

FIDELITY D & D BANCORP INC
Form 10-Q
November 12, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2009

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. at October 30, 2009, the latest practicable date, was 2,093,313 shares.

FIDELITY D & D BANCORP, INC.

Form 10-Q September 30, 2009

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PART I – Financial Information

Item 1: Financial Statements

FIDELITY D & D BANCORP, INC. AND SUBSIDIARY
Consolidated Balance Sheets

	September 30, 2009 (unaudited)	December 31, 2008 (audited)
Assets:		
Cash and due from banks	\$ 11,725,108	\$ 12,335,905
Federal funds sold	5,563,000	-
Interest-bearing deposits with financial institutions	344,073	435,242
Total cash and cash equivalents	17,632,181	12,771,147
Available-for-sale securities	82,401,730	83,278,132
Held-to-maturity securities	740,387	909,447
Federal Home Loan Bank Stock	4,781,100	4,781,100
Loans and leases, net (allowance for loan losses of \$6,724,857 in 2009; \$4,745,234 in 2008)	420,833,765	436,207,460
Loans available-for-sale (fair value \$893,873 in 2009; \$85,312 in 2008)	881,109	84,000
Bank premises and equipment, net	15,514,474	16,056,362
Cash surrender value of bank owned life insurance	9,038,561	8,807,784
Other assets	10,268,397	8,929,917
Accrued interest receivable	2,543,333	2,443,141
Foreclosed assets held-for-sale	1,364,397	1,450,507
Total assets	\$ 565,999,434	\$ 575,718,997
Liabilities:		
Deposits:		
Interest-bearing	\$ 403,268,503	\$ 361,869,281
Non-interest-bearing	73,990,068	71,442,651
Total deposits	477,258,571	433,311,932
Accrued interest payable and other liabilities	3,338,059	3,316,710
Short-term borrowings	5,238,457	38,129,704
Long-term debt	32,000,000	52,000,000
Total liabilities	517,835,087	526,758,346
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; 2,093,313 in 2009; and 2,075,182 shares issued and 2,062,927 shares outstanding in 2008)	19,775,652	19,410,306

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Treasury stock, at cost (no shares in 2009; 12,255 shares in 2008)	-	(351,665)
Retained earnings	35,336,330	38,126,250
Accumulated other comprehensive loss	(6,947,635)	(8,224,240)
Total shareholders' equity	48,164,347	48,960,651
Total liabilities and shareholders' equity	\$ 565,999,434	\$ 575,718,997

See notes to consolidated financial statements

FIDELITY D & D BANCORP, INC. AND SUBSIDIARY
Consolidated Statements of Income
(unaudited)

	Three months ended		Nine months ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Interest income:				
Loans and leases:				
Taxable	\$ 6,435,487	\$ 6,811,968	\$ 19,353,099	\$ 20,396,282
Nontaxable	110,566	93,454	338,828	256,860
Interest-bearing deposits with financial institutions	89	606	537	2,408
Investment securities:				
U.S. government agency and corporations	534,629	1,047,561	1,852,457	3,584,878
States and political subdivisions (nontaxable)	318,299	170,098	787,208	469,330
Other securities	50,994	295,753	393,502	976,447
Federal funds sold	3,422	-	10,781	91,133
Total interest income	7,453,486	8,419,440	22,736,412	25,777,338
Interest expense:				
Deposits	1,949,402	2,598,805	6,279,307	8,663,941
Securities sold under repurchase agreements	5,872	11,545	22,427	92,141
Other short-term borrowings and other	1,446	142,954	27,991	256,625
Long-term debt	1,075,934	786,989	2,420,466	2,395,484
Total interest expense	3,032,654	3,540,293	8,750,191	11,408,191
Net interest income	4,420,832	4,879,147	13,986,221	14,369,147
Provision for loan losses	3,125,000	130,000	3,850,000	255,000
Net interest income after provision for loan losses	1,295,832	4,749,147	10,136,221	14,114,147
Other income (loss):				
Service charges on deposit accounts	676,107	715,528	1,956,755	2,216,127
Fees and other service charges	428,049	451,382	1,407,538	1,344,020
Gain (loss) on sale or disposal of:				
Loans	139,451	64,778	957,777	215,974
Investment securities	-	16,775	-	25,428
Premises and equipment	(34,617)	(34,674)	(41,241)	(35,658)
Foreclosed assets held-for-sale	7,780	33,685	33,667	42,794
Write-down of foreclosed assets held-for-sale	(77,560)	-	(77,560)	-

Impairment losses on investment securities:					
Other-than-temporary impairment on investment securities	(6,468,236)	(403,031)	(6,794,331)	(403,031)	
Non-credit related losses on investment securities not expected to be sold (recognized in other comprehensive income/(loss))					
	4,036,470	-	4,036,470	-	
Net impairment losses on investment securities recognized in earnings	(2,431,766)	(403,031)	(2,757,861)	(403,031)	
Total other (loss) income	(1,292,556)	844,443	1,479,075	3,405,654	
Other expenses:					
Salaries and employee benefits	2,502,818	2,474,969	7,495,167	7,364,817	
Premises and equipment	874,028	813,380	2,685,343	2,385,489	
Advertising	117,897	242,937	396,290	579,641	
Other	1,614,552	1,141,368	3,933,271	3,179,996	
Total other expenses	5,109,295	4,672,654	14,510,071	13,509,943	
(Loss) income before income taxes	(5,106,019)	920,936	(2,894,775)	4,009,858	
(Credit) provision for income taxes	(1,895,339)	179,821	(1,421,306)	975,850	
Net (loss) income	\$ (3,210,680)	\$ 741,115	\$ (1,473,469)	\$ 3,034,008	
Per share data:					
Net (loss) income - basic	\$ (1.55)	\$ 0.35	\$ (0.71)	\$ 1.46	
Net (loss) income – diluted	\$ (1.55)	\$ 0.35	\$ (0.71)	\$ 1.46	
Dividends	\$ 0.25	\$ 0.25	\$ 0.75	\$ 0.75	

FIDELITY D & D BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Changes in Shareholders' Equity
For the nine months ended September 30, 2009 and 2008

	Capital stock		Treasury stock		Retained	Accumulated other comprehensive income (loss)	Total
	Shares	Amount	Shares	Amount	earnings		
Balance, December 31, 2007	2,072,929	\$ 19,223,363	-	\$ -	\$ 36,564,157	\$ (596,226)	\$ 55,191,294
Total comprehensive income (loss):							
Net income					3,034,008		3,034,008
Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects						(5,957,194)	(5,957,194)
Change in cash flow hedge intrinsic value						96,383	96,383
Comprehensive loss							(2,826,803)
Issuance of common stock through Employee Stock Purchase Plan	2,253	57,891					57,891
Stock-based compensation expense		129,052					129,052
Purchase of treasury stock			(13,000)	(379,810)			(379,810)
Cash dividends declared					(1,553,635)		(1,553,635)
Balance, September 30, 2008 (unaudited)	2,075,182	\$ 19,410,306	(13,000)	\$ (379,810)	\$ 38,044,530	\$ (6,457,037)	\$ 50,617,989

