, decrease compared to \$2.0 million recorded during the three months ended March 31, 2013. A slowdown in mortgage loan origination and mortgage loan refinance activities resulted in \$0.4 million less in gains recognized from the sales of fewer mortgage loans in the current year quarter compared to the same quarter of 2013. In conjunction with the waning activity in the residential lending area, mortgage loan fees declined \$0.1 million during the quarter ended March 31, 2014 compared to March 31, 2013. These items were partially offset by the cumulative amount of \$0.2 million from additional interchange, security gains, net loan servicing fees, rental income and trust service fees.

## Other operating expenses

For the three months ended March 31, 2014, total other operating expenses decreased \$0.1 million, or 2%, compared to the three months ended March 31, 2013. The decline in loan collection expenses of \$0.2 million for the quarter ended March 31, 2014 compared to the same period in 2013 was mainly attributable to the accelerated pace by which problem loans migrate into foreclosure and the 2013 charges for the final expenses on a large problematic loan. The net expense to carry other real estate (ORE) including, carrying costs, write-down to fair value, gains and losses from their sales and disposition of other foreclosed assets held-for-sale, decreased \$58 thousand primarily due to a net gain recognized on the sale of foreclosed assets of \$48 thousand for the three months ended March 31, 2014 compared to a net loss from sales of \$19 thousand recognized for the three months ended March 31, 2013. Though the assessment base upon which the FDIC insurance premium rate is applied increased, a lower assessment rate caused a \$27 thousand, or 21%, decrease in the assessment in the current year quarter compared to the first quarter of 2013. Advertising and marketing expenses increased \$80 thousand, or 32%, during the three months ended March 31, 2014 compared to the same period in 2013. The increase was caused mostly by \$0.2 million in contributions to educational organizations through the "Educational Improvement Tax Credit" (EITC) program administered by the state of Pennsylvania. The increase in donations was partially offset by a decrease in other advertising and marketing related expenses of \$80 thousand caused by the delay in launching the Company's annual home equity loan campaign to the second quarter of 2014 and less use of media advertising in 2014 compared to 2013. The increase in premises and equipment was predominantly caused by higher facilities maintenance in conjunction with this winter's comparatively extreme weather conditions and higher equipment repair and upkeep caused by higher technology maintenance in the current year quarter. The higher professional services is related to 2013 legal accrual adjustments and the timing of legal service needs for the Company's trust department. The decrease in the other component of operating expenses of \$0.1 million was caused by the decrease in shares tax expense due to the timing and receipt of state-sponsored educational tax credits.

Comparison of financial condition at

March 31, 2014 and December 31, 2013

#### Overview

Consolidated assets increased \$30.6 million, or 5%, to \$654.4 million as of March 31, 2014 from \$623.8 million at December 31, 2013. The increase in assets was funded through growth in deposits of \$25.1 million, short-term borrowings of \$3.7 million and a \$1.8 million increase in shareholders' equity. Net income of \$1.5 million and \$0.5 million in other comprehensive income partially offset by \$0.4 million of dividends declared net of activity in the Company's dividend reinvestment plan drove equity growth. The increase in the funding sources was used to fund loan and investment growth with the excess available to fund 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 on the consolidated balance sheets with unrealized gains and losses, net of deferred income taxes, reported separately within shareholders' equity as a component of accumulated other comprehensive income (loss) (OCI). 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 March 31, 2014, the carrying value of investment securities amounted to \$102.2 million, or 16% of total assets, compared to \$97.4 million, or 16% of total assets, at December 31, 2013. On December 31, 2013, 49% 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, loan demand, unexpected deposit outflow, facility expansion or operations.

As of March 31, 2014, investment securities were comprised of AFS securities with a carrying value of \$102.2 million. The AFS securities were recorded with a net unrealized gain of \$2.7 million as of March 31, 2014 compared to a net unrealized gain of \$1.9 million as of December 31, 2013, or a net improvement of \$0.8 million during the first quarter of 2014. As interest rates along the treasury yield curve rise, especially at the intermediate and long end, the value of bonds tend to decline. Whether or not the value of Company's investment portfolio will continue to exceed its amortized cost will be dependent on the direction and magnitude of interest rate movements and the duration of the Company's bonds. Management has concluded that the present unrealized losses in the portfolio are wholly attributable to the movement in interest rates and not the credit quality of the collateral that secures these investments. With interest rates on the rise, the market values of bank's debt securities portfolio could be subject to market value declines.

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. As noted above, management has determined that the unrealized losses in the portfolio were due to the movement in interest rates and not the credit quality.

During the first three months of 2014, the carrying value of total investments increased \$4.8 million, or 5%. The increase was due to the deployment of the proceeds from the sale of the Company's corporate bonds, consisting of pooled trust preferred securities that occurred late in the fourth quarter of 2013. For the remainder of 2014, the Company expects marginal growth in the investment portfolio and will be used to complement loan growth, the latter providing the potential for stronger earnings performance. The Company expects to maintain a diverse and, in terms of total assets, a proportionately level investment portfolio throughout 2014.

