

FIDELITY D & D BANCORP INC  
Form 10-K  
March 19, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2013

COMMISSION FILE NUMBER 333-90273

FIDELITY D & D BANCORP, INC.

COMMONWEALTH OF PENNSYLVANIA I.R.S. EMPLOYER IDENTIFICATION NO: 23-3017653

BLAKELY AND DRINKER STREETS

DUNMORE, PENNSYLVANIA 18512

TELEPHONE NUMBER (570) 342-8281

SECURITIES REGISTERED UNDER SECTION 12(b) OF THE ACT:

None

SECURITIES REGISTERED UNDER SECTION 12(g) OF THE ACT:

Common Stock, without par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant was \$45.2 million as of June 30, 2013, based on the closing price of \$24.50. The number of shares of common stock outstanding as of February 28, 2014, was 2,401,240.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement to be used in connection with the 2014 Annual Meeting of Shareholders are incorporated herein by reference in partial response to Part III.

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FIDELITY D & D BANCORP, INC.

PART I

Forward-Looking Statements

Certain of the matters discussed in this Annual Report on Form 10-K 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 there under;
- § impacts of the new capital and liquidity requirements of the Basel III standards and other regulatory pronouncements, regulations and rules;
- § governmental monetary and fiscal policies, as well as legislative and regulatory changes;
- § effects of short- and long-term federal budget and tax negotiations and their effect on economic and business conditions;
- § the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;
- § the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks;
- § the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet;
- § technological changes;
- § acquisitions and integration of acquired businesses;
- § the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities;
- § volatilities in the securities markets;
- § acts of war or terrorism; and
- § disruption of credit and equity markets.

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

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

ITEM 1:BUSINESS

Fidelity D & D Bancorp, Inc. (the Company) was incorporated in the Commonwealth of Pennsylvania, on August 10, 1999, and is a bank holding company, whose wholly-owned state chartered commercial bank is The Fidelity Deposit and Discount Bank (the Bank) (collectively, the Company). The Company is headquartered at Blakely and Drinker Streets in Dunmore, Pennsylvania.

The Bank has offered a full range of traditional banking services since it commenced operations in 1903. The Bank has a personal and corporate trust department and also provides alternative financial and insurance products with asset management services. A full list of services provided by the Bank is detailed in the section entitled “Products and Services” contained within the 2013 Annual Report to Shareholders, incorporated by reference. The service area is comprised of the Borough of Dunmore and the surrounding communities within Lackawanna and Luzerne counties in Northeastern Pennsylvania.

The banking business is highly competitive, and the profitability of the Company depends principally upon the its ability to compete in its market area. Competition includes, among other sources: local community banks; savings banks; regional banks; national banks; credit unions; savings & loans; insurance companies; money market funds; mutual funds; small loan companies and other financial services companies.

The Company has been able to compete effectively with other financial institutions by emphasizing customer service enhanced by local decision making. These efforts enabled the Company to establish long-term customer relationships and build customer loyalty by providing products and services designed to address their specific needs.

The Company's profitability is significantly affected by general economic and competitive conditions, changes in market interest rates, government policies and actions of regulatory authorities. The Company's loan portfolio is comprised principally of residential, commercial and commercial real estate loans. The properties underlying the Company's mortgages are concentrated in Northeastern Pennsylvania. Credit risk, which represents the possibility of the Company not recovering amounts due from its borrowers, is significantly related to local economic conditions in the areas where the properties are located as well as the Company's underwriting standards. Economic conditions affect the market value of the underlying collateral as well as the levels of adequate cash flow and revenue generation from income-producing commercial properties. During 2013, the national economy remained weak despite a decline in the unemployment rate to 6.7% at December 31, 2013 compared to 7.9% as of December 31, 2012. The unemployment rate in the Scranton—Wilkes-Barre market continued to trail national levels at 7.7% at December 31, 2013, down from 9.5% at the end of 2012. Despite the decrease in the local unemployment rate, it was driven down mostly by people giving up on the search for jobs. In addition, regional foreclosures advanced at the state's highest percentage among metropolitan areas in 2013. While there is moderate improvement nationally and locally, the economic climate in the Company's marketplace remains weak. A weak economy that reflects high unemployment and lower property values could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. The Company's credit function strives to mitigate the negative impact of economic weaknesses by maintaining strict underwriting principles for commercial, mortgage and consumer lending.

There are no concentrations of loans that, if lost, would have a materially adverse effect on the continued business of the Company. There are no material concentrations within a single industry or group of related industries that are vulnerable to the risk of a near-term severe impact. However, the Company's success is dependent, to a significant degree, on economic conditions in Northeastern Pennsylvania, especially Lackawanna and Luzerne counties which the Company defines as its primary market area. The banking industry is affected by general economic conditions including the effects of inflation, recession, unemployment, real estate values, trends in national and global economies and other factors beyond the Company's control. An economic recession or a delayed economic recovery over a prolonged period of time in the Company's primary market area could cause an increase in the level of the Company's non-performing assets and loan losses, and thereby cause operating losses, impairment of liquidity and erosion of capital. We cannot assure you that adverse changes in the local economy would not have a material effect on the Company's future consolidated financial condition, results of operations and cash flows. Refer to Item 1A, "Risk Factors" for material risks and uncertainties that management believes affect the Company.

The Company had 162 full-time equivalent employees on December 31, 2013, which includes exempt officers, exempt, non-exempt and part-time employees.

Federal and state banking laws contain numerous provisions that affect various aspects of the business and operations of the Company and the Bank. The Company is subject to, among others, the regulations of the Securities and Exchange Commission (the SEC) and the Federal Reserve Board (the FRB) and the Bank is subject to, among others, the regulations of the Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation (the FDIC) and the rules promulgated by the Consumer Financial Protection Bureau (the CFPB) but continues to be examined and supervised by federal banking regulators for consumer compliance purposes. Refer to Part II, Item 7 "Supervision and Regulation" for descriptions of and references to applicable statutes and regulations which are not intended to be complete descriptions of these provisions or their effects on the Company or the Bank. They are summaries only and

are qualified in their entirety by reference to such statutes and regulations. Applicable regulations relate to, among other things:

- operations
- securities
- risk management
- consumer compliance
- mergers
- consolidation
- reserves
- dividends
- branches
- capital adequacy

The Bank can be examined by the Pennsylvania Department of Banking and/or the FDIC. The last examination was conducted by the FDIC as of September 30, 2013.



The Company's website address is <http://www.bankatfidelity.com>. The Company makes available through this website the annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K and amendments to those reports as soon as reasonably practical after filing with the SEC. You may read and copy any materials filed with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an internet site that contains reports, proxy and information statements and other information about the Company at <http://www.sec.gov>.

The Company's accounting policies and procedures are designed to comply with accounting principles generally accepted in the United States of America (GAAP). Refer to "Critical Accounting Policies," which are incorporated by reference in Part II, Item 7.

#### ITEM 1A: RISK FACTORS

An investment in the Company's common stock is subject to risks inherent to the Company's business. The material risks and uncertainties that management believes affect the Company are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing the Company. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair the Company's business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, the Company's financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of the Company's common stock could decline significantly, and you could lose all or part of your investment.

##### Risks Related to the Company's Business

The Company's business is subject to interest rate risk and variations in interest rates may negatively affect its financial performance.

Changes in the interest rate environment may reduce profits. The Company's earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between the interest earned on loans, securities and other interest-earning assets, and interest paid on deposits, borrowings and other interest-bearing liabilities. As prevailing interest rates change, net interest spreads are affected by the difference between the maturities and re-pricing characteristics of interest-earning assets and interest-bearing liabilities. In addition, loan volume and yields are affected by market interest rates on loans, and rising interest rates generally are associated with a lower volume of loan originations. An increase in the general level of interest rates may also adversely affect the ability of certain borrowers to pay the interest on and principal of their obligations. Accordingly, changes in levels of market interest rates could materially adversely affect the Company's net interest spread, asset quality, loan origination volume and overall profitability.

The Company is subject to lending risk.

There are inherent risks associated with the Company's lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets where the Company operates as well as those across the Commonwealth of Pennsylvania and the United States. Increases in interest rates and/or weakening economic conditions could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. The Company is also subject to various laws and regulations that affect its lending activities. Failure to comply with applicable laws and regulations could subject the Company to regulatory enforcement action that could result in the assessment of significant civil money penalties against the Company.

Commercial, commercial real estate and real estate construction loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because these loans generally have larger balances than residential real estate loans and consumer loans, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for possible loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Company's financial condition and results of operations.

The Company's allowance for possible loan losses may be insufficient.

The Company maintains an allowance for possible loan losses, which is a reserve established through a provision for possible loan losses charged to expense, that represents management's best estimate of probable losses that have been incurred within

the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for possible loan losses inherently involves a high degree of subjectivity and requires the Company to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of the Company's control, may require an increase in the allowance for possible loan losses. In addition, bank regulatory agencies periodically review the Company's allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for possible loan losses, the Company will need additional provisions to increase the allowance for possible loan losses. Any increases in the allowance for loan losses will result in a decrease in net income and capital and may have a material adverse effect on the Company's financial condition and results of operations.

The Company may need or be compelled to raise additional capital in the future, but that capital may not be available when it is needed and on terms favorable to current shareholders.

Federal banking regulators require the Company and Bank to maintain adequate levels of capital to support their operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by the Company's management and board of directors based on capital levels that they believe are necessary to support the Company's business operations. The Company is evaluating its present and future capital requirements and needs, is developing a comprehensive capital plan and is analyzing capital raising alternatives, methods and options. Even if the Company succeeds in meeting the current regulatory capital requirements, the Company may need to raise additional capital in the near future to support possible loan losses during future periods or to meet future regulatory capital requirements.

Further, the Company's regulators may require it to increase its capital levels. If the Company raises capital through the issuance of additional shares of its common stock or other securities, it would likely dilute the ownership interests of current investors and would likely dilute the per-share book value and earnings per share of its common stock. Furthermore, it may have an adverse impact on the Company's stock price. New investors may also have rights, preferences and privileges senior to the Company's current shareholders, which may adversely impact its current shareholders. The Company's ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside its control, and on its financial performance. Accordingly, the Company cannot assure you of its ability to raise additional capital on terms and time frames acceptable to it or to raise additional capital at all. If the Company cannot raise additional capital in sufficient amounts when needed, its ability to comply with regulatory capital requirements could be materially impaired. Additionally, the inability to raise capital in sufficient amounts may adversely affect the Company's operations, financial condition and results of operations.

If we conclude that the decline in value of any of our investment securities is other-than-temporary, we will be required to write down the credit-related portion of the impairment of that security through a charge to earnings.

We review our investment securities portfolio at each quarter-end reporting period to determine whether the fair value is below the current carrying value. When the fair value of any of our investment securities has declined below its carrying value, we are required to assess whether the decline is other-than-temporary. If we conclude that the decline is other-than-temporary, we will be required to write down the credit-related portion of the impairment of that security through a charge to earnings.

The Basel III capital requirements may require us to maintain higher levels of capital, which could reduce our profitability.

Basel III targets higher levels of base capital, certain capital buffers and a migration toward common equity as the key source of regulatory capital. Although the new capital requirements are phased in over the next decade and may change substantially before final implementation, Basel III signals a growing effort by domestic and international bank regulatory agencies to require financial institutions, including depository institutions, to maintain higher levels of capital. The direction of the Basel III implementation activities or other regulatory viewpoints could require additional capital to support our business risk profile prior to final implementation of the Basel III standards. If the Company and the Bank are required to maintain higher levels of capital, the Company and the Bank may have fewer opportunities to invest capital into interest-earning assets, which could limit the profitable business operations available to the Company and the Bank and adversely impact our financial condition and results of operations.

The Company is subject to environmental liability risk associated with lending activities.

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

The Company's profitability depends significantly on economic conditions in the Commonwealth of Pennsylvania and the local region in which it conducts business.

The Company's success depends primarily on the general economic conditions of the Commonwealth of Pennsylvania and the specific local markets in which the Company operates. Unlike larger national or other regional banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in Lackawanna and Luzerne Counties in Northeastern Pennsylvania. The local economic conditions in these areas have a significant impact on the demand for the Company's products and services as well as the ability of the Company's customers to repay loans, the value of the collateral securing loans and the stability of the Company's deposit funding sources. A significant decline in general economic conditions caused by inflation, recession, acts of terrorism, an outbreak of hostilities or other international or domestic occurrences, unemployment, changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Company's financial condition and results of operations.

There is no assurance that the Company will be able to successfully compete with others for business.

The Company competes for loans, deposits and investment dollars with numerous regional and national banks and other community banking institutions, as well as other kinds of financial institutions and enterprises, such as securities firms, insurance companies, savings associations, credit unions, mortgage brokers and private lenders. Many competitors have substantially greater resources than the Company does, and operate under less stringent regulatory environments. The differences in resources and regulations may make it more difficult for the Company to compete profitably, reduce the rates that it can earn on loans and on its investments, increase the rates it must offer on deposits and other funds, and adversely affect its overall financial condition and earnings.

The Company is subject to extensive government regulation and supervision.

The Company, primarily through the Bank, is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect the Company's lending practices, capital structure, investment practices, dividend policy and growth, among other things. Federal or commonwealth regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect the Company in substantial and unpredictable ways. Such changes could subject the Company to additional costs, limit the types of financial services and products the Company may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Company's business, financial condition and results of

operations. While the Company has policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur.

The Company's controls and procedures may fail or be circumvented.

Management regularly reviews and updates the Company's internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Company's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Company's business, results of operations and financial condition.

New lines of business or new products and services may subject the Company to additional risks.

From time-to-time, the Company may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services the Company may invest significant time and resources. Initial timetables for the introduction and development of new lines of

business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Company's system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Company's business, results of operations and financial condition.

The Company's future acquisitions could dilute your ownership and may cause it to become more susceptible to adverse economic events.

The Company may use its common stock to acquire other companies or make investments in banks and other complementary businesses in the future. The Company may issue additional shares of common stock to pay for future acquisitions, which would dilute your ownership interest in the Company. Future business acquisitions could be material to the Company, and the degree of success achieved in acquiring and integrating these businesses into the Company could have a material effect on the value of the Company's common stock. In addition, any acquisition could require it to use substantial cash or other liquid assets or to incur debt. In those events, it could become more susceptible to economic downturns and competitive pressures.

The Company may not be able to attract and retain skilled people.

The Company's success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities engaged in by the Company can be intense and the Company may not be able to hire people or to retain them. The unexpected loss of services of one or more of the Company's key personnel could have a material adverse impact on the Company's business because of their skills, knowledge of the Company's market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

The Company's information systems may experience an interruption or breach in security.

The Company relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Company's customer relationship management, general ledger, deposit, loan and other systems. The Company has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems, however there can be no assurance that any such failures, interruptions or security breaches will not occur. The occurrence of any failures, interruptions or security breaches of the Company's information systems could damage the Company's reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny, or expose the Company to civil litigation and possible financial liability, any of which could have a material adverse effect on the Company's financial condition and results of operations.

The Company continually encounters technological change.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Company's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in the Company's operations. Many of the Company's competitors have substantially greater resources to invest in technological improvements. The Company may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on the Company's business and, in turn, the Company's financial condition and results of operations.

The operations of our business, including our interaction with customers, are increasingly done via electronic means, and this has increased our risks related to cyber security.

We are exposed to the risk of cyber-attacks in the normal course of business. In general, cyber incidents can result from deliberate attacks or unintentional events. We have observed an increased level of attention in the industry focused on cyber-attacks that include, but are not limited to, gaining unauthorized access to digital systems for purposes of misappropriating assets or sensitive information, corrupting data, or causing operational disruption. To combat against these attacks, policies and procedures are in place to prevent or limit the effect of the possible security breach of our information systems and we have insurance against some cyber-risks and attacks. While we have not incurred any material losses related to cyber-attacks, nor are we aware of any specific or threatened cyber-incidents as of the date of this report, we may incur substantial costs and suffer other negative consequences if we fall victim to successful cyber-attacks. Such negative consequences could include remediation costs that may include liability for stolen assets or information and repairing system damage that may have been caused; deploying additional personnel and protection technologies, training employees, and engaging third party experts and consultants; lost revenues resulting from unauthorized use of proprietary information or the failure to retain or attract customers following an attack; litigation; and reputational damage adversely affecting customer or investor confidence.



The Company is subject to claims and litigation pertaining to fiduciary responsibility.

From time-to-time, customers make claims and take legal action pertaining to the Company's performance of its fiduciary responsibilities. Whether customer claims and legal action related to the Company's performance of its fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Company, they may result in significant financial liability and/or adversely affect the market perception of the Company and its products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Company's business, which, in turn, could have a material adverse effect on the Company's financial condition and results of operations.

Pennsylvania Business Corporation Law and various anti-takeover provisions under our articles and bylaws could impede the takeover of the Company.

Various Pennsylvania laws affecting business corporations may have the effect of discouraging offers to acquire the Company, even if the acquisition would be advantageous to shareholders. In addition, we have various anti-takeover measures in place under our articles of incorporation and bylaws, including a supermajority vote requirement for mergers, a staggered board of directors, and the absence of cumulative voting. Any one or more of these measures may impede the takeover of the Company without the approval of our board of directors and may prevent our shareholders from taking part in a transaction in which they could realize a premium over the current market price of our common stock.

The Company is a holding company and relies on dividends from its banking subsidiary for substantially all of its revenue and its ability to make dividends, distributions, and other payments.

As a bank holding company, the Company's ability to pay dividends depends primarily on its receipt of dividends from its subsidiary bank. Dividend payments from the bank are subject to legal and regulatory limitations, generally based on net profits and retained earnings, imposed by bank regulatory agencies. The ability of the bank to pay dividends is also subject to profitability, financial condition, regulatory capital requirements, capital expenditures and other cash flow requirements. There is no assurance that the bank will be able to pay dividends in the future or that the Company will generate cash flow to pay dividends in the future. The Company's failure to pay dividends on its common stock may have a material adverse effect on the market price of its common stock.

The Company's banking subsidiary may be required to pay higher FDIC insurance premiums or special assessments which may adversely affect its earnings.

Poor economic conditions and the resulting bank failures have increased the costs of the FDIC and depleted its deposit insurance fund. Additional bank failures may prompt the FDIC to increase its premiums or to issue special assessments. The Company generally is unable to control the amount of premiums or special assessments that its subsidiary is required to pay for FDIC insurance. Any future changes in the calculation or assessment of FDIC insurance premiums may have a material adverse effect on our results of operations, financial condition, and our ability to continue to pay dividends on our common stock at the current rate or at all.

Severe weather, natural disasters, acts of war or terrorism and other external events could significantly impact the Company's business.

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on the Company's ability to conduct business. Such events could affect the stability of the Company's deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause the Company to incur additional expenses. Severe

weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on the Company's business, which, in turn, could have a material adverse effect on the Company's financial condition and results of operations.

#### Risks Associated with the Company's Common Stock

The Company's stock price can be volatile.

Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. The Company's stock price can fluctuate significantly in response to a variety of factors including, among other things:

Actual or anticipated variations in quarterly results of operations.

Recommendations by securities analysts.

Operating and stock price performance of other companies that investors deem comparable to the Company.

News reports relating to trends, concerns and other issues in the financial services industry.

Perceptions in the marketplace regarding the Company and/or its competitors.

New technology used, or services offered, by competitors.

Significant acquisitions or business combinations, strategic partnerships, joint ventures or capital commitments by or involving the Company or its competitors.

Failure to integrate acquisitions or realize anticipated benefits from acquisitions.

Changes in government regulations.

Geopolitical conditions such as acts or threats of terrorism or military conflicts.

General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause the Company's stock price to decrease regardless of operating results.

The trading volume in the Company's common stock is less than that of other larger financial services companies.

The Company's common stock is listed for trading on the over-the-counter bulletin board and the trading volume in its common stock is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Company's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Company has no control. Given the lower trading volume of the Company's common stock, significant sales of the Company's common stock, or the expectation of these sales, could cause the Company's stock price to fall.

#### Risks Associated with the Company's Industry

Future governmental regulation and legislation could limit the Company's future growth.

The Company is a registered bank holding company, and its subsidiary bank is a depository institution whose deposits are insured by the FDIC. As a result, the Company is subject to various regulations and examinations by various regulatory authorities. In general, statutes establish the corporate governance and eligible business activities for the Company, certain acquisition and merger restrictions, limitations on inter-company transactions such as loans and dividends, capital adequacy requirements, requirements for anti-money laundering programs and other compliance matters, among other regulations. The Company is extensively regulated under federal and state banking laws and regulations that are intended primarily for the protection of depositors, federal deposit insurance funds and the banking system as a whole. Compliance with these statutes and regulations is important to the Company's ability to engage in new activities and consummate additional acquisitions.

In addition, the Company is subject to changes in federal and state tax laws as well as changes in banking and credit regulations, accounting principles and governmental economic and monetary policies. The Company cannot predict whether any of these changes may adversely and materially affect it. Federal and state banking regulators also possess broad powers to take supervisory actions as they deem appropriate. These supervisory actions may result in higher capital requirements, higher insurance premiums and limitations on the Company's activities that could have a material adverse effect on its business and profitability. While these statutes are generally designed to minimize potential loss to depositors and the FDIC insurance funds, they do not eliminate risk, and compliance with such statutes increases the Company's expense, requires management's attention and can be a disadvantage from a competitive standpoint with respect to non-regulated competitors.

The earnings of financial services companies are significantly affected by general business and economic conditions.

The Company's operations and profitability are impacted by general business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, money supply, political issues, legislative and regulatory changes, fluctuations in both debt and equity capital markets, broad trends in industry and finance, and the strength of the U.S. economy and the local economies in which the Company operates, all of which are beyond the Company's control. Deterioration in economic conditions could result in an increase in loan delinquencies and non-performing assets, decreases in loan collateral values and a decrease in demand for the Company's products and services, among other things, any of which could have a material adverse impact on the Company's financial condition and results of operations.

Financial services companies depend on the accuracy and completeness of information about customers and counterparties.

In deciding whether to extend credit or enter into other transactions, the Company may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. The Company may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse impact on the Company's business and, in turn, the Company's financial condition and results of operations.

Consumers may decide not to use banks to complete their financial transactions.

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank

deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as “disintermediation,” could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on the Company’s financial condition and results of operations.

Future Downgrades of the United States Government may adversely affect the Company.

In August 2011, Standard & Poor’s downgraded the United States’ credit rating from AAA to AA+, and there are indications that Moody’s or Fitch Ratings also may downgrade the United States’ credit ratings in the future. Standard & Poor’s also downgraded the credit rating of the Federal Home Loan Bank System, a government-sponsored enterprise in which the Company invests and from which the Company receives a line of credit, from AAA to AA+. Furthermore, the credit rating of other entities, such as state and local governments, may be downgraded as a consequence of the downgrading of the United States’ credit rating. The impact that these credit rating downgrades may have on the national and local economy and on the Company’s financial condition and results of operation is uncertain and may adversely affect the Company and its business.

The regulatory environment for the financial services is being significantly impacted by financial regulatory reform initiatives in the United States and elsewhere, including Dodd-Frank and regulations promulgated to implement it.

Dodd-Frank, which was signed into law on July 21, 2010, comprehensively reforms the regulation of financial institutions, products and services. Dodd-Frank requires various federal regulatory agencies to implement numerous rules and regulations. Because the federal agencies are granted broad discretion in drafting these rules and regulations, many of the details and the impact of Dodd-Frank may not be known for many months or years.

While much of how the Dodd-Frank and other financial industry reforms will change our current business operations depends on the specific regulatory reforms and interpretations, many of which have yet to be released or finalized, it is clear that the reforms, both under Dodd-Frank and otherwise, will have a significant effect on our entire industry. Although Dodd-Frank and other reforms will affect a number of the areas in which we do business, it is not clear at this time the full extent of the adjustments that will be required and the extent to which we will be able to adjust our businesses in response to the requirements. Although it is difficult to predict the magnitude and extent of these effects at this stage, we believe compliance with Dodd-Frank and implementing its regulations and initiatives will negatively impact revenue and increase the cost of doing business, both in terms of transition expenses and on an ongoing basis, and it may also limit our ability to pursue certain business opportunities.

#### ITEM 1B: UNRESOLVED STAFF COMMENTS

None

## ITEM 2: PROPERTIES

As of December 31, 2013, the Company operated 11 full-service banking offices, of which six were owned and five were leased. None of the lessors of the properties leased by the Company are affiliated with the Company and all of the properties are located in the Commonwealth of Pennsylvania. The Company is headquartered at its owner-occupied main branch located on the corner of Blakely and Drinker Streets in Dunmore, PA.

