

FIDELITY D & D BANCORP INC

Form 10-Q

August 06, 2014

Table Of Contents

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 June 30, 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  
 ]  
Non-accelerated filer  ]  
Accelerated  
filer  ]  
Smaller  
reporting  
company  [X]

reporting company) (Do not check if a smaller

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

] YES  [X] NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on July 31, 2014, the latest practicable date, was 2,419,587 shares.

---

Table Of Contents

FIDELITY D & D BANCORP, INC.

Form 10-Q June 30, 2014

Index

<u>Part I. Financial Information</u>		Page
Item 1.	<u>Financial Statements (unaudited):</u>	
	<u>Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013</u>	3
	<u>Consolidated Statements of Income for the three- and six- months ended June 30, 2014 and 2013</u>	4
	<u>Consolidated Statements of Comprehensive Income for the three- and six- months ended June 30, 2014 and 2013</u>	5
	<u>Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2014 and 2013</u>	6
	<u>Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013</u>	7
	<u>Notes to Consolidated Financial Statements (Unaudited)</u>	8
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27
Item 3.	<u>Quantitative and Qualitative Disclosure about Market Risk</u>	44
Item 4.	<u>Controls and Procedures</u>	48
 <u>Part II. Other Information</u>		
Item 1.	<u>Legal Proceedings</u>	48
Item 1A.	<u>Risk Factors</u>	49
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	49
Item 3.	<u>Defaults upon Senior Securities</u>	49
Item 4.	<u>Mine Safety Disclosures</u>	49
Item 5.	<u>Other Information</u>	49
Item 6.	<u>Exhibits</u>	49
	<u>Signatures</u>	51
	<u>Exhibit index</u>	52



Table Of Contents

## PART I – Financial Information

## Item 1: Financial Statements

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

	June 30, 2014	December 31, 2013
(dollars in thousands)		
Assets:		
Cash and due from banks	\$ 14,419	\$ 13,197
Interest-bearing deposits with financial institutions	20	21
Total cash and cash equivalents	14,439	13,218
Available-for-sale securities	102,699	97,246
Held-to-maturity securities (fair value of \$0 in 2014, \$195 in 2013)	-	177
Federal Home Loan Bank stock	2,954	2,640
Loans and leases, net (allowance for loan losses of \$9,029 in 2014; \$8,928 in 2013)	486,471	469,216
Loans held-for-sale (fair value \$1,664 in 2014, \$937 in 2013)	1,633	917
Foreclosed assets held-for-sale	2,186	2,086
Bank premises and equipment, net	14,341	13,602
Cash surrender value of bank owned life insurance	10,569	10,402
Accrued interest receivable	2,082	2,068
Other assets	12,932	12,253
Total assets	\$ 650,306	\$ 623,825
Liabilities:		
Deposits:		
Interest-bearing	\$ 412,495	\$ 406,779
Non-interest-bearing	126,008	122,919
Total deposits	538,503	529,698
Accrued interest payable and other liabilities	4,005	3,425
Short-term borrowings	21,872	8,642
Long-term debt	16,000	16,000
Total liabilities	580,380	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; 2,419,587 in 2014; and 2,391,617 in 2013)	25,947	25,302
Retained earnings	41,394	39,519
Accumulated other comprehensive income	2,585	1,239
Total shareholders' equity	69,926	66,060
Total liabilities and shareholders' equity	\$ 650,306	\$ 623,825

See notes to unaudited consolidated financial statements



Table Of ContentsFidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Statements of Income

(Unaudited)

(dollars in thousands except per share data)

	Three months ended		Six months ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Interest income:				
Loans and leases:				
Taxable	\$ 5,393	\$ 5,335	\$ 10,669	\$ 10,705
Nontaxable	131	121	262	220
Interest-bearing deposits with financial institutions	5	2	12	14
Investment securities:				
U.S. government agency and corporations	257	137	502	316
States and political subdivisions (nontaxable)	333	299	654	589
Other securities	26	18	48	36
Total interest income	6,145	5,912	12,147	11,880
Interest expense:				
Deposits	498	511	987	1,026
Securities sold under repurchase agreements	4	4	12	13
Other short-term borrowings and other	6	4	6	5
Long-term debt	213	213	423	423
Total interest expense	721	732	1,428	1,467
Net interest income	5,424	5,180	10,719	10,413
Provision for loan losses	300	600	600	1,150
Net interest income after provision for loan losses	5,124	4,580	10,119	9,263
Other income:				
Service charges on deposit accounts	431	459	854	911
Interchange fees	332	307	637	580
Fees from trust fiduciary activities	172	192	336	340
Fees from financial services	153	140	292	296
Service charges on loans	307	348	424	582
Fees and other revenue	190	119	361	221
Earnings on bank-owned life insurance	84	86	167	166
Gain (loss) on sale, recovery, or disposal of:				
Loans	124	390	252	894
Investment securities	94	9	301	128
Premises and equipment	(66)	1	(65)	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	1,821	2,051	3,559	4,119



Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Other expenses:				
Salaries and employee benefits	2,488	2,422	4,964	4,896
Premises and equipment	875	805	1,792	1,660
Advertising and marketing	274	215	606	467
Professional services	321	328	639	577
FDIC assessment	79	123	178	249
Loan collection	70	168	117	363
Other real estate owned	24	61	89	184
Office supplies and postage	100	114	207	216
Automated transaction processing	154	115	305	240
Other	376	255	649	635
Total other expenses	4,761	4,606	9,546	9,487
Income before income taxes	2,184	2,025	4,132	3,895
Provision for income taxes	557	512	1,049	988
Net income	\$ 1,627	\$ 1,513	\$ 3,083	\$ 2,907
Per share data:				
Net income - basic	\$ 0.67	\$ 0.64	\$ 1.28	\$ 1.24
Net income - diluted	\$ 0.67	\$ 0.64	\$ 1.28	\$ 1.24
Dividends	\$ 0.25	\$ 0.25	\$ 0.50	\$ 0.50

See notes to unaudited consolidated financial statements

Table Of Contents

## Fidelity D &amp; D Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income (Unaudited) (dollars in thousands)	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net income	\$ 1,627	\$ 1,513	\$ 3,083	\$ 2,907
Other comprehensive income, before tax:				
Unrealized holding gain (loss) on available-for-sale securities	1,325	(1,810)	2,340	(2,227)
Reclassification adjustment for net gains realized in income	(94)	(9)	(301)	(128)
Net unrealized gain (loss)	1,231	(1,819)	2,039	(2,355)
Tax effect	(419)	619	(693)	801
Unrealized gain (loss), net of tax	812	(1,200)	1,346	(1,554)
Non-credit-related impairment gain on investment securities not expected to be sold	-	92	-	53
Reclassification adjustment for net gains realized in income	-	-	-	-
Net non-credit-related impairment gain on investment securities	-	92	-	53
Tax effect	-	(31)	-	(18)
Non-credit-related impairment gain on investment securities, net of tax	-	61	-	35
Other comprehensive income (loss), net of tax	812	(1,139)	1,346	(1,519)
Total comprehensive income, net of tax	\$ 2,439	\$ 374	\$ 4,429	\$ 1,388

See notes to unaudited consolidated financial statements

Table Of Contents

Fidelity D & D Bancorp, Inc. and Subsidiary  
 Consolidated Statements of Changes in Shareholders' Equity  
 For the six months ended June 30, 2014 and 2013  
 (Unaudited)

(dollars in thousands)	Capital stock		Retained	Accumulated other comprehensive	Total
	Shares	Amount	earnings	income (loss)	
Balance, December 31, 2012	2,323,248	\$ 23,711	\$ 34,999	\$ 236	\$ 58,946
Net income			2,907		2,907
Other comprehensive loss				(1,519)	(1,519)
Issuance of common stock through Employee Stock Purchase Plan	4,256	78			78
Issuance of common stock through Dividend Reinvestment Plan	29,191	606			606
Issuance of common stock from vested restricted share grants through stock compensation plans	134				
Stock-based compensation expense		59			59
Cash dividends declared			(1,174)		(1,174)
Balance, June 30, 2013	2,356,829	\$ 24,454	\$ 36,732	\$ (1,283)	\$ 59,903
Balance, December 31, 2013	2,391,617	\$ 25,302	\$ 39,519	\$ 1,239	\$ 66,060
Net income			3,083		3,083
Other comprehensive income				1,346	1,346
Issuance of common stock through Employee Stock Purchase Plan	4,373	80			80
Issuance of common stock through Dividend Reinvestment Plan	18,347	448			448
Issuance of common stock from vested restricted share grants through stock compensation plans	5,250				
Stock-based compensation expense		117			117
Cash dividends declared			(1,208)		(1,208)
Balance, June 30, 2014	2,419,587	\$ 25,947	\$ 41,394	\$ 2,585	\$ 69,926

See notes to unaudited consolidated financial statements



Table Of ContentsFidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Statements of Cash Flows