A comparison of investment securities at March 31, 2014 and December 31, 2013 is as follows:

| (dollars in thousands)                 | March 31, 2014 |         | December 31, 2013 |         |
|----------------------------------------|----------------|---------|-------------------|---------|
|                                        | Amount         | %       | Amount            | %       |
| MBS - GSE residential                  | \$ 50,375      | 49.3 %  | \$ 49,686         | 51.0 %  |
| State & municipal subdivisions         | 35,660         | 34.9    | 32,611            | 33.5    |
| Agency - GSE                           | 15,622         | 15.3    | 14,601            | 15.0    |
| Equity securities - financial services | 556            | 0.5     | 525               | 0.5     |
| Total                                  | \$ 102,213     | 100.0 % | \$ 97,423         | 100.0 % |

#### 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 repurchased from the Company at par if the amount of borrowings decline to a predetermined level. In addition, the Company earns a return or dividend based on the amount invested. The dividends received from the FHLB totaled \$15 thousand and \$2 thousand for the three months ended March 31, 2014 and 2013, respectively. The dividend rate has continued to rise in each of the quarters of 2013 and into 2014. The balance in FHLB stock was \$2.2 million and \$2.6 million as of March 31, 2014 and December 31, 2013, respectively.

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

Upon origination, most residential mortgages and certain small business administration (SBA) guaranteed loans may be classified as held-for-sale (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 March 31, 2014 and December 31, 2013, loans HFS consisted of residential mortgage loans.

As of March 31, 2014 and December 31, 2013, loans HFS had a carrying amount of \$0.5 million and \$0.9 million, respectively, which approximated their fair values. During the three months ended March 31, 2014, residential mortgage loans with principal balances of \$7.0 million were sold into the secondary market and the Company recognized net gains of \$0.1 million, compared to \$27.7 million and \$0.5 million, respectively during the three months ended March 31, 2013. Gains of \$41 thousand, deferred from sales of SBA loans in the fourth quarter of 2012, were recognized in the first quarter of 2013. There were no gains recognized from sales of SBA loans in the first quarter of 2014. With a decline in the residential mortgage origination and loan modification activities, the Company does not expect to achieve the same level of gains from loan sales as it had in 2013.

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 March 31, 2014 and December 31, 2013, the servicing portfolio balance of sold residential mortgage loans was \$251.8 million and \$250.2 million, respectively.

#### Loans and leases

The Company's continued focus to improve asset quality in 2014 has resulted in a reduction of \$2.1 million in non-performing loans. Asset quality will certainly continue to be a priority. A practical determination of our risk-rating matrices, the expertise of our external auditors, guidance from our regulators and the experience of the Company's chief risk officer, loan work-out area and the chief lending officer with relationship managers will provide the framework for continued improvement and detection of potential problems. The utilization of loan participations (sharing loans with other financial institutions) and various government guaranty programs will help us to reduce risk in the future.

The continued use of a formal calling program which builds customer loyalty, a teamwork approach, and the knowledge of our relationship managers and branch personnel will provide the emphasis to achieve our targeted loan growth goals for 2014. Growing relationships, reliance on a strong referral base, targeting prospects, and offering seasonal promotions will also provide opportunities for growth. As the leading community bank in our marketplace in the Small Business Administration (SBA) program, our community involvement in the local chambers and civic organizations continues to give

us a competitive edge. Our objective remains, steady growth by continuing to identify customer needs and provide appropriate products and services based upon the expertise of the Company's personnel.

#### Commercial and industrial

Comparing the commercial and industrial (C&I) loan portfolio at December 31, 2013 of \$74.6 million and \$75.7 million at March 31, 2014, there was an increase of \$1.1 million, or 2%. Loan demand remains steady and minimal growth is likely to continue.

#### Commercial real estate

The commercial real estate loan portfolio increased \$3.3 million, or 2%, from \$186.3 million at December 31, 2013 to \$189.6 million as of March 31, 2014. The majority of growth was in the owner occupied real estate category, which historically has proven to have less risk and has been targeted as a growth opportunity. Focused growth in this portfolio is expected to continue.

#### Consumer

The consumer loan portfolio increased by \$1.5 million, or 2%, from \$98.8 million at December 31, 2013 to \$100.3 million at March 31, 2014. The increase in this portfolio is attributed to the auto loans and leases category. During the second quarter, there are strategies in place to increase the home equity category.

#### Residential

The residential loan portfolio decreased \$0.6 million, or 1%, from \$118.6 million at December 31, 2013 to \$118.0 million at March 31, 2014. Runoff in this category is expected, but will be replaced, to some extent, by the booking of mortgages with a maturity date of fifteen years or less.

The composition of the loan portfolio at March 31, 2014 and December 31, 2013, is summarized as follows:

| (dollars in thousands)     | March 31, 2014 |      |   | December 31, 2013 |      |   |
|----------------------------|----------------|------|---|-------------------|------|---|
|                            | Amount         | %    |   | Amount            | %    |   |
| Commercial and industrial  | \$ 75,717      | 15.7 | % | \$ 74,551         | 15.6 | % |
| Commercial real estate:    |                |      |   |                   |      |   |
| Non-owner occupied         | 90,647         | 18.7 |   | 89,255            | 18.7 |   |
| Owner occupied             | 89,373         | 18.5 |   | 86,294            | 18.0 |   |
| Construction               | 9,609          | 1.9  |   | 10,765            | 2.2  |   |
| Consumer:                  |                |      |   |                   |      |   |
| Home equity installment    | 34,161         | 7.1  |   | 34,480            | 7.2  |   |
| Home equity line of credit | 37,202         | 7.7  |   | 36,836            | 7.7  |   |
| Auto and leases            | 23,725         | 4.9  |   | 22,261            | 4.7  |   |
| Other                      | 5,242          | 1.1  |   | 5,205             | 1.1  |   |
| Residential:               |                |      |   |                   |      |   |
| Real estate                | 110,675        | 22.9 |   | 110,365           | 23.1 |   |
| Construction               | 7,292          | 1.5  |   | 8,188             | 1.7  |   |