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Balance, December 31, 2008	2,075,182	\$ 19,410,306	(12,255)	\$ (351,665)	\$ 38,126,250	\$ (8,224,240)	\$ 48,960,651
Cumulative effect of change in accounting principle, adoption of FASB ASC 320-10					350,720	(350,720)	-
Total comprehensive income:							
Net loss					(1,473,469)		(1,473,469)
Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects						4,852,351	4,852,351
Non-credit related impairment losses on investment securities not expected to be sold, net of tax						(2,664,070)	(2,664,070)
Change in cash flow hedge intrinsic value						(560,956)	(560,956)
Comprehensive income							153,856
Issuance of common stock through Employee Stock Purchase Plan	1,701	40,569					40,569
Purchase of treasury stock			(2,500)	(56,505)			(56,505)
Dividends reinvested through Dividend Reinvestment Plan	16,430	320,269	14,755	408,170	(112,329)		616,110
Stock-based compensation expense		4,508					4,508
Cash dividends declared					(1,554,842)		(1,554,842)
	2,093,313	\$ 19,775,652	-	\$ -	\$ 35,336,330	\$ (6,947,635)	\$ 48,164,347

Balance, September
30, 2009
(unaudited)

See notes to consolidated financial statements

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FIDELITY DEPOSIT & DISCOUNT BANCORP, INC. AND SUBSIDIARY
Consolidated Statements of Cash Flows
(unaudited)

	Nine months ended September 30,	
	2009	2008
Cash flows from operating activities:		
Net (loss) income	\$ (1,473,469)	\$ 3,034,008
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation, amortization and accretion	1,130,120	442,338
Provision for loan losses	3,850,000	255,000
Deferred income tax expense	(1,211,999)	158,834
Stock-based compensation expense	4,508	129,052
Loss from investment in limited partnership	40,961	60,300
Proceeds from sale of loans available-for-sale	90,195,545	42,687,143
Originations of loans available-for-sale	(79,702,670)	(11,163,004)
Write-down of foreclosed assets held-for-sale	77,560	-
Increase in cash surrender value of life insurance	(230,777)	(239,905)
Net gain on sale of loans	(957,777)	(215,974)
Net gain on sale of investment securities	-	(25,428)
Net gain on sale of foreclosed assets held for sale	(33,667)	(42,794)
Loss on disposal of equipment	41,241	35,658
Other-than-temporary impairment on securities	2,757,861	403,031
Change in:		
Accrued interest receivable	(285,893)	(35,235)
Other assets	(1,262,594)	(1,625,694)
Accrued interest payable and other liabilities	22,564	130,552
Net cash provided by operating activities	12,961,514	33,987,882
Cash flows from investing activities:		
Held-to-maturity securities:		
Proceeds from maturities, calls and principal pay-downs	169,017	201,209
Available-for-sale securities:		
Proceeds from sales	-	48,402,449
Proceeds from maturities, calls and principal pay-downs	30,396,495	30,445,671
Purchases	(28,383,313)	(51,961,087)
Net decrease in FHLB stock	-	(1,467,800)
Net increase in loans and leases	(85,653)	(37,941,827)
Acquisition of bank premises and equipment	(808,304)	(3,662,291)
Proceeds from sale of bank premises and equipment	-	600
Proceeds from sale of foreclosed assets held-for-sale	510,554	262,406
Net cash provided by (used in) investing activities	1,798,796	(15,720,670)
Cash flows from financing activities:		
Net increase in deposits	43,946,639	9,723,176

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Net decrease in short-term borrowings	(32,891,247)	(22,570,040)
Repayments of long-term debt	(20,000,000)	(637,016)
Purchase of treasury stock	(56,505)	(321,105)
Proceeds from employee stock purchase plan	40,569	57,891
Dividends paid, net of dividends reinvested	(938,732)	(1,553,635)
Net cash used in financing activities	(9,899,276)	(15,300,729)
Net increase in cash and cash equivalents	4,861,034	2,966,483
Cash and cash equivalents, beginning	12,771,147	10,408,816
Cash and cash equivalents, ending	\$ 17,632,181	\$ 13,375,299

See notes to 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

The 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 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 10-01 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, 2008.

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

In the opinion of management, the consolidated balance sheets as of September 30, 2009 and December 31, 2008 and the related consolidated statements of income for the three- and nine-month periods ended September 30, 2009 and 2008 and changes in shareholders' equity and cash flows for the nine months ended September 30, 2009 and 2008 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.

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, 2008, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

Critical accounting policies

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

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at September 30, 2009 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

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

Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes from more than one source may be obtained. 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 sheet, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity through accumulated other comprehensive income (loss).

The fair value of residential mortgage loans, classified as AFS, is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells 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 and lease portfolio to loans AFS. 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. For a further discussion on the accounting treatment of AFS loans, see the section entitled "Loans available-for-sale," contained within management's discussion and analysis. As of September 30, 2009 and December 31, 2008, loans classified as AFS consisted of residential mortgages.

2. New Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued SFAS No. 168 (FASB ASC 105-10), The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (SFAS 168) (FASB ASC 105-10). SFAS 168 (FASB ASC 105-10) establishes the FASB Accounting Standards Codification (codification) as the single source of authoritative non-governmental U.S. generally accepted accounting principles, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related accounting literature. The codification does not change GAAP. Instead, it takes the thousands of individual pronouncements that currently comprise GAAP and reorganizes them into approximately 90 accounting topics, and displays all topics using a consistent structure. Contents in each topic are further organized first by subtopic, then section and finally paragraph. The paragraph level is the only level that contains substantive content. Citing particular content in the codification involves specifying the unique numeric path to the content through the topic, subtopic, section and paragraph structure. FASB suggests that all citations begin with "FASB ASC," where ASC stands for Accounting Standards Codification. SFAS 168, (FASB ASC 105-10) is effective for interim and annual periods ending after September 15, 2009 and has impacted the Company's financial statements only to the extent that references to authoritative accounting literature are now referenced in accordance with FASB ASC 105-10. Accordingly, where deemed necessary, the balance of this report will reference the Accounting Standards Codification (ASC).

On January 1, 2009, the Company adopted FASB ASC 350-30-35, Determination of the Useful Life of Intangible Assets, which provides guidance on the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB ASC 350-10, Goodwill and Other Intangible Assets. The intent of this guidance is to improve the consistency between the useful life of a

recognized intangible asset and the period of expected cash flows, particularly as used to measure fair value in business combinations. FASB ASC 350-30-35 is effective for fiscal years beginning after December 15, 2008, and is immaterial as it relates to the Company's consolidated financial statements.