(Unaudited)	Six months ended June 30,	
(dollars in thousands)	2014	2013
Cash flows from operating activities:		
Net income	\$ 3,083	\$ 2,907
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	1,542	1,722
Provision for loan losses	600	1,150
Deferred income tax expense	47	406
Stock-based compensation expense	117	59
Proceeds from sale of loans held-for-sale	14,523	50,623
Originations of loans held-for-sale	(15,165)	(42,730)
Earnings on bank-owned life insurance	(167)	(166)
Net gain from sales of loans	(252)	(894)
Net gain from sales of investment securities	(301)	(111)
Net (gain) loss on sale and write-down of foreclosed assets held-for-sale	(57)	87
Net loss (gain) on disposal of equipment	66	(1)
Change in:		
Accrued interest receivable	(14)	(94)
Other assets	(1,011)	(338)
Accrued interest payable and other liabilities	580	(271)
Net cash provided by operating activities	3,591	12,349
Cash flows from investing activities:		
Held-to-maturity securities:		
Proceeds from sales	187	-
Proceeds from maturities, calls and principal pay-downs	3	82
Available-for-sale securities:		
Proceeds from sales	4,877	756
Proceeds from maturities, calls and principal pay-downs	6,319	15,838
Purchases	(14,944)	(15,374)
Increase in FHLB stock	(314)	(590)
Net increase in loans and leases	(19,949)	(32,000)
Acquisition of bank premises and equipment	(955)	(467)
Proceeds from sale of foreclosed assets held-for-sale	1,051	310
Net cash used by investing activities	(23,725)	(31,445)
Cash flows from financing activities:		
Net increase in deposits	8,805	4,863
Net increase in short-term borrowings	13,230	8,143
Proceeds from employee stock purchase plan participants	80	78

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Dividends paid, net of dividends reinvested	(864)	(727)
Proceeds from dividend reinvestment plan participants	104	159
Net cash provided by financing activities	21,355	12,516
Net increase (decrease) in cash and cash equivalents	1,221	(6,580)
Cash and cash equivalents, beginning	13,218	21,846
Cash and cash equivalents, ending	\$ 14,439	\$ 15,266

See notes to unaudited consolidated financial statements

7

---

Table Of Contents

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 June 30, 2014 and December 31, 2013 and the related consolidated statements of income and consolidated statements of comprehensive income for the three- and six- months ended June 30, 2014 and 2013, and consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the six months ended June 30, 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 June 30, 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 June 30, 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.



## Table Of Contents

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 June 30, 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 the six months ended June 30, 2014 and 2013, the Company paid interest of \$1.4 million and \$1.5 million, respectively. The Company was required to pay income taxes of \$0.4 million and \$0.9 million during the first six months of 2014 and 2013. Transfers from loans to foreclosed assets held-for-sale amounted to \$1.2 million and \$1.4 million during the six months ended June 30, 2014 and 2013, respectively. During the same respective periods, transfers from loans to loans HFS amounted to \$0 and \$2.7 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.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP: identify the contract(s) with a customer; identify the performance obligations in the contract; determine the transaction price; allocate the transaction price to the performance obligations in the contract; recognize revenue when (or as) the entity satisfies a performance obligation. The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). The Company is evaluating the impact of the adoption of ASU 2014-09 on its consolidated financial statements and has not yet determined the method by which it will adopt the standard in 2017.

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:

Table Of Contents

As of and for the six months ended June 30, 2014

(dollars in thousands)	Unrealized gains on available-for- sale securities	Non-credit-related impairment losses on investment securities	Total
Beginning balance	\$ 1,239	\$ -	\$ 1,239
Other comprehensive income before reclassifications	1,545	-	1,545
Amounts reclassified from accumulated other comprehensive income	(199)	-	(199)
Net current-period other comprehensive income	1,346	-	1,346
Ending balance	\$ 2,585	\$ -	\$ 2,585

As of and for the three months ended June 30, 2014

(dollars in thousands)	Unrealized gains on available-for- sale securities	Non-credit-related impairment losses on investment securities	Total
Beginning balance	\$ 1,773	\$ -	\$ 1,773
Other comprehensive income before reclassifications	874	-	874
Amounts reclassified from accumulated other comprehensive income	(62)	-	(62)
Net current-period other comprehensive income	812	-	812
Ending balance	\$ 2,585	\$ -	\$ 2,585

As of and for the six months ended June 30, 2013

(dollars in thousands)	Unrealized gains on available-for- sale securities	Non-credit-related impairment losses on investment securities	Total
Beginning balance	\$ 1,905	\$ (1,669)	\$ 236
Other comprehensive (loss) income before reclassifications	(1,469)	35	(1,434)
Amounts reclassified from accumulated other comprehensive income	(85)	-	(85)
Net current-period other comprehensive (loss) income	(1,554)	35	(1,519)
Ending balance	\$ 351	\$ (1,634)	\$ (1,283)

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

(dollars in thousands)	Unrealized gains on available-for- sale securities	Non-credit-related impairment losses on investment securities	Total
Beginning balance	\$ 1,551	\$ (1,695)	\$ (144)
Other comprehensive (loss) income before reclassifications	(1,194)	61	(1,133)
Amounts reclassified from accumulated other comprehensive income	(6)	-	(6)
Net current-period other comprehensive (loss) income	(1,200)	61	(1,139)
Ending balance	\$ 351	\$ (1,634)	\$ (1,283)

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

Table Of Contents

Details about accumulated other comprehensive income components (dollars in thousands)	Amount reclassified from accumulated other comprehensive income				Affected line item in the statement where net income is presented
	Three months ended June 30, 2014		Six months ended June 30, 2013		
Unrealized gains on AFS securities	\$ 94	\$ 9	\$ 301	\$ 128	Gain on sale, recovery, or disposal of investment securities
	(32)	(3)	(102)	(43)	Provision for income taxes
Total reclassifications for the period	\$ 62	\$ 6	\$ 199	\$ 85	Net income

## 4. Investment securities

The amortized cost and fair value of investment securities at June 30, 2014 and December 31, 2013 are summarized as follows:

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
June 30, 2014				
Held-to-maturity securities:				
MBS - GSE residential	\$ -	\$ -	\$ -	\$ -
Available-for-sale securities:				
Agency - GSE	\$ 15,591	\$ 113	\$ 4	\$ 15,700
Obligations of states and political subdivisions	33,257	1,888	39	35,106
MBS - GSE residential	49,639	1,674	10	51,303
Total debt securities	98,487	3,675	53	102,109

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Equity securities - financial services	295	295	-	590
Total available-for-sale securities	\$ 98,782	\$ 3,970	\$ 53	\$ 102,699

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair 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 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

Table Of Contents

The amortized cost and fair value of debt securities at June 30, 2014 by contractual maturity are summarized below:

(dollars in thousands)	Amortized cost	Fair value
Held-to-maturity securities:		
MBS - GSE residential	\$ -	\$ -
Available-for-sale securities:		
Debt securities:		
Due in one year or less	\$ 1,000	\$ 1,002
Due after one year through five years	9,377	9,419
Due after five years through ten years	6,451	6,637
Due after ten years	32,020	33,748
Total debt securities	48,848	50,806
MBS - GSE residential	49,639	51,303
Total available-for-sale debt securities	\$ 98,487	\$ 102,109

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 June 30, 2014 and December 31, 2013:

(dollars in thousands)	Less than 12 months		More than 12 months		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
June 30, 2014						
Agency - GSE	\$ 3,064	\$ 4	\$ -	\$ -	\$ 3,064	\$ 4
Obligations of states and political subdivisions	-	-	2,379	39	2,379	39
MBS - GSE residential	2,105	4	1,930	6	4,035	10

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Total temporarily impaired securities	\$ 5,169	\$ 8	\$ 4,309	\$ 45	\$ 9,478	\$ 53
Number of securities	4		7		11	
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.



Table Of Contents

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 June 30, 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 June 30, 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- to long-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), Federal Home Loan Bank (FHLB) 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.

Table Of Contents

## 5. Loans and leases

The classifications of loans and leases at June 30, 2014 and December 31, 2013 are summarized as follows:

(dollars in thousands)	June 30, 2014	December 31, 2013
Commercial and industrial	\$ 76,343	\$ 74,551
Commercial real estate:		
Non-owner occupied	92,272	89,255
Owner occupied	90,364	86,294
Construction	7,167	10,765
Consumer:		
Home equity installment	34,459	34,480
Home equity line of credit	39,465	36,836
Auto loans and leases	26,295	22,261
Other	6,751	5,205
Residential:		
Real estate	115,082	110,365
Construction	7,435	8,188
Total	495,633	478,200
Less:		
Allowance for loan losses	(9,029)	(8,928)
Unearned lease revenue	(133)	(56)
Loans and leases, net	\$ 486,471	\$ 469,216

Net deferred loan costs of \$1.2 million and \$1.1 million have been added to the carrying values of loans at June 30, 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 \$251.5 million as of June 30, 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.

Table Of Contents

Non-accrual loans, segregated by class, at June 30, 2014 and December 31, 2013, were as follows:

(dollars in thousands)	June 30, 2014	December 31, 2013
Commercial and industrial	\$ 27	\$ 62
Commercial real estate:		
Non-owner occupied	634	1,518
Owner occupied	1,536	1,422
Construction	272	635
Consumer:		
Home equity installment	481	393
Home equity line of credit	516	254
Auto loans and leases	-	12
Other	30	22
Residential:		
Real estate	576	1,350
Total	\$ 4,072	\$ 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 June 30, 2014, total TDRs amounted to \$1.7 million (5 loans), of which one loan with a balance of \$0.9 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 June 30, 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 six and twelve months ended June 30, 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.

15

---

Table Of Contents

## 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):

	30 - 59 Days	60 - 89 Days	Past due		Current	Total loans	Recorded investment past due ≥ 90 days and accruing
			90 days or more *	Total past due			
June 30, 2014	past due	past due	*	past due	Current	loans	
Commercial and industrial	\$ 130	\$ 271	\$ 27	\$ 428	\$ 75,915	\$ 76,343	\$ -
Commercial real estate:							
Non-owner occupied	248	-	634	882	91,390	92,272	-
Owner occupied	910	405	1,536	2,851	87,513	90,364	-
Construction	-	-	272	272	6,895	7,167	-
Consumer:							
Home equity installment	278	81	481	840	33,619	34,459	-
Home equity line of credit	10	-	516	526	38,939	39,465	-
Auto loans and leases	383	-	9	392	25,770	26,162	9
Other	17	7	34	58	6,693	6,751	4
Residential:							
Real estate	185	564	576	1,325	113,757	115,082	-
Construction	-	-	-	-	7,435	7,435	-
Total	\$ 2,161	\$ 1,328	\$ 4,085	\$ 7,574	\$ 487,926	\$ 495,500	\$ 13

\* Includes \$4.1 million of non-accrual loans.