|                           |            |         |            |         |
|---------------------------|------------|---------|------------|---------|
| Gross loans               | 483,643    | 100.0 % | 478,200    | 100.0 % |
| Less:                     |            |         |            |         |
| Allowance for loan losses | (8,899)    |         | (8,928)    |         |
| Unearned lease revenue    | (79)       |         | (56)       |         |
| Net loans                 | \$ 474,665 |         | \$ 469,216 |         |
| Loans held-for-sale       | \$ 451     |         | \$ 917     |         |

#### 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 (trailing twelve-quarter 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 for loan losses. The Company's Special Assets Committee meets monthly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount, if applicable, based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered regarding not only loans considered for specific reserves, but also the collectability of loans that may be past due. The assessment process also 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 three months ended March 31, 2014 were \$0.3 million compared to \$1.3 million for the three months ended March 31, 2013. This represented a year-over-year improvement due to a general increase in overall credit quality. The first quarter of 2014 charge-offs were taken on a variety of consumer and commercial loans in relatively small amounts. 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 \$8.9 million as of March 31, 2014 and December 31, 2013. 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.

During the fourth quarter of 2013, the Company changed its methodology to determine historical loss percentages from a two-year average that was calculated annually to a trailing twelve-quarter average. Management determined that utilizing a trailing twelve-quarter average minimizes the impact of certain anomalies caused by irregular occurrences such as infrequent large loan charge-offs. In addition, during the fourth quarter of 2013, management changed its methodology used to calculate the allowance for loan losses by eliminating certain loans from the calculation that have very little risk of not being collected. Such loans would include the guaranteed portion of all commercial loans that carry a guarantee by the SBA and all loan categories that are fully secured by cash collateral. The change in the averaging convention had an immaterial impact on the March 31, 2014 allowance calculation. By excluding the cash secured and guarantee portion of SBA loans, as of March 31, 2014 the Company was able to reduce the allowance requirement by approximately \$51 thousand.

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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<br>the<br>three months<br>ended<br>March 31,<br>2014 | As of and for<br>the<br>twelve<br>months ended<br>December 31,<br>2013 | As of and for<br>the<br>three months<br>ended<br>March 31,<br>2013 |   |  |
|-----------------------------------------------------------------------------|--------------------------------------------------------------------|------------------------------------------------------------------------|--------------------------------------------------------------------|---|--|
| Balance at beginning of period                                              | \$ 8,928                                                           | \$ 8,972                                                               | \$ 8,972                                                           |   |  |
| Charge-offs:                                                                |                                                                    |                                                                        |                                                                    |   |  |
| Commercial and industrial                                                   | 28                                                                 | 56                                                                     | 44                                                                 |   |  |
| Commercial real estate                                                      | 152                                                                | 2,091                                                                  | 1,244                                                              |   |  |
| Consumer                                                                    | 118                                                                | 400                                                                    | 39                                                                 |   |  |
| Residential                                                                 | 59                                                                 | 218                                                                    | 39                                                                 |   |  |
| Total                                                                       | 357                                                                | 2,765                                                                  | 1,366                                                              |   |  |
| Recoveries:                                                                 |                                                                    |                                                                        |                                                                    |   |  |
| Commercial and industrial                                                   | 11                                                                 | 30                                                                     | 4                                                                  |   |  |
| Commercial real estate                                                      | 1                                                                  | 30                                                                     | 3                                                                  |   |  |
| Consumer                                                                    | 16                                                                 | 110                                                                    | 73                                                                 |   |  |
| Residential                                                                 | -                                                                  | 1                                                                      | -                                                                  |   |  |
| Total                                                                       | 28                                                                 | 171                                                                    | 80                                                                 |   |  |
| Net charge-offs                                                             | 329                                                                | 2,594                                                                  | 1,286                                                              |   |  |
| Provision for loan losses                                                   | 300                                                                | 2,550                                                                  | 550                                                                |   |  |
| Balance at end of period                                                    | \$ 8,899                                                           | \$ 8,928                                                               | \$ 8,236                                                           |   |  |
| Net charge-offs (annualized) to average total loans outstanding             | 0.27                                                               | % 0.56                                                                 | % 1.14                                                             | % |  |
| Allowance for loan losses to net charge-offs (annualized)                   | 6.76                                                               | x 3.44                                                                 | x 1.60                                                             | x |  |
| Allowance for loan losses to total loans                                    | 1.84                                                               | % 1.86                                                                 | % 1.83                                                             | % |  |
| Loans 30 - 89 days past due and accruing                                    | \$ 2,702                                                           | \$ 5,268                                                               | \$ 4,014                                                           |   |  |
| Loans 90 days or more past due and accruing                                 | \$ 20                                                              | \$ 155                                                                 | \$ 841                                                             |   |  |
| Non-accrual loans                                                           | \$ 3,709                                                           | \$ 5,668                                                               | \$ 9,742                                                           |   |  |
| Allowance for loan losses to loans 90 days or more<br>past due and accruing | 444.95                                                             | x 57.60                                                                | x 9.79                                                             | x |  |
| Allowance for loan losses to non-accrual loans                              | 2.40                                                               | x 1.58                                                                 | x 0.85                                                             | x |  |
| Allowance for loan losses to non-performing loans                           | 2.39                                                               | x 1.53                                                                 | x 0.78                                                             | x |  |
| Average total loans                                                         | \$ 480,875                                                         | \$ 461,539                                                             | \$ 450,821                                                         |   |  |