The following table provides information with respect to the principal properties from which the Bank conducts business:

| Location  | Owned / leased* | Type of use                     | Full service | Drive-thru | ATM |
|---|-----------------|---------------------------------|--------------|------------|-----|
| Drinker & Blakely Streets,<br>Dunmore, PA         | Owned           | Main Branch (1) (2)             | x            | x          | x   |
| 111 Green Ridge St.,<br>Scranton, PA              | Leased          | Green Ridge Branch (2)          | x            | x          | x   |
| 1311 Morgan Hwy.,<br>Clarks Summit, PA            | Leased          | Abington Branch (3)             | x            | x          | x   |
| 1232 Keystone Industrial Park Rd.,<br>Dunmore, PA | Owned           | Keystone Industrial Park Branch | x            | x          | x   |
| 338 North Washington Ave.,<br>Scranton, PA        | Owned           | Financial Center Branch (4)     | x            |            | x   |
| 4010 Birney Ave.,<br>Moosic, PA                   | Owned           | Moosic Branch                   | x            | x          | x   |
| 801 Wyoming Ave.,<br>West Pittston, PA            | Leased          | West Pittston Branch            | x            |            | x   |
| 1598 Main St.,<br>Peckville, PA                   | Leased          | Peckville Branch                | x            | x          | x   |
| 247 Wyoming Ave.,<br>Kingston, PA                 | Owned           | Kingston Branch                 | x            | x          | x   |
|   | Leased          | Eynon Branch                    | x            | x          | x   |

511 Scranton-Carbondale Hwy.,  
Eynon, PA

400 S. Main St.,

|              |       |                         |   |   |   |
|--------------|-------|-------------------------|---|---|---|
| Scranton, PA | Owned | West Scranton Branch(2) | x | x | x |
|--------------|-------|-------------------------|---|---|---|

\*All of the owned properties are free of encumbrances. At the Green Ridge St., Scranton branch office, the Company leases the land from an unrelated third party, however the building is the Company's own capital improvement.

(1) Executive and administrative, commercial lending, trust and asset management services are located at the Main Branch.

(2) This office has two automated teller machines (ATMs).

(3) In addition, there is a banking facility located in the Clarks Summit State Hospital. The office is leased from the hospital under a lease-for-service-provided agreement with service limited to employees and patients of the hospital.

(4) Executive, mortgage and consumer lending, finance, operations and a full-service call center are located in this building. A portion of the building is leased to a non-related entity.

The Bank maintains two free-standing 24-hour ATMs located at the following locations:

- The Shoppes at Montage, 1035 Shoppes Blvd., Moosic, PA
- Gino Merili Veteran's Center, 401 Penn Ave., Scranton, PA

Foreclosed assets held-for-sale include other real estate owned. The Company had fifteen ORE properties as of December 31, 2013, which stemmed from fourteen unrelated borrowers. Nine of the properties are listed for sale, three have signed sales agreements, one has a pending insurance claim and two are in litigation. Upon possession, foreclosed properties are recorded on the Company's balance sheet at the lower of cost or fair value.

### ITEM 3: 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 consulting with legal counsel, no legal proceedings are pending, which, if determined adversely to the Company or the Bank, would have a material effect on the Company's undivided profits or financial condition. No legal proceedings are pending other than ordinary routine litigation incidental to the business of the

Company and the Bank. In addition, to management's knowledge, no governmental authorities have initiated or contemplated any material legal actions against the Company or the Bank.

ITEM 4: MINE SAFETY DISCLOSURES

Not Applicable

PART II

ITEM 5: MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The common stock of the Company is traded on the over-the-counter bulletin board under the symbol "FDBC." Shareholders requesting information about the Company's common stock may contact:

Salvatore R. DeFrancesco, Jr., Treasurer

Fidelity D & D Bancorp, Inc.

Blakely and Drinker Streets

Dunmore, PA 18512

(570) 342-8281

The following table lists the quarterly cash dividends paid per share and the range of high and low bid prices for the Company's common stock based on information obtained from on-line published sources. Such over-the-counter prices do not include retail mark-ups, markdowns or commissions:

|             | 2013        |          |                | 2012        |          |                |
|-------------|-------------|----------|----------------|-------------|----------|----------------|
|             | Prices High | Low      | Dividends paid | Prices High | Low      | Dividends paid |
| 1st Quarter | \$ 27.50    | \$ 20.11 | \$ 0.25        | \$ 26.25    | \$ 19.99 | \$ 0.25        |
| 2nd Quarter | \$ 27.00    | \$ 22.50 | \$ 0.25        | \$ 26.25    | \$ 20.25 | \$ 0.25        |
| 3rd Quarter | \$ 27.00    | \$ 24.05 | \$ 0.25        | \$ 25.00    | \$ 20.05 | \$ 0.25        |
| 4th Quarter | \$ 30.00    | \$ 25.00 | \$ 0.35        | \$ 22.00    | \$ 20.00 | \$ 0.25        |

Dividends are determined and declared by the Board of Directors of the Company. The Company expects to continue to pay cash dividends in the future; however, future dividends are dependent upon earnings, financial condition, capital strength and other factors of the Company. For a further discussion of regulatory capital requirements see Note 15, "Regulatory Matters," contained within the notes to the consolidated financial statements, incorporated by reference in Part II, Item 8.

The Company established a dividend reinvestment plan (DRP) for its shareholders. The DRP provides shareholders with a convenient and economical method of investing cash dividends payable on their common stock and the



opportunity to make voluntary optional cash payments to purchase additional shares of the Company's common stock. Participants pay no brokerage commissions or service charges when they acquire additional shares of common stock through the plan. The administrator may purchase shares directly from the Company, in the open market, in negotiated transactions or using a combination of these methods.

The Company had approximately 1,370 shareholders at December 31, 2013 and 1,387 shareholders as of February 28, 2014. The number of shareholders is the actual number of individual shareholders of record. Each security depository is considered a single shareholder for purposes of determining the approximate number of shareholders.

Securities authorized for issuance under equity compensation plans

The following table summarizes the Company's equity compensation plans as of December 31, 2013 that have been approved and not approved by Fidelity D&D Bancorp, Inc. shareholders:

|   | (a)   | (b)  | (c)   |
|---|---|--|---|
| Plan Category   | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights. | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
| Equity compensation plans approved by security holders:           |   |  |   |
| 2000 Independent Director Stock Option Plan                       | 15,000  | \$ 28.90   | -   |
| 2000 Stock Incentive Plan   | 4,500   | \$ 28.01   | -   |
| 2002 Employee Stock Purchase Plan                                 | 4,373   | \$ 18.45   | 78,594  |
| 2012 Omnibus Stock Incentive Plan                                 | 5,000   | \$ 21.20   | 494,866   |
| 2012 Director Stock Incentive Plan                                | 8,000   | \$ 21.20   | 492,000   |
| Equity compensation plans not approved by security holders - none | -   | -  | -   |
| Total   | 36,873  | \$ 24.84   | 1,065,460   |

## Performance graph

The following graph and table compare the cumulative total shareholder return on the Company's common stock against the cumulative total return of the NASDAQ Composite and the SNL index of greater than \$500 million in-asset banks traded on the OTC-BB and Pink Sheet (the SNL index) for the period of five fiscal years commencing January 1, 2009, and ending December 31, 2013. As of December 31, 2013, the SNL index consisted of 151 banks. A listing of the banks that comprise the index can be found on the Company's website at [www.bankatfidelity.com](http://www.bankatfidelity.com) and then clicking on, Investor Relations, Fidelity D & D Bancorp Stock, Stock Graph, List of all companies in The SNL U.S. Bank Pink > \$500M link under volume graph. The graph illustrates the cumulative investment return to shareholders, based on the assumption that a \$100 investment was made on December 31, 2008, in each of: the Company's common stock, the NASDAQ Composite and the SNL index. All cumulative total returns are computed assuming the reinvestment of dividends into the applicable securities. The shareholder return shown on the graph and table below is not necessarily indicative of future performance:

| Index                        | Period Ending |          |          |          |          |          |
|------------------------------|---------------|----------|----------|----------|----------|----------|
|                              | 12/31/08      | 12/31/09 | 12/31/10 | 12/31/11 | 12/31/12 | 12/31/13 |
| Fidelity D & D Bancorp, Inc. | 100.00        | 61.48    | 85.58    | 92.25    | 95.56    | 129.02   |
| NASDAQ Composite             | 100.00        | 145.36   | 171.74   | 170.38   | 200.63   | 281.22   |
| SNL Bank Pink > \$500M       | 100.00        | 85.50    | 90.32    | 88.80    | 97.92    | 119.01   |

## ITEM 6: SELECTED FINANCIAL DATA

Set forth below are our selected consolidated financial and other data. This financial data is derived in part from, and should be read in conjunction with the consolidated financial statements and notes thereto included in Part II, Item 8 of this report:

(dollars in thousands except per share data)

|   |            |            |            |            |            |
|---|------------|------------|------------|------------|------------|
| Balance sheet data:                                 | 2013       | 2012       | 2011       | 2010       | 2009       |
| Total assets  | \$ 623,825 | \$ 601,525 | \$ 606,742 | \$ 561,673 | \$ 556,017 |
| Total investment securities                         | 97,423     | 100,730    | 108,543    | 83,431     | 76,530     |
| Net loans and leases                                | 469,216    | 424,584    | 398,186    | 407,903    | 423,124    |
| Loans held-for-sale                                 | 917        | 10,545     | 4,537      | 213        | 1,221      |
| Total deposits                                      | 529,698    | 514,660    | 515,802    | 482,448    | 458,994    |
| Short-term borrowings                               | 8,642      | 8,056      | 9,507      | 8,548      | 16,533     |
| Long-term debt                                      | 16,000     | 16,000     | 21,000     | 21,000     | 32,000     |
| Total shareholders' equity                          | 66,060     | 58,946     | 53,624     | 46,774     | 45,675     |
| Operating data for the year ended:                  |            |            |            |            |            |
| Total interest income                               | \$ 23,853  | \$ 23,994  | \$ 25,603  | \$ 27,580  | \$ 29,909  |
| Total interest expense                              | 2,968      | 3,354      | 4,761      | 6,827      | 10,797     |
| Net interest income                                 | 20,885     | 20,640     | 20,842     | 20,753     | 19,112     |
| Provision for loan losses                           | 2,550      | 3,250      | 1,800      | 2,085      | 5,050      |
| Net interest income after provision for loan losses | 18,335     | 17,390     | 19,042     | 18,668     | 14,062     |
| Other-than-temporary impairment                     | -          | (136)      | (246)      | (11,836)   | (3,300)    |
| Other income  | 10,541     | 7,788      | 5,946      | 5,480      | 5,554      |
| Other operating expense                             | 19,119     | 18,581     | 18,052     | 18,073     | 19,334     |
| Income (loss) before income taxes                   | 9,757      | 6,461      | 6,690      | (5,761)    | (3,018)    |
| Provision (credit) for income taxes                 | 2,635      | 1,559      | 1,645      | (2,557)    | (1,618)    |
| Net income (loss)                                   | \$ 7,122   | \$ 4,902   | \$ 5,045   | \$ (3,204) | \$ (1,400) |
| Per share data:                                     |            |            |            |            |            |
| Net income (loss) per share, basic                  | \$ 3.03    | \$ 2.14    | \$ 2.28    | \$ (1.50)  | \$ (0.67)  |
| Net income (loss) per share, diluted                | \$ 3.02    | \$ 2.14    | \$ 2.28    | \$ (1.50)  | \$ (0.67)  |
| Dividends declared                                  | \$ 2,602   | \$ 2,283   | \$ 2,210   | \$ 2,137   | \$ 2,078   |
| Dividends per share                                 | \$ 1.10    | \$ 1.00    | \$ 1.00    | \$ 1.00    | \$ 1.00    |
| Book value per share                                | \$ 27.62   | \$ 25.37   | \$ 23.78   | \$ 21.48   | \$ 21.69   |
| Weighted-average shares outstanding                 | 2,353,056  | 2,286,233  | 2,213,631  | 2,141,323  | 2,080,507  |
| Shares outstanding                                  | 2,391,617  | 2,323,248  | 2,254,542  | 2,178,028  | 2,105,860  |
| Ratios:   |            |            |            |            |            |
| Return on average assets                            | 1.15%      | 0.81%      | 0.85%      | -0.55%     | -0.25%     |
| Return on average equity                            | 11.70%     | 8.62%      | 10.01%     | -6.69%     | -2.91%     |

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|                                    |        |        |        |        |        |
|------------------------------------|--------|--------|--------|--------|--------|
| Net interest margin                | 3.80%  | 3.80%  | 3.89%  | 3.89%  | 3.71%  |
| Efficiency ratio                   | 64.99% | 63.40% | 65.47% | 65.38% | 72.51% |
| Expense ratio                      | 1.87%  | 1.78%  | 2.04%  | 2.07%  | 2.37%  |
| Allowance for loan losses to loans | 1.86%  | 2.02%  | 1.97%  | 1.90%  | 1.75%  |
| Dividend payout ratio              | 36.54% | 46.56% | 43.80% | N/M*   | N/M*   |
| Equity to assets                   | 10.59% | 9.80%  | 8.84%  | 8.33%  | 8.21%  |
| Equity to deposits                 | 12.47% | 11.45% | 10.40% | 9.70%  | 9.95%  |

\* The result of this calculation is not meaningful.

## ITEM 7: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

### Critical accounting policies

The presentation of financial statements in conformity with U.S. 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 December 31, 2013 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. Except for the Company's investment in corporate bonds, that consisted of pooled trust preferred securities, fair values on the other investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. For the pooled trust preferred securities, management had been unable to obtain readily attainable and realistic pricing from market traders due to a lack of active market participants and therefore management has determined the market for these securities to be inactive. The Company sold its entire position of pooled trust preferred securities in the fourth quarter of 2013. For 2012 and up until the date of sale, to determine the fair value of the pooled trust preferred securities, management relied on the use of an income valuation approach (present value technique) that maximized the use of observable inputs and minimized the use of unobservable inputs, the results of which were more representative of fair value than the market approach valuation technique used for the other investment securities.

Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. As described in Notes 1 and 4 of the consolidated financial statements, incorporated by reference in Part II, Item 8, 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 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. For a further discussion on the accounting treatment of HFS loans, see the section entitled "Loans held-for-sale," contained within this management's discussion and analysis. As of December 31, 2013 and 2012, loans classified as HFS consisted of residential mortgages.

All significant accounting policies are contained in Note 1, "Nature of Operations and Summary of Significant Accounting Policies", within the notes to consolidated financial statements and incorporated by reference in Part II, Item 8.

The following discussion and analysis presents the significant changes in the financial condition and in the results of operations of the Company as of December 31, 2013 and December 31, 2012 and for each of the years then ended. This discussion should be read in conjunction with the consolidated financial statements and notes thereto included in Part II, Item 8 of this report.

Comparison of Financial Condition as of December 31, 2013

and 2012 and Results of Operations for each of the Years then Ended

Executive Summary

Nationally, the unemployment rate declined from 7.9% at December 31, 2012 to 6.7% at December 31, 2013, remaining at the lowest level since 2008. While the unemployment rate has been declining nationally, the unemployment rate in the Scranton-Wilkes-Barre Metropolitan Statistical Area (local) still remains above national and state levels. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at December 31, 2013 was 7.7%, a decline of 1.8 percentage points from 9.5% at December 31, 2012. However, during the same period, the local labor force declined by more than 3%. A sizeable decline in the workforce has the effect of driving the unemployment rate downward and masking the unemployment statistics. In addition, approximately 44% of the labor force decline was comprised of those unemployed who have stopped looking for work. By comparison, nationally, the labor force declined by less than 0.4% and those who have

stopped looking for work declined by 14%. The number of foreclosures has been declining on a national level, but was up 60% in our local metropolitan area in 2013 compared to 2012. Foreclosures climbed in the area in all four quarters of the year. The high foreclosure rate is due mostly to the high unemployment rate in the area. Notwithstanding these issues, high levels of unemployment and the prolonged weakness in the local housing and real estate markets may negatively impact the performance and condition of the Company's loan portfolios.

During 2013, the Company used deposit growth, net cash inflow from maturities, pay downs, proceeds from security sales and cash on hand to fund loan growth. In 2014, the Company expects to continue to grow the loan portfolio, mostly within commercial loans funded with deposit growth. The Company continued its mission to improve asset quality during 2013, reducing non-performing assets by \$8.7 million, or almost 50% from year-end 2012, now representing less than 1.5% of total assets. The Company will continue working toward further improving asset quality throughout 2014. Management expects non-performing assets to continue to decline during 2014, but may at times edge upward as it works through credit issues and disposes its inventory of foreclosed real estate. The Company will focus on continuing to strengthen its capital position from sound financial performance while containing credit risk to a tolerable level and further improving overall asset quality.

We expect to continue to operate in a low, albeit a slow-rising interest rate environment. A rising rate environment positions the Company to improve its interest income performance. With a rising rate environment we anticipate net interest margin to stabilize or improve marginally in 2014 compared to 2013. The Federal Open Market Committee (FOMC) has not adjusted the short-term federal funds rate upward and expectations are for short-term rates to remain at historic low levels well into 2015, helping contain funding costs. The general shape of the interest rate yield curve continued to slope positively in 2013 and into 2014 with the mid- and long-term ranges slowly but steadily moving upward. Growth in commercial lending at prudent loan pricing coupled with historically low funding costs, could help boost the interest rate margin. Thus, funding longer term assets with shorter term liabilities position the Company to maximize its interest margin performance.

#### Financial Condition

Consolidated assets increased \$22.3 million, or 4%, to \$623.8 million as of December 31, 2013 from \$601.5 million at December 31, 2012. The increase in assets was funded through growth in deposits of \$15.0 million and a \$7.1 million increase in shareholders' equity. Net income of \$7.1 million and \$1.0 million in other comprehensive income partially offset by \$1.2 million of dividends declared net of activity in the Company's dividend reinvestment plan drove equity growth. The growth in deposits, cash on hand and net cash inflow was used to finance growth in the loan portfolio.

The following table is a comparison of condensed balance sheet data as of December 31:

(dollars in thousands)

| Assets:                             | 2013       | %       | 2012       | %       | 2011       | %       |
|-------------------------------------|------------|---------|------------|---------|------------|---------|
| Cash and cash equivalents           | \$ 13,218  | 2.1 %   | \$ 21,846  | 3.6 %   | \$ 52,165  | 8.6 %   |
| Investment securities               | 97,423     | 15.6    | 100,730    | 16.7    | 108,543    | 17.9    |
| Federal Home Loan Bank Stock        | 2,640      | 0.4     | 2,624      | 0.4     | 3,699      | 0.6     |
| Loans and leases, net               | 470,133    | 75.4    | 435,129    | 72.3    | 402,723    | 66.4    |
| Bank premises and equipment         | 13,602     | 2.2     | 14,127     | 2.3     | 13,575     | 2.2     |
| Life insurance cash surrender value | 10,402     | 1.7     | 10,065     | 1.7     | 9,740      | 1.6     |
| Other assets                        | 16,407     | 2.6     | 17,004     | 3.0     | 16,297     | 2.7     |
| Total assets                        | \$ 623,825 | 100.0 % | \$ 601,525 | 100.0 % | \$ 606,742 | 100.0 % |



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Liabilities:

|  |            |         |            |         |            |         |
|--|------------|---------|------------|---------|------------|---------|
| Total deposits                             | \$ 529,698 | 84.9 %  | \$ 514,660 | 85.6 %  | \$ 515,802 | 85.0 %  |
| Short-term borrowings                      | 8,642      | 1.4     | 8,056      | 1.3     | 9,507      | 1.6     |
| Long-term debt                             | 16,000     | 2.6     | 16,000     | 2.7     | 21,000     | 3.5     |
| Other liabilities                          | 3,425      | 0.5     | 3,863      | 0.6     | 6,809      | 1.1     |
| Total liabilities                          | 557,765    | 89.4    | 542,579    | 90.2    | 553,118    | 91.2    |
| Shareholders' equity                       | 66,060     | 10.6    | 58,946     | 9.8     | 53,624     | 8.8     |
| Total liabilities and shareholders' equity | \$ 623,825 | 100.0 % | \$ 601,525 | 100.0 % | \$ 606,742 | 100.0 % |

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A comparison of net changes in selected balance sheet categories as of December 31, are as follows:

| (dollars in thousands) | Assets    | Earning<br>% assets* | % Deposits | Short-term<br>% borrowings | Other<br>% borrowings | % |          |      |          |      |
|------------------------|-----------|----------------------|------------|----------------------------|-----------------------|---|----------|------|----------|------|
| 2013                   | \$ 22,300 | 4                    | \$ 30,087  | 6                          | \$ 15,038             | 3 | \$ 586   | 7    | \$ -     | -    |
| 2012                   | (5,217)   | (1)                  | (1,690)    | -                          | (1,142)               | - | (1,451)  | (15) | (5,000)  | (24) |
| 2011                   | 45,069    | 8                    | 37,257     | 7                          | 33,354                | 7 | 959      | 11   | -        | -    |
| 2010                   | 5,656     | 1                    | 7,352      | 1                          | 23,453                | 5 | (7,985)  | (48) | (11,000) | (34) |
| 2009                   | (19,702)  | (3)                  | (26,475)   | (5)                        | 25,683                | 6 | (21,597) | (57) | (20,000) | (38) |

\* Earning assets exclude: loans and securities placed on non-accrual status.

#### Funds Provided:

#### Deposits

The Company is a community based commercial depository financial institution, member FDIC, which offers a variety of deposit products with varying ranges of interest rates and terms. Generally, deposits are obtained from consumers, businesses and public entities within the communities that surround the Company's 11 branch offices and all deposits are insured by the FDIC up to the full extent permitted by law. Deposit products consist of transaction accounts including: savings; clubs; interest-bearing checking; money market and non-interest bearing checking (DDA). The Company also offers short- and long-term time deposits or certificates of deposit (CDs). CDs are deposits with stated maturities which can range from seven days to ten years. Deposit inflow and outflow is influenced by economic conditions, changes in the interest rate environment, pricing and competition. To determine interest rates on its deposit products, the Company considers local competition, spreads to earning-asset yields, liquidity position and rates charged for alternative sources of funding such as short-term borrowings and FHLB advances.

The following table represents the components of total deposits as of December 31:

| (dollars in thousands)    | 2013       |       | 2012       |       |
|---------------------------|------------|-------|------------|-------|
|                           | Amount     | %     | Amount     | %     |
| Money market              | \$ 83,512  | 15.8  | \$ 76,571  | 14.9  |
| Interest-bearing checking | 100,315    | 18.9  | 87,981     | 17.1  |
| Savings and clubs         | 109,253    | 20.6  | 107,447    | 20.8  |
| Certificates of deposit   | 113,699    | 21.5  | 116,626    | 22.7  |
| Total interest-bearing    | 406,779    | 76.8  | 388,625    | 75.5  |
| Non-interest bearing      | 122,919    | 23.2  | 126,035    | 24.5  |
| Total deposits            | \$ 529,698 | 100.0 | \$ 514,660 | 100.0 |

Total deposits increased \$15.0 million, or 3%, from \$514.7 million at December 31, 2012 to \$529.7 million at December 31, 2013. Interest-bearing checking had significant growth at \$12.3 million, or 14%, which was partially offset by a \$3.1 million decrease in non-interest bearing deposits. The increase in the interest-bearing checking was from the Company's success in cultivating relationships with new and existing business customers. The Company's focus will be to continue to partner with our business clientele, both new and existing, to build a full-banking relationship. In 2014, we expect to continue to experience growth in our business deposit products.

The rates along the intermediate and long end of the treasury yield curve continued to slowly rise while rates at the short end, where transaction deposits are typically priced, remained relatively flat. The long-end has not risen enough to entice depositors to move their cash reserves into longer-term CDs and as such, banks will most likely increase rates cautiously slow until there is a clear indication that the yield curve will rise and steepen. Managing the yield curve in a changing rate environment is imperative to maintain interest rate spread. The current environment continues to cause business and retail customers to seek short-term alternatives for their deposits. Business interest-bearing checking accounts benefited the most followed by retail money market and savings. The Company's focus continues to be on the acquisition and retention of retail and business households 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 these deposits in other participating institutions, the deposits of our customers are fully insured by the FDIC. In return for

deposits placed with network institutions, the Company receives from network institutions deposits that are approximately equal in amount and are comprised of terms similar to those placed for our customers. Deposits the Company receives, or reciprocal deposits, from other institutions are considered brokered deposits by regulatory definitions. As of December 31, 2013 and 2012, CDARS represented \$10.3 million and \$10.2 million, respectively, or 2%, of total deposits.