	30 - 59 Days	60 - 89 Days	Past due		Current	Total loans	Recorded investment past due ≥ 90 days and accruing
			90 days or more *	Total past due			
December 31, 2013	past due	past due	*	past due	Current	loans	
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:							

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

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 June 30, 2014 and December 31, 2013, impaired loans consisted of non-accrual loans and TDRs.

At June 30, 2014, impaired loans consisted of accruing TDRs totaling \$0.8 million and \$4.1 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 June 30, 2014 and December 31, 2013, the non-accrual loans included non-accruing TDRs of \$0.9 million and \$1.0 million, respectively. Payments received from impaired loans are first applied against the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income.

Table Of Contents

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
June 30, 2014								
Commercial & industrial	\$ 52	\$ 18	\$ 34	\$ 52	\$ 5	\$ 84	\$ 1	\$ -
Commercial real estate:								
Non-owner occupied	1,284	723	387	1,110	60	1,680	14	-
Owner occupied	1,925	316	1,478	1,794	42	1,954	6	-
Construction	355	-	272	272	-	565	-	-
Consumer:								
Home equity installment	614	35	446	481	3	433	-	-
Home equity line of credit	533	-	516	516	-	327	20	-
Auto loans and leases	-	-	-	-	-	5	-	-
Other	37	-	30	30	-	21	-	-
Residential:								
Real estate	657	201	375	576	51	1,133	-	-
Construction	-	-	-	-	-	-	-	-
Total	\$ 5,457	\$ 1,293	\$ 3,538	\$ 4,831	\$ 161	\$ 6,202	\$ 41	\$ -

(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.

Table Of Contents

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	
	6/30/2014	12/31/2013	6/30/2014	12/31/2013	6/30/2014	12/31/2013

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

(dollars in thousands)

Pass	\$ 72,224	\$ 71,122	\$ 82,247	\$ 78,069	\$ 85,149	\$ 82,975	\$ 6,116	\$ 9,026
Special mention	2,597	2,244	2,687	2,734	2,283	656	715	1,037
Substandard	1,522	1,185	7,338	8,452	2,932	2,663	336	702
Doubtful	-	-	-	-	-	-	-	-
Total	\$ 76,343	\$ 74,551	\$ 92,272	\$ 89,255	\$ 90,364	\$ 86,294	\$ 7,167	\$ 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	
	6/30/2014	12/31/2013	6/30/2014	12/31/2013	6/30/2014	12/31/2013	6/30/2014	12/31/2013
Performing	\$ 33,978	\$ 34,087	\$ 38,949	\$ 36,561	\$ 26,153	\$ 22,182	\$ 6,717	\$ 5,183
Non-performing	481	393	516	275	9	23	34	22
Total	\$ 34,459	\$ 34,480	\$ 39,465	\$ 36,836	\$ 26,162	\$ 22,205	\$ 6,751	\$ 5,205

Mortgage lending credit exposure

Credit risk profile based on payment activity

(dollars in thousands)	Residential real estate		Residential construction	
	6/30/2014	12/31/2013	6/30/2014	12/31/2013
Performing	\$ 114,506	\$ 108,899	\$ 7,435	\$ 8,188
Non-performing	576	1,466	-	-
Total	\$ 115,082	\$ 110,365	\$ 7,435	\$ 8,188

## Table Of Contents

### 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

Table Of Contents

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 six months ended  
June 30, 2014

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 944	\$ 4,253	\$ 1,482	\$ 1,613	\$ 636	\$ 8,928
Charge-offs	36	217	240	77	-	570
Recoveries	14	1	22	34	-	71
Provision	114	305	306	8	(133)	600
Ending balance	\$ 1,036	\$ 4,342	\$ 1,570	\$ 1,578	\$ 503	\$ 9,029
Ending balance: individually evaluated for impairment	\$ 5	\$ 102	\$ 3	\$ 51		\$ 161
Ending balance: collectively evaluated for impairment	\$ 1,031	\$ 4,240	\$ 1,567	\$ 1,527		\$ 8,365
Loans Receivables:						
Ending balance	\$ 76,343	\$ 189,803	\$ 106,837	\$ 122,517		\$ 495,500
Ending balance: individually evaluated for impairment	\$ 52	\$ 3,176	\$ 1,027	\$ 576		\$ 4,831
Ending balance: collectively evaluated for impairment	\$ 76,291	\$ 186,627	\$ 105,810	\$ 121,941		\$ 490,669

As of and for the three months ended June  
30, 2014

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 962	\$ 4,317	\$ 1,517	\$ 1,524	\$ 579	\$ 8,899
Charge-offs	8	65	122	18	-	213
Recoveries	3	-	6	34	-	43

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Provision	79	90	169	38	(76)	300
Ending balance	\$ 1,036	\$ 4,342	\$ 1,570	\$ 1,578	\$ 503	\$ 9,029

As of and for the year ended December 31, 2013

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 922	\$ 4,908	\$ 1,639	\$ 1,503	\$ -	\$ 8,972
Charge-offs	56	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 evaluated for impairment	\$ 31	\$ 117	\$ 24	\$ 110		\$ 282
Ending balance: collectively 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 evaluated for impairment	\$ 97	\$ 4,585	\$ 681	\$ 1,350		\$ 6,713
Ending balance: collectively evaluated for impairment	\$ 74,454	\$ 181,729	\$ 98,045	\$ 117,203		\$ 471,431

Table Of Contents

Information related to the change in the allowance for loan losses as of and for the three- and six-months ended June 30, 2013 is as follows:

As of and for the six months ended June 30, 2013

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 922	\$ 4,908	\$ 1,639	\$ 1,503	\$ -	\$ 8,972
Charge-offs	48	1,627	180	64	-	1,919
Recoveries	6	12	75	-	-	93
Provision	39	228	113	279	491	1,150
Ending balance	\$ 919	\$ 3,521	\$ 1,647	\$ 1,718	\$ 491	\$ 8,296

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

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 854	\$ 3,729	\$ 1,581	\$ 1,658	\$ 414	\$ 8,236
Charge-offs	4	383	142	25	-	554
Recoveries	2	9	3	-	-	14
Provision	67	166	205	85	77	600
Ending balance	\$ 919	\$ 3,521	\$ 1,647	\$ 1,718	\$ 491	\$ 8,296

## 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 the three and six months ended June 30, 2014, there were 38 and 27 potentially dilutive shares related to issued and unexercised stock options. There were no potentially dilutive shares related to stock options as of the three and six months ended June 30, 2013. For restricted stock, dilution would occur from the Company's previously granted but unvested shares. There were 3,631 and 2,932 potentially dilutive shares related to unvested restricted share grants as of the three months ended June 30, 2014 and 2013, respectively. There were 3,665 and 4,172 potentially dilutive shares related to unvested restricted share grants as of the six months ended June 30, 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 June		Six months ended June 30,	
	30,	2013	2014	2013
	2014			
(dollars in thousands except per share data)				
Basic EPS:				
Net income available to common shareholders	\$ 1,627	\$ 1,513	\$ 3,083	\$ 2,907
Weighted-average common shares outstanding	2,411,754	2,345,763	2,405,278	2,338,087
Basic EPS	\$ 0.67	\$ 0.64	\$ 1.28	\$ 1.24
Diluted EPS:				
Net income available to common shareholders	\$ 1,627	\$ 1,513	\$ 3,083	\$ 2,907
Weighted-average common shares outstanding	2,411,754	2,345,763	2,405,278	2,338,087
Potentially dilutive common shares	3,669	2,932	3,692	4,172
Weighted-average common and potentially dilutive shares outstanding	2,415,423	2,348,695	2,408,970	2,342,259
Diluted EPS	\$ 0.67	\$ 0.64	\$ 1.28	\$ 1.24

Table Of Contents

## 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 June 30, 2014, the Company had 19,000 of previously issued and unexercised stock options outstanding. Also, as of June 30, 2014, the intrinsic value for outstanding stock options with market prices that exceeded their strike price amounted to \$1,900. The Company has not issued stock options since 2008.

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 six months ended June 30, 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 June 30, 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 June 30, 2014, the intrinsic value of the Company's restricted stock under the Director and Omnibus plans was \$27.85 per share.

Table Of Contents

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- and six-months ended June 30, 2014 and 2013 and the unrecognized stock-based compensation expense as of June 30, 2014:

(dollars in thousands)	Three months ended		Six months ended	
	June 30, 2014	2013	June 30, 2014	2013
Stock-based compensation expense:				
Director plan	\$ 35	\$ 21	\$ 65	\$ 35
Omnibus plan	10	9	19	14
Total stock-based compensation expense	\$ 45	\$ 30	\$ 84	\$ 49

(dollars in thousands)	As of June 30, 2014
Unrecognized stock-based compensation expense:	
Director plan	\$ 81
Omnibus plan	120
Total unrecognized stock-based compensation expense	\$ 201

The unrecognized stock-based compensation expense as of June 30, 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 June 30, 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. The Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the six months ended June 30, 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.