On January 1, 2009, the Company adopted FASB ASC 815-10-50, Disclosures about Derivative Instruments and Hedging Activities that provides guidance on the disclosure requirements of derivative instruments and hedging activities. The guidance requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. The adoption of FASB ASC 815-10-50 had no impact on the Company's consolidated financial statements.

In May 2009, the FASB issued FASB ASC 855-10, Subsequent Events, which establishes standards under which an entity shall recognize and disclose events that occur after a balance sheet date but before the related financial statements are issued or are available to be issued. The requirements of the subsequent events standard are effective for interim and annual reporting periods ending after June 15, 2009. The adoption of FASB ASC 855-10 had no impact on the Company's consolidated financial statements.

Prior to the FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, in June 2009, the FASB issued SFAS No. 166 (Not yet reflected in FASB ASC), Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140 (FASB ASC 860-10). SFAS No. 166 makes several significant amendments to SFAS No. 140 (FASB ASC 860-10), including the removal of the concept of a qualifying special-purpose entity from SFAS No. 140 (FASB ASC 860-10). SFAS No. 166 also clarifies that a transferor must evaluate whether it has maintained effective control of a financial asset by considering its continuing direct or indirect involvement with the transferred financial asset. The provisions of SFAS No. 166 are effective for interim and annual reporting periods that begin after November 15, 2009. The adoption of the provisions of SFAS No. 166 is not expected to have a material impact on the Company's consolidated financial statements.

Prior to the FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, in June 2009, the FASB issued SFAS No. 167 (Not yet reflected in FASB ASC), Amendments to FASB Interpretation No. 46(R) (FASB ASC 810-10). SFAS No. 167 requires a qualitative rather than a quantitative analysis to determine the primary beneficiary of a variable interest entity (VIE) for consolidation purposes. The primary beneficiary of a VIE is the enterprise that has: (1) the power to direct the activities of the VIE that most significantly impact the VIE's economic performance, and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits of the VIE that could potentially be significant to the VIE. The provisions of SFAS No. 167 are effective for interim and annual reporting periods that begin after November 15, 2009. The adoption of the provisions of SFAS No. 167 is not expected to have an impact on the Company's consolidated financial statements.

Additional accounting pronouncements recently adopted are discussed where applicable in the notes to the consolidated financial statements.

3. Investment securities

The amortized cost and fair value of investment securities at September 30, 2009 and December 31, 2008 are summarized as follows (dollars in thousands):

	Amortized cost	September 30, 2009 Gross unrealized gains	Gross unrealized losses	Fair value
Held-to-maturity securities:				
Mortgage-backed securities	\$ 740	\$ 56	\$ -	\$ 796
Available-for-sale securities:				
U.S. government agencies and corporations	\$ 36,175	\$ 177	\$ 1,356	\$ 34,996
Obligations of states and political subdivisions	28,365	1,409	10	29,764
Corporate bonds:				
Pooled trust preferred securities	19,300	-	11,461	7,839
Mortgage-backed securities	8,836	521	-	9,357
Total debt securities	92,676	2,107	12,827	81,956
Equity securities	322	143	19	446
Total available-for-sale	\$ 92,998	\$ 2,250	\$ 12,846	\$ 82,402

	December 31, 2008			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Held-to-maturity securities:				
Mortgage-backed securities	\$ 909	\$ 31	\$ -	\$ 940
Available-for-sale securities:				
U.S. government agencies and corporations	\$ 45,824	\$ 134	\$ 2,451	\$ 43,507
Obligations of states and political subdivisions	18,009	97	553	17,553
Corporate bonds:				
Pooled trust preferred securities	21,415	-	11,155	10,260
Mortgage-backed securities	11,088	442	-	11,530
Total debt securities	96,336	673	14,159	82,850
Equity securities	322	122	16	428
Total available-for-sale	\$ 96,658	\$ 795	\$ 14,175	\$ 83,278

The amortized cost and fair value of debt securities at September 30, 2009 and December 31, 2008 by contractual maturity are summarized below (dollars in thousands):

	September 30, 2009		December 31, 2008	
	Amortized cost	Market value	Amortized cost	Market value
Held-to-maturity securities:				
Mortgage-backed securities	\$ 740	\$ 796	\$ 909	\$ 940
Available-for-sale securities:				
Debt securities:				
Due in one year or less	\$ -	\$ -	\$ -	\$ -
Due after one year through five years	-	-	-	-
Due after five years through ten years	6,273	6,331	10,649	10,706
Due after ten years	77,567	66,268	74,599	60,614
Total debt securities	83,840	72,599	85,248	71,320
Mortgage-backed securities	8,836	9,357	11,088	11,530
Total available-for-sale debt securities	\$ 92,676	\$ 81,956	\$ 96,336	\$ 82,850

Expected 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. Federal agency and municipal securities are included based on their original stated maturity. Mortgage-backed securities, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total.

The following tables present the fair value and gross unrealized losses of investment securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss

position as of September 30, 2009 and December 31, 2008 (dollars in thousands):

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	September 30, 2009					
	Less than 12 months		More than 12 months		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. government agencies and corporations	\$ 7,019	\$ 73	\$ 4,454	\$ 1,283	\$ 11,473	\$ 1,356
Obligations of states and political subdivisions	-	-	2,615	10	2,615	10
Corporate bonds:						
Pooled trust preferred securities	-	-	7,839	11,461	7,839	11,461
Total debt securities	7,019	73	14,908	12,754	21,927	12,827
Equity securities	112	12	70	7	182	19
Total securities	\$ 7,131	\$ 85	\$ 14,978	\$ 12,761	\$ 22,109	\$ 12,846
Number of securities	8		19		27	

	December 31, 2008					
	Less than 12 months		More than 12 months		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. government agencies and corporations	\$ 12,506	\$ 1,878	\$ 5,145	\$ 573	\$ 17,651	\$ 2,451
Obligations of states and political subdivisions	8,154	496	1,455	57	9,609	553
Corporate bonds:						
Pooled trust preferred securities	2,235	2,352	8,025	8,803	10,260	11,155
Mortgage-backed securities	17	-	-	-	17	-
Total debt securities	22,912	4,726	14,625	9,433	37,537	14,159
Equity securities	-	-	60	16	60	16
Total securities	\$ 22,912	\$ 4,726	\$ 14,685	\$ 9,449	\$ 37,597	\$ 14,175
Number of securities	20		22		42	

In the table above, the unrealized losses on mortgage-backed securities were less than \$1,000 in 2008.