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 quarter-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 March 31, 2014, non-performing assets represented 1.07% of total assets, favorable results compared with 1.44% as of December 31, 2013 and 2.47% at March 31, 2013. The improvement resulted from a significant reduction in non-performing loans, elimination of the non-accrual securities (pooled trust preferred securities), and a reduction in troubled debt restructurings. Most of the non-performing loans are collateralized, thereby mitigating the Company's potential for loss.

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

| (dollars in thousands)                         | March 31,<br>2014 | December 31,<br>2013 | March 31,<br>2013 |
|------------------------------------------------|-------------------|----------------------|-------------------|
| Loans past due 90 days or more and accruing    | \$ 20             | \$ 155               | \$ 841            |
| Non-accrual loans *                            | 3,709             | 5,668                | 9,742             |
| Total non-performing loans                     | 3,729             | 5,823                | 10,583            |
| Troubled debt restructurings                   | 763               | 1,045                | 1,091             |
| Other real estate owned and repossessed assets | 2,511             | 2,086                | 2,302             |
| Non-accrual securities                         | -                 | -                    | 1,032             |
| Total non-performing assets                    | \$ 7,003          | \$ 8,954             | \$ 15,008         |
| <br>Total loans, including loans held-for-sale | <br>\$ 484,015    | <br>\$ 479,061       | <br>\$ 450,677    |
| Total assets                                   | \$ 654,429        | \$ 623,825           | \$ 608,171        |
| Non-accrual loans to total loans               | 0.77%             | 1.18%                | 2.16%             |
| Non-performing loans to total loans            | 0.77%             | 1.22%                | 2.35%             |
| Non-performing assets to total assets          | 1.07%             | 1.44%                | 2.47%             |

\* In the table above, the amount includes non-accrual TDRs of \$1.0 million as of March 31, 2014 and December 31, 2013 and \$1.1 million as of March 31, 2013.

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, consisting of loans over 90 days past due and accruing and non-accrual loans, decreased \$2.1 million, or 36%, from \$5.8 million on December 31, 2013 to \$3.7 million at March 31, 2014. As of year-end 2013, the over 90 days past due portion was \$0.2 million, which consisted of four loans to four unrelated borrowers, ranging from \$7 thousand to \$0.1 million. At quarter end March 31, 2014, there was one loan past due over 90 days totaling \$20 thousand. The Company seeks payments from all past due customers through an aggressive customer communication process. 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, 2013, there were 47 loans to 37 unrelated borrowers ranging from less than \$1 thousand to \$1.0 million in the non-accrual category. At March 31, 2014 there were 37 loans to 35 borrowers on non-accrual ranging from less than \$1 thousand to \$1.0 million. The decrease in non-accrual loans was related to loans that were charged off, paid off, transferred to ORE or moved back to accrual status.

At March 31, 2014, the non-accrual loans aggregated \$3.7 million as compared to \$5.7 million at December 31, 2013. The net decrease in the level of non-accrual loans during the period ending March 31, 2014 occurred as follows: additions to the non-accrual loan component of the non-performing assets totaling \$0.7 million were made during the period; these were offset by reductions or payoffs of \$0.1 million, charge-offs of \$0.3 million, \$1.2 million of transfers to ORE and \$0.1 million of loans that returned to performing status. In addition, during the first quarter of 2014, \$1.0 million of non-accrual loans were transferred from loans to premises and equipment as more fully described under the caption "Premises and equipment", contained in this management's discussion and analysis below. Loans past due 90 days or more and accruing were \$20 thousand at March 31, 2014, compared to \$0.2 million as of December 31, 2013. The ratio of non-performing loans to total loans was 0.77% at March 31, 2014 compared to 1.22% at December 31, 2013.

The composition of non-performing loans as of March 31, 2014 is as follows:

|                            | Gross<br>loan<br>balances | Past due<br>90<br>days or<br>more<br>and still<br>accruing | Non-<br>accrual<br>loans | Total non-<br>performing<br>loans | % of<br>gross<br>loans |
|----------------------------|---------------------------|------------------------------------------------------------|--------------------------|-----------------------------------|------------------------|
| (dollars in thousands)     |                           |                                                            |                          |                                   |                        |
| Commercial and industrial  | \$ 75,717                 | \$ -                                                       | \$ 62                    | \$ 62                             | 0.08%                  |
| Commercial real estate:    |                           |                                                            |                          |                                   |                        |
| Non-owner occupied         | 90,647                    | -                                                          | 640                      | 640                               | 0.71%                  |
| Owner occupied             | 89,373                    | -                                                          | 1,567                    | 1,567                             | 1.75%                  |
| Construction               | 9,609                     | -                                                          | 281                      | 281                               | 2.92%                  |
| Consumer:                  |                           |                                                            |                          |                                   |                        |
| Home equity installment    | 34,161                    | -                                                          | 211                      | 211                               | 0.62%                  |
| Home equity line of credit | 37,202                    | -                                                          | 138                      | 138                               | 0.37%                  |
| Auto loans and leases      | 23,646                    | 20                                                         | -                        | 20                                | 0.08%                  |
| Other                      | 5,242                     | -                                                          | 22                       | 22                                | 0.42%                  |
| Residential:               |                           |                                                            |                          |                                   |                        |
| Real estate                | 110,675                   | -                                                          | 788                      | 788                               | 0.71%                  |
| Construction               | 7,292                     | -                                                          | -                        | -                                 | -                      |
| Loans held-for-sale        | 451                       | -                                                          | -                        | -                                 | -                      |
| Total                      | \$ 484,015                | \$ 20                                                      | \$ 3,709                 | \$ 3,729                          | 0.77%                  |

Payments received from non-accrual loans are recognized on a cash method. Payments are first applied to the outstanding principal balance, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of interest income. If the non-accrual loans that were outstanding as of March 31, 2014 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of \$52 thousand.

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 \$1.7 million at March 31, 2014, which was a slight decrease from the December 31, 2013 total of \$2.0 million, the result of loan payoffs during the first quarter of 2014.

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

As of and for the three months  
ended March 31, 2014

|                             | Accruing Commercial & Commercial industrial real estate |          | Non-accruing Commercial real estate | Total    |
|-----------------------------|---------------------------------------------------------|----------|-------------------------------------|----------|
| (dollars in thousands)      |                                                         |          |                                     |          |
| Troubled Debt Restructures: |                                                         |          |                                     |          |
| Beginning balance           | \$ 35                                                   | \$ 1,010 | \$ 967                              | \$ 2,012 |
| Pay downs / payoffs         | 10                                                      | 272      | 13                                  | 295      |
| Ending balance              | \$ 25                                                   | \$ 738   | \$ 954                              | \$ 1,717 |

As of and for the year ended December 31, 2013

| (dollars in thousands)      | Accruing<br>Commercial<br>& Commercial<br>industrial estate |          | Non-accruing<br>Commercial<br>real estate | Total    |
|-----------------------------|-------------------------------------------------------------|----------|-------------------------------------------|----------|
| Troubled Debt Restructures: |                                                             |          |                                           |          |
| Beginning balance           | \$ 42                                                       | \$ 1,061 | \$ 1,066                                  | \$ 2,169 |
| Pay downs / payoffs         | 7                                                           | 51       | 99                                        | 157      |
| Ending balance              | \$ 35                                                       | \$ 1,010 | \$ 967                                    | \$ 2,012 |

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. The concessions granted consisted of temporary interest-only payments or a reduction in the rate of interest to a below-market rate for a contractual period of time for a contractual period of time. The Company believes concessions have been made in the best interests of the borrower and the Company. 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 \$2.5 million at March 31, 2014 and \$2.1 million at December 31, 2013. The following table sets forth the activity in the ORE component of foreclosed assets held-for-sale:

|                                | March 31, 2014 |     | December 31, 2013 |      |
|--------------------------------|----------------|-----|-------------------|------|
| (dollars in thousands)         | Amount         | #   | Amount            | #    |
| Balance at beginning of period | \$ 2,078       | 15  | \$ 1,600          | 12   |
| Additions                      | 1,131          | 5   | 2,381             | 15   |
| Pay downs                      | -              |     | (34)              |      |
| Write downs                    | -              |     | (443)             |      |
| Sold                           | (711)          | (6) | (1,426)           | (12) |
| Balance at end of period       | \$ 2,498       | 14  | \$ 2,078          | 15   |

As of March 31, 2014, ORE consisted of fourteen properties from unrelated borrowers totaling \$2.5 million. Five of these properties (\$1.1 million total) were added in 2014; five were added in 2013 (\$514 thousand total); two were added in 2012 (\$289 thousand); one was added in 2011 (\$152 thousand) and one was added in 2010 (\$400 thousand).

One property (\$150 thousand) has a pending insurance claim, six properties (\$1.5 million) were listed for sale, two (\$136 thousand) had signed sales agreements, two (\$253 thousand) were in litigation, and three properties (\$455 thousand) were awaiting disposition plans.

Other non-real estate foreclosed assets held-for-sale included an automobile with a book value of \$13 thousand at March 31, 2014. At December 31, 2013, other repossessed assets consisted of an automobile with a book value of \$8 thousand which was sold during 2014.

#### Premises and equipment

Net of depreciation, premises and equipment increased \$0.8 million during the first quarter of 2014. During the quarter, the Company received through foreclosure the deed that secured the collateral for a non-owner occupied commercial real estate loan that was on non-accrual status. During the first quarter, the loan, in the amount \$1.0 million, was transferred from loans to foreclosed assets held-for-sale and then to bank premises. The Company expects to use the property for future facility expansion.

#### Other assets and liabilities

The \$1.1 million increase in other assets was due principally to a \$0.6 million purchase of an investment security that did not settle until after quarter end. The purchase obligation is reflected in an equal amount in other liabilities. Other assets also increased by progress payments on facility construction projects and by residual values associated with recording new automobile leases, net of lease disposals.