The maturity distribution of certificates of deposit at December 31, 2013 is as follows:

|                            | Three<br>months<br>or less | More<br>than<br>three<br>months<br>to six<br>months | More<br>than<br>six<br>months<br>to<br>twelve<br>months | More<br>than<br>twelve<br>months | Total      |
|----------------------------|----------------------------|---|---|----------------------------------|------------|
| (dollars in thousands)     |                            |   |   |                                  |            |
| CDs of \$100,000 or more   | \$ 5,228                   | \$ 3,095  | \$ 8,356  | \$ 24,493                        | \$ 41,172  |
| CDs of less than \$100,000 | 7,466                      | 7,005   | 16,874  | 30,932                           | 62,277     |
| CDARS                      | -                          | 5,979   | 2,000   | 2,271                            | 10,250     |
| Total CDs                  | \$ 12,694                  | \$ 16,079   | \$ 27,230   | \$ 57,696                        | \$ 113,699 |

Including CDARS, approximately 49% of the CDs, with a weighted-average interest rate of 0.81%, are scheduled to mature in 2014 and an additional 23%, with a weighted-average interest rate of 1.21%, are scheduled to mature in 2015. Renewing CDs may re-price to lower or higher market rates depending on the rate on the maturing CD, the pace and direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative, non-term products. The widespread preference has been for customers with maturing CDs to hold their deposits in readily available transaction accounts. Though the CD portfolio has declined \$2.9 million, or by less than 3%, the Company projects a flat to marginal increase in its CDs in 2014.

#### Short-term 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. 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 December 31, 2013, overnight borrowings amounted to \$2.5 million. At December 31, 2012, the Company did not have a balance in overnight borrowings.

Repurchase agreements are non-insured interest-bearing liabilities that have a perfected security interest in qualified investments of the Company. The FDIC Depositor Protection Act of 2009 requires banks to provide a perfected security interest to the purchasers of uninsured repurchase agreements. Repurchase agreements are offered through a sweep product. A sweep account is designed to ensure that on a daily basis, an attached DDA is adequately funded and excess funds are transferred, or swept, into an interest-bearing overnight repurchase agreement account. Due to the constant inflow and outflow of funds of the sweep product, their balances tend to be somewhat volatile, similar to a DDA. Customer liquidity is the typical cause for variances in repurchase agreements, which during the 2013 decreased \$1.9 million, or 23%, from year-end December 31, 2012.

#### Long-term debt

As of December 31, 2013 and 2012, long-term debt consisted of a single \$16.0 million advance from the FHLB bearing an interest rate of 5.26%. The advance is scheduled to mature in 2016. The rate on the advance was 95 basis points above the tax-equivalent yield of 4.31% earned from the Company's portfolio of average interest-earning assets for the year ended December 31, 2013. The interest rate on the advance is fixed until 2016, however the rate is structured to adjust quarterly should market interest rates increase beyond the issue's strike rate. In the event underlying market rates drift above the rate currently paid on this borrowing, the fixed-rate would convert to a floating-rate and at that juncture, the Company would have the option to repay, without penalty, or renegotiate the converted rate. Significant prepayment penalties are attached to the borrowing and prepaying the high-cost debt is considered only when the Company concludes that it is economically feasible to do so. Determination to prepay is assessed frequently, however, prepayment is more likely to occur at a time that is closer to the advance's maturity date. In February 2012, the Company paid off \$5.0 million of its outstanding long-term debt and incurred a prepayment fee of \$0.2 million. The advance carried an interest rate of 3.61% and was scheduled to mature in the fourth quarter of 2013. As of December 31, 2013, the Company had the ability to borrow an additional \$159.4 million from the FHLB.

#### Funds Deployed:

#### Investment Securities

The Company's investment policy is designed to complement its lending activities, provide monthly cash flow, manage interest rate sensitivity and generate a favorable return without incurring excessive interest rate and credit risk and manage liquidity at acceptable levels. In establishing investment strategies, the Company considers its business, growth strategies or restructuring plans, the economic environment, the interest rate sensitivity position, the types of securities in its portfolio,

permissible purchases, credit quality, maturity and re-pricing terms, call or average-life intervals and investment concentrations. The Company's policy prescribes permissible investment categories that meet the policy standards and management is responsible for structuring and executing the specific investment purchases within these policy parameters. Management buys and sells investment securities from time-to-time depending on market conditions, business trends, liquidity needs, capital levels and structuring strategies. Investment security purchases provide a way to quickly invest excess liquidity in order to generate additional earnings. The Company generally earns a positive interest spread by assuming interest rate risk using deposits or borrowings to purchase securities with longer maturities.

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 December 31, 2013, the carrying value of investment securities amounted to \$97.4 million, or 16% of total assets, compared to \$100.7 million, or 17% of total assets, at December 31, 2012. On December 31, 2013, 51% of the carrying value of the investment portfolio was comprised of U.S. Government Sponsored Enterprise residential mortgage-backed securities (MBS – GSE residential or mortgage-backed securities) that amortize and provide monthly cash flow that the Company can use for reinvestment, loan demand, unexpected deposit outflow, facility expansion or operations.

As of December 31, 2013, investment securities were comprised of HTM and AFS securities with carrying values of \$0.2 million and \$97.2 million, respectively. The AFS debt and equity securities were recorded with a combined net unrealized gain of \$1.9 million as of December 31, 2013 compared to an unrealized gain of \$0.4 million as of December 31, 2012, respectively, or a net improvement of \$1.5 million during 2013. The improvement stems from the Company's fourth quarter sale of its entire portfolio of pooled trust preferred securities that carried a net unrealized loss of \$4.5 million as of December 31, 2012. At the time of sale, the portfolio had an amortized cost of \$6.1 million and the Company recognized a net gain of \$2.9 million. Interest rates along the intermediate and long end of the treasury yield curve have begun to rise from year-end 2012. The value of bonds usually move in the opposite direction of interest rates. With interest rates on the rise, the market values of bank's debt securities portfolio could be subject to market value decline.

During the year ended December 31, 2013, the carrying value of total investments decreased \$3.3 million, or 3%, and during the same period the total loan portfolio increased \$35.0 million, or 8%. With the loan portfolio offering better returns than can be obtained in the capital markets, growth in the investment portfolio will be considered after loan demand, facility expansion and deposit outflow. The Company expects to maintain a diverse and proportionately level investment portfolio throughout 2014.

A comparison of total investment securities as of December 31 follows:

| (dollars in thousands) | 2013   |   | 2012   |   |
|------------------------|--------|---|--------|---|
|                        | Amount | % | Amount | % |

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|  |           |         |            |         |
|--|-----------|---------|------------|---------|
| MBS - GSE residential                  | \$ 49,686 | 51.0 %  | \$ 50,842  | 50.5 %  |
| State & municipal subdivisions         | 32,611    | 33.5    | 29,857     | 29.6    |
| Agency - GSE                           | 14,601    | 15.0    | 17,740     | 17.6    |
| Pooled trust preferred securities      | -         | -       | 1,825      | 1.8     |
| Equity securities - financial services | 525       | 0.5     | 466        | 0.5     |
| Total                                  | \$ 97,423 | 100.0 % | \$ 100,730 | 100.0 % |

The distribution of debt securities by stated maturity and tax-equivalent yield at December 31, 2013 are as follows:

| (dollars in thousands)         | One year or less |        | More than one year to five years |        | More than five years to ten years |        | More than ten years |        | Total     |        |
|--------------------------------|------------------|--------|----------------------------------|--------|-----------------------------------|--------|---------------------|--------|-----------|--------|
|                                | \$               | %      | \$                               | %      | \$                                | %      | \$                  | %      | \$        | %      |
| MBS - GSE residential          | \$ -             | - %    | \$ 56                            | 6.00 % | \$ 21,763                         | 2.10 % | \$ 27,867           | 2.48 % | \$ 49,686 | 2.32 % |
| State & municipal subdivisions | -                | -      | -                                | -      | 2,051                             | 4.59   | 30,560              | 5.88   | 32,611    | 5.80   |
| Agency - GSE                   | 2,008            | 0.76   | 5,103                            | 0.89   | 7,490                             | 2.32   | -                   | -      | 14,601    | 1.61   |
| Total debt securities          | \$ 2,008         | 0.76 % | \$ 5,159                         | 0.95 % | \$ 31,304                         | 2.32 % | \$ 58,427           | 4.27 % | \$ 96,898 | 3.39 % |

In the above table, the book yields on state & municipal subdivisions were adjusted to a tax-equivalent basis using the corporate federal tax rate of 34%. In addition, average yields on securities AFS are based on amortized cost and do not reflect unrealized gains or losses.

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

Prior to their sale in the fourth quarter of 2013, the Company owned 13 tranches of pooled trust preferred securities (PreTSLs). The Company sold the portfolio to eliminate the volatile and unpredictable behavior of the bond's collateral thereby eliminating the risk of incremental credit risk exposure remaining on the balance sheet potentially jeopardizing the Company's earnings performance and capital condition. By selling the PreTSL portfolio, the Company strengthened its capital adequacy, reduced non-performing assets and redeployed \$9.0 million in sales proceeds into better performing assets.

The following discussion relates to 2012 and all interim periods in the current year leading up to the sale of the PreTSL portfolio. The market for these and other issues of PreTSLs remained inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which PreTSLs trade, then by a significant decrease in the volume of trades relative to historical levels. There had not been a new PreTSL issue since 2007. Newly imposed restrictions for institutions to qualify and receive favorable capital treatment lessened the likelihood of new issues coming to market. There were very few market participants who were willing and/or able to transact for these securities. The Company determined that the volume of trading activity in PreTSLs was minor, restricted mostly to speculative hedge fund traders, transacted on a bid basis and could take as long as weeks to fill orders and for the transactions to settle. Therefore, the Company concluded that the market for these securities was inactive where pricing quotes were sparse, incorporated large illiquidity premiums, and existed with dislocation between spreads and default activity resulting in difficulties in assessing relative observable market inputs to determine fair value. To determine PreTSL valuations, the Company used an independent third party that employed Moody's Wall Street Analytics. Thus, in lieu of a market-quote approach to determine fair value of the PreTSL portfolio, a fair value "Level 3" modeled income approach was utilized. The income approach maximized the use of observable inputs and minimized the use of unobservable inputs and was more representative of fair value than the market-quote approach in markets that were inactive. Core assumption categories were: probability of default; loss given defaults; industry-wide correlations, discount rate and structural behavior. Discounted cash flows were modeled via Monte Carlo simulation to determine the orderly liquidation value as an indication of fair value of all tranches of each PreTSL.

Prior to the sale of the PreTSLs, the Company engaged a structured finance products specialist firm to analyze the securities in the portfolio that had an amortized cost basis. The analysis established a base of fundamental cash flow values to determine whether the Company would receive all of its principal and interest. One security (PreTSL XXVII) was deemed to have a high probability of receiving all principal and interest payments and thus impairment was considered temporary. The firm applied the following steps and assumptions to the remaining securities to arrive at a single best estimate of cash flow that is used as a basis to determine the presence of OTTI:

- o Data about the transaction structure, as defined in the offering indenture and the underlying collateral, was collected;



- o The credit quality of the collateral was estimated using issuer specific probability of default for each security. Deferrals of interest payments were treated as defaults. Once an issuer defaulted, the potential for the tendency was correlated among other issuers. The loss given default, or the amount of cash lost to the investor was assumed to be 100% with no recovery of principal and no prepayments;
- o The analysis used a Monte Carlo simulation framework to simulate the time-to-default on a portfolio of obligors based on individual obligor default probabilities and inter-obligor correlations;
- o Cash flow modeling was performed using the output from the simulation engine to arrive at the single best estimate of cash flow for each tranche;
- o Present value techniques as prescribed in the accounting guidance were used to determine the expected cash flows of each of the tranches. The present value technique for one of the OTTI securities was based upon a discount rate determined at the time of acquisition. For the other OTTI securities, the discount rate used in the present value calculation was the yield to accrete beneficial interest;

- o The present value results were then compared to the present value cash flow results from the immediately prior measurement date. An adverse change in estimated cash flow from the previous measurement date was indicative of credit-related OTTI. If the present value of the cash flow was less than the amortized cost basis, the difference was charged to current earnings as an impairment loss on investment securities.

The results of the OTTI analysis (refer to Note 4, "Investment securities", within the notes to the consolidated financial statements for a description of the analysis performed) determined as of the date of sale, including all interim periods in 2013, the estimated value, based on the expected discounted cash flows, of all securities was sufficient to recover the amortized cost basis, and therefore no credit-related OTTI was required in 2013 compared to \$0.1 million for the year ended December 31, 2012. When present, credit-related OTTI is charged to current earnings as a component of other income in the consolidated statements of income.

#### Federal Home Loan Bank Stock

Investment in FHLB stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB of Pittsburgh. Excess stock is typically repurchased from the Company at par if the amount of borrowings decline to a predetermined level. In addition, the Company typically earns a return or dividend based on the amount invested. The \$2.6 million balance in FHLB stock as of December 31, 2013 approximated the amount as of December 31, 2012.

#### Loans and leases

The Company's focus to improve asset quality in 2013 resulted in a reduction of non-performing assets of \$8.7 million, or 49%, from year-end 2012. Improving asset quality will continue to be a priority. The utilization of our risk-rating matrices, the expertise of our external auditors, guidance from our regulators and the experience of the Company's loan work-out area and the relationship managers will provide framework for continued improvement and early detection of potential problems. We continue to reduce our risk exposure by utilizing loan participations (sharing loans with other financial institutions) and various government guaranty programs. Using a formal process, a teamwork approach, and the knowledge of our relationship managers and branch personnel, the Company achieved 10% growth in the loan and lease portfolio in 2013. In 2014, the Company will focus on: growing existing relationships; reliance on a strong referral base; targeting new prospects; exercising superb salesmanship and using seasonal promotions that encourage a full banking relationship. Our affiliation with the Small Business Administration (SBA) as a preferred lender, our involvement with various local chambers and other organizations will allow us to continue having a competitive edge.

Net of loan participations, in 2013 the Company originated \$22.6 million of commercial and industrial loans and \$14.0 million of commercial real estate loans compared to \$26.9 million and \$23.7 million, respectively in 2012. Also, during 2013, the Company originated \$19.1 million of residential real estate loans for portfolio retention and \$30.7 million of consumer loans, compared to \$31.7 million and \$22.5 million, respectively, in 2012. Included in mortgage loans were \$9.1 million of residential real estate construction lines in 2013 and \$9.5 million in 2012. In addition for 2013, the Company had net originations of lines of credit in the amounts of \$36.1 million for commercial borrowers and \$13.4 million in home equity and other consumer lines of credit.

#### Commercial and industrial

Comparing the commercial and industrial (C&I) loan portfolio at December 31, 2012 of \$65.1 million and \$74.6 million at December 31, 2013, there was an increase of \$9.5 million, or 15%. This growth can be attributed to several factors including, strong customer retention, additional relationship building efforts and the Company's efforts to attract new relationships. The Company expects this sector to experience moderate growth in 2014.

#### Commercial real estate

The commercial real estate loan portfolio increased \$13.1 million, or 8%, from \$173.2 million at December 31, 2012 to \$186.3 million as of December 31, 2013. Our focus continues to be the utilization of various programs and knowledgeable relationship managers to provide our customers with the best possible products and service. Our underwriting will continue to be conservative and remain driven by cash flow and understanding the overall financial picture of our borrowers. We continue to use licensed third party appraisers and, when appropriate, have appraisals reviewed by our outside loan review professional. We anticipate modest growth in this category during 2014.

To help achieve the anticipated growth in the commercial lending portfolio, during the fourth quarter of 2013, the Company added two highly experienced relationship managers to its commercial lending staff, both of whom have more than thirty years of banking experience.

#### Consumer

The consumer loan portfolio increased by \$8.2 million, or 9%, from \$90.6 million at December 31, 2012 to \$98.8 million at December 31, 2013. The increase was primarily attributed to auto loans and leases which increased \$4.9 million, or 28%. Home equity activity continues to be consistent as well, showing increases in home equity installment and home equity lines

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of credit of \$1.7 million, or 5%, and \$2.7 million, or 8%, respectively. We have continued our efforts to methodically grow our dealership relationships along with promotional activity in our home equity program. In 2014, we expect growth in all sectors of the consumer loan portfolio, the majority from the expansion of the auto lending category.

Residential

The residential loan portfolio increased \$13.9 million, or 13%, from \$104.7 million at December 31, 2012 to \$118.6 million at December 31, 2013. In 2013, the Company continued the mortgage loan modification program and focused on retaining mortgage loans with maturities of 10 years or less. Based on the continued softness in the purchase marketplace, lack of incremental mortgage refinancing activity and the winding down of the modification program, for 2014 the Company anticipates stagnant residential mortgage activity with the expectation that the majority of the originations will be sold into the secondary market.

A comparison of domestic loans and related percentage of gross loans, at December 31, for the five previous periods is as follows:

|                            | 2013      |         | 2012      |         | 2011      |         | 2010      |         | 2009      |         |
|----------------------------|-----------|---------|-----------|---------|-----------|---------|-----------|---------|-----------|---------|
|                            | Amount    | %       | Amount    | %       | Amount    | %       | Amount    | %       | Amount    | %       |
| Commercial and industrial  | \$ 74,551 | 15.6 %  | \$ 65,110 | 15.0 %  | \$ 68,372 | 16.8 %  | \$ 85,129 | 20.5 %  | \$ 77,071 | 17.9 %  |
| Commercial real estate:    |           |         |           |         |           |         |           |         |           |         |
| Non-owner occupied         | 89,255    | 18.7    | 81,998    | 18.9    | 79,475    | 19.6    | 87,355    | 21.0    | 99,397    | 23.1    |
| Owner occupied             | 86,294    | 18.0    | 80,509    | 18.6    | 76,611    | 18.9    | 69,338    | 16.7    | 79,013    | 18.3    |
| Construction               | 10,765    | 2.2     | 10,679    | 2.5     | 9,387     | 2.3     | 12,501    | 3.0     | 11,078    | 2.6     |
| Consumer:                  |           |         |           |         |           |         |           |         |           |         |
| Home equity installment    | 34,480    | 7.2     | 32,828    | 7.6     | 36,390    | 9.0     | 40,089    | 9.6     | 48,177    | 11.2    |
| Home equity line of credit | 36,836    | 7.7     | 34,169    | 7.9     | 32,486    | 8.0     | 29,185    | 7.0     | 21,851    | 5.1     |
| Auto and leases            | 22,261    | 4.7     | 17,411    | 4.0     | 13,539    | 3.3     | 10,734    | 2.6     | 9,857     | 2.3     |
| Other                      | 5,205     | 1.1     | 6,139     | 1.4     | 5,833     | 1.4     | 7,165     | 1.7     | 5,760     | 1.3     |
| Residential:               |           |         |           |         |           |         |           |         |           |         |
| Real estate                | 110,365   | 23.1    | 96,765    | 22.3    | 80,091    | 19.7    | 68,160    | 16.4    | 70,958    | 16.5    |
| Construction               | 8,188     | 1.7     | 7,948     | 1.8     | 4,110     | 1.0     | 6,145     | 1.5     | 7,535     | 1.7     |
| Gross loans                | 478,200   | 100.0 % | 433,556   | 100.0 % | 406,294   | 100.0 % | 415,801   | 100.0 % | 430,697   | 100.0 % |
| Less:                      |           |         |           |         |           |         |           |         |           |         |
| Allowance for loan losses  | (8,928)   |         | (8,972)   |         | (8,108)   |         | (7,898)   |         | (7,573)   |         |
| Unearned lease revenue     | (56)      |         | -         |         | -         |         | -         |         | -         |         |

|                     |            |            |            |            |            |
|---------------------|------------|------------|------------|------------|------------|
| Net loans           | \$ 469,216 | \$ 424,584 | \$ 398,186 | \$ 407,903 | \$ 423,124 |
| Loans held-for-sale | \$ 917     | \$ 10,545  | \$ 4,537   | \$ 213     | \$ 1,221   |

The following table sets forth the maturity distribution of select components of the loan portfolio at December 31, 2013. Excluded from the table are residential real estate and consumer loans:

| (dollars in thousands)               | One year or less | More than one year to five years | More than five years | Total      |
|--------------------------------------|------------------|----------------------------------|----------------------|------------|
| Commercial and industrial            | \$ 23,515        | \$ 21,660                        | \$ 29,376            | \$ 74,551  |
| Commercial real estate               | 31,560           | 72,586                           | 71,403               | 175,549    |
| Commercial real estate construction  | 10,765           | -                                | -                    | 10,765     |
| Residential real estate construction | 8,188            | -                                | -                    | 8,188      |
| Total                                | \$ 74,028        | \$ 94,246                        | \$ 100,779           | \$ 269,053 |

Both residential and commercial real estate construction loans are included in the one-year or less category since, by their nature, these loans are converted into residential and CRE loans within one year from the date the real estate construction loan was consummated. Upon conversion, the residential and CRE loans would normally mature after five years.

The following table sets forth the greater than one-year sensitivity changes in interest rates for commercial and CRE loans as of December 31, 2013:

| (dollars in thousands) | One to<br>five<br>years | More than<br>five years | Total      |
|------------------------|-------------------------|-------------------------|------------|
| Fixed interest rate    | \$ 9,237                | \$ 26,333               | \$ 35,570  |
| Variable interest rate | 80,311                  | 105,265                 | 185,576    |
| Total                  | \$ 89,548               | \$ 131,598              | \$ 221,146 |

Non-refundable fees and costs associated with all loan originations are deferred. Using the principal reduction method, the deferral is released as credits or charges to loan interest income over the life of the loan.

There are no concentrations of loans to a number of borrowers engaged in similar industries exceeding 10% of total loans that are not otherwise disclosed as a category in the tables above. There are no concentrations of loans that, if resulted in a loss, would have a material adverse effect on the business of the Company. The Company's loan portfolio does not have a material concentration within a single industry or group of related industries that is vulnerable to the risk of a near-term severe negative business impact. As of December 31, 2013, approximately 49% of the total loan portfolio was secured by real estate. The Company considers this segment concentration to be normal. The banking industry is affected by general economic conditions including, among other things, the effects of real estate values. The Company's credit function strives to mitigate the negative impact of economic conditions by maintaining strict underwriting principles for all loan types and ensuring mortgage lending adheres to standards of secondary market compliance.

#### Loans held-for-sale

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 December 31, 2013 and 2012, loans HFS consisted of residential mortgage loans.

At December 31, 2013, loans HFS had a carrying amount of \$0.9 million which approximated fair value, compared to \$10.5 million carrying value and \$10.8 million fair value, respectively, at December 31, 2012. During the year ended December 31, 2013, residential mortgage loans with principal balances of \$83.5 million were sold into the secondary market and the Company recognized net gains of \$1.4 million, compared to \$82.8 million and \$1.7 million, respectively during 2012. In comparing gains from loan sales in 2013 and 2012, gains of \$41 thousand, deferred from sales of SBA loans in the fourth quarter of 2012, were recognized in the first quarter of 2013 compared to \$18 thousand recognized from sales of SBA loans in 2012.

The Company retains mortgage servicing rights (MSRs) on loans sold into the secondary market. MSRs are retained so that the Company can foster personal relationships with its loyal customer base. At December 31, 2013 and December 31, 2012, the servicing portfolio balance of sold residential mortgage loans was \$250.2 million and \$214.7 million, respectively.

#### Allowance for loan losses

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

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

- identification of specific impaired loans by loan category;

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

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

Each quarter, management performs an assessment of the allowance for loan losses. The Company's Special Assets Committee meets monthly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount, if applicable, based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered regarding not only loans considered for specific reserves, but also the collectability of loans that may be past due. The assessment process also includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company's Credit Administration function have assigned a criticized or classified risk rating.

Total net charge-offs for the twelve months ended December 31, 2013 were \$2.6 million compared to \$2.4 million for the twelve months ended December 31, 2012. This increase is related, in part, to the charge down on one owner-occupied commercial real estate non-accrual loan in the first quarter of 2013. This loan carried a specific reserve as of December 31, 2012, based on the estimated net realizable value of the loan's collateral. This collateral was sold on May 10, 2013 and no material charge-offs or expenses were subsequently incurred. For a discussion on the provision for loan losses, see the "Provision for loan losses," located in the results of operations section of management's discussion and analysis contained herein.

The allowance for loan losses was \$8.9 million as of December 31, 2013, compared to \$9.0 million at December 31, 2012. Management believes that the current balance in the allowance for loan losses is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but inherent to the portfolio. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status nor past due 90 days or more. There could be additional instances which become identified in future periods that may require additional charge-offs and/or increases to the allowance due to continued sluggishness in the economy and pressure on property values.