Management conducts a formal review of investment securities on a quarterly basis for the presence of other-than-temporary-impairment (OTTI). During the second quarter of 2009, the Company adopted FASB ASC 320-10-65, Recognition and Presentation of Other-Than-Temporary Impairments. The Company assesses whether OTTI is present when the fair value of a debt security is less than its amortized cost basis at the balance sheet date. Under these circumstances as required by the guidance, 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 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 (OCI). Non-credit-related OTTI is based on other factors effecting market conditions, including illiquidity. Presentation of OTTI is made in the statement of income on a gross basis with an offset for the amount of non-credit related OTTI recognized in OCI. Non-credit-related OTTI recognized in earnings prior to April 1, 2009 has been reclassified from retained earnings to accumulated OCI as a cumulative effect adjustment.

The Company's OTTI evaluation process also follows the guidance of FASB ASC 320-10, Investments - Debt and Equity Securities and FASB ASC 325-40, Investments – Other - Beneficial Interests in Securitized Financial Assets. This guidance requires 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 maturity, and other factors when evaluating for the existence of OTTI in securities portfolios. The requirements of this guidance are effective for reporting periods ending after December 15, 2008. This guidance also eliminates the requirement that a holder's best estimate of cash flows is based upon those that a market participant would use. Instead, the guidance requires that 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 discussed below where no OTTI is considered necessary at September 30, 2009, the Company applied the criteria provided in the recognition and presentation of OTTI guidance. 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.

U.S. government agencies and corporations

The agency securities consist of medium and long-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA). These securities are fixed-rate issues, have varying mid- to long-term maturity dates and have contractual cash flows guaranteed by agencies of the U.S. government. In the latter half of 2008, the U.S. Government provided substantial liquidity to FNMA and FHLMC to bolster their creditworthiness.

Agency guaranteed mortgage-backed securities

The agency mortgage-backed securities are comprised largely of fixed-rate residential mortgage-backed securities issued by FNMA or FHLMC. They have mid- to long-term maturity dates and have contractual cash flows guaranteed by agencies of the U.S. Government. In the latter half of 2008, the U.S. government provided substantial liquidity to both FNMA and FHLMC to bolster their creditworthiness.

Obligations of states and political subdivisions

The municipal securities are rated as investment grade by various credit rating agencies and are at fixed rates with mid- to long-term maturities. Fair values of these securities are highly driven by interest rates. Management performs ongoing credit quality reviews on these issues.

In the above three securities types, the decline in fair value is attributable to changes in interest rates and not credit quality. As such, no OTTI is considered necessary for these securities at September 30, 2009.

Pooled trust preferred securities

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

There are various tranches or classes issued by the CDO with the most senior tranche having the lowest yield but the most protection from credit losses (versus other tranches that are subordinate). Losses are generally allocated from the lowest tranche with the equity piece holding the most risk and then subordinate tranches in reverse order up to the senior tranche. The allocation of losses is defined in the indenture when the CDO was formed.

Unrealized losses were caused mainly by the following factors: (1) collateral deterioration due to bank failures and credit concerns across the banking sector; (2) widening of credit spreads; and (3) illiquidity in the market. The Company's review of these securities, in accordance with the previous discussion, determined that in 2009 credit-related OTTI be recorded on five holdings of these securities all of which are in the AFS securities portfolio. The following table summarizes the amount of credit-related OTTI recognized in earnings under the new guidance for 2009 and the amount of credit- and non-credit related OTTI recognized in earnings under the former guidance for 2008 by security during the periods indicated (dollars in thousands):

Three months ended		Nine months ended	
September 30,		September 30,	
2009	2008	2009	2008

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Pooled trust preferred securities:							
PreTSL VII, Mezzanine	\$	325	\$	397	\$	651	\$ 397
PreTSL IX, B1, B3		690		-		690	-
PreTSL XV, B1		154		-		154	-
PreTSL XVI, C		756		-		756	-
PreTSL XXV, C1		507		-		507	-
Equity securities		-		6		-	6
Total	\$	2,432	\$	403	\$	2,758	\$ 403

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The following table is a tabular roll-forward of the amount of credit-related OTTI recognized in earnings (dollars in thousands):

	Three months ended September 30, 2009			Nine months ended September 30, 2009		
	HTM	AFS	Total	HTM	AFS	Total
Beginning balance of credit-related OTTI	\$ -	\$ (224)	\$ (224)	\$ -	\$ (429)	\$ (429)
Reduction - cumulative effect of accounting change	-	-	-	-	531	531
Additions for credit-related OTTI not previously recognized	-	(2,107)	(2,107)	-	(2,107)	(2,107)
Additional credit-related OTTI previously recognized when there is no intent to sell before recovery of amortized cost basis	-	(325)	(325)	-	(651)	(651)
Ending balance of credit-related OTTI	\$ -	\$ (2,656)	\$ (2,656)	\$ -	\$ (2,656)	\$ (2,656)

To determine the ending balance of credit-related OTTI, the Company used discounted present value cash flow analysis and compared the results with the bond's face value. The analysis considered the following assumptions: the discount rate which equated to the discount margin for each tranche (credit spread) at the time of purchase which was then added to the appropriate three-month libor forward rate obtained from the forward libor curve; historical average default rates obtained from the FDIC for U.S. Banks and Thrifts for the period spanning 1988 to 1991 increased by a factor of three and rolled forward to project a rate of default of approximately one-third; the default rate was reduced by the actual deferrals / defaults experienced in all preferred term securities for the full year 2008 and the first half of 2009; the remaining 10% estimated default rate was then stratified with higher default rates occurring in the beginning regressing to normal in 2011 with an estimated 15% recovery by way of a two year lag; and no prepayments with receipt of principal at maturity. The present value of PreTSL VII as modeled resulted in cash flow of \$777,000 as of April 1, 2009, or approximately \$224,000 below the bond's face value of \$1,001,000. Upon adoption, the recognition and presentation of OTTI guidance in the second quarter of 2009, and as a result of the credit-related OTTI determination as explained, the \$531,000 non-credit related portion of OTTI that existed prior to April 1, 2009, or \$351,000 after tax, was reclassified from retained earnings to OCI as a cumulative effect adjustment.

As of September 30, 2009, the book value of the Company's pooled trust preferred securities amounted to \$19,300,000 with an estimated fair value of \$7,839,000 compared to \$21,415,000 and \$10,260,000, respectively as of December 31, 2008.