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. 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. Deposit products consist of transaction accounts including: savings; clubs; interest-bearing checking; money market and non-interest bearing checking (DDA). The Company also offers short- and long-term time deposits or certificates of deposit (CDs). CDs are deposits with stated maturities which can range from seven days to ten years. Deposit inflow and outflow 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)    | March 31, 2014 |         | December 31, 2013 |         |
|---------------------------|----------------|---------|-------------------|---------|
|                           | Amount         | %       | Amount            | %       |
| Money market              | \$ 86,193      | 15.5 %  | \$ 83,512         | 15.8 %  |
| Interest-bearing checking | 113,749        | 20.5    | 100,315           | 18.9    |
| Savings and clubs         | 111,859        | 20.2    | 109,253           | 20.6    |
| Certificates of deposit   | 110,869        | 20.0    | 113,699           | 21.5    |
| Total interest-bearing    | 422,670        | 76.2    | 406,779           | 76.8    |
| Non-interest bearing      | 132,096        | 23.8    | 122,919           | 23.2    |
| Total deposits            | \$ 554,766     | 100.0 % | \$ 529,698        | 100.0 % |

Total deposits increased \$25.1 million, or 5%, from \$529.7 million at December 31, 2013 to \$554.8 million at March 31, 2014. Interest-bearing checking and noninterest-bearing checking had significant growth at \$13.4 million, or 13%, and \$9.2 million, or 7%. The principal cause of the increase was due to the timing of the receipt of public tax deposits. Public deposits are usually received mid-quarter, are retained for a relatively short period of time with disbursements occurring shortly after they are received. Success in deposit gathering strategies including periodic promotions helped boost non-maturing deposits for retail customers while business transaction accounts experienced minor cash outflow. The Company's focus will be to continue to partner with business clientele, establish new and continue to cultivate existing banking relationships. In 2014, we expect to experience moderate deposit growth from year-end 2013 levels.

The rates along the intermediate and long end of the treasury yield curve continued to slowly rise while rates at the short end, where transaction deposits are typically priced, remained relatively flat. The long-end has not risen enough to induce depositors to move their cash reserves into longer-term CDs and as such, banks will most likely increase rates cautiously slow until there is a clear indication that the rates along the curve rise, steepen and stabilize. Managing the yield curve in a changing rate environment is imperative to maintain interest rate spread. The current environment continues to cause business and retail customers to seek short-term alternatives for their deposits. When rates begin to rise, however, there is no assurance that customers will continue to hold their deposits with the Company or they may seek higher rates from term CDs, thereby increasing funding costs. The Company will continue to pursue and retain retail and business households with an emphasis on deepening and broadening those relationships thereby containing interest expense.

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 per person. 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 the 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 both March 31, 2014 and December 31, 2013, CDARS represented \$10.3 million, or 2%, of total deposits.

Excluding CDARS, certificates of deposit accounts of \$100,000 or more amounted to \$40.2 million and \$41.2 million at March 31, 2014 and December 31, 2013, respectively. Certificates of deposit of \$250,000 or more amounted to \$15.3 million and \$15.7 million as of March 31, 2014 and December 31, 2013, respectively.

Including CDARS, approximately 41% of the CDs, with a weighted-average interest rate of 0.75%, are scheduled to mature in 2014 and an additional 27%, with a weighted-average interest rate of 1.11%, are scheduled to mature in 2015. Renewing CDs may re-price to lower or higher market rates depending on the rate on the maturing CD, the pace and 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. The widespread preference has been for customers with maturing CDs to hold their deposits in readily available transaction accounts. Though the CD portfolio has declined \$2.8 million, or by less than 3%, the Company projects a flat to marginal increase in its CDs in 2014.

#### 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 as required by the FDIC Depositor Protection Act of 2009. 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 quarter of 2014

increased \$6.2 million, or 100%, from year-end December 31, 2013. 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 March 31, 2014, the Company did not have balances in overnight borrowings compared to \$2.5 million as of December 31, 2013.

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

| (dollars in thousands)                      | March 31, 2014 |       | December 31, 2013 |         |
|---------------------------------------------|----------------|-------|-------------------|---------|
|                                             | Amount         | %     | Amount            | %       |
| Overnight borrowings                        | \$ -           | -     | % \$ 2,472        | 10.0 %  |
| Securities sold under repurchase agreements | 12,327         | 43.5  | 6,171             | 25.0    |
| Long-term FHLB advances                     | 16,000         | 56.5  | 16,000            | 64.9    |
| Total                                       | \$ 28,327      | 100.0 | % \$ 24,643       | 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) indicates 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 March 31, 2014, the Company maintained a one-year cumulative gap of positive (asset sensitive) \$63.8 million, or 10%, 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, 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 March 31, 2014:

| (dollars in thousands)                        | Three<br>months<br>or less | More than<br>three<br>months to<br>twelve<br>months | More than<br>one year<br>to three<br>years | More than<br>three years | Total      |
|-----------------------------------------------|----------------------------|-----------------------------------------------------|--------------------------------------------|--------------------------|------------|
| Cash and cash equivalents                     | \$ 16,643                  | \$ -                                                | \$ -                                       | \$ 15,456                | \$ 32,099  |
| Investment securities (1)(2)                  | 3,066                      | 10,356                                              | 22,552                                     | 68,415                   | 104,389    |
| Loans and leases(2)                           | 178,870                    | 69,473                                              | 111,760                                    | 115,013                  | 475,116    |
| Fixed and other assets                        | -                          | 10,485                                              | -                                          | 32,340                   | 42,825     |
| Total assets                                  | \$ 198,579                 | \$ 90,314                                           | \$ 134,312                                 | \$ 231,224               | \$ 654,429 |
| Total cumulative assets                       | \$ 198,579                 | \$ 288,893                                          | \$ 423,205                                 | \$ 654,429               |            |
| Non-interest-bearing transaction deposits (3) | \$ -                       | \$ 13,223                                           | \$ 36,300                                  | \$ 82,573                | \$ 132,096 |
| Interest-bearing transaction deposits (3)     | 123,850                    | 18,618                                              | 110,321                                    | 59,012                   | 311,801    |
| Certificates of deposit                       | 16,660                     | 40,400                                              | 45,634                                     | 8,175                    | 110,869    |
| Repurchase agreements                         | 12,327                     | -                                                   | -                                          | -                        | 12,327     |
| Long-term debt                                | -                          | -                                                   | 16,000                                     | -                        | 16,000     |
| Other liabilities                             | -                          | -                                                   | -                                          | 3,487                    | 3,487      |
| Total liabilities                             | \$ 152,837                 | \$ 72,241                                           | \$ 208,255                                 | \$ 153,247               | \$ 586,580 |
| Total cumulative liabilities                  | \$ 152,837                 | \$ 225,078                                          | \$ 433,333                                 | \$ 586,580               |            |
| Interest sensitivity gap                      | \$ 45,742                  | \$ 18,073                                           | \$ (73,943)                                | \$ 77,977                |            |
| Cumulative gap                                | \$ 45,742                  | \$ 63,815                                           | \$ (10,128)                                | \$ 67,849                |            |
| Cumulative gap to total assets                | 7.0%                       | 9.8%                                                | -1.5%                                      | 10.4%                    |            |

(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.

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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 March 31, 2014 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 March 31, 2014 levels:

|                                                       | % change |         |
|-------------------------------------------------------|----------|---------|
|                                                       | Rates    | Rates   |
|                                                       | +200     | -200    |
| Earnings at risk:                                     |          |         |
| Net interest income                                   | 7.0 %    | (2.7) % |
| Net income                                            | 19.5     | (7.4)   |
| Economic value at risk:                               |          |         |
| Economic value of equity                              | (9.2)    | (15.6)  |
| Economic value of equity as a percent of total assets | (1.2)    | (2.0)   |

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 March 31, 2014, the Company's risk-based capital ratio was 15.5%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning April 1, 2014, under alternate interest rate scenarios using the income simulation model described above:

|                                    | Net       |          |          |
|------------------------------------|-----------|----------|----------|
| (dollars in thousands)             | interest  | \$       | %        |
|                                    | income    | variance | variance |
| Simulated change in interest rates |           |          |          |
| +200 basis points                  | \$ 23,057 | \$ 1,517 | 7.0 %    |
| +100 basis points                  | 22,121    | 581      | 2.7      |
| Flat rate                          | 21,540    | -        | -        |
| -100 basis points                  | 21,347    | (193)    | (0.9)    |
| -200 basis points                  | 20,955    | (585)    | (2.7)    |

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. 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's contingency funding plan (CFP) sets a framework for handling liquidity issues in the event circumstances arise which the Company deems to be less than normal. The Company established guidelines for identifying, measuring, monitoring and managing the resolution of potentially serious liquidity crises. The 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 March 31, 2014, the Company had not experienced any adverse issues that would give rise to its inability to raise liquidity in an emergency situation.

During the three months ended March 31, 2014, the Company generated \$18.9 million of cash. During the period, the Company was in receipt of public tax deposits that it received later than normal during the first quarter. Cash received from the sale of PreTSL portfolio in the fourth quarter of 2013 was used to fund growth in loan and re-deployment in the investment portfolios. The growth in the loan portfolio occurred in all sectors with the commercial portfolio leading the growth. The Company expects to continue to grow the commercial loan portfolio in 2014 using growth in deposits, repos and operations. 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 customer base. The CFP is a tool to help the Company ensure that alternative funding sources are available to meet its liquidity needs.

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, 2013.

As of March 31, 2014, the Company maintained \$32.1 million in cash and cash equivalents and \$102.7 million of investments AFS and loans HFS. Also as of March 31, 2014, the Company had approximately \$165.7 million available to borrow from the FHLB, \$21.0 million from correspondent banks, \$28.7 million from the FRB and \$31.2 million from the CDARS program. The combined total of \$381.4 million represented 58% of total assets at March 31, 2014. Management believes this level of liquidity to be strong and adequate to support current operations.

## Capital

During the three months ended March 31, 2014, total shareholders' equity increased \$1.8 million, or 3%, due principally from the \$1.5 million in net income added into retained earnings and the \$0.5 million, after-tax improvement in the net unrealized gain position in the Company's investment portfolio. Capital was further enhanced by \$0.3 million from investments in the Company's common stock via the Employee Stock Purchase (ESPP) and

Dividend Reinvestment (DRP) Plans. These items were partially offset by the \$0.6 million of cash dividends declared on the Company's common stock.