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

The following table sets forth the activity in the allowance for loan losses and certain key ratios for the periods indicated:

| (dollars in thousands)   | 2013 |         | 2012 |         | 2011 |         | 2010 |         | 2009 |         |   |
|--|------|---------|------|---------|------|---------|------|---------|------|---------|---|
| Balance at beginning of period   | \$   | 8,972   | \$   | 8,108   | \$   | 7,898   | \$   | 7,574   | \$   | 4,745   |   |
| Charge-offs:   |      |         |      |         |      |         |      |         |      |         |   |
| Commercial and industrial  |      | 56      |      | 185     |      | 128     |      | 452     |      | 983     |   |
| Commercial real estate   |      | 2,091   |      | 1,335   |      | 699     |      | 892     |      | 844     |   |
| Consumer   |      | 400     |      | 737     |      | 654     |      | 463     |      | 433     |   |
| Residential  |      | 218     |      | 231     |      | 577     |      | 2       |      | 9       |   |
| Total  |      | 2,765   |      | 2,488   |      | 2,058   |      | 1,809   |      | 2,269   |   |
| Recoveries:  |      |         |      |         |      |         |      |         |      |         |   |
| Commercial and industrial  |      | 30      |      | 26      |      | 407     |      | 4       |      | 35      |   |
| Commercial real estate   |      | 30      |      | 46      |      | 37      |      | 3       |      | 2       |   |
| Consumer   |      | 110     |      | 30      |      | 17      |      | 39      |      | 11      |   |
| Residential  |      | 1       |      | -       |      | 7       |      | 2       |      | -       |   |
| Total  |      | 171     |      | 102     |      | 468     |      | 48      |      | 48      |   |
| Net charge-offs  |      | 2,594   |      | 2,386   |      | 1,590   |      | 1,761   |      | 2,221   |   |
| Provision for loan losses  |      | 2,550   |      | 3,250   |      | 1,800   |      | 2,085   |      | 5,050   |   |
| Balance at end of period   | \$   | 8,928   | \$   | 8,972   | \$   | 8,108   | \$   | 7,898   | \$   | 7,574   |   |
| Net charge-offs (annualized) to average total loans outstanding          |      |         |      |         |      |         |      |         |      |         |   |
|  |      | 0.56    | %    | 0.56    | %    | 0.39    | %    | 0.41    | %    | 0.51    | % |
| Allowance for loan losses to net charge-offs (annualized)                |      |         |      |         |      |         |      |         |      |         |   |
|  |      | 3.44    | x    | 3.76    | x    | 5.10    | x    | 4.48    | x    | 3.41    | x |
| Allowance for loan losses to total loans                                 |      |         |      |         |      |         |      |         |      |         |   |
|  |      | 1.86    | %    | 2.02    | %    | 1.97    | %    | 1.90    | %    | 1.75    | % |
| Loans 30 - 89 days past due and accruing                                 | \$   | 5,268   |      | 2,920   |      | 4,358   |      | 2,611   |      | 5,173   |   |
| Loans 90 days or more past due and accruing                              | \$   | 155     |      | 1,723   |      | 265     |      | 289     |      | 555     |   |
| Non-accrual loans  | \$   | 5,668   |      | 12,121  |      | 13,962  |      | 9,969   |      | 12,329  |   |
| Allowance for loan losses to loans 90 days or more past due and accruing |      |         |      |         |      |         |      |         |      |         |   |
|  |      | 57.60   | x    | 5.21    | x    | 30.55   | x    | 27.36   | x    | 13.65   | x |
| Allowance for loan losses to non-accrual loans                           |      |         |      |         |      |         |      |         |      |         |   |
|  |      | 1.58    | x    | 0.74    | x    | 0.58    | x    | 0.79    | x    | 0.61    | x |
| Allowance for loan losses to non-performing loans                        |      |         |      |         |      |         |      |         |      |         |   |
|  |      | 1.53    | x    | 0.65    | x    | 0.57    | x    | 0.77    | x    | 0.59    | x |
| Average total loans  | \$   | 461,539 |      | 426,636 |      | 411,839 |      | 427,464 |      | 432,642 |   |

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 year-to-year are based upon year-end reviews of the loan portfolio.

Allocation of the allowance among major categories of loans for the past five years is summarized in the following table. This table should not be interpreted as an indication that charge-offs in future periods will occur in these amounts or proportions, or that the allocation indicates future charge-off trends. When present, the portion of the allowance designated as unallocated is within the Company's guidelines.

| (dollars in thousands)    | 2013     | %       | 2012     | %       | 2011     | %       | 2010     | %       | 2009     | %       |
|---------------------------|----------|---------|----------|---------|----------|---------|----------|---------|----------|---------|
| Category                  |          |         |          |         |          |         |          |         |          |         |
| Commercial real estate    | \$ 4,253 | 47.6 %  | \$ 4,908 | 54.6 %  | \$ 3,979 | 49.1 %  | \$ 4,238 | 53.7 %  | \$ 4,314 | 56.9 %  |
| Commercial and industrial | 944      | 10.6    | 922      | 10.3    | 1,221    | 15.1    | 1,368    | 17.3    | 1,406    | 18.6    |
| Consumer                  | 1,482    | 16.6    | 1,639    | 18.3    | 1,435    | 17.7    | 1,249    | 15.8    | 1,253    | 16.5    |
| Residential real estate   | 1,613    | 18.1    | 1,503    | 16.8    | 1,051    | 13.0    | 863      | 10.9    | 505      | 6.7     |
| Unallocated               | 636      | 7.1     | -        | -       | 422      | 5.1     | 180      | 2.3     | 96       | 1.3     |
| Total                     | \$ 8,928 | 100.0 % | \$ 8,972 | 100.0 % | \$ 8,108 | 100.0 % | \$ 7,898 | 100.0 % | \$ 7,574 | 100.0 % |

The allocation of the allowance for the commercial loan portfolio, which is comprised of commercial real estate and commercial and industrial loans, accounted for approximately 58%, or \$5.2 million, of the total allowance for loan losses at December 31, 2013, which represents a 6.8 percentage point decrease from December 31, 2012. The decrease in the commercial real estate allocation from December 31, 2012 to December 31, 2013 was related to the charge down of one large owner-occupied commercial real estate non-accrual loan as explained above. The allocation to the consumer and mortgage categories of loans is adequate compared to the actual historical net charge-offs and qualitative adjustments. The unallocated amount represents the portion of the allowance not specifically identified with a loan or groups of loans. Though credit quality is improving, management provided the amount to support growth in the loan portfolio and reinforce the allowance for the potential credit risks that still exist from an uncertain local economic climate.

#### 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 December 31, 2013, non-performing assets represented 1.44% of total assets reduced from 2.94% at December 31, 2012, mainly resulting from the reduction of commercial loans 90 days or more past due and accruing, coupled with a reduction in residential, consumer and commercial loans on non-accrual status. Most of the non-performing loans are collateralized, thereby mitigating the Company's potential for loss. At December 31, 2013, the Company no longer held the non-accrual corporate bonds consisting of pooled trust preferred securities, therefore there were no securities on non-accrual status, compared to \$1.1 million at December 31, 2012. For a further discussion on the Company's securities portfolio, see Note 4, "Investment securities", within the notes to the consolidated financial statements and the section entitled "Investments", contained within this management's discussion and analysis section.

The following table sets forth non-performing assets at December 31:

| (dollars in thousands)                         | 2013       | 2012       | 2011       | 2010       | 2009       |
|--|------------|------------|------------|------------|------------|
| Loans past due 90 days or more and accruing    | \$ 155     | \$ 1,723   | \$ 265     | \$ 289     | \$ 555     |
| Non-accrual loans *                            | 5,668      | 12,121     | 13,962     | 9,969      | 12,329     |
| Total non-performing loans                     | 5,823      | 13,844     | 14,227     | 10,258     | 12,884     |
| Troubled debt restructurings                   | 1,045      | 1,103      | 5,314      | 783        | -          |
| Other real estate owned and repossessed assets | 2,086      | 1,607      | 1,169      | 1,261      | 887        |
| Non-accrual securities                         | -          | 1,132      | 1,038      | 1,091      | 583        |
| Total non-performing assets                    | \$ 8,954   | \$ 17,686  | \$ 21,748  | \$ 13,393  | \$ 14,354  |
| Total loans, including loans held-for-sale     | \$ 479,061 | \$ 444,101 | \$ 410,831 | \$ 416,014 | \$ 431,918 |
| Total assets                                   | \$ 623,825 | \$ 601,525 | \$ 606,742 | \$ 561,673 | \$ 556,017 |
| Non-accrual loans to total loans               | 1.18%      | 2.73%      | 3.40%      | 2.40%      | 2.85%      |
| Non-performing loans to total loans            | 1.22%      | 3.12%      | 3.46%      | 2.47%      | 2.98%      |
| Non-performing assets to total assets          | 1.44%      | 2.94%      | 3.58%      | 2.38%      | 2.58%      |

\* In the table above, the amount includes non-accrual TDRs of \$1.0 million, \$1.1 million and \$1.4 million as of December 31, 2013, 2012 and 2011, respectively. There were no non-accrual TDRs as of December 31, 2010 and 2009.

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 \$8.0 million, or 58%, from \$13.8 million on December 31, 2012 to \$5.8 million at December 31, 2013. As of year-end 2012, there were seventeen loans to sixteen unrelated borrowers aggregating \$1.7 million in the over 90 day category ranging from less than \$1 thousand to \$0.6 million. At December 31, 2013, the over 90 days past due portion was \$0.2 million and was comprised of four loans to four unrelated borrowers, ranging from \$7 thousand to \$0.1 million. Of the four loans past due over 90 days, one loan, totaling \$115 thousand, was a residential mortgage, one loan was a secured commercial loan for \$7 thousand, and two were consumer loans aggregating \$33 thousand. The Company seeks payments from all past due customers through an aggressive customer communication process. However, these loans remained past due after the quarter ended.

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A past due loan will be placed on non-accrual at the 90 day point when it is deemed that a customer is non-responsive and uncooperative to collection efforts. At December 31, 2012, there were 65 loans to 57 unrelated borrowers ranging from less than \$1 thousand to \$3.2 million in the non-accrual category. At 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. The decrease in non-accrual loans during the twelve months ended December 31, 2013 was related to loans that were charged off, paid off, transferred to ORE or moved back to accrual status.

At December 31, 2013, the non-accrual loans aggregated \$5.7 million as compared to \$12.1 million at December 31, 2012. The net decrease in the level of non-accrual loans during the period ending December 31, 2013 occurred as follows: additions to the non-accrual loan component of the non-performing assets totaling \$2.3 million were made during the period; these were offset by reductions or payoffs of \$3.4 million, charge-offs of \$2.5 million, \$2.1 million of transfers to ORE and \$0.8 million of loans that returned to performing status. Loans past due 90 days or more and accruing were \$0.2 million at December 31, 2013, compared to \$1.7 million as of December 31, 2012. The ratio of non-performing loans to total loans was 1.22% at December 31, 2013 compared to 3.12% at December 31, 2012.

The composition of non-performing loans as of December 31, 2013 is as follows:

|                            | Gross<br>loan<br>balances | Past due<br>90<br>days or<br>more<br>and still<br>accruing | Non-<br>accrual<br>loans | Total non-<br>performing<br>loans | % of<br>gross<br>loans |
|----------------------------|---------------------------|--|--------------------------|-----------------------------------|------------------------|
| (dollars in thousands)     |                           |  |                          |                                   |                        |
| Commercial and industrial  | \$ 74,551                 | \$ 7   | \$ 62                    | \$ 69                             | 0.09%                  |
| Commercial real estate:    |                           |  |                          |                                   |                        |
| Non-owner occupied         | 89,255                    | -  | 1,518                    | 1,518                             | 1.70%                  |
| Owner occupied             | 86,294                    | -  | 1,422                    | 1,422                             | 1.65%                  |
| Construction               | 10,765                    | -  | 635                      | 635                               | 5.90%                  |
| Consumer:                  |                           |  |                          |                                   |                        |
| Home equity installment    | 34,480                    | -  | 393                      | 393                               | 1.14%                  |
| Home equity line of credit | 36,836                    | 21   | 254                      | 275                               | 0.75%                  |
| Auto loans and leases      | 22,205                    | 11   | 12                       | 23                                | 0.10%                  |
| Other                      | 5,205                     | -  | 22                       | 22                                | 0.42%                  |
| Residential:               |                           |  |                          |                                   |                        |
| Real estate                | 110,365                   | 116  | 1,350                    | 1,466                             | 1.33%                  |
| Construction               | 8,188                     | -  | -                        | -                                 | -                      |
| Loans held-for-sale        | 917                       | -  | -                        | -                                 | -                      |
| Total                      | \$ 479,061                | \$ 155   | \$ 5,668                 | \$ 5,823                          | 1.22%                  |

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. For the year of 2013, \$78 thousand in cash basis interest income was recognized. If the

non-accrual loans that were outstanding as of December 31, 2013 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of \$189 thousand during the year ended December 31, 2013.

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

The following tables set forth the activity in accruing and non-accruing TDRs as of the period indicated:

As of and for the year ended  
December 31, 2013

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

As of and for the year ended December 31, 2012

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

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

#### Foreclosed assets held-for-sale

Foreclosed assets held-for-sale aggregated \$2.1 million at December 31, 2013 and \$1.6 million at December 31, 2012. The following table sets forth the activity in the ORE component of foreclosed assets held-for-sale:



| (dollars in thousands)         | 2013     |      | 2012     |     |
|--------------------------------|----------|------|----------|-----|
|                                | Amount   | #    | Amount   | #   |
| Balance at beginning of period | \$ 1,600 | 12   | \$ 1,169 | 6   |
| Additions                      | 2,381    | 15   | 1,778    | 14  |
| Pay downs                      | (34)     |      | (92)     |     |
| Write downs                    | (443)    |      | (86)     |     |
| Sold                           | (1,426)  | (12) | (1,169)  | (8) |
| Balance at end of period       | \$ 2,078 | 15   | \$ 1,600 | 12  |

As of December 31, 2012, ORE consisted of twelve properties that stemmed from eleven unrelated borrowers and was comprised of: nine properties totaling \$0.8 million from 2012 additions; two properties aggregating \$0.2 million acquired in 2011 and one property acquired in 2010 for \$0.6 million. As of December 31, 2013, fifteen properties were added to ORE, which contributed an additional \$2.4 million to ORE during 2013, and twelve were sold. Of the twelve properties that were sold in 2013, six were added to ORE in 2012 and six were added in 2013. Of these fifteen properties added in 2013, four were commercial real estate and eleven were residential real estate. Of the fifteen ORE properties as of December 31, 2013, which stemmed from fourteen unrelated borrowers, one has a pending insurance claim, nine are listed for sale, three have signed sales agreements, and two are in litigation.

In addition, foreclosed assets held-for-sale included one other repossessed asset, an automobile with a book value of \$8 thousand at December 31, 2013. At December 31, 2012, other repossessed assets consisted of an automobile with a book value of \$6 thousand which was sold during 2013.

#### Cash surrender value of bank owned life insurance

The Company maintains bank owned life insurance (BOLI) for a chosen group of employees at the time of purchase, namely its officers, where the Company is the owner and sole beneficiary of the policies. BOLI is classified as a non-interest earning asset. Increases in the cash surrender value are recorded as components of non-interest income. The BOLI is profitable from the appreciation of the cash surrender values of the pool of insurance and its tax-free advantage to the Company. This profitability is used to offset a portion of current and future employee benefit costs. The BOLI can be liquidated if necessary with associated tax costs. However, the Company intends to hold this pool of insurance, because it provides income that enhances the Company's capital position. Therefore, the Company has not provided for deferred income taxes on the earnings from the increase in cash surrender value.

### Results of Operation

#### Earnings Summary

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 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 impacted by: changes in interest rates and market yield curves and their related effect on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in the marketplace.

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

#### Overview

For the year ended December 31, 2013, the Company generated net income of \$7.1 million or \$3.02 per diluted share, compared to \$4.9 million or \$2.14 per diluted share, for the year ended December 31, 2012. The 45% increase in earnings was due to higher net interest and non-interest income, up 1% and 37%, respectively and a \$0.7 million, or 22%, lower provision for loan loss requirement, offset partially by an increase in non-interest expense. The most significant factor contributing to the 45% increase in net income was from the sale of the corporate bond portfolio, consisting of pooled trust preferred securities, producing a net gain of \$2.9 million. Other non-interest expenses increased \$0.5 million, or 3%, in the current year compared to 2012 from higher salary and employee benefit costs and expenses related to foreclosed assets held-for-sale.

For the year ended December 31, 2013, ROA and ROE were 1.15% and 11.70%, respectively, compared to 0.81% and 8.62% for the same period in 2012. The improvement in ROA and ROE was caused by the increase in net income.

Net interest income and interest sensitive assets / liabilities

Net interest income increased \$0.3 million, or 1%, from \$20.6 million at December 31, 2012 to \$20.9 million at December 31, 2013. The Company experienced a \$10.5 million net decrease in average interest-bearing deposits, and an eight basis point decline on average rates paid - mostly from a 22 basis point decline on rates paid on CDs. The lower rates paid on CDs in conjunction with a \$3.0 million decline in their average balances resulted in a \$0.3 million decrease in interest expense from these deposits. These factors were the primary cause of interest expense declining by \$0.4 million, the balance of the decline due mostly to lower average balances of interest-bearing transaction deposits in 2013 compared to 2012. The lower interest expense more than offset the marginal decline, or \$0.1 million, in interest income. Although the portfolio of interest-earning assets increased \$7.9 million, an eight basis point reduction in yield more than offset the earnings impact of the higher volume. In 2013, the Company shifted its emphasis from the lower yielding investment portfolio to higher yielding loans - particularly in the commercial and residential mortgage loan portfolios where average loan volume increases of \$32.7 million helped boost interest income by \$0.3 million despite a decline in yield of 26 basis points in commercial loans and 36 basis points in residential mortgage loans. The performance of the commercial and residential loan portfolios more than offset the 62 basis points lower yields earned on \$2.2 million larger average balances of consumer loans, which generated \$0.2 million less interest income for the year ended 2013 compared to 2012.

The fully-taxable equivalent (FTE) net interest rate spread and net interest margin remained unchanged at 3.62% and 3.80%, respectively, for the years ended December 31, 2013 and 2012. The increase in average non-interest bearing deposits of \$14.7 million reduced the overall cost of funds by 7 basis points in the current year compared to 2012. This no-cost funding source helped stabilize the Company's net interest margin.

The low interest rate environment caused yields from earning assets to further decline in 2013, albeit at a slower pace than in 2012. In 2014, the Company expects to continue to operate in a low, but rising interest rate environment with a steep yield curve. A rising rate environment positions the Company to improve its interest income performance. For 2014, we anticipate net interest margin to stabilize or improve marginally. The FOMC has not adjusted the short-term federal funds rate upward and is not expected to do so well into 2015, helping contain funding costs. Growth in the commercial loan portfolio, the Company's strategy for 2014, coupled with historically and sustaining low funding costs, should help contain the interest rate margin.

At 69 basis points, the Company's cost of interest-bearing liabilities for the year ended December 31, 2013 is eight basis points lower than the cost in 2012. Other than retaining maturing long-term CDs, reducing deposit rates from all-time lows would have a minor cost-savings impact. As noted, interest rates along the treasury yield curve have been slowly rising. Competition, could potentially pressure banks to increase term deposit rates. On the asset side, the prime interest rate, the benchmark rate that banks use as a base rate for adjustable rate loans, is not expected to rise in tandem with the treasury yield curve thereby further pressuring net interest income should deposit rates begin to steadily rise. To help combat the imminent change to the economic landscape, the Company has successfully developed and will continue to strengthen its association with existing customers, develop new business relationships, generate new loan volumes, retain and generate higher levels of average non-interest bearing DDA balances. Strategically deploying these funds into interest earning-assets such as in the retail and commercial loan portfolios is an effective margin-enhancing strategy that the Company expects to pursue and expand upon to help stabilize net interest margin erosion.

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

The table that follows sets forth a comparison of average balances of assets and liabilities and their related net tax equivalent yields and rates for the years indicated. Within the table, interest income was adjusted to a tax-equivalent basis, using the corporate federal tax rate of 34% to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. This treatment allows a uniform comparison among yields on interest-earning assets. Loans include loans HFS and non-accrual loans but exclude the allowance for loan losses. Net deferred loan cost amortization of \$0.3 million in 2013 and \$0.2 million in 2012 and 2011, respectively, are included in interest income from loans. Securities include non-accrual securities. Average balances are based on amortized cost and do not reflect net unrealized gains or losses. Net interest margin is calculated by dividing net interest income by total average interest-earning assets. Cost of funds includes the effect of average non-interest bearing deposits as a funding source:

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| (dollars in thousands)               | 2013            |          |              | 2012            |          |              | 2011            |          |              |
|--------------------------------------|-----------------|----------|--------------|-----------------|----------|--------------|-----------------|----------|--------------|
| Assets                               | Average balance | Interest | Yield / rate | Average balance | Interest | Yield / rate | Average balance | Interest | Yield / rate |
| Interest-earning assets              |                 |          |              |                 |          |              |                 |          |              |
| Interest-bearing                     |                 |          |              |                 |          |              |                 |          |              |
| deposits                             | \$ 7,650        | \$ 22    | 0.29 %       | \$ 25,637       | \$ 65    | 0.25 %       | \$ 39,699       | \$ 101   | 0.25 %       |
| Investments:                         |                 |          |              |                 |          |              |                 |          |              |
| Agency - GSE                         | 16,077          | 151      | 0.94         | 24,399          | 267      | 1.09         | 23,863          | 420      | 1.76         |
| MBS - GSE                            |                 |          |              |                 |          |              |                 |          |              |
| residential                          | 49,238          | 582      | 1.18         | 50,857          | 677      | 1.33         | 42,719          | 908      | 2.13         |
| State and municipal                  | 29,777          | 1,838    | 6.17         | 27,649          | 1,820    | 6.58         | 27,075          | 1,799    | 6.65         |
| Other                                | 9,041           | 90       | 1.00         | 9,947           | 81       | 0.81         | 11,835          | 72       | 0.60         |
| Total investments                    | 104,133         | 2,661    | 2.56         | 112,852         | 2,845    | 2.52         | 105,492         | 3,199    | 3.03         |
| Loans and leases:                    |                 |          |              |                 |          |              |                 |          |              |
| Commercial and                       |                 |          |              |                 |          |              |                 |          |              |
| commercial real estate               | 248,999         | 12,284   | 4.93         | 236,922         | 12,289   | 5.19         | 248,836         | 13,745   | 5.52         |
| Consumer                             | 58,593          | 3,504    | 5.98         | 56,417          | 3,725    | 6.60         | 56,255          | 3,962    | 7.04         |
| Residential real estate              | 153,947         | 6,274    | 4.08         | 133,297         | 5,922    | 4.44         | 106,748         | 5,449    | 5.10         |
| Total loans and leases               | 461,539         | 22,062   | 4.78         | 426,636         | 21,936   | 5.14         | 411,839         | 23,156   | 5.62         |
| Federal funds sold                   | 195             | -        | 0.25         | 577             | 1        | 0.26         | 290             | 1        | 0.25         |
| Total interest-earning assets        | 573,517         | 24,745   | 4.31 %       | 565,702         | 24,847   | 4.39 %       | 557,320         | 26,457   | 4.75 %       |
| Non-interest earning assets          | 45,255          |          |              | 42,784          |          |              | 39,007          |          |              |
| Total Assets                         | \$ 618,772      |          |              | \$ 608,486      |          |              | \$ 596,327      |          |              |
| Liabilities and shareholders' equity |                 |          |              |                 |          |              |                 |          |              |
| Interest-bearing liabilities         |                 |          |              |                 |          |              |                 |          |              |
| Deposits:                            |                 |          |              |                 |          |              |                 |          |              |
| Savings                              | \$ 108,850      | \$ 224   | 0.21 %       | \$ 107,401      | \$ 231   | 0.22 %       | \$ 110,818      | \$ 501   | 0.45 %       |
| Interest-bearing                     |                 |          |              |                 |          |              |                 |          |              |
| checking                             | 87,230          | 123      | 0.14         | 82,487          | 113      | 0.14         | 68,174          | 123      | 0.18         |
| MMDA                                 | 81,598          | 443      | 0.54         | 95,385          | 504      | 0.53         | 92,790          | 551      | 0.59         |
| CDs < \$100,000                      | 75,729          | 779      | 1.03         | 78,348          | 969      | 1.24         | 87,401          | 1,416    | 1.62         |
| CDs > \$100,000                      | 41,422          | 509      | 1.23         | 41,763          | 620      | 1.49         | 45,787          | 1,076    | 2.35         |
| Clubs                                | 1,583           | 3        | 0.16         | 1,563           | 2        | 0.16         | 1,598           | 5        | 0.30         |
| Total interest-bearing deposits      | 396,412         | 2,081    | 0.52         | 406,947         | 2,439    | 0.60         | 406,568         | 3,672    | 0.90         |