Table Of Contents

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

June 30, 2014

(dollars in thousands)	Carrying amount	Estimated fair value	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Financial assets:					
Cash and cash equivalents	\$ 14,439	\$ 14,439	\$ 14,439	\$ -	\$ -
Available-for-sale securities	102,699	102,699	590	102,109	-
FHLB stock	2,954	2,954	-	2,954	-
Loans and leases, net	486,471	487,436	-	-	487,436
Loans held-for-sale	1,633	1,664	-	1,664	-
Financial liabilities:					
Deposit liabilities	538,503	538,682	-	538,682	-
Short-term borrowings	21,872	21,872	-	21,872	-
Long-term debt	16,000	17,598	-	17,598	-

December 31, 2013

(dollars in thousands)	Carrying amount	Estimated fair value	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Financial assets:					
Cash and cash equivalents	\$ 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 and leases, 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 equal to its carrying value or cost since there is no market value available and investments in and transactions for the stock are restricted and limited to the FHLB and its member-banks.

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

Table Of Contents

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 periods indicated:

	Total carrying value June 30, 2014	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
(dollars in thousands)				
Available-for-sale securities:				
Agency - GSE	\$ 15,700	\$ -	\$ 15,700	\$ -
Obligations of states and political subdivisions	35,106	-	35,106	-
MBS - GSE residential	51,303	-	51,303	-
Equity securities - financial services	590	590	-	-
Total available-for-sale securities	\$ 102,699	\$ 590	\$ 102,109	\$ -

	Total carrying value December 31, 2013	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
(dollars in thousands)				
Available-for-sale securities:				
Agency - GSE	\$ 14,601	\$ -	\$ 14,601	\$ -
Obligations of states and political subdivisions	32,611	-	32,611	-



Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

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 six months ended June 30, 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 six months 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:

Table Of Contents

(dollars in thousands)

As of and for the six months ended June 30, 2013

Balance at beginning of period	\$ 1,825
Realized gains (losses) in earnings	-
Unrealized gains (losses) in OCI:	
Gains	542
Losses	(124)
Pay down / settlement	(127)
Interest paid-in-kind	5
Accretion	2
Balance at end of period	\$ 2,123

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

(dollars in thousands)	Total carrying value at June 30, 2014	Quoted	Significant	Significant
		prices in active markets (Level 1)	other observable inputs (Level 2)	other unobservable inputs (Level 3)
Impaired loans	\$ 1,132	\$ -	\$ -	\$ 1,132
Other real estate owned	1,738	-	-	1,738
Total	\$ 2,870	\$ -	\$ -	\$ 2,870

(dollars in thousands)	Total carrying value at December 1)	Quoted	Significant	Significant
		prices in active markets (Level 1)	other observable inputs (Level 2)	other unobservable inputs (Level 3)

31, 2013

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 June 30, 2014 and December 31, 2013, the range of liquidation expenses and other valuation adjustments applied to impaired loans ranged from -9.00% to -37.86% and from -16.00% to -36.15%, respectively.

The weighted-average of liquidation expenses and other valuation adjustments applied to impaired loans amounted to -28.79% and -24.84% as of

## Table Of Contents

June 30, 2014 and December 31, 2013, 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. Appraisals form the basis for determining the net realizable value from these properties. Net realizable value is the result of the appraised value less certain costs or discounts associated with liquidation which occurs in the normal course of business. 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 June 30, 2014 and December 31, 2013, the discounts applied to the appraised value of other real estate owned ranged from -17.35% to -41.50% and from -18.22% to 72.17%, respectively. As of June 30, 2014 and December 31, 2013, the weighted-average of discount to the appraisal values for other real estate owned amounted to -28.13% and -30.79%, respectively.

As of June 30, 2014, there were no adjustments to the carrying value of repossessed assets, consisting of automobiles, compared to one automobile at 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 June 30, 2014 compared to December 31, 2013 and a comparison of the results of operations for the three- and six- months ended June 30, 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;
- § the adequacy of the allowance for loan losses;
- §

- 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;
  - § disruptions due to flooding, severe weather conditions, or other natural disasters or Acts of God;
  - § acts of war or terrorism; and
  - § disruption of credit and equity markets.

## Table Of Contents

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.

### Executive Summary

The Company is a Pennsylvania corporation and is a bank holding company, whose wholly-owned state chartered commercial bank is The Fidelity Deposit and Discount Bank. The Company is headquartered in Dunmore, Pennsylvania. We consider Lackawanna and Luzerne Counties our primary marketplace.

As a leading Northeastern Pennsylvania community bank, our goals are to enhance shareholder value while continuing to build a full-service community bank. We focus on growing our core business of retail and business lending and deposit gathering while maintaining strong asset quality and controlling operating expenses. We continue to implement strategies to diversify earning assets and to increase low cost core deposits. These strategies include a greater level of commercial lending and the ancillary business products and services supporting our commercial customers' needs as well as residential lending strategies and an array of consumer products. We focus on developing a full banking relationship with existing, as well as new, small- and middle-sized business prospects. In addition, we explore opportunities to selectively expand our physical presence, consisting presently of our 11-branch network, with construction underway to improve our footprint in Luzerne County.

We are impacted by both national and regional economic factors, with commercial, commercial real estate and residential mortgage loans concentrated in Northeastern Pennsylvania. Although the U.S. economy has shown signs of modest improvement, the operating environment continues to remain challenging. Interest rates have been at or near historical lows and we expect them to remain low for the near-term. Long-term interest rates moved higher during the latter half of 2013 but receded in the 2014 first half, with the ten-year U.S. Treasury rate decreasing from 3.04% at the end of December 2013 to 2.53% at the end of June 2014, approximating the rate from one year ago. The national unemployment rate for June 2014 was 6.1%, down from 6.7% at December 2013 with new job growth in 2014 continuing at its slow pace. In our region (Scranton, Wilkes-Barre Metropolitan Statistical Area), the unemployment rate has decreased to 6.9% at June 30, 2014 from 7.7% as of December 31, 2013 and 9.4% at June 30, 2013. In the year-over-year comparison, the regional unemployment rate declined due to the departure of people in the labor force. During the first six months of 2014, the decline in the labor force matched the decline in the number of unemployed. Despite the decline in the first half of the year, our region continues to have the highest unemployment rate among the state's 14 metropolitan areas. Also, softness persists in the housing and real estate markets. Foreclosure activity has continued to be above average, fueled by the high unemployment rate. We believe market conditions are slowly improving in our region; however they continue to lag behind the national recovery rate. In light of these statistics, we will continue to monitor the economic climate in our region and scrutinize growth prospects with credit quality as a principal consideration.

In addition to the challenging economic environment in which we compete, the regulation and oversight of our business has changed significantly in recent years. As described more fully in Part I, Item 1A, "Risk Factors," and in the "Supervisory and Regulation" section of management's discussion and analysis of financial condition and results of operations in our 2013 Annual Report filed on Form 10-K, certain aspects of the Dodd-Frank Wall Street Reform Act (Dodd-Frank Act) continue to have a significant impact on us. In addition, final rules to implement Basel III regulatory capital reform, approved by the federal bank regulatory agencies in 2013, subject many banks including the Company, to capital requirements which will be phased in. The initial provisions effective for us begin on January 1,

2015. The rules also revise the minimum risk-based and leverage capital ratio requirements applicable to the Company and revise the calculation of risk-weighted assets to enhance their risk sensitivity. We will continue to prepare for the impacts that the Dodd-Frank Act and the Basel III capital standards, and related rulemaking will have on our business, financial condition and results of operations.

#### General

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

Table Of Contents

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- and six- months ended June 30, 2014 and 2013

Overview

Net income for the second quarter of 2014 increased \$0.1 million, or 8%, to \$1.6 million, or \$0.67 per diluted share, compared to \$1.5 million, or \$0.64 per diluted share, in the same 2013 quarter. For the six months ended June 30, 2014, the Company generated net income of \$3.1 million, or \$1.28 per diluted share, compared to \$2.9 million, or \$1.24 per diluted share, for the six months ended June 30, 2013. In both the quarter and year-to-date comparisons, the increase in net income was caused by higher net interest income coupled with lower provisions for loan losses which were partially offset by a decline in non-interest income and higher non-interest expenses. Non-interest income decreased mostly because of lower total net gains on sales of fewer loans.

Return on average assets (ROA) was 1.01% and 1.00% for the second quarters of 2014 and 2013, respectively and 0.96% for both the six months ended June 30, 2014 and 2013, respectively. ROA did not experience significant change in the quarter and year-to-date periods because the impact of the increase in net income was largely in line with the increase in average assets. Return on average shareholders' equity (ROE) was 9.47% and 9.98% for the three months ended June 30, 2014 and 2013, respectively and 9.14% and 9.74% for the six months ended June 30, 2014 and 2013, respectively. The decrease in ROE in the three and six month comparison was caused by an increase in shareholders' equity that was boosted mostly by 2013 earnings.

Net interest income and interest sensitive assets / liabilities

Net interest income increased \$0.2 million, or 5%, from \$5.2 million for the quarter ended June 30, 2013 to \$5.4 million for the quarter ended June 30, 2014, with increased interest income and to a lesser extent, reduced interest expense combining for the increase. The Company experienced a \$25.2 million net increase in average interest-bearing deposits, but a four basis point decline on average rates paid due to a 12 basis point decline on rates paid on certificates of deposit, or CDs. The lower rates paid on CDs in conjunction with a \$7.4 million decline in their average balances resulted in a \$54 thousand decrease in interest expense from time deposits. Interest expense from interest-bearing transaction deposits increased \$41 thousand mostly due to higher average balances, from successful efforts in generating interest-bearing checking and money market deposits and also from higher rates paid on promotional deposit-gathering offerings and negotiated rates. The portfolio of interest-earning assets increased \$37.4 million and helped offset the negative impact of a ten basis point net reduction in their yields – the negative impact stemming from the loan portfolio. The loan portfolio increased \$32.4 million on average, which boosted its earnings despite a 26 basis point reduction in yield. The increase in interest income was driven by a 70 basis point increase in the yields earned on investment securities. In the fourth quarter of 2013, the Company's sold its entire portfolio of corporate bonds, which consisted of pooled trust preferred securities that were essentially non-performing. The proceeds of the sale were re-deployed into earning assets.