Two of the Company's initial mezzanine holdings (PreTSLs IV and V) are now senior tranches and the remainders are mezzanine tranches. As of September 30, 2009, none of the pooled trust preferred securities were investment grade. At the time of initial issue, the subordination in the Company's tranches ranged in size from approximately 8.0% to 25.2% of the total principal amount of the respective securities and no more than 5% of any pooled trust preferred security consisted of a security issued by any one bank and 4% for insurance companies. As of September 30, 2009, management estimates the subordination in the Company's tranches ranging from 0% to 18.9% of the current performing collateral. The following table provides additional information with respect to the Company's pooled trust preferred securities:

Current number	Actual deferrals	Excess Effective
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										subordination		
										*	**	
										as a % of	as a % of	
										Excess	current	current
										subordination	performing	performing
Deal	Class	Book value	Fair value	Unrealized loss	Fitch ratings	insured companies	defaults and deferrals \$ (000)	and current collateral % of	subordination \$ (000)	performing collateral	performing collateral	
Pre TSL IV	Mezzanine	\$ 609,971	\$ 458,454	\$ (151,517)	Ca / B	6 / -	18,000	27.1	9,718	18.9	33.1	
Pre TSL V	Mezzanine	275,503	194,477	(81,026)	Ba3 / A	4 / -	18,950	43.1	None	N/A	N/A	
Pre TSL VII	Mezzanine	453,186	275,952	(177,234)	Ca / CC	20 / -	138,000	60.8	None	N/A	N/A	
Pre TSL IX	B-1,B-3	2,810,338	1,517,600	(1,292,738)	Ca / CC	49 / -	118,480	26.3	None	N/A	0.4	
Pre TSL XI	B-3	2,390,079	1,203,750	(1,186,329)	Ca / CC	65 / -	107,250	17.8	None	N/A	12.0	
Pre TSL XV	B-1	1,359,562	506,421	(853,141)	Ca / CC	63 / 9	131,550	22.0	None	N/A	3.9	
Pre TSL XVI	C	1,808,881	523,756	(1,285,125)	Ca / CC	50 / 8	157,150	25.9	None	N/A	2.9	
Pre TSL XVII	C	997,495	262,918	(734,577)	Ca / CC	51 / 8	81,960	17.0	None	N/A	10.7	
Pre TSL XVIII	C	999,718	293,417	(706,301)	Ca / CCC	69 / 14	134,031	19.8	None	N/A	8.8	
Pre TSL XIX	C	2,527,613	798,130	(1,729,483)	Ca / CC	60 / 14	103,000	14.7	None	N/A	14.1	
Pre TSL XXIV	B-1	2,190,737	681,711	(1,509,026)	Caa3 / BB	80 / 13	299,300	28.5	None	N/A	17.6	
Pre TSL XXV	C-1	506,673	78,441	(428,232)	Ca / C	64 / 9	264,100	30.1	None	N/A	0.8	
Pre TSL XXVII	B	2,369,969	1,043,561	(1,326,408)	B3 / BB	42 / 7	65,300	20.0	14,001	5.4	26.9	
		\$ 19,299,725	\$ 7,838,588	\$ (11,461,137)								

For a further discussion on the fair value determination of the Company's investment in pooled trust preferred securities, see "Investment securities" under the caption "Comparison of financial condition at September 30, 2009 and December 31, 2008" of Part 1, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations"; below.

4. Earnings (loss) per share

Basic earnings (loss) per share (EPS) is computed by dividing income (loss) available to common shareholders by the weighted-average number of common stock outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but reflects the potential dilution that could occur if stock options to issue additional common stock were exercised, which would then result in additional stock outstanding to share in or dilute the earnings (loss) of the Company. The Company maintains two share-based compensation plans that may generate additional potential dilutive common shares. Generally, dilution would occur if Company-issued stock options were exercised and converted into common stock. There were no potentially dilutive shares outstanding at September 30, 2009 and 85 potentially dilutive shares outstanding at September 30, 2008.

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. Under the treasury stock method, the assumed proceeds received from shares issued, in a hypothetical stock option exercise, are assumed to be used to purchase treasury stock. There were no potentially dilutive shares outstanding as of September 30, 2009 because the average share price of the Company's common stock during the nine months ended September 30, 2009 was below the strike prices of all options granted. For a further discussion on the Company's stock option plans, see note 5, "Stock plans," below.

The following table illustrates the data used in computing basic EPS and a reconciliation to derive at the components of diluted EPS for the periods indicated:

Nine months ended September 30,	2009	2008
Net income (loss) available to common shareholders	\$ (1,473,469)	\$ 3,034,008
Weighted-average common shares outstanding	2,075,181	2,071,242
Basic EPS	\$ (0.71)	\$ 1.46
Diluted EPS:		
Net income (loss) available to common shareholders	\$ (1,473,469)	\$ 3,034,008
Weighted-average common shares outstanding	2,075,181	2,071,242
Potentially dilutive common shares	-	85
Weighted-average common shares and dilutive potential shares	2,075,181	2,071,327
Diluted EPS	\$ (0.71)	\$ 1.46

5. Stock plans

The Company has two stock-based compensation plans (the stock option plans) and applies the fair value method of accounting for stock-based compensation provided under the guidelines of FASB ASC 718-10, Share Based Payment. The guidelines require the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements.

Under the stock option plans, options are granted with an exercise price equal to the market price of the Company's stock on the date of grant. The awards vest based on six months of continuous service from the date of grant and have 10-year contractual terms. Stock-based compensation expense is recognized over the six-month vesting

period. Generally, all shares that are granted become fully vested. Stock-based compensation is recorded in the consolidated income statement as a component of salaries and employee benefits.

The Company established the 2000 Independent Directors Stock Option Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. No stock options were awarded during the nine months ended September 30, 2009 and 2008. As of September 30, 2009, there were 27,400 unexercised stock options outstanding under this plan.

The Company also established the 2000 Stock Incentive Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. There were no options awarded during the nine months ended September 30, 2009. During the nine months ended September 30, 2008, 2,000 stock options were issued under this plan at a weighted-average grant-date fair value of \$4.85 per share. The Company uses the Black-Scholes Option Pricing Valuation Model to determine the fair value of awarded options on the date of grant. The model considers expected volatility, expected dividends, risk-free interest rate and the expected term. As of September 30, 2009, there were 10,190 unexercised stock options outstanding under this plan.

The following tables illustrate stock-based compensation expense recognized during the three- and nine months ended September 30, 2009 and 2008. There was no unrecognized stock-based compensation expense as of September 30, 2009, September 30, 2008 and December 31, 2008:

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Stock-based compensation expense:				
Director's Plan	\$ -	\$ -	\$ -	\$ 90,550
Incentive Plan	-	2,314	-	35,562
Total stock-based compensation expense	\$ -	\$ 2,314	\$ -	\$ 126,112

In addition to the two stock option 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 plan was designed to promote broad-based employee ownership of the Company's stock. Under the ESPP, employees may elect to purchase the Company's capital stock at a discounted price based on the fair market value of the Company's capital stock on either the commencement date or termination date. At September 30, 2009, 12,271 shares have been issued under the ESPP. Under the guidelines required by share based payments, the Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the nine months ended September 30, 2009 and 2008, compensation expense related to the ESPP approximated \$5,000 and \$3,000, respectively, and is included as components of salaries and employee benefits in the consolidated statements of income.