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|  |            |           |        |            |           |        |            |           |        |
|--|------------|-----------|--------|------------|-----------|--------|------------|-----------|--------|
| Repurchase agreements                      | 11,629     | 22        | 0.19   | 13,027     | 33        | 0.25   | 11,939     | 52        | 0.44   |
| Borrowed funds                             | 19,895     | 865       | 4.35   | 16,768     | 882       | 5.26   | 21,692     | 1,037     | 4.78   |
| Total interest-bearing liabilities         | 427,936    | 2,968     | 0.69 % | 436,742    | 3,354     | 0.77 % | 440,199    | 4,761     | 1.08 % |
| Non-interest bearing deposits              | 126,149    |           |        | 111,458    |           |        | 102,440    |           |        |
| Non-interest bearing liabilities           | 3,802      |           |        | 3,390      |           |        | 3,290      |           |        |
| Total liabilities                          | 557,887    |           |        | 551,590    |           |        | 545,929    |           |        |
| Shareholders' equity                       | 60,885     |           |        | 56,896     |           |        | 50,398     |           |        |
| Total liabilities and shareholders' equity | \$ 618,772 |           |        | \$ 608,486 |           |        | \$ 596,327 |           |        |
| Net interest income                        |            | \$ 21,777 |        |            | \$ 21,493 |        |            | \$ 21,696 |        |
| Net interest spread                        |            |           | 3.62 % |            |           | 3.62 % |            |           | 3.67 % |
| Net interest margin                        |            |           | 3.80 % |            |           | 3.80 % |            |           | 3.89 % |
| Cost of funds                              |            |           | 0.54 % |            |           | 0.61 % |            |           | 0.88 % |

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Changes in net interest income are a function of both changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities. The following table presents the extent to which changes in interest rates and changes in volumes of interest-earning assets and interest-bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. Information is provided in each category with respect to (1) the changes attributable to changes in volume (changes in volume multiplied by the prior period rate), (2) the changes attributable to changes in interest rates (changes in rates multiplied by prior period volume) and (3) the net change. The combined effect of changes in both volume and rate has been allocated proportionately to the change due to volume and the change due to rate. Tax-exempt income was not converted to a tax-equivalent basis on the rate/volume analysis:

| (dollars in thousands)                               | Years ended December 31,   |          |        |                       |            |          |
|--|----------------------------|----------|--------|-----------------------|------------|----------|
|  | 2013 compared to 2012      |          |        | 2012 compared to 2011 |            |          |
|  | Increase (decrease) due to |          |        |                       |            |          |
|  | Volume                     | Rate     | Total  | Volume                | Rate       | Total    |
| Interest income:                                     |                            |          |        |                       |            |          |
| Loans and leases:                                    |                            |          |        |                       |            |          |
| Residential real estate                              | \$ 865                     | \$ (513) | \$ 352 | \$ 1,240              | \$ (767)   | \$ 473   |
| Commercial and CRE                                   | 603                        | (615)    | (12)   | (629)                 | (819)      | (1,448)  |
| Consumer   | 139                        | (360)    | (221)  | 11                    | (244)      | (233)    |
| Total loans and leases                               | 1,607                      | (1,488)  | 119    | 622                   | (1,830)    | (1,208)  |
| Investment securities, interest-bearing deposits and |                            |          |        |                       |            |          |
| Federal funds sold                                   | (477)                      | 217      | (260)  | (115)                 | (286)      | (401)    |
| Total interest income                                | 1,130                      | (1,271)  | (141)  | 507                   | (2,116)    | (1,609)  |
| Interest expense:                                    |                            |          |        |                       |            |          |
| Deposits:  |                            |          |        |                       |            |          |
| Certificates of deposit greater than \$100,000       | (5)                        | (106)    | (111)  | (88)                  | (368)      | (456)    |
| Other  | (94)                       | (153)    | (247)  | (110)                 | (667)      | (777)    |
| Total deposits                                       | (99)                       | (259)    | (358)  | (198)                 | (1,035)    | (1,233)  |
| Other interest-bearing liabilities                   | 51                         | (79)     | (28)   | (120)                 | (54)       | (174)    |
| Total interest expense                               | (48)                       | (338)    | (386)  | (318)                 | (1,089)    | (1,407)  |
| Net interest income                                  | \$ 1,178                   | \$ (933) | \$ 245 | \$ 825                | \$ (1,027) | \$ (202) |

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 \$2.6 million were recorded during 2013, compared to \$3.3 million during 2012. The Company's non-performing loans declined to \$5.8 million as of December 31, 2013, an \$8.0 million decrease from year-end 2012. Though credit quality is improving, the additional provision throughout 2013 was necessary to fund the allowance to support growth in the loan portfolio, as well as reinforce the allowance for the potential credit risks that still exist from an uncertain local economic climate. The allowance for loan losses was \$8.9 million as of December 31, 2013, compared to \$9.0 million



for December 31, 2012. For a further discussion on the allowance for loan losses, see “Allowance for loan losses” under the caption “Comparison of financial condition at December 31, 2013 and 2012” above.

#### Other income

For the year ended December 31, 2013, non-interest income amounted to \$10.5 million, a \$2.8 million, or 38%, increase compared to \$7.7 million recorded during the year ended December 31, 2012. The majority of this increase was due to \$2.8 million of additional recognized gains from sales of investment securities in 2013 compared to 2012. Security gains included the \$2.9 million of net gains from the sale of the entire portfolio of preferred term securities in the fourth quarter of 2013. Additional fees from growth in interchange, deposit, financial services and trust and the absence of \$0.1 million in credit-related OTTI charges in the current year helped boost non-interest related revenue. Growth in fees from other services was offset by a decline in mortgage loan service, late and other loan related fee income in 2013 compared to 2012. In addition, a slowdown in mortgage loan origination and refinance activity and the decision to hold intermediate-term mortgage loans for portfolio has resulted in \$0.4 million less gains recognized from the sales of mortgage loans into the secondary market during the year ended December 31, 2013 compared to December 31, 2012.

#### Other operating expenses

For the year ended December 31, 2013, total other operating expenses increased \$0.5 million, or 3%, compared to the year ended December 31, 2012. Salary and employee benefits increased \$0.3 million, or 3%, due to annual merit increases, internal promotions, employee incentives, the hiring of new senior staff positions and the related increase in payroll taxes partially offset by lower group insurance costs. Advertising and marketing expenses increased \$44 thousand, or 4%, during the year ended December 31, 2013 compared to the same period in 2012. The increase was caused by a new branding initiative with expenses including a year-long, multi-media marketing campaign consisting of television, billboard, direct mail and social media, along with a very visible public relations initiative. The costs of these events were partially offset by a decrease of \$0.2 million in contributions to qualifying educational organizations through the “Educational Improvement Tax Credit” (EITC) program administered by the state of Pennsylvania. Excluding the decrease in contributions, advertising and marketing expenses increased \$0.2 million. The state was oversubscribed and initially the Company received only partial approval for an amount that was lower than the amount approved in 2012. The Company was waitlisted but was informed, in February 2014 by the state, that the remainder of the amount requested was approved and \$0.2 million was donated for 2014. The net expense to carry other real estate including, carrying costs, write-down to fair value and gains and losses from their sales, increased \$0.3 million in 2013 compared to 2012. Because of the struggling housing market, carrying values of foreclosed properties were written down to fair value based upon the receipt of new property appraisals. In addition, new and poorly maintained properties and the length of time a property is held in inventory requires extended maintenance, taxes and other carrying costs. It is the Company’s objective to take control of these properties and soon as feasibly possible, assess their salability, repair as needed and list with a real estate broker. The \$0.2 million increase in automated transaction processing expense was due to the effect of the new regulation that allows the Company’s card processors the right to bill for services related to point-of-sale transactions. In addition, the Company’s rollout of a new debit card rewards program required implementation and program expenses in 2013 that did not exist in 2012. The non-recurring prepayment fee of \$0.2 million from the payoff of the \$5.0 million, 3.61%, FHLB loan in the first quarter of 2012 caused the decrease in the other expense category, partially offset by the increase in shares tax expense due to the Company not receiving the tax credits as described above. Collections expense declined \$0.1 million due to the increase of internal workouts of delinquent loans often times lessening the need to engage professional services. Premises and equipment decreased \$0.1 million during the year ended December 31, 2013 due to lower equipment depreciation and lower expenses for leased facilities.

The ratios of non-interest expense less non-interest income to average assets, known as the expense ratio, at December 31, 2013 and 2012 were 1.87% and 1.78%, respectively. The expense ratio, which excludes OTTI and other securities transactions and non-recurring expenses, increased due to higher expenses and lower non-interest income.

## Provision for income taxes

The Company's effective income tax rate approximated 27.0% in 2013 and 24.1% 2012. The difference between the effective rate and the enacted corporate rate of 34% is mostly to the effect of tax exempt income. The higher effective tax rate in 2013 was caused by a higher amount of pre-tax income subject to the the statutory 34% income tax rate.

## Comparison of Financial Condition as of December 31, 2012

and 2011 and Results of Operations for each of the Years then Ended

## Financial Condition

### Overview

During 2012, the Company used available cash to fund loan growth. The Company made progress in improving asset quality during 2012, reducing non-performing assets by \$4.1 million, or 19% from year-end 2011, representing less than 3% of total assets.

Consolidated assets decreased \$5.2 million, or 1%, to \$601.5 million as of December 31, 2012 from \$606.7 million at December 31, 2011. The decrease was from a \$5.0 million payoff of a long-term FHLB advance, a decline in deposits of \$1.1 million – mostly interest-bearing money market accounts and certificates of deposit, offset by \$2.6 million in retained earnings, additional capital stock outstanding and a \$1.3 million improvement in other comprehensive income/loss (OCI).

#### Funds Provided:

##### Deposits

Compared to December 31, 2011, total deposits fell \$1.1 million, or less than 1%, during the year ended December 31, 2012. The decrease stemmed from declines in: money market accounts, \$31.1 million; CDs, \$8.7 million; savings and clubs, \$0.1 million; partially offset by growth in interest-bearing checking, \$8.9 million, and non-interest bearing deposits, \$29.9 million.

The low interest rate environment continued to cause customers to seek short-term alternatives for their deposits. Balances of certificates of deposit declined \$8.7 million, or 7%, in 2012. The Company continued to experience a shift toward transactional accounts which increased \$7.6 million, or 2%, in 2012. The significant decrease in money market deposit accounts was due to some of the Company's larger depositors who re-deployed their cash balances. Additionally, the expiration of money market promotions resulted in decreases to money market levels as some of these deposits shifted into savings and DDAs. The increase in non-interest bearing and interest-bearing checking deposits was due to the Company focusing on a new checking account campaign targeting the acquisition of new retail and business households along with continued sales emphasis on broadening and deepening existing business and retail relationships with operational checking accounts.

As of December 31, 2012 and 2011, CDARS represented \$10.2 million and \$11.0 million, respectively, or 2%, of total deposits.

##### Short-term borrowings

Because of the liquidity position during 2012 the Company did not have the need for short-term overnight borrowings. Customer liquidity is the typical cause for variances in repurchase agreements, which during 2012 decreased \$1.5 million, or 15%, from year-end December 31, 2011.

##### Long-term debt

As of December 31, 2012 and 2011, long-term debt consisted of borrowings from the FHLB of \$16.0 million and \$21.0 million, at weighted-average rates of 5.26% and 4.87%, respectively. The 2012 weighted-average rate was 87 basis points above the tax-equivalent yield of 4.39% earned from the Company's portfolio of average interest-earning assets for the year ended December 31, 2012. In February 2012, the Company paid off \$5.0 million of its outstanding long-term debt and incurred a prepayment fee of \$0.2 million. The advance carried an interest rate of 3.61% and was scheduled to mature in the fourth quarter of 2013. As of December 31, 2012, the Company had the ability to borrow an additional \$128.2 million from the FHLB.

##### Accrued interest payable and other liabilities

The \$2.9 million decrease in other liabilities was caused by a \$3.7 million participated loan which was paid off on the last business day of December 2011 and was subsequently distributed to participant banks in January 2012. This was offset by a \$0.5 million security purchase obligation that was recorded in December 2012 for a January 2013 settlement and also higher real estate escrow balances.

Funds Deployed:

Investment Securities

As of December 31, 2012, AFS debt and equity securities were recorded with a combined unrealized net gain of \$0.4 million. As of December 31, 2012 and December 31, 2011, the aggregate fair value of securities HTM exceeded their respective aggregate amortized cost by \$31 thousand and \$42 thousand, respectively.

As of December 31, 2012, the carrying value of total investment securities amounted to \$100.7 million, or 17% of total assets, compared to \$108.5 million, or 18% of total assets, at December 31, 2011. During 2012, the amortized cost declined by approximately \$9.8 million from the amortized cost as of December 31, 2011.

The distribution of debt securities by stated maturity and tax-equivalent yield at December 31, 2012 were as follows:

| (dollars in thousands)         | One year or less |        | More than one year to five years |        | More than five years to ten years |        | More than ten years |        | Total      |        |
|--------------------------------|------------------|--------|----------------------------------|--------|-----------------------------------|--------|---------------------|--------|------------|--------|
|                                | \$               | %      | \$                               | %      | \$                                | %      | \$                  | %      | \$         | %      |
| MBS - GSE                      |                  |        |                                  |        |                                   |        |                     |        |            |        |
| residential                    | \$ -             | - %    | \$ 49                            | 6.01 % | \$ 21,993                         | 1.75 % | \$ 28,800           | 2.77 % | \$ 50,842  | 2.33 % |
| State & municipal subdivisions | -                | -      | -                                | -      | 1,387                             | 6.02   | 28,470              | 6.11   | 29,857     | 6.11   |
| Agency - GSE                   | 3,533            | 0.55   | 13,179                           | 1.32   | 1,028                             | 3.55   | -                   | -      | 17,740     | 1.30   |
| Pooled trust                   |                  |        |                                  |        |                                   |        |                     |        |            |        |
| preferred securities           | -                | -      | -                                | -      | -                                 | -      | 1,825               | 2.26   | 1,825      | 2.26   |
| Total debt securities          | \$ 3,533         | 0.55 % | \$ 13,228                        | 1.34 % | \$ 24,408                         | 2.05 % | \$ 59,095           | 4.16 % | \$ 100,264 | 3.16 % |

The total fair value of the investment portfolio was recorded at a net unrealized gain of \$0.4 million as of December 31, 2012 compared to a net unrealized loss of \$1.7 million as of December 31, 2011. The pooled trust preferred securities (PreTSL) portfolio was recorded at an unrealized loss of \$4.5 million as of December 31, 2012, a \$0.6 million improvement from the \$5.1 million unrealized loss recorded as of December 31, 2011. The remainder of the investment portfolio was recorded at a net unrealized gain of \$4.9 million, an improvement of \$1.5 million from the amount recorded as of December 31, 2011.

The Company determined that as of and for the year ended December 31, 2012, the estimated value, based on the expected discounted cash flow, of two PreTSLs: IX and XVIII was insufficient to recover the amortized cost basis, and therefore experienced credit-related OTTI in the amount of \$0.1 million for the year ended December 31, 2012 (all of which occurred in the first two quarters of 2012) compared to \$0.2 million for the year ended December 31, 2011.

#### Loans

Net of loan participations, in 2012 the Company originated \$26.9 million of commercial and industrial loans and \$23.7 million of commercial real estate loans compared to \$30.9 million and \$9.6 million, respectively in 2011. Also, during 2012, the Company originated \$31.7 million of residential real estate loans for portfolio retention and \$22.5 million of consumer loans, compared to \$19.1 million and \$19.1 million, respectively, in 2011. Included in mortgage loans were \$9.5 million of residential real estate construction lines in 2012 and \$4.3 million in 2011. In addition for 2012, the Company had net originations of lines of credit in the amounts of \$22.1 million for commercial borrowers and \$9.4 million in home equity and other consumer lines of credit.

#### Commercial and industrial

The commercial and industrial (C&I) loan portfolio decreased \$3.3 million, or 5%, from \$68.4 million at December 31, 2011 to \$65.1 million at December 31, 2012. During 2012, the Bank had large credit pay offs in this category of approximately \$13 million. The largest was an unexpected payoff of \$6 million, while others were due to the sale of businesses or terms and conditions that were offered elsewhere and were not acceptable to our Company.

#### Commercial real estate

The commercial real estate loan portfolio increased \$7.7 million, or 5%, from \$165.5 million at December 31, 2011 to \$173.2 million as of December 31, 2012. There was a multitude of worthy credit facilities provided during 2012. In order to mitigate risk associated with commercial real estate we continued to obtain current real estate appraisals which were reviewed by a third party, used prudence in establishing and regulating loan-to-value analysis including the impact of rate increases, vacancy, historical and projected cash flow, liquidity and where appropriate guarantee of principles who have acceptable credit scores. The increase was spread among all of the classes of commercial real estate loans.

#### Consumer loans

The consumer loan portfolio increased slightly by \$2.3 million, or 2.6%, from \$88.2 million at December 31, 2011 to \$90.5 million at December 31, 2012. Within the portfolio was an increase in auto loan activity through the Company's dealer loan program partially offset by a decrease in home equity installment loans. The increase was the result of efforts in business development and the decrease attributed to home equity installment loan payoffs from mortgage refinances.

#### Residential

The residential portfolio increased \$20.5 million, or 24.4%, from \$84.2 million at December 31, 2011 to \$104.7 million at December 31, 2012. This increase was primarily attributed to a mortgage loan modification program and retaining a portion of mortgages in-house with maturities of 15 years or less. During the fourth quarter of 2012, the Company began a new mortgage loan modification program with the focus on retaining mortgage loans with maturities of 10 years or less. The program attributed to slight growth in the residential loan portfolio in 2012.

### Loans held-for-sale

Loans HFS as of December 31, 2012 were \$10.5 million which approximated fair value compared to \$4.5 million, respectively, at December 31, 2011. During 2012, the Company originated \$85.3 million of residential mortgages HFS, compared to \$45.1 million in 2011. The increase in volume in 2012 was a function of the sustaining low mortgage interest rate environment which bolstered refinancing of existing home debt. During 2012, residential mortgage loans with principal balances of \$82.8 million were sold into the secondary market and the Company recognized net gains of approximately \$1.7 million, compared to \$46.1 million and \$0.7 million, respectively during 2011.

At December 31, 2012 and 2011, the servicing portfolio balance of sold residential mortgage loans was \$214.7 million and \$193.5 million, respectively.

### Allowance for loan losses

Total charge-offs, net of recoveries, for 2012 were \$2.4 million, compared to \$1.6 million in 2011. Commercial and industrial loans recorded a net charge off of \$0.2 million during 2012, as opposed to a net recovery of \$0.3 million for 2011. Consumer loan net charge-offs of \$0.7 million were recorded during 2012 versus \$0.6 million of net charge-offs during 2011. There were \$1.3 million of commercial real estate net charge-offs during 2012 versus \$0.7 million recorded in 2011. Lower appraisal valuations made necessary the increased amount of commercial real estate charge-offs. Residential real estate net charge-offs totaled \$0.2 million for 2012 versus \$0.6 million for 2011.

The allowance for loan losses was \$9.0 million at December 31, 2012 and \$8.1 million at December 31, 2011.

The allocation of the allowance for the commercial loan portfolio, which is comprised of commercial real estate and commercial and industrial loans, accounted for approximately 65% or \$5.8 million of the total allowance for loan losses at December 31, 2012. The increase in the commercial real estate allocation reflected information obtained on the collateral value of a participated, non-accrual loan. The increase in the residential real estate allocation at December 31, 2012 resulted from the increase in loans outstanding, as well as qualitative factor adjustments made due to the stagnant economy.

### Non-performing assets

As of December 31, 2012, non-performing assets represented 2.94% of total assets reduced from 3.58% at December 31, 2011, mainly resulting from the reduction of TDR's during 2012. At December 31, 2012, \$1.1 million of corporate bonds consisting of pooled trust preferred securities were on non-accrual status compared to \$1.0 million at December 31, 2011.

Non-performing loans decreased from \$14.2 million on December 31, 2011 to \$13.8 million at December 31, 2012. At December 31, 2011, the over 90 days past due portion was \$0.3 million and was comprised of three loans ranging from \$47 thousand to \$0.2 million, and the non-accrual loan portion numbered 74 loans ranging from \$3 thousand to \$3.4 million. At December 31, 2012, there were seventeen loans to sixteen unrelated borrowers aggregating \$1.7 million in the over 90 day category ranging from less than \$1 thousand to \$0.6 million. Of the seventeen loans past due over 90 days, nine loans, aggregating \$1.0 million were residential mortgages to unrelated borrowers. Of these nine loans, seven of them (aggregating \$0.9 million) made payments prior to year-end and future payments are expected to continue. In addition, two loans to one borrower were secured commercial loans aggregating \$0.6 million. Three payments were received just after the year-end, bringing these loans to near current status. The higher amount of loans past due 90 days was mostly from a \$0.8 million rise in past due residential real estate loans and a \$0.4 million increase in owner-occupied commercial loans. These increases were characteristic of the state of the economy. Of the \$1.7 million outstanding at December 31, 2012, one commercial loan of approximately \$0.1 million was subsequently re-classified to non-accrual status.

At December 31, 2012, there were 65 loans to 57 unrelated borrowers ranging from less than \$1 thousand to \$3.2 million in the non-accrual category. The net decline for the year resulted from a combination of charge offs, transfers to ORE and repayments, partially offset by additions to non-accrual loans.

TDR loans aggregated \$2.2 million at December 31, 2012 which consisted of \$1.1 million of accruing commercial real estate loans, \$1.1 million of non-accrual commercial real estate loans and \$42 thousand of accruing commercial & industrial loans. At December 31, 2011, TDR loans aggregated \$6.7 million which consisted of \$5.3 million of accruing commercial real estate loans, \$1.4 million of non-accrual commercial real estate loans and \$44 thousand of accruing commercial & industrial loans.

At December 31, 2012, the non-accrual loans aggregated \$12.1 million as compared to \$14.0 million at December 31, 2011. The net decrease in the level of non-accrual loans during the period ending December 31, 2012 occurred as follows: additions to the non-accrual loan component of the non-performing assets totaling \$4.5 million were made during the year; these were offset by reductions or payoffs of \$2.0 million, charge-offs of \$2.2 million, \$1.8 million of transfers to ORE and \$0.4 million of loans that returned to performing status. Loans past due 90 days or more and accruing were \$1.7 million at December 31, 2012 and \$0.3 million at December 31, 2011. The ratio of non-performing loans to total loans was 3.12% at December 31, 2012 compared to 3.46% at December 31, 2011.

During 2011, the Company collected approximately \$77 thousand of interest income recognized on the cash basis. There was \$20 thousand in interest income recognized on the cash basis in 2012. If the non-accrual loans that were outstanding as



of December 31, 2012 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of \$0.6 million for the period ended December 31, 2012.

#### Bank premises and equipment, net

Net of depreciation, bank premises and equipment increased \$0.6 million, or 4%, in 2012. The increase was primarily attributable to the purchase of the Company's Moosic and Kingston branches, vehicle replacements, telecommunication, and other system-related upgrades. Prior to the acquisition of the Moosic and Kingston branches, the Company leased these offices from unrelated third parties under terms of operating leases that extended to 2019 and 2028, respectively.

#### Foreclosed assets held-for-sale

Foreclosed assets held-for-sale aggregated \$1.6 million at December 31, 2012 and \$1.2 million at December 31, 2011. As of December 31, 2012, the ORE balance consisted of: nine properties totaling \$0.8 million from 2012 additions; two properties aggregating \$0.2 million acquired in 2011 and one property acquired in 2010 for \$0.6 million. Of the twelve ORE properties as of December 31, 2012, which stemmed from eleven unrelated borrowers, eleven were either listed for sale or pending listing with local realtors and one property was in the process of eviction. In addition, as of December 31, 2012, foreclosed assets held-for-sale included one other repossessed asset, an automobile in the amount of \$6 thousand. There were no other repossessed assets at December 31, 2011.

### Results of Operations

#### Earnings Summary

For the year ended December 31, 2012, the Company produced net income of \$4.9 million, or \$2.14 per diluted share, compared to \$5.0 million, or \$2.28 per diluted share, for the year ended December 31, 2011. For the year ended December 31, 2012, the Company's return on average assets (ROA) and return on average shareholders' equity (ROE) were 0.81% and 8.62% compared to 0.85% and 10.01%, respectively, for the year ended December 31, 2011. Non-interest related revenue generated from residential lending, interchange fees, trust services, transactions producing security gains and lower OTTI charges partially offset a modest decline in net interest income, the cost incurred to improve credit quality, necessitating the need to reinforce the allowance for loans losses by increasing the provision for loan losses, more ORE related expenses due to a higher volume of foreclosure activity, higher marketing expenses, salary and employee benefit costs and to a non-recurring fee incurred to reduce high-costing long-term debt. The decline in ROA was caused by slightly lower (\$0.1 million) net income and increased average assets while the decline in ROE was caused mostly by a larger level of average shareholders' equity, strengthened by improvement in other comprehensive income (OCI) - most of the improvement occurring in the first quarter of 2012.

#### Net interest income

The FOMC had not adjusted the short-term federal funds rate which remained near zero percent during 2012 and 2011. In addition, at 3.25%, the national prime interest rate remained constant throughout 2012 - at the same level as 2011. In 2012, the Company's net interest margin, like other banks, declined due principally to the impact of the prolonged low interest rate environment.

The Company's overall cost of funds, which includes the effect of adding non-interest bearing DDA balances as a no-cost funding source declined 27 basis points, from 0.88% to 0.61%, for the year ended December 31, 2011 and 2012, respectively. Similar to the rate paid on interest-bearing liabilities, the cost of funds declined steadily over the past several years. The yield on earning-assets declined 36 basis points from 2011 to 2012 and similarly has been declining steadily over the past several years and the speed of decline outpaced deposit rate reductions.