Net interest income for the six months ended June 30, 2014 increased \$0.3 million, or 3%, from \$10.4 million in the first half of 2013 to \$10.7 million in the first half of 2014. As explained above, proceeds from the sale of the



corporate bonds in the fourth quarter of 2013 were reinvested to generate higher income in the first half of 2014. Although total average investment securities decreased by \$1.5 million, interest income from these securities increased \$0.3 million due to a 68 basis point higher yield. The higher average balances in the commercial and residential loan portfolios drove an additional increase in interest income despite a decline in yield of 37 basis points and four basis points, respectively.

The fully-taxable equivalent (FTE) net interest rate spread and margin both decreased by five basis points for the three- and six-months ended June 30, 2014 compared to the three- and six-months ended June 30, 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 and six months ended June 30, 2014 compared to the same periods in 2013 because of lower rates paid notwithstanding higher balances of average interest-bearing liabilities.

During 2014, the Company expects to continue to operate in a low interest rate environment, with volatility continuing 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. Until there is a sustained period of yield curve steepening, with rates rising at the long end, interest rate margin may continue to experience compression. However for 2014, the Company anticipates net interest income to stabilize or improve marginally as growth in interest-earning assets would help offset the impact of lower rates. 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. Continued growth in the commercial and consumer loan portfolios will be the Company's strategy for 2014, and when coupled with historically low funding costs, should help contain the interest rate margin.

The Company's cost of interest-bearing liabilities was 65 basis points for both the three- and six- months ended June 30, 2014 or five basis points lower than the cost for the three- and six- months ended June 30, 2013. Other than retaining maturing long-term CDs,

Table Of Contents

further reductions in deposit rates from the current historic low levels would have an insignificant cost-savings impact. As noted, interest rates along the treasury yield curve have been volatile with stability existing only at the short end. Competition could pressure banks to increase 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 mitigate the impact of 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 no- and low-cost deposits into interest earning-assets is an effective margin-enhancing strategy that the Company expects to continue to pursue and expand 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. ALM also discusses revenue enhancing strategies to help combat the potential for a decline in net interest income. The Company's marketing department, together with ALM, lenders and deposit gatherers, continue to develop prudent strategies that will grow the loan portfolio and accumulate low-cost deposits to improve net interest income performance.

The tables that follow set forth a comparison of average balances of assets and liabilities and their related net tax equivalent yields and rates for the periods 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. In the 2013 periods, securities include non-accrual securities. Net deferred loan cost amortization of \$83.3 thousand and \$72.2 thousand for the second quarters of 2014 and 2013, respectively, and \$147.7 thousand and \$137.9 thousand for the first halves of 2014 and 2013, respectively, are included in interest income from loans. 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:

Table Of Contents

(dollars in thousands)	Three months ended					
	June 30, 2014			June 30, 2013		
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
<b>Assets</b>						
Interest-earning assets						
Interest-bearing deposits	\$ 6,353	\$ 5	0.28 %	\$ 2,463	\$ 2	0.31 %
Investments:						
Agency - GSE	15,612	56	1.44	15,190	13	0.34
MBS - GSE residential	49,742	201	1.62	48,233	123	1.03
State and municipal	34,411	519	6.05	29,516	459	6.23
Other	2,904	27	3.78	9,190	19	0.83
Total investments	102,669	803	3.14	102,129	614	2.44
Loans and leases:						
Commercial	267,483	3,097	4.64	247,859	3,087	4.99
Consumer	65,247	896	5.51	57,522	876	6.11
Residential real estate	158,707	1,598	4.04	153,642	1,556	4.06
Total loans and leases	491,437	5,591	4.56	459,023	5,519	4.82
Federal funds sold	580	-	0.25	22	-	0.26
Total interest-earning assets	601,039	6,399	4.27 %	563,637	6,135	4.37 %
Non-interest earning assets	48,388			45,215		
Total assets	\$ 649,427			\$ 608,852		
<b>Liabilities and shareholders' equity</b>						
Interest-bearing liabilities						
Deposits:						
Savings	\$ 110,502	\$ 53	0.19 %	\$ 109,414	\$ 56	0.21 %
Interest-bearing checking	101,261	40	0.16	80,110	19	0.10
MMDA	91,047	129	0.57	80,736	105	0.52
CDs < \$100,000	69,126	160	0.93	76,912	200	1.04
CDs > \$100,000	41,789	116	1.11	41,355	130	1.26
Clubs	1,830	1	0.14	1,865	1	0.16
Total interest-bearing deposits	415,555	499	0.48	390,392	511	0.52
Repurchase agreements	8,215	3	0.17	8,807	4	0.18
Borrowed funds	23,692	219	3.70	22,392	217	3.89
Total interest-bearing liabilities	447,462	721	0.65 %	421,591	732	0.70 %
Non-interest bearing deposits	129,069			122,805		
Non-interest bearing liabilities	3,942			3,657		
Total liabilities	580,473			548,053		
Shareholders' equity	68,954			60,799		
Total liabilities and shareholders' equity	\$ 649,427			\$ 608,852		
Net interest income - FTE		\$ 5,678			\$ 5,403	
Net interest spread			3.62 %			3.67 %
Net interest margin			3.79 %			3.84 %
Cost of funds			0.50 %			0.54 %



Table Of Contents

(dollars in thousands)	Six months ended					
	June 30, 2014			June 30, 2013		
Assets	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Interest-earning assets						
Interest-bearing deposits	\$ 9,057	\$ 12	0.26 %	\$ 9,900	\$ 14	0.29 %
Investments:						
Agency - GSE	15,605	110	1.42	16,325	58	0.71
MBS - GSE residential	49,413	392	1.60	49,336	258	1.06
State and municipal	33,936	1,018	6.05	28,435	894	6.34
Other	2,728	51	3.81	9,125	39	0.86
Total investments	101,682	1,571	3.12	103,221	1,249	2.44
Loans and leases:						
Commercial	265,091	6,130	4.66	244,827	6,110	5.03
Consumer	63,730	1,744	5.52	56,490	1,784	6.37
Residential real estate	157,364	3,192	4.09	153,627	3,144	4.13
Total loans and leases	486,185	11,066	4.59	454,944	11,038	4.89
Federal funds sold	312	-	0.26	231	-	0.26
Total interest-earning assets	597,236	12,649	4.27 %	568,296	12,301	4.37 %
Non-interest earning assets	48,046			45,083		
Total assets	\$ 645,282			\$ 613,379		
Liabilities and shareholders' equity						
Interest-bearing liabilities						
Deposits:						
Savings	\$ 110,002	\$ 108	0.20 %	\$ 109,146	\$ 112	0.21 %
Interest-bearing checking	101,212	82	0.16	81,631	46	0.11
MMDA	88,742	244	0.55	80,640	209	0.52

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

CDs < \$100,000	70,154	326	0.94	75,899	398	1.06
CDs > \$100,000	41,165	226	1.11	41,313	260	1.27
Clubs	1,610	1	0.14	1,624	1	0.16
Total interest-bearing deposits	412,885	987	0.48	390,253	1,026	0.53
Repurchase agreements	12,138	12	0.19	13,068	13	0.20
Borrowed funds	20,066	429	4.31	19,333	428	4.46
Total interest-bearing liabilities	445,089	1,428	0.65 %	422,654	1,467	0.70 %
Non-interest bearing deposits	128,406			126,812		
Non-interest bearing liabilities	3,769			3,734		
Total liabilities	577,264			553,200		
Shareholders' equity	68,018			60,179		
Total liabilities and shareholders' equity	\$ 645,282			\$ 613,379		
Net interest income - FTE		\$ 11,221			\$ 10,834	
Net interest spread			3.62 %			3.67 %
Net interest margin			3.79 %			3.84 %
Cost of funds			0.50 %			0.54 %

## Table Of Contents

### 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 second quarter of 2014, compared to provisions of \$0.6 million in the second quarter of 2013, a decline of \$0.3 million. Similarly, provisions for loan losses declined in the first half of 2014 compared to the first half of 2013 – a \$0.6 million decline. The decline in the provisions for loan losses in both periods was due to a substantial improvement in credit quality. The Company's non-performing loans declined to \$4.1 million as of June 30, 2014, a \$1.7 million decrease from year-end 2013. Although credit quality continues to improve, additions to the provision during the first six months of 2014 were required to reserve in connection with loan growth in the period, protect against inherent losses that exist in the portfolio and reinforce the allowance for the potential credit risks that still exist from an uncertain local economic climate. The allowance for loan losses was \$9.0 million as of June 30, 2014 compared to \$8.9 million as of 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 June 30, 2014, non-interest income amounted to \$1.8 million, a \$0.2 million, or 11%, decrease compared to \$2.0 million recorded during the three months ended June 30, 2013. A decline in the mortgage loan origination and refinance activities resulted in \$0.3 million less 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 declining activity in the residential lending area, mortgage loan fees declined \$0.1 million during the quarter ended June 30, 2014 compared to June 30, 2013. These items were partially offset by gains recognized from investment security sales, interchange fees, commercial loan service charges and rental income, or approximately \$0.2 million in the aggregate.

For the six months ended June 30, 2014, non-interest income decreased \$0.6 million, or 14%, to \$3.5 million recorded in the first half of 2014 compared to \$4.1 million recorded in the first half of 2013. The high volume of residential loan refinance activity, molded by the prevailing low interest rate environment, has subsided as many existing mortgage holders as well as new home owners have previously availed themselves to this rare economic occurrence. While the Company continues to seek borrowers who have not yet benefited from this event, the volume of residential loans sold into the secondary market has declined resulting in a \$0.6 million decline in gains from their sales in the first six months of 2014 compared to the same 2013 period. In tandem with this decline are lower mortgage service charges of approximately \$0.2 million. Partially offsetting these items were gains from security sales, interchange fees, and rental income of \$0.3 million in total.