As of March 31, 2014, the Company reported a net unrealized gain position of \$1.8 million, net of tax, from the securities AFS portfolio compared to a net unrealized gain of \$1.2 million as of December 31, 2013. The increase in unrealized gains during the first quarter of 2014 was due mostly to an increase in unrealized gains on municipal securities. Management believes that volatility in fair value of the Company's securities is due to changes in interest rates and not deterioration in the creditworthiness of the issuers. When, U.S. Treasury rates rise, investment securities' pricing declines and fair values of investment securities also decline. With the yield curve slowly increasing at the mid- to long-range, the Company expects pricing in the bond portfolio to decline. Bond prices move inversely to the movement of interest rates. As such, there is no assurance that future realized and unrealized losses will not be recognized from the Company's portfolio of investment securities. To help maintain a healthy capital position, the Company expects to continue to issue stock to participants in the DRP and ESPP plans. The DRP affords the Company the option to acquire shares in open market purchases and/or issue shares directly from the Company to issue stock to participants. These two plans have been a consistent source of capital from the Company's loyal employees and shareholders and their participation in these plans will continue to help strengthen the Company's balance sheet. Beginning in 2009, the Company's board of directors had allowed a benefit to our loyal shareholders as a discount on the purchase price for shares issued directly from the Company through the DRP and voluntary cash feature. During the first quarter of 2014, the DRP was amended to discontinue a portion of the discount on the voluntary cash feature as the board of directors had determined that the Company's capital position has achieved sufficient levels.

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 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 March 31, 2014, 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 March 31, 2014:

| (dollars in thousands)<br>As of March 31, 2014 | Actual    |         | For capital<br>adequacy purposes |        | To be well<br>capitalized<br>under prompt<br>corrective<br>action provisions |         |
|------------------------------------------------|-----------|---------|----------------------------------|--------|------------------------------------------------------------------------------|---------|
|                                                | Amount    | Ratio   | Amount                           | Ratio  | Amount                                                                       | Ratio   |
| Total capital (to risk-weighted assets)        |           |         |                                  |        |                                                                              |         |
| Consolidated                                   | \$ 71,941 | 15.5% ≥ | \$ 37,231                        | ≥ 8.0% | N/A                                                                          | N/A     |
| Bank                                           | \$ 71,416 | 15.4% ≥ | \$ 37,186                        | ≥ 8.0% | ≥ \$ 46,482                                                                  | ≥ 10.0% |
| Tier I capital (to risk-weighted assets)       |           |         |                                  |        |                                                                              |         |
| Consolidated                                   | \$ 65,967 | 14.2% ≥ | \$ 18,616                        | ≥ 4.0% | N/A                                                                          | N/A     |
| Bank                                           | \$ 65,565 | 14.1% ≥ | \$ 18,593                        | ≥ 4.0% | ≥ \$ 27,889                                                                  | ≥ 6.0%  |
| Tier I capital (to average assets)             |           |         |                                  |        |                                                                              |         |
| Consolidated                                   | \$ 65,967 | 10.3% ≥ | \$ 25,636                        | ≥ 4.0% | N/A                                                                          | N/A     |
| Bank                                           | \$ 65,565 | 10.2% ≥ | \$ 25,617                        | ≥ 4.0% | ≥ \$ 32,021                                                                  | ≥ 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 2013 Form 10-K for a discussion on the regulatory environment and recent legislation and rulemaking.

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 March 31, 2014.

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 2013 Form 10-K filed with the Securities and Exchange Commission on March 19, 2014.

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

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 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 as amended February 3, 2014.

\*10.2 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.

\*10.3 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.

\*10.4 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.

\*10.5 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.

\*10.6 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.

\*10.7 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.

\*10.8 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.

\*10.9 Amended and Restated Executive Employment Agreement between the Registrant, The Fidelity Deposit and Discount Bank and Timothy P. O'Brien, dated March 23, 2011. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

\*10.10 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.

\*10.11 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.

\*10.12 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 March 31, 2014, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of March 31, 2014 and December 31, 2013; Consolidated Statements of Income for the three months ended March 31, 2014 and 2013; Consolidated Statements of Comprehensive Income for the three months ended March 31, 2014 and 2013, Consolidated Statements of Changes in Shareholders' Equity for the three months ended March 31, 2014 and 2013, Consolidated Statements of Cash Flows for the three months ended March 31, 2014 and 2013 and the Notes to the Consolidated Financial Statements.

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\* Management contract or compensatory plan or arrangement.



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: May 7, 2014 /s/Daniel J. Santaniello  
Daniel J. Santaniello,

President and Chief Executive Officer

Fidelity D & D Bancorp, Inc.

Date: May 7, 2014 /s/Salvatore R. DeFrancesco, Jr.  
Salvatore R. DeFrancesco, Jr.,

Treasurer and Chief Financial Officer

EXHIBIT INDEX

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|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
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Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

\*

10.10 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.

\*

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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: May 7, 2014

/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: May 7, 2014 /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 March 31, 2014, 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: May 7, 2014 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 March 31, 2014, 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: May 7, 2014 By:/s/ Salvatore R. DeFrancesco, Jr.  
Salvatore R. DeFrancesco, Jr.,  
Treasurer and Chief Financial