Interest expense decreased \$1.4 million, or 30%, from \$4.7 million in 2011 to \$3.3 million in 2012. Though the Company recorded a \$0.4 million net increase in average interest-bearing deposits, interest expense on deposits declined \$1.2 million in 2012 compared to 2011 caused by a 30 basis point decline on average rates paid. The 30 basis point decline equated to approximately \$1.0 million of the reduction in interest expense. Interest expense on borrowed funds declined \$0.2 million during 2012. The lower interest from borrowings was from the \$5.0 million reduction in long-term debt during 2012. The advance with the FHLB carried an interest rate of 3.61%.

The resulting performance of the mix of the Company's interest-sensitive assets and liabilities and the impact of market rates in 2012, combined with pay-off of high-cost long-term debt, caused net interest income to decrease \$0.2 million, or less than 1%, compared to 2011. On a tax-equivalent basis, the net interest rate spread decreased five basis points from 3.67% to 3.62% and the tax-equivalent margin decreased nine basis points from 3.89% in 2011 to 3.80% in 2012.

#### Provision for loan losses

Provisions for loan losses of \$3.3 million were made for the year ended December 31, 2012 as compared to \$1.8 million for the December 31, 2011 year. The increase in the provision during the 12 months ended December 31, 2012, resulted from the effect of the charge offs on historical loss allocations, increased provisions for historical loss percentages, increased qualitative factor adjustments for current economic conditions and providing \$0.8 million of additional specific loan loss reserves for a participated non-accrual commercial real estate loan up to a newly determined estimated loss.

#### Other income

For the year ended December 31, 2012, the Company recorded net other (non-interest) income of \$7.5 million, an increase of \$1.8 million, or 32%, compared to non-interest income of \$5.7 million recorded during the year ended December 31, 2011. The improvement in 2012 was principally from increased gains from the sales of mortgage and SBA loans of \$1.0 million. A higher volume of residential mortgage lending activity helped boost gains from sales and also generate \$0.2 million of incremental residential mortgage loan service fees. Supplementing the improvement in 2012 included: \$0.3 million more in securities gains; \$0.2 million more fees from growth in the trust department; \$0.1 million of higher interchange fees and a lower amount, or \$0.1 million, of OTTI charges incurred from impaired pooled trust preferred securities. These items were partially offset by net losses on sales and charges for write-downs on foreclosed assets of \$160 thousand during 2012 compared to \$20 thousand during 2011.

#### Other expenses

For the year ended December 31, 2012, other operating expenses increased \$0.4 million, or 2%, compared to the year ended December 31, 2011. Salary and employee benefits increased \$0.3 million, or 4%, due to a larger work force, including the hiring of a chief operating officer, and the implementation of normal merit increases of salaries and market benefit increases. Compared to 2011, the average number of full-time equivalent employees increased from 159 to 162 in 2012. The \$0.2 million, or 5%, decrease in premises and equipment was due to lower depreciation expense stemming from fully depreciated furniture and equipment. In addition, the Company incurred less expense related to facility upkeep, utilities and had lower lease expenses, the latter associated with the acquisition of the two previously leased branch offices. These items were partially offset by higher equipment maintenance from implementing the mobile banking technology at the end of 2011 and higher software maintenance costs. The primary reasons that advertising and marketing expenses increased by \$0.2 million, or 18%, were expenses for a branding campaign designed to build additional business relationships, higher expense associated with giveaways at all of the Company's branch offices and the cost incurred for promotional items in conjunction with this year's checking account campaign. A change to the FDIC insurance assessment, in the third quarter of 2011, resulted in a lower base upon which the assessment was determined which resulted in a \$0.1 million, or 18%, decline in 2012's charge compared to 2011. The increase in ORE expenses of \$63 thousand, or 59%, was due to higher balances of and more ORE properties, on average, during 2012 compared to 2011. The \$0.1 million, or 7%, increase in other expense category was caused mostly by a non-recurring prepayment fee of \$0.2 million from the payoff of the \$5.0 million, 3.61%, FHLB advance in the first quarter of 2012.

The ratios of non-interest expense less non-interest income to average assets, known as the expense ratio, at December 31, 2012 and 2011 were 1.78% and 2.04%, respectively. The expense ratio, which excludes OTTI and other securities transactions and nonrecurring expenses, declined or improved due to a higher level of non-interest earnings primarily from mortgage banking activity, relatively stable operating expenses and to a much lesser extent, a larger average balance sheet.

#### Provision for income taxes

The Company's effective income tax rate approximated 24.1% in 2012 and 24.6% 2011. The difference between the effective rate and the enacted corporate rate of 34% is mostly to the effect of tax exempt income.

#### Off-Balance Sheet Arrangements and Contractual Obligations

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 following table presents, as of December 31, 2013, the Company's significant determinable contractual obligations and significant commitments by payment date. The payment amounts represent those amounts contractually due to the recipient, excluding interest:

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| (dollars in thousands)      | One year<br>or less | Over one<br>year<br>through<br>three<br>years | Over<br>three<br>years<br>through<br>five<br>years | Over<br>five<br>years | Total      |
|-----------------------------|---------------------|---|--|-----------------------|------------|
| Contractual obligations:    |                     |   |  |                       |            |
| Certificates of deposit (1) | \$ 56,003           | \$ 49,075                                     | \$ 6,505   | \$ 2,116              | \$ 113,699 |
| Long-term debt              | -                   | 16,000  | -  | -                     | 16,000     |
| Short-term borrowings       | 8,642               | -   | -  | -                     | 8,642      |
| Operating leases            | 218                 | 361   | 364  | 2,700                 | 3,643      |
| Commitments:                |                     |   |  |                       |            |
| Letters of credit           | 2,092               | 5,060   | -  | 566                   | 7,718      |
| Loan commitments (2)        | 18,183              | -   | -  | -                     | 18,183     |
| Total                       | \$ 85,138           | \$ 70,496                                     | \$ 6,869   | \$ 5,382              | \$ 167,885 |

(1) Includes certificates in the CDARS program.

(2) Available credit to borrowers in the amount of \$71.6 million is excluded from the above table since, by its nature, the borrowers may not have the need for additional funding, and, therefore, the credit may or may not be disbursed by the Company.

#### Related Party Transactions

Information with respect to related parties is contained in Note 16, "Related Party Transactions", within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

#### Impact of Accounting Standards and Interpretations

Information with respect to the impact of accounting standards is contained in Note 19, "Recent Accounting Pronouncements", within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

#### Impact of Inflation and Changing Prices

The consolidated financial statements and notes thereto presented herein have been prepared in accordance with U.S. GAAP, which requires the measurement of the Company's financial condition and results of operations in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of our operations. Unlike industrial businesses, most all of the Company's assets and liabilities are monetary in nature. As a result, interest rates have a greater impact on our performance than do the effects of general levels of inflation as interest rates do not necessarily move in the same direction or, to the same extent, as the price of goods and services.

#### Capital Resources

The Company is 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 financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classification are also subject to qualitative judgments by the regulators about components, asset risk-weightings and other factors.

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with prescribed risk-weightings. The appropriate risk-weighting, pursuant to regulatory guidelines, require an increase in the weights applied to securities that are rated below investment grade, thereby inflating the total risk-weighted assets. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and certain off-balance sheet items. 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%. The Company's Total Risk Adjusted Capital Ratio was 15.2%, Tier I Capital Ratio was 13.9% and Leverage Ratio was 10.3% as of December 31, 2013. Additional information with respect to capital requirements is contained in Note 15, "Regulatory Matters", within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

During the year-ended December 31, 2013, total shareholders' equity increased \$7.1 million, or 12%, due principally from the \$7.1 million in net income added into retained earnings and the \$1.0 million, after-tax improvement in the net unrealized gain position in the Company's investment portfolio. Capital was further enhanced by \$1.5 million from investments in the Company's common stock via the Employee Stock Purchase and Dividend Reinvestment Plans. These items were partially offset by the \$2.6 million of cash dividends declared on the Company's common stock. The Company's sources (uses) of capital during the previous five years are indicated below:

|                        | Cash                    | DRP<br>and<br>ESPP    | Purchase<br>of<br>treasury<br>stock | Changes<br>in<br>OCI and<br>retained<br>other | Capital                |
|------------------------|-------------------------|-----------------------|-------------------------------------|---|------------------------|
| (dollars in thousands) | Net<br>income<br>(loss) | dividends<br>declared | Earnings<br>retained<br>(used)      | infusion                                      | changes<br>(used)      |
| 2013                   | \$ 7,122                | \$ (2,602)            | \$ 4,520                            | \$ 1,479                                      | \$ - \$ 1,115 \$ 7,114 |
| 2012                   | 4,902                   | (2,283)               | 2,619                               | 1,342   | - 1,361 5,322          |
| 2011                   | 5,045                   | (2,210)               | 2,835                               | 1,284   | - 2,731 6,850          |
| 2010                   | (3,204)                 | (2,137)               | (5,341)                             | 1,056   | - 5,384 1,099          |
| 2009                   | (1,400)                 | (2,078)               | (3,478)                             | 864   | (57) (615) (3,286)     |

As of December 31, 2013, the Company reported a net unrealized gain position of \$1.2 million, net of tax, from the securities AFS portfolio compared to a net unrealized gain of \$0.2 million as of December 31, 2012. During the fourth quarter of 2013, the Company sold its portfolio of pooled trust preferred securities (PreTSLs), that was recorded at a net unrealized loss of \$3.0 million, net of tax, at December 31, 2012, and recognized a \$2.9 million gain on the sale. Excluding the \$3.0 million unrealized loss, the net unrealized gain declined almost \$2.0 million from December 31, 2012 to December 31, 2013. Management believes that volatility in fair value of the Company's securities is due to changes in interest rates and not deterioration in the creditworthiness of the issuers. When, U.S. Treasury rates rise, investment securities' pricing declines and fair values of investment securities also decline. With the yield curve slowly increasing at the mid- to long-range, the Company expects pricing in the bond portfolio to continue to decline. Bond prices move inversely to the movement of interest rates. As such, there is no assurance that future realized and unrealized losses will not be recognized from the Company's portfolio of investment securities. To help maintain a healthy capital position, the Company expects to continue to issue stock to participants in the DRP and ESPP plans. These two plans have been a consistent source of capital from the Company's loyal employees and shareholders and their participation in these plans will continue to help strengthen the Company's balance sheet. Beginning in 2009, the Company's board of directors had allowed a benefit to our loyal shareholders as a discount on the purchase price for shares issued directly from the Company through the DRP and voluntary cash feature. During the first quarter of 2014, the DRP was amended to discontinue a portion of the discount on the voluntary cash feature as the board of directors had determined that the Company's capital position has achieved sufficient levels.

See the section entitled "Supervision and Regulation", below for a discussion on regulatory capital changes and other recent enactments, including a summary of the recently issued federal banking agencies final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

## 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 utilizes a contingency funding plan (CFP) that sets a framework for handling liquidity issues in the event circumstances arise which the Company deems to be less than normal. To accomplish this, the Company established guidelines for identifying, measuring, monitoring and managing the resolution of potentially serious liquidity crises. The Company's CFP outlines required monitoring tools, acceptable alternative funding sources and required actions during various liquidity scenarios. Thus, the Company has implemented a proactive means for the measurement and resolution for handling potentially significant adverse liquidity conditions. At least quarterly, the CFP monitoring tools, current liquidity position and monthly projected liquidity sources and uses are presented and reviewed by the Company's ALCO. As of December 31, 2013 the Company had not experienced any adverse issues that would give rise to its inability to raise liquidity in an emergency situation.

During the twelve months ended December 31, 2013, the Company used \$8.6 million of cash. During the period, the Company grew its loan portfolio from net sales of loans HFS proceeds, growth in deposits, and net cash inflow from



scheduled maturity, prepayment and sales of investment securities, operations and available cash on hand. The growth in the loan portfolio occurred in all sectors with the commercial portfolio leading the growth. The Company expects to continue or grow the commercial loan portfolio in 2014 using growth in deposits, repos and operations. The seasonal nature of deposit balances from municipalities and other public funding sources requires the Company to be prepared for the inherent volatility and the unpredictable timing of cash outflow from this customer base. The CFP is a tool to help the Company ensure that alternative funding sources are available to meet its liquidity needs.

As of December 31, 2013, the Company maintained \$13.2 million in cash and cash equivalents and \$98.2 million of investments AFS and loans HFS. Also as of December 31, 2013, the Company had approximately \$159.4 million available to borrow from the FHLB, \$21.0 million from correspondent banks, \$27.6 million from the FRB and \$32.0 million from the CDARS program. The combined total of \$351.4 million represented 56% of total assets at December 31, 2013. Management believes this level of liquidity to be strong and adequate to support current operations.

For a discussion on the Company's significant determinable contractual obligations and significant commitments, see "Off-Balance Sheet Arrangements and Contractual Obligations," above.

#### 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 December 31, 2013, the Company maintained a one-year cumulative gap of positive (asset sensitive) \$76.4 million, or 12%, 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.

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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 reflects the re-pricing of the balance sheet or “gap” position at December 31, 2013:

| (dollars in thousands)                        | Three<br>months<br>or less | More than<br>three<br>months to<br>twelve<br>months | More than<br>one year<br>to three<br>years | More than<br>three years | Total      |
|---|----------------------------|---|--|--------------------------|------------|
| Cash and cash equivalents                     | \$ 45                      | \$ -  | \$ -                                       | \$ 13,173                | \$ 13,218  |
| Investment securities (1)(2)                  | 4,050                      | 9,506   | 23,077                                     | 63,430                   | 100,063    |
| Loans and leases(2)                           | 178,222                    | 64,573  | 111,038                                    | 116,300                  | 470,133    |
| Fixed and other assets                        | -                          | 10,402  | -  | 30,009                   | 40,411     |
| Total assets                                  | \$ 182,317                 | \$ 84,481   | \$ 134,115                                 | \$ 222,912               | \$ 623,825 |
| Total cumulative assets                       | \$ 182,317                 | \$ 266,798  | \$ 400,913                                 | \$ 623,825               |            |
| Non-interest-bearing transaction deposits (3) | \$ -                       | \$ 12,305   | \$ 33,778                                  | \$ 76,836                | \$ 122,919 |
| Interest-bearing transaction deposits (3)     | 94,590                     | 18,904  | 122,245                                    | 57,341                   | 293,080    |
| Certificates of deposit                       | 12,696                     | 43,309  | 49,075                                     | 8,619                    | 113,699    |
| Repurchase agreements                         | 6,170                      | -   | -  | -                        | 6,170      |
| Short-term borrowings                         | 2,472                      | -   | -  | -                        | 2,472      |
| Long-term debt                                | -                          | -   | 16,000                                     | -                        | 16,000     |
| Other liabilities                             | -                          | -   | -  | 3,425                    | 3,425      |
| Total liabilities                             | \$ 115,928                 | \$ 74,518   | \$ 221,098                                 | \$ 146,221               | \$ 557,765 |
| Total cumulative liabilities                  | \$ 115,928                 | \$ 190,446  | \$ 411,544                                 | \$ 557,765               |            |
| Interest sensitivity gap                      | \$ 66,389                  | \$ 9,963  | \$ (86,983)                                | \$ 76,691                |            |
| Cumulative gap                                | \$ 66,389                  | \$ 76,352   | \$ (10,631)                                | \$ 66,060                |            |
| Cumulative gap to total assets                | 10.6%                      | 12.2%   | -1.7%                                      | 10.6%                    |            |

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

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

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

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

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

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

The following table illustrates the simulated impact of an immediate 200 basis points upward or downward movement in interest rates on net interest income, net income and the change in the economic value (portfolio equity). This analysis assumed that interest-earning asset and interest-bearing liability levels at December 31, 2013 remained constant. The impact of the rate movements was developed by simulating the effect of the rate change over a twelve-month period from the December 31, 2013 levels:

|   | % change      |               |
|---|---------------|---------------|
|   | Rates<br>+200 | Rates<br>-200 |
| Earnings at risk:                                     |               |               |
| Net interest income                                   | 6.7           | (2.5)%        |
| Net income  | 19.2          | (7.0)         |
| Economic value at risk:                               |               |               |
| Economic value of equity                              | (13.7)        | (5.6)         |
| Economic value of equity as a percent of total assets | (1.6)         | (0.6)         |

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 December 31, 2013, the Company's risk-based capital ratio was 15.2%.

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

| (dollars in thousands)             | Net                |                | %<br>variance |
|------------------------------------|--------------------|----------------|---------------|
|                                    | interest<br>income | \$<br>variance |               |
| Simulated change in interest rates |                    |                |               |
| +200 basis points                  | \$ 22,716          | \$ 1,417       | 6.7 %         |
| +100 basis points                  | 21,839             | 540            | 2.5           |
| Flat rate                          | 21,299             | -              | -             |
| -100 basis points                  | 21,180             | (119)          | (0.6)         |
| -200 basis points                  | 20,774             | (525)          | (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.

#### Supervision and Regulation

The following is a brief summary of the regulatory environment in which the Company and the Bank operate and is not designed to be a complete discussion of all statutes and regulations affecting such operations, including those statutes and regulations specifically mentioned herein. Changes in the laws and regulations applicable to the Company and the Bank can affect the operating environment in substantial and unpredictable ways. We cannot accurately predict whether legislation will ultimately be enacted, and if enacted, the ultimate effect that legislation or implementing regulations would have on our financial condition or results of operations. While banking regulations are material to the operations of the Company and the Bank, it should be noted that supervision, regulation and examination of the Company and the Bank are intended primarily for the protection of depositors, not shareholders.

## Recent Legislation and Rulemaking

### Regulatory Capital Changes

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

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

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

Under the proposed rules, accumulated other comprehensive income (AOCI) would have been included in a banking organization's common equity tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The opt-out election must be made in the first call report or FR Y-9 series report that is filed after the financial institution becomes subject to the final rule.

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

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

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

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

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

#### JOBS Act

In 2012, the Jumpstart Our Business Startups Act (the "JOBS Act") became law. The JOBS Act is aimed at facilitating capital raising by smaller companies and banks and bank holding companies by implementing the following changes:

- raising the threshold requiring registration under the Securities Exchange Act of 1934 (the "Exchange Act") for banks and bank holdings companies from 500 to 2,000 holders of record;
- raising the threshold for triggering deregistration under the Exchange Act for banks and bank holding companies from 300 to 1,200 holders of record;
- raising the limit for Regulation A offerings from \$5 million to \$50 million per year and exempting some Regulation A offerings from state blue sky laws;
- permitting advertising and general solicitation in Rule 506 and Rule 144A offerings;
- allowing private companies to use "crowdfunding" to raise up to \$1 million in any 12-month period, subject to certain conditions; and



- creating a new category of issuer, called an "Emerging Growth Company," for companies with less than \$1 billion in annual gross revenue, which will benefit from certain changes that reduce the cost and burden of carrying out an equity IPO and complying with public company reporting obligations for up to five years.

While the JOBS Act is not expected to have any immediate application to the Company, management will continue to monitor the implementation rules for potential effects which might benefit the Company.

#### Dodd-Frank Wall Street Reform and Consumer Protection Act.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became law. Dodd-Frank is intended to effect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank creates a new Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators new authority to take control of and liquidate financial firms. Dodd-Frank additionally creates a new independent federal regulator to administer federal consumer protection laws. Dodd-Frank is expected to have a significant impact on our business operations as its provisions take effect. It is difficult to predict at this time what specific impact Dodd-Frank and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense. Among the provisions that are likely to affect us and the community banking industry are the following:

**Holding Company Capital Requirements.** Dodd-Frank requires the Federal Reserve to apply consolidated capital requirements to bank holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, pooled trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by a bank holding company with less than \$15 billion in assets. Dodd-Frank additionally requires that bank regulators issue countercyclical capital requirements so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

**Deposit Insurance.** Dodd-Frank permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to \$250,000 per depositor, and extended unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. Dodd-Frank also broadens the base for FDIC insurance assessments. Assessments will now be based on the average consolidated total assets less tangible equity capital of a financial institution. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Dodd-Frank also eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

**Corporate Governance.** Dodd-Frank requires publicly traded companies to give shareholders a non-binding vote on executive compensation at least every three years, a non-binding vote regarding the frequency of the vote on executive compensation at least every six years, and a non-binding vote on "golden parachute" payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders. The SEC has finalized the rules implementing these requirements. Additionally, Dodd-Frank directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of \$1.0 billion, regardless of whether the company is publicly traded. Dodd-Frank also gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

**Prohibition Against Charter Conversions of Troubled Institutions.** Dodd-Frank prohibits a depository institution from converting from a state to federal charter or vice versa while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the

enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the conversion application with its current federal regulator which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating thereto.

**Interstate Branching.** Dodd-Frank authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks will be able to enter new markets more freely.

**Limits on Interstate Acquisitions and Mergers.** Dodd-Frank precludes a bank holding company from engaging in an interstate acquisition – the acquisition of a bank outside its home state – unless the bank holding company is both well capitalized and well managed. Furthermore, a bank may not engage in an interstate merger with another bank headquartered in another state unless the surviving institution will be well capitalized and well managed. The previous standard in both cases was adequately capitalized and adequately managed.

**Limits on Interchange Fees.** Dodd-Frank amends the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card

issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. The interchange rules became effective on October 1, 2011.

Consumer Financial Protection Bureau. Dodd-Frank creates a new, independent federal agency called the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. Dodd-Frank authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, Dodd-Frank will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a "qualified mortgage" as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

#### Future Federal and State Legislation and Rulemaking

From time-to-time, various types of federal and state legislation have been proposed that could result in additional regulations and restrictions on the business of the Company and the Bank. We cannot predict whether legislation will be adopted, or if adopted, how the new laws would affect our business. As a consequence, we are susceptible to legislation that may increase the cost of doing business. Management believes that the effect of any current legislative proposals on the liquidity, capital resources and the results of operations of the Company and the Bank will be minimal.

It is possible that there will be regulatory proposals which, if implemented, could have a material effect upon our liquidity, capital resources and results of operations. In addition, the general cost of compliance with numerous federal and state laws does have, and in the future may have, a negative impact on our results of operations. As with other banks, the status of the financial services industry can affect the Bank. Consolidations of institutions are expected to continue as the financial services industry seeks greater efficiencies and market share. Bank management believes that such consolidations may enhance the Bank's competitive position as a community bank.

#### Future Outlook

The Company is highly impacted by local economic factors that could influence the performance and strength of our loan portfolios. Though the national economy has shown signs of improvement, the local operating environment continues to be challenging. Short-term interest rates have been at or near historic lows and we expect them to remain low for the near-term. Long-term interest rates moved higher during the second half of 2013 and are higher than a year ago, but have been somewhat volatile over the past few months. The national prime rate has held steady at 3.25% for several years. The local employment statistics continue to trail the national figures both remaining stubbornly high. Softness persists in the residential housing market and competition for commercial loans is fierce.

In addition to the challenging economic environment, regulatory oversight has changed significantly in recent years. As described in more detail in "supervision and regulation" section above, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The rules revise the quantity and quality of required minimum risk-based and leverage capital requirements and revise the calculation of risk-weighted assets.

The Company is prepared to face the challenges ahead. Progress in the improvement in asset quality will not wane. Our conservative approach to loan underwriting will help keep non-performing assets at bay. The Company will avail itself to the positively sloped yield curve by prudently taking on interest rate risk to enhance financial performance. We will grow commercial loans and business sector non-interest bearing deposits to stabilize of improve margin and we will continue to prepare for the phase-in of the new regulatory standards and related rules promulgated by the Dodd-Frank Act.

**Item 7A: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information required by 7A is set forth at Item 7, under “Liquidity” and “Management of interest rate risk and market risk analysis,” contained within management’s discussion and analysis of financial condition and results of operations and incorporated herein by reference.

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Item 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

Fidelity D & D Bancorp, Inc.:

We have audited the accompanying consolidated balance sheets of Fidelity D & D Bancorp, Inc. and Subsidiary as of December 31, 2013 and 2012 and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Fidelity D & D Bancorp, Inc. and Subsidiary as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America.