6. Derivative instruments

As part of its overall interest rate risk management strategy, the Company has adopted a policy whereby it may periodically use derivative instruments to minimize significant fluctuations in earnings caused by interest rate volatility. This interest rate risk management strategy entails the use of interest rate floors, caps and swaps. During the fourth quarter of 2006, the Company entered into a three-year interest rate floor derivative agreement on \$20,000,000 notional value of its prime-based loan portfolio. The transaction required the payment of a premium by the Company to the seller for the right to receive payments in the event national prime drops below a pre-determined level (strike rate), essentially converting floating rate loans to fixed rate loans when prime drops below the contractual strike rate. When purchased, the Company recorded an asset representing the fair value of the hedge at the time of purchase. The Company has designated this agreement as a cash flow hedge pursuant to the implementation of FASB ASC 815-20, Accounting for Derivative Instruments and Hedging Activities. Accordingly, the change in the fair value of the instrument related to the hedge's intrinsic value, or approximately (\$561,000) and \$96,000 for the nine months ended September 30, 2009 and 2008, respectively, is recorded as a component of other comprehensive income (loss) (OCI) in the consolidated statement of changes in shareholders' equity and the portion of the change in fair value related to the time value expiration, or approximately \$2,000 and \$12,000 for the nine months ended September 30, 2009 and 2008, respectively, is recorded in the consolidated statements of income as a reduction of interest income. No gain or loss has been recognized in earnings due to hedge ineffectiveness as of September 30, 2009. Also, as of September 30, 2009 and December 31, 2008, the fair value of the derivative contract approximated \$73,000 and \$636,000, respectively, and is recorded as a component of other assets in the consolidated balance sheets. As of September 30, 2009, the Company expects to close out the residual net value of the derivative, or approximately \$29,000, from other assets and OCI to earnings during the fourth quarter in concert with the contract's expiration date. The following table illustrates the present value, intrinsic value and time value components of the Company's derivative contract and the financial statement impact of the change in the fair value for the periods indicated:

	Nine months ended or as of September 30,		
	Present value Balance sheet	Intrinsic value Balance sheet	Time value Income statement Interest income
	Other assets	OCI	
2009			
Beginning Balance	\$ 635,839	\$ 606,492	
Change in fair value	(562,499)	(560,956)	(1,543)
Balance September 30, 2009	\$ 73,340	\$ 45,536	
2008			
Beginning Balance	\$ 440,593	\$ 385,741	
Change in fair value	84,402	96,383	(11,981)
Balance September 30, 2008	\$ 524,995	\$ 482,124	

As a result of the low national prime rate relative to the contract's strike rate, the Company earned \$683,000 and \$353,000 for the nine months ended September 30, 2009 and 2008, respectively and \$230,000 and \$141,000 for the three months ended September 30, 2009 and 2008, respectively, and is included as a component of interest income from loans in the consolidated income statements. The contract expired early in the fourth quarter of 2009.

The use of derivative instruments exposes the Company to credit risk in the event of non-performance by the agreement's counterparty to the derivative instrument. In the event of default by the counterparty, the Company would have been subject to an economic loss that corresponded to the cost to replace the agreement. The Company controlled the credit risk associated with the derivative instrument by engaging counterparties with high credit ratings, establishing counterparty exposure limits and monitoring procedures.

7. Fair value measurements

On April 9, 2009, the FASB issued ASC 820-10-35, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, and FASB ASC 825-10-65, Interim Disclosures about Fair Value of Financial Instruments. The Company adopted the guidance under these topics in the second quarter of 2009.

This topic provides guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity. The requirements of fair value measurement also call for additional disclosures on fair value measurements and provide additional guidance on circumstances that may indicate that a transaction is not orderly.

On January 1, 2008, the Company adopted FASB ASC 820-10, Fair Value Measurements which defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measurements. The guidelines of fair value reporting establishes 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 inputs based on our 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.

Adoption of the requirements of the fair value measurement under generally accepted account principles did not have an impact on the Company's financial statements.

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. This is done for AFS securities, loans AFS and derivatives. Fair value is used on a non-recurring basis to measure certain assets when adjusting carrying values to market values, such as impaired loans.

The following table illustrates the financial instruments measured at fair value on a recurring basis segregated by hierarchy fair value levels as of September 30, 2009 and December 31, 2008 (dollars in thousands):

	Total carrying value at September 30, 2009	Fair value measurements at September 30, 2009:			
		Quoted prices in active markets (Level 1)	Significant other		Significant unobservable inputs (Level 3)
			observable inputs		
			(Level 2)		
Assets:					
Available-for-sale securities:					
U.S. government agencies and corporations	\$ 34,996	\$ -	\$ 34,996	\$ -	
Obligations of states and political subdivisions	29,764	-	29,764	-	
Corporate bonds:					
Pooled trust preferred securities	7,839	-	-	7,839	
Mortgage-backed securities	9,357	-	9,357	-	
Equity securities	446	446	-	-	
Total available-for-sale securities:	82,402	446	74,117	7,839	
Loans available-for-sale	881	-	881	-	
Derivative instrument	73	-	73	-	
Total	\$ 83,356	\$ 446	\$ 75,071	\$ 7,839	
	Total carrying value at December 31, 2008	Fair value measurements at December 31, 2008:			
		Quoted prices in active markets (Level 1)	Significant other		Significant unobservable inputs (Level 3)
			observable inputs		
			(Level 2)		
Assets:					
Available-for-sale securities:					
U.S. government agencies and corporations	\$ 43,507	\$ -	\$ 43,507	\$ -	
Obligations of states and political subdivisions	17,553	-	17,553	-	
Corporate bonds:					
Pooled trust preferred securities	10,260	-	-	10,260	
Mortgage-backed securities	11,530	-	11,530	-	
Equity securities	428	428	-	-	
Total available-for-sale securities:	83,278	428	72,590	10,260	
Loans available-for-sale	84	-	84	-	
Derivative instrument	636	-	636	-	
Total	\$ 83,998	\$ 428	\$ 73,310	\$ 10,260	

Equity securities in the AFS portfolio are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Other than the Company's investment in corporate bonds, consisting of pooled trust preferred securities, all other debt securities in the AFS portfolio are measured at fair value using prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services

to financial institutions. The Company's pooled trust preferred securities include both observable and unobservable inputs to determine fair value and, therefore, are considered Level 3 inputs. For a further discussion on the fair value determination of the Company's investment in pooled trust preferred securities, see "Investment securities" under the caption "Comparison of financial condition at September 30, 2009 and December 31, 2008" of Part 1, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations," below.