#### Other operating expenses

For the three months ended June 30, 2014, total other operating expenses increased \$0.2 million, or 3%, compared to the three months ended June 30, 2013. Salary and employee benefits increased \$66 thousand, or 3%, in the second quarter of 2014 compared to the second quarter of 2013. The primary cause of the increase was comprised of: the addition of a full-time equivalent (FTE) employee to the commercial lending department due to the focus on growing the commercial loan portfolio; annual merit increases; incentives awarded to key members of management partially offset by a reduction in the cost of group insurance due to lower amounts of medical claims, net of increased carrying costs. The increase in premises and equipment of \$70 thousand, or 9%, was caused by higher costs of utilities, facility and equipment repairs, insurance and higher technology costs for core system maintenance price increases and also a higher volume of mobile and online banking usage. Advertising and marketing expenses increased \$59 thousand, or 27%, in the second quarter 2014 compared to the second quarter 2013. The current year quarter included brand advertising, consisting of television, radio, billboards and newspaper media. The other component of other operating expenses increased due to a



Table Of Contents

large tax refund from a favorable outcome of a state sales tax appeal in the 2013 quarter and in the 2014 quarter, a greater amount of overhead due to lower levels of loan cost deferrals. On the upside, loan collection expenses declined \$0.1 million for the quarter ended June 30, 2014 compared to the same period in 2013 due principally to fewer problem loans requiring significant collection effort. 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 \$37 thousand primarily due to a \$73 thousand lower write-down to fair value during the current year quarter partially offset by \$20 thousand in lower net gains on property sales and a \$14 thousand increase in property ownership carrying costs.

For the six months ended June 30, 2014, total other operating expenses increased by \$59 thousand, or less than 1%, compared to the six months ended June 30, 2013. Salary and employee benefits increased \$68 thousand, or 1%, during the first half of 2014 compared to the first half of 2013. The cause of the increase stems from select staff replacements at higher salary levels, the aforementioned addition of an FTE to commercial lending, annual merit increases and one-time salary increases awarded to employees in the normal course of performance management. As noted above, these items were offset by a reduction in expenses incurred for group insurance due to reduced medical claims net of increased carrying costs. Premises and equipment increased during the period by \$0.1 million, or 8%. In addition to the items noted above in the quarterly comparison, the extreme winter weather conditions in the current year required additional expenditures for facility maintenance. The \$0.1 million, or 30%, increase in advertising and marketing in the six months ended June 30, 2014 compared to the six months ended June 30, 2013 was caused by an increase in contributions to help fund marketplace educational institutions under one of the Pennsylvania-administered educational improvement programs. The higher professional services is related to a 2013 legal accrual adjustment and the timing of legal service needs for the Company's trust department. The \$65 thousand, or 27%, increase in automated transaction processing was caused by a higher volume of transactions as well as increased transaction fees caused by regulatory requirements placed on processing networks. In addition, the Company introduced a debit card rewards program whereby customers earn points that can be redeemed at area merchants. The program did not begin until the end of the second quarter of 2013, compared to a full six months in 2014. These items were partially offset by a decrease of \$0.2 million, or 68%, in loan collection expenses. The Company is making significant progress in addressing and resolving problematic loans in an effort to contain these costs. The 2013 figure includes the final collection related expenditures associated with one large commercial loan. ORE expenses declined by nearly \$0.1 million, or by more than half in the current year. Almost all of the decline can be attributed to a lower write-down to fair value of ORE balances in the current period. A lower assessment rate caused the FDIC insurance premium to decrease \$71 thousand, or 28%, during the six months ended June 30, 2014 compared to the same 2013 period.

Comparison of financial condition at

June 30, 2014 and December 31, 2013

Overview

Consolidated assets increased \$26.5 million, or 4%, to \$650.3 million as of June 30, 2014 from \$623.8 million at December 31, 2013. The increase in assets was funded through growth in deposits of \$8.8 million, short-term borrowings of \$13.2 million and a \$3.9 million increase in shareholders' equity. Net income of \$3.1 million and \$1.3 million in other comprehensive income partially offset by \$0.8 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.

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 June 30, 2014, the carrying value of investment securities amounted to \$102.7 million, or 16% of total assets, compared to \$97.4 million, or 16% of total assets, at December 31, 2013. On June 30, 2014, 50% 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.

Investment securities were comprised of AFS securities with a carrying value of \$102.7 million as of June 30, 2014. The AFS securities were recorded with a net unrealized gain of \$3.9 million as of June 30, 2014 compared to a net unrealized gain of \$1.9 million as of December 31, 2013, or a net improvement of \$2.0 million during the first half of 2014. The direction and magnitude of the change in value of the Company's investment portfolio is attributable to the direction and magnitude of the change in interest rates along the treasury yield curve. Generally, the values of debt securities move in the opposite direction of the changes in interest rates.

Table Of Contents

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 the 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. If interest rates rise, the market values of the Company'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.

During the first six months of 2014, the carrying value of total investments increased \$5.3 million, or 5%. The increase was due to the deployment of the proceeds from the sale of the Company's corporate bonds that consisted 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 which 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 June 30, 2014 and December 31, 2013 is as follows:

(dollars in thousands)	June 30, 2014		December 31, 2013	
	Amount	%	Amount	%
MBS - GSE residential	\$ 51,303	49.9 %	\$ 49,686	51.0 %
State & municipal subdivisions	35,106	34.2	32,611	33.5
Agency - GSE	15,700	15.3	14,601	15.0
Equity securities - financial services	590	0.6	525	0.5
Total	\$ 102,699	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 \$37 thousand and \$4

thousand for the six months ended June 30, 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 \$3.0 million and \$2.6 million as of June 30, 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 June 30, 2014 and December 31, 2013, loans HFS consisted of residential mortgage loans.

As of June 30, 2014 and December 31, 2013, loans HFS had a carrying amount of \$1.6 million and \$0.9 million, respectively, which approximated their fair values. During the six months ended June 30, 2014, residential mortgage loans with principal balances of \$14.4 million were sold into the secondary market and the Company recognized net gains of \$0.3 million, compared to \$50.2 million and \$0.8 million, respectively during the six months ended June 30, 2013. Gains of \$41 thousand, deferred from sales of Small Business Administration (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 2014. With a decline in the residential mortgage origination, refinance and modification activities, the Company does not expect to achieve the same level of gains from loan sales as it had in 2013.

## Table Of Contents

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 June 30, 2014 and December 31, 2013, the servicing portfolio balance of sold residential mortgage loans was \$251.5 million and \$250.2 million, respectively.

### Loans and leases

Asset quality remains a top priority for our Company. For the first six months of 2014, we have seen a reduction of \$1.7 million, or 30%, in non-performing loans. We have been able to institute best practices by utilizing the expertise of our personnel, and making use of their experience and/or contacts of both internal and external auditors and our regulators which has not only been helpful to us in achieving this reduction but, has provided the framework for maintaining a strong asset quality given our local, regional and national economy. We continue the utilization of loan participations (sharing loans with other financial institutions) and various government guaranty programs helping us by further reducing our risk. These programs help reduce our risk exposure to any one borrower.

We have a relationship management system in place which consists of a formal calling program for existing and prospective clients and centers of influence such as, accountants and attorneys. During the first six months of 2014, this program has documented in excess of 2,600 meetings stemming predominantly from commercial customer relationships but discussion topics address both business and retail services. This program continues to build customer loyalty and a teamwork approach. We strive toward being a fully focused customer centric organization and a trusted financial advisor.

We remain a preferred lender and ranked in the top twenty-five in volume of our peers in the Philadelphia region of the SBA program. As a preferred lender it allows us to provide the business community with credit under terms and conditions that without SBA would not be possible.

### Commercial and industrial

The commercial and industrial (C&I) loan portfolio increased \$1.7 million, or 2%, from \$74.6 million at December 31, 2013 to \$76.3 million at June 30, 2014. While this product experienced some growth during the first six months of 2014, due to the lack of demand for C&I credits and high competition in the community banking arena within our market place, we expect flat to nominal growth for the remainder of 2014.

### Commercial real estate

The commercial real estate loan portfolio increased \$3.5 million, or 2%, from \$186.3 million at December 31, 2013 to \$189.8 million as of June 30, 2014. The majority of growth continues to be in the owner occupied real estate category. Inherently, the owner occupied real estate category has less risk and continues to be our focus for growth.

### Consumer

The consumer loan portfolio increased by \$8.2 million, or 8%, from \$98.8 million at December 31, 2013 to \$107.0 million at June 30, 2014. The increase in this portfolio was primarily attributable to the auto loans and leases category. During the first half of 2014, the Company's strategy of building on its existing relationships with automobile dealerships for loans and leases enabled the Company to grow this portfolio segment. Steady growth here as well as seasonal promotions of home equity lines of credit accounted for the consumer loan growth in the first half of 2014. Continued emphasis on this segment is expected for the remainder of the year.

### Residential

The residential loan portfolio grew \$3.9 million, or 3%, from \$118.6 million at December 31, 2013 to \$122.5 million at June 30, 2014. Incremental originations, primarily within the scope of the Company's residential mortgage loan modification program targeting loans of relatively short duration – 15 years or less, has had reasonable success in light of contravening market factors including an extended low interest rate environment.