/s/ ParenteBeard LLC

ParenteBeard LLC

Wilkes-Barre, Pennsylvania

March 18, 2014

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

| (dollars in thousands)  | As of December 31, |                   |
|---|--------------------|-------------------|
|   | 2013               | 2012              |
| <b>Assets:</b>  |                    |                   |
| Cash and due from banks   | \$ 13,197          | \$ 12,657         |
| Interest-bearing deposits with financial institutions   | 21                 | 9,189             |
| <b>Total cash and cash equivalents</b>  | <b>13,218</b>      | <b>21,846</b>     |
| Available-for-sale securities   | 97,246             | 100,441           |
| Held-to-maturity securities   | 177                | 289               |
| Federal Home Loan Bank stock  | 2,640              | 2,624             |
| Loans and leases, net (allowance for loan losses of \$8,928 in 2013; \$8,972 in 2012)   | 469,216            | 424,584           |
| Loans held-for-sale (fair value \$937 in 2013, \$10,824 in 2012)  | 917                | 10,545            |
| Foreclosed assets held-for-sale   | 2,086              | 1,607             |
| Bank premises and equipment, net  | 13,602             | 14,127            |
| Cash surrender value of bank owned life insurance   | 10,402             | 10,065            |
| Accrued interest receivable   | 2,068              | 1,985             |
| Other assets  | 12,253             | 13,412            |
| <b>Total assets</b>   | <b>\$ 623,825</b>  | <b>\$ 601,525</b> |
| <b>Liabilities:</b>   |                    |                   |
| <b>Deposits:</b>  |                    |                   |
| Interest-bearing  | \$ 406,779         | \$ 388,625        |
| Non-interest-bearing  | 122,919            | 126,035           |
| <b>Total deposits</b>   | <b>529,698</b>     | <b>514,660</b>    |
| Accrued interest payable and other liabilities  | 3,425              | 3,863             |
| Short-term borrowings   | 8,642              | 8,056             |
| Long-term debt  | 16,000             | 16,000            |
| <b>Total liabilities</b>  | <b>557,765</b>     | <b>542,579</b>    |
| <b>Shareholders' equity:</b>  |                    |                   |
| 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; 2,391,617 in 2013; and 2,323,248 in 2012) | 25,302             | 23,711            |
| Retained earnings   | 39,519             | 34,999            |
| Accumulated other comprehensive income  | 1,239              | 236               |
| <b>Total shareholders' equity</b>   | <b>66,060</b>      | <b>58,946</b>     |

|  |            |            |
|--|------------|------------|
| Total liabilities and shareholders' equity | \$ 623,825 | \$ 601,525 |
|--|------------|------------|

See notes to consolidated financial statements



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

## Consolidated Statements of Income

(dollars in thousands except per share data)

|  | 2013      | 2012      | 2011      |
|--|-----------|-----------|-----------|
| Interest income:   |           |           |           |
| Loans and leases:  |           |           |           |
| Taxable  | \$ 21,344 | \$ 21,237 | \$ 22,420 |
| Nontaxable   | 474       | 462       | 486       |
| Interest-bearing deposits with financial institutions  | 22        | 65        | 101       |
| Investment securities:   |           |           |           |
| U.S. government agency and corporations  | 732       | 944       | 1,328     |
| States and political subdivisions (nontaxable)   | 1,197     | 1,212     | 1,203     |
| Other securities   | 83        | 73        | 64        |
| Federal funds sold   | 1         | 1         | 1         |
| Total interest income  | 23,853    | 23,994    | 25,603    |
| Interest expense:  |           |           |           |
| Deposits   | 2,081     | 2,439     | 3,672     |
| Securities sold under repurchase agreements  | 22        | 32        | 52        |
| Other short-term borrowings and other  | 12        | 1         | 1         |
| Long-term debt   | 853       | 882       | 1,036     |
| Total interest expense   | 2,968     | 3,354     | 4,761     |
| Net interest income  | 20,885    | 20,640    | 20,842    |
| Provision for loan losses  | 2,550     | 3,250     | 1,800     |
| Net interest income after provision for loan losses  | 18,335    | 17,390    | 19,042    |
| Other income:  |           |           |           |
| Service charges on deposit accounts  | 1,863     | 1,787     | 1,777     |
| Interchange fees   | 1,222     | 1,090     | 972       |
| Fees from trust fiduciary activities   | 630       | 611       | 420       |
| Fees from financial services   | 558       | 519       | 556       |
| Service charges on loans   | 899       | 1,022     | 721       |
| Fees and other revenue   | 472       | 357       | 325       |
| Earnings on bank-owned life insurance  | 337       | 325       | 315       |
| Gain (loss) on sale, recovery, or disposal of:   |           |           |           |
| Loans  | 1,402     | 1,766     | 799       |
| Investment securities  | 3,168     | 328       | 63        |
| Premises and equipment   | (10)      | (17)      | (2)       |
| Impairment losses on investment securities:  |           |           |           |
| Other-than-temporary impairment on investment securities   | (61)      | (259)     | (519)     |
| Non-credit-related losses on investment securities not expected to be sold (recognized in other comprehensive income (loss)) | 61        | 123       | 273       |
| Net impairment losses on investment securities   | -         | (136)     | (246)     |
| Total other income   | 10,541    | 7,652     | 5,700     |
| Other expenses:  |           |           |           |
| Salaries and employee benefits   | 9,363     | 9,104     | 8,786     |
| Premises and equipment   | 3,345     | 3,448     | 3,633     |
| Advertising and marketing  | 1,223     | 1,179     | 1,003     |
| Professional services  | 1,303     | 1,305     | 1,289     |
| FDIC assessment  | 464       | 505       | 617       |

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|                                  |          |          |          |
|----------------------------------|----------|----------|----------|
| Loan collection                  | 514      | 609      | 610      |
| Other real estate owned          | 603      | 313      | 115      |
| Office supplies and postage      | 461      | 429      | 426      |
| Automated transaction processing | 590      | 404      | 338      |
| Other                            | 1,253    | 1,285    | 1,235    |
| Total other expenses             | 19,119   | 18,581   | 18,052   |
| Income before income taxes       | 9,757    | 6,461    | 6,690    |
| Provision for income taxes       | 2,635    | 1,559    | 1,645    |
| Net income                       | \$ 7,122 | \$ 4,902 | \$ 5,045 |
| Per share data:                  |          |          |          |
| Net income - basic               | \$ 3.03  | \$ 2.14  | \$ 2.28  |
| Net income - diluted             | \$ 3.02  | \$ 2.14  | \$ 2.28  |
| Dividends                        | \$ 1.10  | \$ 1.00  | \$ 1.00  |

See notes to consolidated financial statements

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

| (dollars in thousands)  | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2013                     | 2012     | 2011     |
| Net income  | \$ 7,122                 | \$ 4,902 | \$ 5,045 |
| Other comprehensive income, before tax:   |                          |          |          |
| Unrealized holding (loss) gain on available-for-sale securities                     | (946)                    | 1,724    | 3,626    |
| Reclassification adjustment for net gains realized in income                        | (63)                     | (328)    | (63)     |
| Net impairment losses on investment securities                                      | -                        | 136      | 246      |
| Net unrealized (loss) gain  | (1,009)                  | 1,532    | 3,809    |
| Tax effect  | 343                      | (521)    | (1,295)  |
| Unrealized (loss) gain, net of tax  | (666)                    | 1,011    | 2,514    |
| Non-credit-related impairment gain on investment securities not expected to be sold | 5,634                    | 507      | 292      |
| Reclassification adjustment for net gains realized in income                        | (3,105)                  | -        | -        |
| Net non-credit-related impairment gain on investment securities                     | 2,529                    | 507      | 292      |
| Tax effect  | (860)                    | (172)    | (99)     |
| Non-credit-related impairment gain on investment securities, net of tax             | 1,669                    | 335      | 193      |
| Other comprehensive income, net of tax  | 1,003                    | 1,346    | 2,707    |
| Total comprehensive income, net of tax  | \$ 8,125                 | \$ 6,248 | \$ 7,752 |

See notes to consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary  
 Consolidated Statements of Changes in Shareholders' Equity  
 Years ended December 31, 2013, 2012 and 2011

| (dollars in thousands)  | Capital stock |           | Retained  | Accumulated<br>other<br>comprehensive | Total     |
|---|---------------|-----------|-----------|---------------------------------------|-----------|
|   | Shares        | Amount    | earnings  | income (loss)                         |           |
| Balance, December 31, 2010  | 2,178,028     | \$ 21,046 | \$ 29,545 | \$ (3,817)                            | \$ 46,774 |
| Net income  |               |           | 5,045     |                                       | 5,045     |
| Other comprehensive income  |               |           |           | 2,707                                 | 2,707     |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 4,801         | 67        |           |                                       | 67        |
| Issuance of common stock through Dividend Reinvestment Plan                                   | 71,713        | 1,217     |           |                                       | 1,217     |
| Stock-based compensation expense  |               | 24        |           |                                       | 24        |
| Cash dividends declared   |               |           | (2,210)   |                                       | (2,210)   |
| Balance, December 31, 2011  | 2,254,542     | \$ 22,354 | \$ 32,380 | \$ (1,110)                            | \$ 53,624 |
| Net income  |               |           | 4,902     |                                       | 4,902     |
| Other comprehensive income  |               |           |           | 1,346                                 | 1,346     |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 3,874         | 67        |           |                                       | 67        |
| Issuance of common stock through Dividend Reinvestment Plan                                   | 64,832        | 1,275     |           |                                       | 1,275     |
| Stock-based compensation expense  |               | 15        |           |                                       | 15        |
| Cash dividends declared   |               |           | (2,283)   |                                       | (2,283)   |
| Balance, December 31, 2012  | 2,323,248     | \$ 23,711 | \$ 34,999 | \$ 236                                | \$ 58,946 |
| Net income  |               |           | 7,122     |                                       | 7,122     |
| Other comprehensive income  |               |           |           | 1,003                                 | 1,003     |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 4,256         | 78        |           |                                       | 78        |
| Issuance of common stock through Dividend Reinvestment Plan                                   | 63,979        | 1,401     |           |                                       | 1,401     |
| Issuance of common stock from vested restricted share grants through stock compensation plans | 134           |           |           |                                       |           |
| Stock-based compensation expense  |               | 112       |           |                                       | 112       |
| Cash dividends declared   |               |           | (2,602)   |                                       | (2,602)   |
| Balance, December 31, 2013  | 2,391,617     | \$ 25,302 | \$ 39,519 | \$ 1,239                              | \$ 66,060 |

See notes to consolidated financial statements



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

| (dollars in thousands)  | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2013                     | 2012     | 2011     |
| Cash flows from operating activities:   |                          |          |          |
| Net income  | \$ 7,122                 | \$ 4,902 | \$ 5,045 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |          |          |
| Depreciation, amortization and accretion  | 3,323                    | 3,473    | 3,242    |
| Provision for loan losses   | 2,550                    | 3,250    | 1,800    |
| Deferred income tax expense (benefit)   | 6,166                    | (452)    | (115)    |
| Stock-based compensation expense  | 112                      | 15       | 24       |
| Proceeds from sale of loans held-for-sale   | 83,928                   | 83,766   | 46,359   |
| Originations of loans held-for-sale   | (70,436)                 | (85,293) | (45,096) |
| Earnings on bank-owned life insurance   | (337)                    | (325)    | (315)    |
| Net gain from sales of loans  | (1,402)                  | (1,766)  | (799)    |
| Net gain from sales of investment securities                                      | (2,979)                  | (251)    | (49)     |
| Net loss on sale and write-down of foreclosed assets held-for-sale                | 418                      | 160      | 20       |
| Loss on disposal of equipment   | 10                       | 17       | 2        |
| Other-than-temporary impairment on securities                                     | -                        | 136      | 246      |
| Change in:  |                          |          |          |
| Accrued interest receivable   | (89)                     | 69       | 130      |
| Other assets  | (4,928)                  | (297)    | 591      |
| Accrued interest payable and other liabilities                                    | (398)                    | (2,860)  | 3,996    |
| Net cash provided by operating activities   | 23,060                   | 4,544    | 15,081   |
| Cash flows from investing activities:   |                          |          |          |
| Held-to-maturity securities:  |                          |          |          |
| Proceeds from maturities, calls and principal pay-downs                           | 112                      | 100      | 101      |
| Available-for-sale securities:  |                          |          |          |
| Proceeds from sales   | 17,651                   | 3,571    | 2,757    |
| Proceeds from maturities, calls and principal pay-downs                           | 25,684                   | 32,542   | 30,722   |
| Purchases   | (37,109)                 | (27,751) | (55,964) |
| (Increase ) decrease FHLB stock   | (16)                     | 1,076    | 843      |
| Net (increase) decrease in loans and leases                                       | (52,956)                 | (34,955) | 1,798    |
| Acquisition of bank premises and equipment  | (1,038)                  | (1,979)  | (418)    |
| Proceeds from sale of foreclosed assets held-for-sale                             | 1,483                    | 1,067    | 891      |
| Net cash used by investing activities   | (46,189)                 | (26,329) | (19,270) |
| Cash flows from financing activities:   |                          |          |          |

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|   |           |           |           |
|---|-----------|-----------|-----------|
| Net increase (decrease) in deposits                     | 15,038    | (1,142)   | 33,354    |
| Net increase (decrease) in short-term borrowings        | 586       | (1,452)   | 959       |
| Repayment of long-term debt                             | -         | (5,000)   | -         |
| Proceeds from employee stock purchase plan participants | 78        | 67        | 67        |
| Dividends paid, net of dividends reinvested             | (1,596)   | (1,493)   | (1,478)   |
| Proceeds from dividend reinvestment plan participants   | 395       | 486       | 485       |
| Net cash provided (used) by financing activities        | 14,501    | (8,534)   | 33,387    |
| Net (decrease) increase in cash and cash equivalents    | (8,628)   | (30,319)  | 29,198    |
| Cash and cash equivalents, beginning                    | 21,846    | 52,165    | 22,967    |
| Cash and cash equivalents, ending                       | \$ 13,218 | \$ 21,846 | \$ 52,165 |

See notes to consolidated financial statements

FIDELITY D & D BANCORP, INC.

AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1.NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements include the accounts of Fidelity D & D Bancorp, Inc. and its wholly-owned subsidiary, The Fidelity Deposit and Discount Bank (the Bank) (collectively, the Company). All significant inter-company balances and transactions have been eliminated in consolidation.

NATURE OF OPERATIONS

The Company provides a full range of banking, trust and financial services to individuals, small businesses and corporate customers. Its primary market areas are Lackawanna and Luzerne Counties, Pennsylvania. The Company's primary deposit products are demand deposits and interest-bearing time and savings accounts. It offers a full array of loan products to meet the needs of retail and commercial customers. The Company is subject to regulation by the Federal Deposit Insurance Corporation (FDIC) and the Pennsylvania Department of Banking.

USE OF ESTIMATES

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

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, the valuation of investment securities, the determination and the amount of impairment in the securities portfolios and the related realization of the deferred tax assets related to the allowance for loan losses, other-than-temporary impairment on and valuations of investment securities.

In connection with the determination of the allowance for loan losses, management generally obtains independent appraisals for significant properties. While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Company to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near-term. However, the amount of the change that is reasonably possible cannot be estimated.

The Company's investment securities are comprised of a variety of financial instruments. The fair values of the securities are subject to various risks including changes in the interest rate environment and general economic conditions including illiquid conditions in the capital markets. Due to the increased level of these risks and their potential impact on the fair values of the securities, it is possible that the amounts reported in the accompanying financial statements could materially change in the near-term including changes caused by other-than-temporary impairment, the recovery of which may not occur until maturity. Credit-related impairment is included as a



component of non-interest income in the consolidated income statements while non-credit-related impairment is charged to other comprehensive income, net of tax.

#### SIGNIFICANT GROUP CONCENTRATION OF CREDIT RISK

The Company originates commercial, consumer, and mortgage loans to customers primarily located in Lackawanna and Luzerne Counties of Pennsylvania. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic sector in which the Company operates. The loan portfolio does not have any significant concentrations from one industry or customer.

#### HELD-TO-MATURITY SECURITIES

Debt securities, for which the Company has the positive intent and ability to hold to maturity, are reported at cost. Premiums and discounts are amortized or accreted, as a component of interest income over the life of the related security as an adjustment to yield using the interest method.

## TRADING SECURITIES

Debt and equity securities held principally for resale in the near-term, or trading securities, are recorded at their fair values. Unrealized gains and losses are included in other income. The Company did not have investment securities held for trading purposes during 2013, 2012 or 2011.

## AVAILABLE-FOR-SALE SECURITIES

Available-for-sale (AFS) securities consist of debt and equity securities classified as neither held-to-maturity nor trading and are reported at fair value. Premiums and discounts are amortized or accreted as a component of interest income over the life of the related security as an adjustment to yield using the interest method. Unrealized holding gains and losses, including non-credit-related other-than-temporary impairment (OTTI), on AFS securities are reported as a separate component of shareholders' equity, net of deferred income taxes, until realized. The net unrealized holding gains and losses are a component of accumulated other comprehensive income. Gains and losses from sales of securities AFS are determined using the specific identification method. Credit-related OTTI is recorded as a reduction of the amortized cost of the impaired security. Net gains and losses from sales and recoveries of securities and credit-related OTTI are recorded as components of other income in the consolidated statements of income.

## FEDERAL HOME LOAN BANK STOCK

The Company, is a member of the Federal Home Loan Bank system, and as such is required to maintain an investment in capital stock of the Federal Home Loan Bank of Pittsburgh (FHLB). The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB. Based on redemption provisions of the FHLB, the stock has no quoted market value and is carried at cost.

## LOANS

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at face value, net of unamortized loan fees and costs and the allowance for loan losses. Interest on residential real estate loans is recorded based on principal pay downs on an actual days basis. Commercial loan interest is accrued on the principal balance on an actual days basis. Interest on consumer loans is determined using the simple interest method.

Generally, loans are placed on non-accrual status when principal or interest is past due 90 days or more. When a loan is placed on non-accrual status, all interest previously accrued but not collected is charged against current earnings. Any payments received on non-accrual loans are applied, first to the outstanding loan amounts, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of lost interest.

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the Company grants a concession that it would not otherwise grant based on current underwriting standards. Regardless of the type of concession, when modifying a loan forgiveness of principal is rarely granted.

## LOANS HELD-FOR-SALE

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income. Unrealized gains are recognized but only to the extent of previous write-downs.

## AUTOMOBILE LEASING

Financing of automobiles, provided to customers under lease arrangements of varying terms, are accounted for as direct finance leases. Interest on automobile direct finance leasing is determined using the interest method. Generally, the interest method is used to arrive at a level effective yield over the life of the lease.

#### ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is established through a provision for loan losses. The allowance represents an amount which, in management's judgment, will be adequate to absorb losses on existing loans that may become uncollectible. Management's judgment in determining the adequacy of the allowance is based on evaluations of the collectability of the loans. These evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, current economic conditions that may affect the borrower's ability to pay, collateral value, overall portfolio quality and review of specific loans for impairment. Management applies two primary components during the loan review process to determine proper allowance levels; a specific loan loss allocation for loans that are deemed impaired; and a general loan loss allocation for those loans not specifically allocated based on historical charge-off history and qualitative factor adjustments for trends or changes in the loan portfolio. Delinquencies, changes in lending policies and local economic conditions are some of the items used for the qualitative factor adjustments. Loans considered uncollectible are charged against the allowance. Recoveries on loans previously charged off are added to the allowance.

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. The risk characteristics of each of the identified portfolio segments are as follows:

**Commercial and industrial loans (C&I):** C&I loans are primarily based on the identified historic and/or the projected cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of the borrower, however, do fluctuate based on changes in the company's internal and external environment including management, human and capital resources, economic conditions, competition and regulation. Most C&I loans are secured by business assets being financed such as equipment, accounts receivable, and/or inventory and generally incorporate a secured or unsecured personal guarantee. Unsecured loans may be made on a short-term basis. The ability of the borrower to collect amounts due from its customers may be affected by its customers' economic and financial condition.

**Commercial real estate loans:** Commercial real estate loans are made to finance the purchase of real estate, refinance existing obligations and/or to provide capital. These commercial real estate loans are generally secured by first lien security interests in the real estate as well as assignment of leases and rents. The real estate may include apartments, hotels, retail stores or plazas and healthcare facilities whether they are owner or non-owner occupied. These loans are typically originated in amounts of no more than 80% of the appraised value of the property.

**Consumer loans:** The Company offers home equity installment loans and lines of credit. Risks associated with loans secured by residential properties are generally lower than commercial real estate loans and include general economic risks, such as the strength of the job market, employment stability and the strength of the housing market. Since most loans are secured by a primary or secondary residence, the borrower's continued employment is considered the greatest risk to repayment. The Company also offers a variety of loans to individuals for personal and household purposes. These loans are generally considered to have greater risk than mortgages on real estate because they may be unsecured, or if they are secured, the value of the collateral may be difficult to assess and more likely to decrease in value than real estate.

**Residential mortgage loans:** Residential mortgages are secured by a first lien position of the borrower's residential real estate. These loans have varying loan rates depending on the financial condition of the borrower and the loan to value ratio. Residential mortgages have terms up to thirty years with amortizations varying from 10 to 30 years. The majority of the loans are underwritten according to FNMA and/or FHLB standards.

## TRANSFER OF FINANCIAL ASSETS

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: the assets have been isolated from the Company—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership; the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets; and the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

## LOAN FEES AND COSTS

Nonrefundable loan origination fees and certain direct loan origination costs are recognized as a component of interest income over the life of the related loans as an adjustment to yield. The unamortized balance of the deferred fees and

costs are included as components of the loan balances to which they relate.

#### BANK PREMISES AND EQUIPMENT

Land is carried at cost. Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the shorter of the term of the lease or the estimated useful lives of the improved property.

#### BANK OWNED LIFE INSURANCE

The Company maintains bank owned life insurance (BOLI) for a chosen group of employees, at the time of purchase, namely its officers where the Company is the owner and sole beneficiary of the policies. The earnings from the BOLI are recognized as a component of other income in the consolidated statements of income. The BOLI is an asset that can be liquidated, if necessary, with tax consequences. However, the Company intends to hold these policies and, accordingly, the Company has not provided for deferred income taxes on the earnings from the increase in the cash surrender value.

## FORECLOSED ASSETS HELD-FOR-SALE

Foreclosed assets held-for-sale are carried at the lower of cost or fair value less cost to sell. Losses from the acquisition of property in full and partial satisfaction of debt are treated as credit losses. Routine holding costs, gains and losses from sales, write-downs for subsequent declines in value and any rental income received are recognized net, as a component of other real estate owned expense in the consolidated statements of income. Gains or losses are recorded when the properties are sold.

## STOCK PLANS

The Company has two stock-based compensation plans. The Company accounts for these plans under the recognition and measurement accounting principles, which requires the cost of share-based payment transactions be recognized in the financial statements. The stock-based compensation accounting guidance requires that compensation cost for stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. Compensation cost is recognized on a straight-line basis over the requisite service period. When granting stock options, the Company uses the Black-Sholes option pricing model to determine their estimated fair value on the date of grant.

## TRUST AND FINANCIAL SERVICE FEES

Trust and financial service fees are recorded on the cash basis, which is not materially different from the accrual basis.

## ADVERTISING COSTS

Advertising costs are charged to expense as incurred.

## LEGAL AND PROFESSIONAL EXPENSES

Generally, the Company recognizes legal and professional fees as incurred and are included as a component of professional services expense in the consolidated statements of income. Legal costs incurred that are associated with the collection of outstanding amounts due from delinquent borrowers are included as a component of loan collection expense in the consolidated statements of income. In the event of litigation proceedings brought about by an employee or third party against the Company, expenses for damages will be accrued if the likelihood of the outcome against the Company is probable, the amount can be reasonably estimated and the amount would have a material impact on the financial results of the Company.

## FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

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

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

## INCOME TAXES

Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

## CASH FLOWS

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks and interest-bearing deposits with financial institutions.

For the years ended December 31, 2013, 2012, and 2011, the Company paid interest of \$3.0 million, \$3.5 million and \$4.9 million, respectively. For the years ended December 31, 2013, 2012, and 2011, the Company paid income taxes of \$1.3 million, \$2.2 million and \$1.6 million, respectively.

Transfers from loans to foreclosed assets held-for-sale amounted to \$2.4 million, \$1.8 million and \$0.8 million in 2013, 2012, and 2011, respectively. Transfers from loans to loans held-for-sale amounted to \$3.7 million, \$3.6 million and \$5.3 million in 2013, 2012 and 2011, respectively. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of premises and equipment.

## RECLASSIFICATION ADJUSTMENTS

Certain reclassifications have been made to the 2012 and 2011 financial statements to conform to the 2013 presentation.

## 2.CASH

The Company is required by the Federal Reserve Bank to maintain average reserve balances based on a percentage of deposits. The amounts of those reserve requirements on December 31, 2013 and 2012 were \$0.9 million and \$1.0 million, respectively.

Deposits with any one financial institution are insured up to \$250,000. From time-to-time, the Company may maintain cash and cash equivalents with certain other financial institutions in excess of the insured amount.