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Loans AFS are measured for fair value from quotes received through secondary market sources, i.e., FNMA or FHLB, who provide pricing for similar assets with similar terms in actively traded markets. In the above table, loans AFS reflect the carrying value which is the lower of cost or market value. The derivative instrument, included in other assets, is measured at fair value from pricing provided by a third party who considers observable interest rates, forward yield curves at commonly quoted intervals and volatility.

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

	As of and for the nine months ended September 30, 2009	As of and for the twelve months ended December 31, 2008
Assets:		
Balance at beginning of period	\$ 10,260	\$ 16,335
Realized / unrealized gains (losses):		
in earnings	(2,758)	(430)
in comprehensive income (loss)	(306)	(9,958)
Purchases, sales, issuances and settlements, amortization and accretion, net	643	4,313
Balance at end of period	\$ 7,839	\$ 10,260

The following table illustrates the financial instruments measured at fair value on a non-recurring basis segregated by hierarchy fair value levels as of September 30, 2009 and December 31, 2008 (dollars in thousands):

	Total carrying value at September 30, 2009	Fair value measurements at September 30, 2009 using:		
		Quoted prices in active markets	Significant other observable inputs	Significant unobservable inputs
		(Level 1)	(Level 2)	(Level 3)
Assets:				
Impaired loans	\$ 3,147	\$ 13	\$ 2,280	\$ 854
	Total carrying value at December 31, 2008	Fair value measurements at December 31, 2008 using:		
		Quoted prices in active markets	Significant other observable inputs	Significant unobservable inputs
		(Level 1)	(Level 2)	(Level 3)
Assets:				
Impaired loans	\$ 1,942	\$ 12	\$ 1,136	\$ 794

Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secures the impaired loan include: quoted market prices for identical assets classified as Level 1 inputs; observable inputs, employed by certified appraisers for similar assets classified as Level 2 inputs. In cases where valuation techniques included inputs that are unobservable or are based on estimates and assumptions developed by management, with significant adjustments from the best information available under each circumstance, the asset valuation is classified as Level 3 inputs.

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Fair value measurement disclosures are now required for interim periods in addition to the annual disclosures. Accordingly, a summary of the carrying values and estimated fair values of certain financial instruments as required by the guidelines follows as of the periods indicated (dollars in thousands):

	September 30, 2009		December 31, 2008	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:				
Cash and cash equivalents	\$ 17,632	\$ 17,632	\$ 12,771	\$ 12,771
Held-to-maturity securities	740	796	910	940
Available-for-sale securities	82,402	82,402	83,278	83,278
FHLB stock	4,781	4,781	4,781	4,781
Loans and leases	420,834	420,839	436,207	438,838
Loans available-for-sale	881	894	84	85
Accrued interest	2,543	2,543	2,443	2,443
Financial liabilities:				
Deposit liabilities	477,258	474,357	433,312	436,011
Short-term borrowings	5,238	5,238	38,130	38,130
Long-term debt	32,000	35,427	52,000	57,230
Accrued interest	1,000	1,000	1,390	1,390
On-balance sheet derivative instrument				
Cash flow hedge	73	73	636	636

The following summarizes the methodology used to determine estimated fair values in the above table:

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 and carry interest rates that approximate market.

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

Securities: With the exception of preferred term securities, fair values on the other investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. The fair values of pooled trust preferred securities is determined based on a present value technique (income valuation) as described under the caption "Investment securities" of the comparison of financial condition at September 30, 2009 and December 31, 2008 in Part I, Item II, below.

FHLB stock, or restricted regulatory equity, is carried at cost, which approximates fair value.

Loans and leases: The fair value of all loans is estimated by the net present value of the future expected cash flows discounted at the current offering rates.

Loans available-for-sale: For loans available-for-sale, the fair value is estimated using rates currently offered for similar loans and are obtained from the FNMA or the FHLB.

Certificates of deposit: The fair values of certificate of deposit accounts are based on discounted cash flows using rates which approximate the rates we offer for deposits of similar maturities.

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

Cash flow hedge: The carrying amount of interest rate contracts are based on pricing provided by a third party who considers observable interest rates, forward yield curves at commonly quoted intervals and volatility.

8. Subsequent Events

Pursuant to the requirements for disclosing events after September 30, 2009, reportable events have been evaluated through November 12, 2009, which is the date the financial statements were available to be issued. Through that date, there were no events requiring disclosure.

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

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of September 30, 2009 compared to December 31, 2008 and the results of operations for the three- and nine month periods ended September 30, 2009 and 2008. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2008 Annual Report filed on Form 10-K.

Forward-looking statements

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

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

- § the effects of economic deterioration 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;
- § governmental monetary and fiscal policies, as well as legislative and regulatory changes;
- § the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;
- § the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks;
- § the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet;
- § technological changes;
- § acquisitions and integration of acquired businesses;
- § the failure of assumptions underlying the establishment of reserves for loan and lease losses and estimations of values of collateral and various financial assets and liabilities;
- § volatilities in the securities markets;
- § deteriorating economic conditions
- § acts of war or terrorism; and
- § disruption of credit and equity markets.

Management cautions readers not to place undue reliance on forward-looking statements, which reflect analyses only as of the date of this document. We have 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

The Company's principal revenues are derived from interest, dividends and fees earned on its interest-earning assets, which are comprised of loans, securities and other short-term investments. The Company's principal expenses consist of interest paid on its interest-bearing liabilities, which are comprised of deposits, short- and long-term borrowings and operating and general expenses. The Company's profitability depends primarily on its net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields 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 dependent upon the interest-rate spread (i.e., 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. The 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 our marketplace.

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The Company's profitability is also affected by the level of its non-interest income and expenses, provision for loan losses and provision for income taxes. Non-interest income consists of service charges on the Bank's loan and deposit products, trust and asset management service fees, increases in the cash surrender value of the bank owned life insurance (BOLI), net gains or losses from sales of loans and securities AFS, net gains or losses from sales of foreclosed properties held-for-sale, write-down to market value of foreclosed properties held-for-sale and from other-than-temporary-impairment (OTTI) charges on investment securities. Non-interest expense consists of compensation and related employee benefit expenses, occupancy, equipment, data processing, advertising, marketing, professional fees, insurance and other operating overhead.

The Company's profitability is significantly affected by general economic and competitive conditions, changes in market interest rates, government policies and actions of regulatory authorities. The Company's loan portfolio is comprised principally of commercial and commercial real estate loans. The properties underlying the Company's mortgages are concentrated in Northeastern Pennsylvania. Credit risk, which represents the possibility of the Company not recovering amounts due from its borrowers, is significantly related to local economic conditions in the areas the properties are located as well as the Company's underwriting standards. Economic conditions affect the market value of the underlying collateral as well as the levels of adequate cash flow and revenue generation from income-producing commercial properties.