Table Of Contents

The composition of the loan portfolio at June 30, 2014 and December 31, 2013, is summarized as follows:

(dollars in thousands)	June 30, 2014		December 31, 2013	
	Amount	%	Amount	%
Commercial and industrial	\$ 76,343	15.4 %	\$ 74,551	15.6 %
Commercial real estate:				
Non-owner occupied	92,272	18.6	89,255	18.7
Owner occupied	90,364	18.2	86,294	18.0
Construction	7,167	1.4	10,765	2.2
Consumer:				
Home equity installment	34,459	7.0	34,480	7.2
Home equity line of credit	39,465	8.0	36,836	7.7
Auto and leases	26,295	5.3	22,261	4.7
Other	6,751	1.4	5,205	1.1
Residential:				
Real estate	115,082	23.2	110,365	23.1
Construction	7,435	1.5	8,188	1.7
Gross loans	495,633	100.0 %	478,200	100.0 %
Less:				
Allowance for loan losses	(9,029)		(8,928)	
Unearned lease revenue	(133)		(56)	
Net loans	\$ 486,471		\$ 469,216	
Loans held-for-sale	\$ 1,633		\$ 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.



Table Of Contents

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 non-accruing status 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.

Net charge-offs for the six months ended June 30, 2014 were \$0.5 million compared to \$1.8 million for the six months ended June 30, 2013. This represented a year-over-year improvement due to a general increase in overall credit quality. During the second quarter of 2014, charge-offs were taken on a variety of consumer and commercial loans. 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 \$9.0 million as of June 30, 2014, \$8.9 million as of December 31, 2013 and \$8.3 million as of June 30, 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.

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.

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 June 30, 2014 and December 31, 2013 allowance calculations. In addition, by excluding the cash secured and guarantee portion of SBA loans, the Company was able to reduce the allowance requirement by approximately \$0.2 million both as of June 30, 2014 and December 31, 2013.

Table Of Contents

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

(dollars in thousands)	As of and for the six months ended June 30, 2014	As of and for the twelve months ended December 31, 2013	As of and for the six months ended June 30, 2013		
Balance at beginning of period	\$ 8,928	\$ 8,972	\$ 8,972		
Charge-offs:					
Commercial and industrial	36	56	48		
Commercial real estate	217	2,091	1,627		
Consumer	240	400	180		
Residential	77	218	64		
Total	570	2,765	1,919		
Recoveries:					
Commercial and industrial	14	30	6		
Commercial real estate	1	30	12		
Consumer	22	110	75		
Residential	34	1	-		
Total	71	171	93		
Net charge-offs	499	2,594	1,826		
Provision for loan losses	600	2,550	1,150		
Balance at end of period	\$ 9,029	\$ 8,928	\$ 8,296		
Net charge-offs (annualized) to average total loans outstanding	0.21	%	0.56	%	0.80
Allowance for loan losses to net charge-offs (annualized)	9.05	x	3.44	x	2.27
Allowance for loan losses to total loans	1.82	%	1.86	%	1.78
Loans 30 - 89 days past due and accruing	\$ 3,489		\$ 5,268		\$ 1,921
Loans 90 days or more past due and accruing	\$ 13		\$ 155		\$ 993
Non-accrual loans	\$ 4,072		\$ 5,668		\$ 6,710
Allowance for loan losses to loans 90 days or more past due and accruing	694.54	x	57.60	x	8.35
Allowance for loan losses to non-accrual loans	2.22	x	1.58	x	1.24
Allowance for loan losses to non-performing loans	2.21	x	1.53	x	1.08
Average total loans	\$ 486,185		\$ 461,539		\$ 454,944

## 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 June 30, 2014, non-performing assets represented 1.08% of total assets, favorable results compared

with 1.44% as of December 31, 2013 and 2.03% at June 30, 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.

Table Of Contents

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

(dollars in thousands)	June 30, 2014	December 31, 2013	June 30, 2013
Loans past due 90 days or more and accruing	\$ 13	\$ 155	\$ 993
Non-accrual loans *	4,072	5,668	6,710
Total non-performing loans	4,085	5,823	7,703
Troubled debt restructurings	759	1,045	1,078
Other real estate owned and repossessed assets	2,186	2,086	2,617
Non-accrual securities	-	-	1,089
Total non-performing assets	\$ 7,030	\$ 8,954	\$ 12,487
Total loans, including loans held-for-sale	\$ 497,133	\$ 479,061	\$ 465,350
Total assets	\$ 650,306	\$ 623,825	\$ 615,175
Non-accrual loans to total loans	0.82%	1.18%	1.44%
Non-performing loans to total loans	0.82%	1.22%	1.66%
Non-performing assets to total assets	1.08%	1.44%	2.03%

\* In the table above, the amount includes non-accrual TDRs of \$0.9 million as of June 30, 2014, \$1.0 million as of December 31, 2013 and \$1.0 million as of June 30, 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 \$1.7 million, or 30%, from \$5.8 million on December 31, 2013 to \$4.1 million at June 30, 2014. As of year-end 2013, the over 90 days past due portion was \$200 thousand, which consisted of four loans to four unrelated borrowers, ranging from \$7 thousand to \$100 thousand. As of June 30, 2014, the past due over 90 days totaled \$13 thousand, which consisted of two loans to two unrelated borrowers. 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 June 30, 2014 there were 42 loans to 39 unrelated borrowers on non-accrual ranging from less than \$1 thousand to \$0.9 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 June 30, 2014, the non-accrual loans aggregated \$4.1 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 June 30, 2014 occurred as follows: additions to the non-accrual loan component of the non-performing assets totaling \$1.2 million were made during the period and capitalized expenditures of \$0.2 million; these were offset by reductions or payoffs of \$0.4 million, charge-offs of \$0.4 million, \$1.1 million of transfers to ORE and \$0.1 million of loans that returned to performing status. In addition, \$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. The ratio of non-performing loans to total loans was 0.82% at June 30, 2014 compared to 1.22% at December 31, 2013.

Table Of Contents

The composition of non-performing loans as of June 30, 2014 is as follows:

	Gross loan balances	Past due 90 days or more and still accruing	Non- accrual loans	Total non- performing loans	% of gross loans
(dollars in thousands)					
Commercial and industrial	\$ 76,343	\$ -	\$ 27	\$ 27	0.04%
Commercial real estate:					
Non-owner occupied	92,272	-	634	634	0.69%
Owner occupied	90,364	-	1,536	1,536	1.70%
Construction	7,167	-	272	272	3.80%
Consumer:					
Home equity installment	34,459	-	481	481	1.40%
Home equity line of credit	39,465	-	516	516	1.31%
Auto loans and leases	26,162	9	-	9	0.03%
Other	6,751	4	30	34	0.50%
Residential:					
Real estate	115,082	-	576	576	0.50%
Construction	7,435	-	-	-	-
Loans held-for-sale	1,633	-	-	-	-
Total	\$ 497,133	\$ 13	\$ 4,072	\$ 4,085	0.82%

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 June 30, 2014 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of \$78 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 June, 2014, which was a slight decrease from the December 31, 2013 total of \$2.0 million, the result of loan payoffs during the first half of 2014.

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

As of and for the six months ended  
June 30, 2014

(dollars in thousands)	Accruing Commercial & Commercial industrial estate	Non-accruing Commercial real estate	Total
Troubled Debt Restructures:			
Beginning balance	\$ 35 \$ 1,010	\$ 967	\$ 2,012
Pay downs / payoffs	10 276	37	323
Ending balance	\$ 25 \$ 734	\$ 930	\$ 1,689

As of and for the year ended December 31, 2013

(dollars in thousands)	Accruing Commercial & Commercial industrial estate	Non-accruing Commercial real estate	Total
Troubled Debt Restructures:			
Beginning balance	\$ 42 \$ 1,061	\$ 1,066	\$ 2,169
Pay downs / payoffs	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

Table Of Contents

a below-market rate 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 \$2.2 million at June 30, 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:

(dollars in thousands)	June 30,		December 31,	
	2014	2013	2013	2012
	Amount	#	Amount	#
Balance at beginning of period	\$ 2,078	15	\$ 1,600	12
Additions	1,071	5	2,381	15
Pay downs	-		(34)	
Write downs	(5)		(443)	
Sold	(970)	(9)	(1,426)	(12)
Balance at end of period	\$ 2,174	11	\$ 2,078	15

As of June 30, 2014, ORE consisted of eleven properties from ten unrelated borrowers totaling \$2.2 million. Four of these properties (\$1.0 million) were added in 2014; three were added in 2013 (\$0.3 million); two were added in 2012 (\$0.3 million); one was added in 2011 (\$0.2 million) and one was added in 2010 (\$0.4 million).

Six properties (\$1.8 million) were listed for sale, one (\$97 thousand) had a signed sales agreement, one (\$152 thousand) was in litigation, one (\$150 thousand) was in the process of being repaired, and two properties (\$25 thousand) were awaiting disposition plans.

Other non-real estate foreclosed assets held-for-sale included an automobile with a book value of \$12 thousand at June 30, 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 half of 2014. During the 2014 first 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. 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



The \$0.7 million increase in other assets was due principally to progress payments on facility remodeling and branch relocation, residual values associated with recording new automobile leases, net of lease disposals, normal cyclical changes to prepaid expenses, amounts due from borrowers for their loan escrow accounts, partially offset by income tax refunds and a decline in the net deferred tax asset.

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 are 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.