Comparison of the results of operations Three and nine months ended September 30, 2009 and 2008

Overview

The Company recorded a net loss of \$3,211,000 for the third quarter of 2009 compared to net income of \$741,000 recorded in the same quarter of 2008. Diluted (loss) earnings per share were (\$1.55) and \$0.35 for each of the respective quarters. For the nine months ended September 30, 2009, net loss was \$1,473,000, or (\$0.71) per share, compared to net income of \$3,034,000, or \$1.46 per share, for the nine months ended September 30, 2008. The decrease in earnings was due to an increase in the provision for loan losses of \$2,995,000 and \$3,595,000, during the quarter and year-to-date periods, respectively, and a decrease in non-interest income from higher levels of non-cash credit-related OTTI charges from the pooled trust preferred securities portfolio of \$2,029,000 and \$2,355,000, respectively, recorded during the comparative periods. Net interest income declined in both the third quarter and for the nine months ended September 30, 2009 compared to the same periods of 2008. During the third quarter of 2009, the Company paid off two of its \$5.0 million FHLB advances and incurred a \$0.5 million interest penalty. Non-interest expense increased 9% and 7%, respectively. These items were partially offset by higher gains recognized from mortgage banking services in the form of sales of mortgage loans in the three- and nine- month periods ended September 30, 2009 compared to the same periods of 2008.

Return on average assets (ROA) and return on average shareholders' equity (ROE) were -2.25% and -25.75%, respectively, for the three months ended September 30, 2009 compared to 0.50% and 5.63%, respectively, for the same period in 2008. For the nine months ended September 30, 2009, ROA and ROE were -0.35% and -4.07%, respectively, compared to 0.69% and 7.42% for the same periods in 2008. The decrease in both ROA and ROE is attributable to lower earnings.

Net interest income and interest sensitive assets / liabilities

Net interest income decreased \$458,000, or 9%, to \$4,421,000 for the third quarter of 2009, from \$4,879,000 recorded in the same period of 2008. During the current quarter, the Company paid off \$10.0 million of long-term Federal Home Loan Bank (FHLB) advances that were scheduled to mature during the third quarter of 2010 and by doing so incurred approximately \$0.5 million of prepayment interest penalties that are included in interest expense. The

paid-off advances carried a weighted-average rate of 6.12% and the deleveraging strategy is immediately accretive to income. Compared to 2008, the Company reduced its average balance of FHLB advances by \$20.4 million and short-term overnight borrowings by approximately \$23.7 million. The FHLB advances were supplanted by growth in average deposits which were also used to help reduce the Company's dependence on short-term borrowings. In this low interest-rate environment, the Company may explore and execute other deleveraging opportunities that management deems prudent for earnings and capital enhancement. Further contributing to the decline in net interest income was a combination of: a 50 basis point decline in yields from earning-assets, mostly in the commercial loan and investment portfolios partially offset by a 35 basis point decline on interest-bearing liabilities primarily from a decrease in rates paid on deposits.

During the third quarter of 2009, the Company's tax-equivalent margin and spread were 3.43% and 2.95%, respectively, compared to 3.62% and 3.10% during the third quarter of 2008. The reduction in spread was caused by lower yields earned on interest-earning assets as well as the early pay-off of the FHLB advances. The decrease in margin was predominately from lower net interest income.

For the nine months ended September 30, 2009, net interest income declined 3%, or, \$383,000 compared to the nine months ended September 30, 2008. Excluding the aforementioned early-pay off of the \$10.0 million FHLB advances, there would have been a minor improvement in net interest income. Despite the lower net interest income, the Company's tax-equivalent margin and spread improved to 3.62% and 3.17%, respectively, from 3.57% and 3.01% during the same period of 2008. The improvements were largely from lower balances of interest-bearing liabilities – most notably from lower long- and short-term borrowings and lower rates paid on deposits. In addition, the lower balance of interest-earning assets, due to the sale of lower yielding residential mortgage loans during the first quarter of 2009, contributed to the improvement in margin. Rates paid on deposits declined 93 basis points compared to lower yields from earning-assets of 53 basis points.

The current interest rate environment has remained essentially unchanged throughout 2009; however, it is much different than a year ago. The interest rate environment was considerably lower during the first nine months of 2009 compared to 2008. The lower rates have caused assets to price and re-price at significantly lower levels thereby pressuring earning-yields downward. Increased prepayment activity in asset portfolios, thereby shortening the duration of interest-earning assets as well as increased activity in loan refinancing all contribute to lower portfolio yields. However, the steepness of the curve has enabled the Company to help mitigate the lower yields earned from its asset portfolios. To manage the interest rate margin to acceptable levels, the Company's Asset Liability Management (ALM) team meets regularly to discuss interest rate risk and when deemed necessary adjusts interest rates on deposits and repurchase agreements and when necessary uses lower costing wholesale funding sources. The actions of the ALM team have helped minimize the effect rate changes have had on interest income so that net interest income is not materially and disproportionately impacted during this lower yield environment. During the first quarter of 2009, the Company sold \$10.8 million of lower yielding mortgage loans and used the proceeds to pay off one \$10.0 million FHLB advance that was scheduled to mature in the second quarter of 2009. Similarly, during the third quarter, the Company paid down an additional \$10.0 million in FHLB advances with funds from deposit growth. The third quarter transaction required the payment of penalty interest of approximately \$0.5 million, however the weighted-average rate on the advances was 6.12% and this strategy will be immediately accretive to future earnings. The Company's proactive attention to interest rate risk should continue to help contain the Company's net interest margin at acceptable levels.

The table that follows sets forth a comparison of average balance sheet amounts and their corresponding fully tax-equivalent (FTE) interest income and expense and annualized tax-equivalent yield and cost for the periods indicated (dollars in thousands):

Three months ended:

	September 30, 2009			September 30, 2008		
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Assets						
Interest-earning assets:						
Loans and leases	\$ 431,024	\$ 6,603	6.08%	\$ 426,002	\$ 6,953	6.49%
Investments	99,922	1,065	4.23	125,901	1,611	5.09
Federal funds sold	5,335	3	0.25	-	-	-
Interest-bearing deposits	622	-	0.06	104	1	2.33
Total interest-earning assets	536,903	7,671	5.67	552,007	8,565	6.17
Non-interest-earning assets	29,089			32,023		
Total assets	\$ 565,992			\$ 584,030		
Liabilities and shareholders' equity						
Interest-bearing liabilities:						
Other interest-bearing deposits	\$ 228,308	\$ 579	1.01%	\$ 191,697	\$ 799	1.66%
Certificates of deposit	163,683	1,370	3.32	168,730	1,800	4.24
Borrowed funds	42,746	1,077	10.00	86,778	930	4.26
Repurchase agreements	7,266	6	0.32	10,907	11	0.42
Total interest-bearing liabilities	442,003					