Table Of Contents

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

(dollars in thousands)	June 30, 2014		December 31, 2013	
	Amount	%	Amount	%
Money market	\$ 93,114	17.3 %	\$ 83,512	15.8 %
Interest-bearing checking	95,498	17.7	100,315	18.9
Savings and clubs	115,624	21.5	109,253	20.6
Certificates of deposit	108,259	20.1	113,699	21.5
Total interest-bearing	412,495	76.6	406,779	76.8
Non-interest bearing	126,008	23.4	122,919	23.2
Total deposits	\$ 538,503	100.0 %	\$ 529,698	100.0 %

Total deposits increased \$8.8 million, or 2%, from \$529.7 million at December 31, 2013 to \$538.5 million at June 30, 2014. Growth in money market, savings and non-interest-bearing checking accounts of \$9.6 million, \$6.4 million and \$3.1 million, or 6% in total, offset declines in interest-bearing checking and certificates of deposit. Success in deposit gathering strategies including periodic promotions and business relationship development helped boost savings and money market accounts for both retail and business customers. The Company has been successful in developing and garnering relationships with all customer segments with growth in retail, business and the public sector in non-maturing deposits during the first six months of 2014. The Company will continue to execute on its relationship development strategy, explore the demographics within its marketplace and tailor creative programs to continue to grow within the market. For the remainder of 2014, growth in public deposits from negotiated contracts, of amounts in upward of \$27 million, is anticipated. Otherwise, moderate deposit growth is expected.

The market interest rate profile had not changed significantly from year end with the long end of the treasury yield curve actually receding to year-ago rate levels. As such, deposit customers continue to opt for non-maturing deposits and for the Company, CDs continue to decrease; having declined \$5.4 million, or almost 5%, from year-end 2013. 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 strategies to grow and retain retail and business customers with an emphasis on deepening and broadening those relationships.

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 June 30, 2014 and December 31, 2013, CDARS represented \$7.7 million, or 1%, and \$10.3 million, or 2%, respectively, of total deposits.

Excluding CDARS, certificates of deposit accounts of \$100,000 or more amounted to \$41.6 million and \$41.2 million at June 30, 2014 and December 31, 2013, respectively. Certificates of deposit of \$250,000 or more amounted to \$17.7 million and \$15.7 million as of June 30, 2014 and December 31, 2013, respectively.

Including CDARS, approximately 31% of the CDs, with a weighted-average interest rate of 0.71%, are scheduled to mature in 2014 and an additional 32%, with a weighted-average interest rate of 1.02%, 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. The Company does not expect significant net CD growth during the remainder of 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

Table Of Contents

variances in repurchase agreements, which during the first half of 2014 increased \$2.0 million, or 33%, 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 June 30, 2014 and December 31, 2013, the Company had balances in overnight borrowings of \$13.7 million and \$2.5 million, respectively.

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

(dollars in thousands)	June 30, 2014		December 31, 2013	
	Amount	%	Amount	%
Overnight borrowings	\$ 13,694	36.2 %	\$ 2,472	10.0 %
Securities sold under repurchase agreements	8,178	21.6	6,171	25.0
Long-term FHLB advances	16,000	42.2	16,000	65.0
Total	\$ 37,872	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 June 30, 2014, the Company maintained a one-year cumulative gap of positive (asset sensitive) \$61.1 million, or 9%, 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.

Table Of Contents

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 June 30, 2014:

(dollars in thousands)	Three months or less	More than three months to twelve months	More than one year to three years	More than three years	Total
Cash and cash equivalents	\$ 40	\$ -	\$ -	\$ 14,399	\$ 14,439
Investment securities (1)(2)	4,311	9,695	22,974	68,673	105,653
Loans and leases(2)	184,750	72,419	114,676	116,259	488,104
Fixed and other assets	-	10,569	-	31,541	42,110
Total assets	\$ 189,101	\$ 92,683	\$ 137,650	\$ 230,872	\$ 650,306
Total cumulative assets	\$ 189,101	\$ 281,784	\$ 419,434	\$ 650,306	
Non-interest-bearing transaction deposits (3)	\$ -	\$ 12,613	\$ 34,627	\$ 78,768	\$ 126,008
Interest-bearing transaction deposits (3)	110,235	19,137	114,041	60,823	304,236
Certificates of deposit	15,834	40,969	42,911	8,545	108,259
Repurchase agreements	8,178	-	-	-	8,178
Short-term borrowings	13,694	-	-	-	13,694
Long-term debt	-	-	16,000	-	16,000
Other liabilities	-	-	-	4,005	4,005
Total liabilities	\$ 147,941	\$ 72,719	\$ 207,579	\$ 152,141	\$ 580,380
Total cumulative liabilities	\$ 147,941	\$ 220,660	\$ 428,239	\$ 580,380	
Interest sensitivity gap	\$ 41,160	\$ 19,964	\$ (69,929)	\$ 78,731	
Cumulative gap	\$ 41,160	\$ 61,124	\$ (8,805)	\$ 69,926	
Cumulative gap to total assets	6.3%	9.4%	-1.4%	10.8%	

(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.

Table Of Contents

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 June 30, 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 June 30, 2014 levels:

	% change	
	Rates	Rates
	+200	-200
Earnings at risk:		
Net interest income	4.9 %	(2.5) %
Net income	14.4	(7.3)
Economic value at risk:		
Economic value of equity	(9.9)	(15.7)
Economic value of equity as a percent of total assets	(1.3)	(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 June 30, 2014, the Company's risk-based capital ratio was 15.4%.

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

(dollars in thousands)	Net			
	interest	\$	%	
Simulated change in interest rates	income	variance	variance	
+200 basis points	\$ 23,021	\$ 1,069	4.9	%
+100 basis points	22,322	370	1.7	
Flat rate	21,952	-	-	
-100 basis points	21,749	(203)	(0.9)	
-200 basis points	21,396	(556)	(2.5)	

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

## Table Of Contents

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 June 30, 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 six months ended June 30, 2014, the Company generated \$1.2 million of cash. During the period, the Company's operations provided approximately \$3.6 million mostly from \$10.7 million of net cash inflow from the components of net interest income partially offset from net non-interest expense /income related payments of \$6.1 million and \$0.6 million of net cash outflow from originating and selling residential mortgage loans. Cash received from the sale of the PreTSL portfolio in the fourth quarter of 2013 along with cash inflow from interest-earning assets and growth in deposits and short-term borrowings were used to fund loan demand growth, security investments and net dividend payments. The growth in the loan portfolio occurred in all sectors and the Company expects to continue growth in the loan portfolio during the remainder of 2014 funded by deposits, repos, operations and if necessary short-term borrowings. 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. Accordingly, the use of short-term overnight borrowings could be used to fulfill funding needs. 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 June 30, 2014, the Company maintained \$14.4 million in cash and cash equivalents and \$104.3 million of investments AFS and loans HFS. Also as of June 30, 2014, the Company had approximately \$153.4 million available to borrow from the FHLB, \$21.0 million from correspondent banks, \$30.5 million from the FRB and \$32.7 million from the CDARS program. The combined total of \$356.3 million represented 55% of total assets at June 30, 2014. Management believes this level of liquidity to be strong and adequate to support current operations.

## Capital

During the six months ended June 30, 2014, total shareholders' equity increased \$3.9 million, or 6%, due principally from the \$3.1 million in net income added into retained earnings and to a lesser extent, the \$1.4 million, after-tax improvement in the net unrealized gain position in the Company's investment portfolio. Capital was further enhanced

by \$0.5 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 \$1.2 million of cash dividends declared on the Company's common stock.

As of June 30, 2014, the Company reported a net unrealized gain position of \$2.6 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 improvement during the first six months of 2014 was from all security types. Management believes that changes in fair value of the Company's securities are due to changes in interest rates and not in the creditworthiness of the issuers. Generally, when U.S. Treasury rates rise, investment securities' pricing declines and fair values of investment securities also decline. While volatility has existed in the yield curve within the past twelve months, a rising rate environment is inevitable and during this period the Company expects pricing in the bond portfolio to decline. Bond prices move inversely to the movement of interest rates. 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 plan participants. Both the DRP and the ESPP 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 achieved sufficient levels.

Table Of Contents

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 June 30, 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 June 30, 2014:

(dollars in thousands) As of June 30, 2014	Actual		For capital adequacy purposes		To be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)						
Consolidated	\$ 73,385	15.4% ≥	\$ 38,237	≥ 8.0%	N/A	N/A
Bank	\$ 72,929	15.3% ≥	\$ 38,232	≥ 8.0%	≥ \$ 47,790	≥10.0%
Tier I capital (to risk-weighted assets)						
Consolidated	\$ 67,239	14.1% ≥	\$ 19,119	≥ 4.0%	N/A	N/A
Bank	\$ 66,916	14.0% ≥	\$ 19,116	≥ 4.0%	≥ \$ 28,674	≥6.0%
Tier I capital (to average assets)						
Consolidated	\$ 67,239	10.4% ≥	\$ 25,977	≥ 4.0%	N/A	N/A
Bank	\$ 66,916	10.3% ≥	\$ 25,958	≥ 4.0%	≥ \$ 32,448	≥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 June 30, 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

Table Of Contents

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.

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

\*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.

Table Of Contents

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 June 30, 2014, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013; Consolidated Statements of Income for the three- and six-months ended June 30, 2014 and 2013; Consolidated Statements of Comprehensive Income for the three- and six-months ended June 30, 2014 and 2013, Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2014 and 2013, Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013 and the Notes to the Consolidated Financial Statements.

---

\* Management contract or compensatory plan or arrangement.



Table Of Contents

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: August 6, 2014 /s/Daniel J. Santaniello  
Daniel J. Santaniello,

President and Chief Executive Officer

Fidelity D & D Bancorp, Inc.

Date: August 6, 2014 /s/Salvatore R. DeFrancesco, Jr.  
Salvatore R. DeFrancesco, Jr.,

Treasurer and Chief Financial Officer

Table Of Contents

EXHIBIT INDEX

	Page
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 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 Registrant's 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.

21

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.

Table Of Contents

101 Interactive data files: The following, from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013; Consolidated Statements of Income for the three- and six- months ended June 30, 2014 and 2013; Consolidated Statements of Comprehensive Income for the three- and six- months ended June 30, 2014 and 2013; Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2014 and 2013, Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013 and the Notes to the Consolidated Financial Statements. \*\*

---

\* 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.