## 3.ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

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

As of and for the year ended December 31, 2013

| (dollars in thousands) | Unrealized<br>gains<br>on<br>available-for-<br>sale securities | Non-credit-related<br>impairment losses<br>on investment<br>securities | Total  |
|------------------------|--|--|--------|
| Beginning balance      | \$ 1,905   | \$ (1,669)   | \$ 236 |



|  |          |         |          |
|--|----------|---------|----------|
| Other comprehensive (loss) income before reclassifications       | (624)    | 3,718   | 3,094    |
| Amounts reclassified from accumulated other comprehensive income | (42)     | (2,049) | (2,091)  |
| Net current-period other comprehensive (loss) income             | (666)    | 1,669   | 1,003    |
| Ending balance   | \$ 1,239 | \$ -    | \$ 1,239 |

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

| Details about accumulated other comprehensive income components<br>(dollars in thousands)<br>For the year ended December 31, 2013 | Amount reclassified from accumulated other comprehensive income | Affected line item in the statement where net income is presented |
|---|---|---|
| Unrealized gains on AFS securities  | \$ 3,168  | Gain on sale, recovery, or disposal of investment securities      |
|   | -   | Net impairment losses on investment securities                    |
|   | 3,168   | Income before income taxes  |
|   | (1,077)   | Provision for income taxes  |
| Total reclassifications for the period  | \$ 2,091  | Net income  |

## 4. INVESTMENT SECURITIES

Amortized cost and fair value of investment securities as of the period indicated are as follows:

| (dollars in thousands)<br>December 31, 2013         | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| Held-to-maturity securities:                        |                   |                              |                               |               |
| MBS - GSE residential                               | \$ 177            | \$ 18                        | \$ -                          | \$ 195        |
| Available-for-sale securities:                      |                   |                              |                               |               |
| Agency - GSE  | \$ 14,667         | \$ 8                         | \$ 74                         | \$ 14,601     |
| Obligations of states and<br>political subdivisions | 32,269            | 912                          | 570                           | 32,611        |
| MBS - GSE residential                               | 48,137            | 1,476                        | 104                           | 49,509        |
| Total debt securities                               | 95,073            | 2,396                        | 748                           | 96,721        |
| Equity securities - financial services              | 295               | 230                          | -                             | 525           |
| Total available-for-sale securities                 | \$ 95,368         | \$ 2,626                     | \$ 748                        | \$ 97,246     |

| (dollars in thousands)<br>December 31, 2012         | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| Held-to-maturity securities:                        |                   |                              |                               |               |
| MBS - GSE residential                               | \$ 289            | \$ 31                        | \$ -                          | \$ 320        |
| Available-for-sale securities:                      |                   |                              |                               |               |
| Agency - GSE  | \$ 17,651         | \$ 102                       | \$ 13                         | \$ 17,740     |
| Obligations of states and<br>political subdivisions | 26,979            | 2,879                        | 1                             | 29,857        |
| Corporate bonds:                                    |                   |                              |                               |               |
| Pooled trust preferred securities                   | 6,323             | 185                          | 4,683                         | 1,825         |
| MBS - GSE residential                               | 48,836            | 1,761                        | 44                            | 50,553        |

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|  |            |          |          |            |
|--|------------|----------|----------|------------|
| Total debt securities                  | 99,789     | 4,927    | 4,741    | 99,975     |
| Equity securities - financial services | 295        | 171      | -        | 466        |
| Total available-for-sale securities    | \$ 100,084 | \$ 5,098 | \$ 4,741 | \$ 100,441 |

Some of the Company's debt securities are pledged to secure trust funds, public deposits, repurchase agreements, other short-term borrowings, FHLB advances, Federal Reserve Bank of Philadelphia Discount Window borrowings and certain other deposits as required by law.

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The amortized cost and fair value of debt securities at December 31, 2013 by contractual maturity are shown below:

| (dollars in thousands)                   | Amortized<br>cost | Fair<br>value |
|--|-------------------|---------------|
| Held-to-maturity securities:             |                   |               |
| MBS - GSE residential                    | \$ 177            | \$ 195        |
| Available-for-sale securities:           |                   |               |
| Debt securities:                         |                   |               |
| Due in one year or less                  | \$ 2,001          | \$ 2,008      |
| Due after one year through five years    | 5,116             | 5,103         |
| Due after five years through ten years   | 9,555             | 9,541         |
| Due after ten years                      | 30,264            | 30,560        |
| Total debt securities                    | 46,936            | 47,212        |
| MBS - GSE residential                    | 48,137            | 49,509        |
| Total available-for-sale debt securities | \$ 95,073         | \$ 96,721     |

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.

Gross realized gains and losses from sales, determined using specific identification, and recoveries of previously charged-off pooled trust preferred (PreTSL) securities for the periods indicated were as follows:

| (dollars in thousands)                     | December 31, |        |       |
|--|--------------|--------|-------|
|  | 2013         | 2012   | 2011  |
| Gross realized gain                        | \$ 4,314     | \$ 251 | \$ 58 |
| Gross realized loss                        | (1,335)      | -      | (8)   |
| Recovery of previously charged-off PreTSLs | 189          | 77     | 13    |
| Net gain                                   | \$ 3,168     | \$ 328 | \$ 63 |

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The following table presents the fair value and gross unrealized losses of investments aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of the period indicated:

| (dollars in thousands)                           | Less than 12 months |                   | More than 12 months |                   | Total      |                   |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|  | Fair value          | Unrealized losses | Fair value          | Unrealized losses | Fair value | Unrealized losses |
| 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         |                   |
| December 31, 2012                                |                     |                   |                     |                   |            |                   |
| Agency - GSE                                     | \$ 1,017            | \$ 13             | \$ -                | \$ -              | \$ 1,017   | \$ 13             |
| Obligations of states and political subdivisions | 281                 | 1                 | -                   | -                 | 281        | 1                 |
| Corporate bonds:                                 |                     |                   |                     |                   |            |                   |
| Pooled trust preferred securities                | -                   | -                 | 1,639               | 4,683             | 1,639      | 4,683             |
| MBS - GSE residential                            | 6,214               | 44                | -                   | -                 | 6,214      | 44                |
| Total temporarily impaired securities            | \$ 7,512            | \$ 58             | \$ 1,639            | \$ 4,683          | \$ 9,151   | \$ 4,741          |
| Number of securities                             | 5                   |                   | 8                   |                   | 13         |                   |

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

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

The Company's OTTI evaluation process also follows the guidance set forth in topics related to debt and equity securities. The guidance set forth in the pronouncements requires the Company to take into consideration current market conditions, fair value in relationship to cost, extent and nature of changes in fair value, issuer rating changes and trends, volatility of earnings, current analysts' evaluations, all available information relevant to the collectability of debt securities, the ability and intent to hold investments until a recovery of fair value which may be 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 December 31, 2013, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that more likely than not would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI in the Company's portfolios of Agency – Government Sponsored Enterprise (GSE), Mortgage-backed securities (MBS) – GSE residential and Obligations of states and political subdivisions.

Agency - GSE and MBS - GSE residential

Agency – GSE and MBS – GSE residential securities consist of short- and medium-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), Federal Home Loan Bank (FHLB), Federal Farm Credit Bank (FFCB) and Government National Mortgage Association (GNMA). These securities have interest

rates that are fixed- and adjustable, have varying short- to long term maturity dates and have contractual cash flows guaranteed by the U.S. government or agencies of the U.S. government.

#### Obligations of states and political subdivisions

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

In the above security types, management believes the change in fair value is attributable to changes in interest rates and those instruments with unrealized losses were not caused by deterioration of credit quality. Accordingly, as of December 31, 2013, recognition of OTTI on these securities was unnecessary.

#### Pooled trust preferred securities

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

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

Unrealized losses in the pooled trust preferred securities (PreTSLs) were caused mainly by: (1) collateral deterioration due to bank failures and credit concerns across the banking sector; (2) widening of credit spreads and (3) illiquidity in the market. The Company's review of its portfolio of pooled trust preferred securities determined that in 2012 credit-related OTTI be recorded on two holdings, both of which were contained in the Company's AFS securities portfolio. The losses were caused by credit quality downgrades on the underlying collateral, including the collateral of four banks deferring interest payments and one bank fully redeeming which removed all future earnings cash flow. There was no credit-related OTTI required to be recognized in 2013. During the fourth quarter of 2013, the Company sold its entire investment of PreTSLs at a net gain of \$2.9 million.

The following table summarizes the amount of credit-related OTTI recognized in earnings during the periods indicated:

| (dollars in thousands)             | Years ended  |      |       |
|------------------------------------|--------------|------|-------|
|                                    | December 31, |      |       |
|                                    | 2013         | 2012 | 2011  |
| Pooled trust preferred securities: |              |      |       |
| PreTSL IV, Mezzanine               | \$ -         | \$ - | \$ 35 |
| PreTSL IX, B1, B3                  | -            | 18   | -     |
| PreTSL XVIII, C                    | -            | 118  | -     |
| PreTSL XIX, C                      | -            | -    | 136   |
| PreTSL XXIV, B1                    | -            | -    | 75    |





investments considered of high credit quality and ASC 325 was used for the remaining securities. In summary, the quarterly evaluations indicated there was no significant adverse change in cash flows in the securities. As a result, there was no credit related OTTI recorded during the year ended December 31, 2013.

The guidance prescribed in ASC 320 was used for investments that, upon purchase, were rated of high credit quality, "AA" or higher, by a nationally recognized statistical rating organization. The Company had two PreTSLs (XXIV and XXVII) that were of high credit quality, "AA" rated, upon acquisition. PreTSL XXVII evaluation proved a high probability that the Company would be able to collect all amounts due, both principal and interest, by maturity and thus, determined the impairment was temporary. PreTSL XXIV was evaluated under ASC 320 to determine if the Company expected to recover the remaining amortized cost basis and whether OTTI was deemed to have occurred. An adverse change or short-fall in the expected cash flows compared to the amortized cost would be recorded as credit-related OTTI. To assess the likelihood of recoverability, the present value of the best estimate of future cash flows was compared to the amortized cost. In this situation, the discount rate used was the interest rate implicit in the security at the date of acquisition. The application of the guidance on this security did not result in an adverse change in cash flows when compared to the last measurement date and therefore, no credit related OTTI was recorded during 2013 or 2012. There was \$75 thousand in credit related OTTI recorded on these holdings in 2011.

The remaining PreTSLs were rated "A" by a nationally recognized statistical rating organization at the date of acquisition and as such are considered beneficial interests of securitized financial assets. For those securities, the Company applied the guidance of ASC 325. Under this and other relevant guidance, if the fair value is below amortized cost and the present value of the best estimate of future cash flows declines significantly, evidencing a probable material adverse change in cash flows since the last measurement date, credit related OTTI was deemed to exist and written down to the determined present value through a charge to current earnings. The discount rate used under ASC 325 was the yield to accrete beneficial interest, which is representative of the resulting interest from the total gross estimated future cash flows less the current amortized cost. In applying the guidance to the remaining securities, none of the securities measured an adverse change in cash flows during 2013 and therefore no credit related OTTI had been recorded in 2013 compared to a total of \$0.1 million recognized in 2012 all of which pertained to cash flow analyses performed during the first half of the year and \$0.2 million recognized in 2011.

The following table is the composition of the Company's pooled trust preferred securities on non-accrual status as of the period indicated:

| (dollars in thousands) |           | As of December 31, |            |            |            |
|------------------------|-----------|--------------------|------------|------------|------------|
|                        |           | 2013               |            | 2012       |            |
| Deal                   | Class     | Book value         | Fair value | Book value | Fair value |
| Pre TSL V              | Mezzanine | \$ -               | \$ -       | \$ -       | \$ 27      |
| Pre TSL VII            | Mezzanine | -                  | -          | -          | 125        |
| Pre TSL IX             | B-1,B-3   | -                  | -          | 1,507      | 630        |
| Pre TSL XI             | B-3       | -                  | -          | 1,053      | 305        |
| Pre TSL XV             | B-1       | -                  | -          | -          | 33         |
| Pre TSL XVIII          | C         | -                  | -          | 167        | -          |
| Pre TSL XIX            | C         | -                  | -          | 316        | -          |
| Pre TSL XXIV           | B-1       | -                  | -          | 407        | 12         |
|                        |           | \$ -               | \$ -       | \$ 3,450   | \$ 1,132   |

The securities included in the above table had experienced impairment of principal and interest was “paid-in-kind”. When these two conditions existed, the security was placed on non-accrual status.

## 5.LOANS AND LEASES

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

| (dollars in thousands)     | 2013       | 2012       |
|----------------------------|------------|------------|
| Commercial and industrial  | \$ 74,551  | \$ 65,110  |
| Commercial real estate:    |            |            |
| Non-owner occupied         | 89,255     | 81,998     |
| Owner occupied             | 86,294     | 80,509     |
| Construction               | 10,765     | 10,679     |
| Consumer:                  |            |            |
| Home equity installment    | 34,480     | 32,828     |
| Home equity line of credit | 36,836     | 34,169     |
| Auto loans and leases      | 22,261     | 17,411     |
| Other                      | 5,205      | 6,139      |
| Residential:               |            |            |
| Real estate                | 110,365    | 96,765     |
| Construction               | 8,188      | 7,948      |
| Total                      | 478,200    | 433,556    |
| Less:                      |            |            |
| Allowance for loan losses  | (8,928)    | (8,972)    |
| Unearned lease revenue     | (56)       | -          |
| Loans and leases, net      | \$ 469,216 | \$ 424,584 |

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

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate amount of mortgages serviced amounted to \$250.2 million and \$214.7 million as of December 31, 2013 and 2012.

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

## Non-accrual loans

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

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

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Non-accrual loans, segregated by class, at December 31, were as follows:

| (dollars in thousands)     | As of December 31, |           |
|----------------------------|--------------------|-----------|
|                            | 2013               | 2012      |
| Commercial and industrial  | \$ 62              | \$ 18     |
| Commercial real estate:    |                    |           |
| Non-owner occupied         | 1,518              | 1,884     |
| Owner occupied             | 1,422              | 5,031     |
| Construction               | 635                | 1,123     |
| Consumer:                  |                    |           |
| Home equity installment    | 393                | 1,306     |
| Home equity line of credit | 254                | 381       |
| Auto loans and leases      | 12                 | -         |
| Other                      | 22                 | 48        |
| Residential:               |                    |           |
| Real estate                | 1,350              | 2,330     |
| Total                      | \$ 5,668           | \$ 12,121 |

#### Troubled Debt Restructuring

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

Loans modified in a TDR may or may not be placed on non-accrual status. As of December 31, 2013, total TDRs amounted to \$2.0 million, of which \$1.0 million were on non-accrual status, compared to \$2.2 million and \$1.1 million, respectively as of December 31, 2012.

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 twelve months ended December 31, 2013.

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

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Past due loans

Loans are considered past due when the contractual principal and/or interest 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<br>past due | 60 - 89<br>Days<br>past due | Past due                |                   | Current    | Total<br>loans<br>receivables | Recorded<br>investment past<br>due ≥ 90 days<br>and accruing |
|----------------------------|--------------------------|-----------------------------|-------------------------|-------------------|------------|-------------------------------|--|
|                            |                          |                             | 90 days<br>or more<br>* | Total<br>past due |            |                               |  |
| December 31, 2013          |                          |                             |                         |                   |            |                               |  |
| Commercial and industrial  | \$ 111                   | \$ 212                      | \$ 69                   | \$ 392            | \$ 74,159  | \$ 74,551                     | \$ 7   |
| Commercial real estate:    |                          |                             |                         |                   |            |                               |  |
| Non-owner occupied         | 484                      | 35                          | 1,518                   | 2,037             | 87,218     | 89,255                        | -  |
| Owner occupied             | 1,714                    | 545                         | 1,422                   | 3,681             | 82,613     | 86,294                        | -  |
| Construction               | -                        | -                           | 635                     | 635               | 10,130     | 10,765                        | -  |
| Consumer:                  |                          |                             |                         |                   |            |                               |  |
| Home equity installment    | 229                      | 72                          | 393                     | 694               | 33,786     | 34,480                        | -  |
| Home equity line of credit | -                        | 114                         | 275                     | 389               | 36,447     | 36,836                        | 21   |
| Auto loans and leases      | 165                      | 14                          | 23                      | 202               | 22,003     | 22,205                        | 11   |
| Other                      | 52                       | 23                          | 22                      | 97                | 5,108      | 5,205                         | -  |
| Residential:               |                          |                             |                         |                   |            |                               |  |
| Real estate                | 158                      | 1,340                       | 1,466                   | 2,964             | 107,401    | 110,365                       | 116  |
| Construction               | -                        | -                           | -                       | -                 | 8,188      | 8,188                         | -  |
| Total                      | \$ 2,913                 | \$ 2,355                    | \$ 5,823                | \$ 11,091         | \$ 467,053 | \$ 478,144                    | \$ 155   |

\* Includes \$5.7 million of non-accrual loans.

|                            | 30 - 59<br>Days<br>past due | 60 - 89<br>Days<br>past due | Past due                |                   | Current   | Total<br>loans<br>receivables | Recorded<br>investment past<br>due ≥ 90 days<br>and accruing |
|----------------------------|-----------------------------|-----------------------------|-------------------------|-------------------|-----------|-------------------------------|--|
|                            |                             |                             | 90 days<br>or more<br>* | Total<br>past due |           |                               |  |
| December 31, 2012          |                             |                             |                         |                   |           |                               |  |
| Commercial and industrial  | \$ 676                      | \$ 15                       | \$ 254                  | \$ 945            | \$ 64,165 | \$ 65,110                     | \$ 236   |
| Commercial real estate:    |                             |                             |                         |                   |           |                               |  |
| Non-owner occupied         | -                           | 141                         | 1,884                   | 2,025             | 79,973    | 81,998                        | -  |
| Owner occupied             | 208                         | 282                         | 5,439                   | 5,929             | 74,580    | 80,509                        | 408  |
| Construction               | -                           | -                           | 1,123                   | 1,123             | 9,556     | 10,679                        | -  |
| Consumer:                  |                             |                             |                         |                   |           |                               |  |
| Home equity installment    | 216                         | 132                         | 1,325                   | 1,673             | 31,155    | 32,828                        | 19   |
| Home equity line of credit | -                           | 66                          | 381                     | 447               | 33,722    | 34,169                        | -  |

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|              |          |          |           |           |            |            |          |
|--------------|----------|----------|-----------|-----------|------------|------------|----------|
| Auto         | 459      | 30       | 16        | 505       | 16,906     | 17,411     | 16       |
| Other        | 48       | 4        | 65        | 117       | 6,022      | 6,139      | 17       |
| Residential: |          |          |           |           |            |            |          |
| Real estate  | 99       | 544      | 3,357     | 4,000     | 92,765     | 96,765     | 1,027    |
| Construction | -        | -        | -         | -         | 7,948      | 7,948      | -        |
| Total        | \$ 1,706 | \$ 1,214 | \$ 13,844 | \$ 16,764 | \$ 416,792 | \$ 433,556 | \$ 1,723 |

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

#### Impaired loans

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

At December 31, 2013, impaired loans consisted of accruing TDRs totaling \$1.0 million and \$5.7 million of non-accrual loans. At December 31, 2012, impaired loans consisted of accruing TDRs totaling \$1.1 million and \$12.1 million of non-accrual loans. As of December 31, 2013 and 2012, the non-accrual loans included non-accruing TDRs of \$1.0 million and \$1.1 million, respectively. Payments received from impaired loans are first applied against the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income.



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

| (dollars in thousands)     | Unpaid principal balance | Recorded investment with allowance | Recorded investment with no allowance | Total recorded investment | Related allowance | Average recorded investment | Interest income recognized | Cash basis interest income recognized |
|----------------------------|--------------------------|------------------------------------|---------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|---------------------------------------|
| 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 loans and leases      | 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                                 |

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

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

### Credit Quality Indicators

#### Commercial and industrial and commercial real estate

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

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

#### Pass

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

### Special Mention

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

### Substandard

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

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| (dollars in thousands) | Commercial and industrial |            |            |            |            |            |            |            |
|------------------------|---------------------------|------------|------------|------------|------------|------------|------------|------------|
|                        | 12/31/2013                | 12/31/2012 | 12/31/2013 | 12/31/2012 | 12/31/2013 | 12/31/2012 | 12/31/2013 | 12/31/2012 |
| Pass                   | \$ 71,122                 | \$ 61,821  | \$ 78,069  | \$ 72,738  | \$ 82,975  | \$ 73,922  | \$ 9,026   | \$ 8,094   |
| Special mention        | 2,244                     | 2,221      | 2,734      | 3,520      | 656        | 222        | 1,037      | 1,422      |
| Substandard            | 1,185                     | 1,068      | 8,452      | 5,740      | 2,663      | 6,365      | 702        | 1,163      |
| Doubtful               | -                         | -          | -          | -          | -          | -          | -          | -          |
| Total                  | \$ 74,551                 | \$ 65,110  | \$ 89,255  | \$ 81,998  | \$ 86,294  | \$ 80,509  | \$ 10,765  | \$ 10,679  |

Consumer credit exposure

Credit risk profile based on payment activity

| (dollars in thousands) | Home equity installment |            | Home equity line of credit |            | Auto loans and leases |            | Other      |            |
|------------------------|-------------------------|------------|----------------------------|------------|-----------------------|------------|------------|------------|
|                        | 12/31/2013              | 12/31/2012 | 12/31/2013                 | 12/31/2012 | 12/31/2013            | 12/31/2012 | 12/31/2013 | 12/31/2012 |
| Performing             | \$ 34,087               | \$ 31,503  | \$ 36,561                  | \$ 33,788  | \$ 22,182             | \$ 17,395  | \$ 5,183   | \$ 6,074   |
| Non-performing         | 393                     | 1,325      | 275                        | 381        | 23                    | 16         | 22         | 65         |
| Total                  | \$ 34,480               | \$ 32,828  | \$ 36,836                  | \$ 34,169  | \$ 22,205             | \$ 17,411  | \$ 5,205   | \$ 6,139   |

## Mortgage lending credit exposure

## Credit risk profile based on payment activity

| (dollars in thousands) | Residential real estate |            | Residential construction |            |
|------------------------|-------------------------|------------|--------------------------|------------|
|                        | 12/31/2013              | 12/31/2012 | 12/31/2013               | 12/31/2012 |
| Performing             | \$ 108,899              | \$ 93,408  | \$ 8,188                 | \$ 7,948   |
| Non-performing         | 1,466                   | 3,357      | -                        | -          |
| Total                  | \$ 110,365              | \$ 96,765  | \$ 8,188                 | \$ 7,948   |

## Allowance for loan losses

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

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

- § identification of specific impaired loans by loan category;
- § 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.

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. Prior to the fourth quarter of 2013 the Company used a two-year average that was calculated annually. During the fourth quarter of 2013, the Company changed to a trailing twelve-quarter average to determine historical loss percentages. 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. The Company will use this new averaging convention in future quarterly interim periods.

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 and all of 2012. Beginning in the fourth quarter of 2013, certain loans were eliminated from the allowance for loan loss calculation. The loans eliminated include the following: the guaranteed portion of all commercial loans that carry a guarantee by the Small Business Administration and loans in all loan categories that are fully secured by cash collateral. Management has determined that these loans have very little risk of not being fully collected. Therefore, upon origination, these loans have been eliminated from allowance for loan loss calculations.

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

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

As of and for the year ended December  
31, 2013

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

|                          |           |            |           |            |            |
|--------------------------|-----------|------------|-----------|------------|------------|
| evaluated for impairment | \$ 74,454 | \$ 181,729 | \$ 98,045 | \$ 117,203 | \$ 471,431 |
|--------------------------|-----------|------------|-----------|------------|------------|



As of and for the year ended December  
31, 2012

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

## 6.BANK PREMISES AND EQUIPMENT

Components of bank premises and equipment are summarized as follows:

| (dollars in thousands)                         | As of December 31, |          |
|--|--------------------|----------|
|  | 2013               | 2012     |
| Land   | \$ 2,627           | \$ 2,463 |
| Bank premises                                  | 11,682             | 11,497   |
| Furniture, fixtures and equipment              | 9,500              | 9,620    |
| Leasehold improvements                         | 4,168              | 4,168    |
| Total  | 27,977             | 27,748   |
| Less accumulated depreciation and amortization | (14,375)           | (13,621) |

Bank premises and equipment, net                      \$ 13,602    \$ 14,127

Depreciation expense, which includes amortization of leasehold improvements, was \$1.2 million, \$1.3 million and \$1.5 million for the years ended December 31, 2013, 2012 and 2011.

In 2013 and 2012, the Company leased its Green Ridge, West Pittston, Peckville, Clarks Summit and Eynon branches and the former Scranton branch under the terms of operating leases. Rental expense was \$0.3 million in both 2013 and 2012, and \$0.4 million in 2011. The future minimum lease payments for the Company's branch network as of December 31, 2013 are as follows:

(dollars in thousands) Amount

|                     |          |
|---------------------|----------|
| 2014                | \$ 218   |
| 2015                | 180      |
| 2016                | 181      |
| 2017                | 182      |
| 2018                | 182      |
| 2019 and thereafter | 2,700    |
| Total               | \$ 3,643 |

During 2009, the Company closed its Wyoming Ave., Scranton branch but continued to pay monthly lease payments under an operating lease agreement that expired during the first quarter of 2014. To offset the expense related to the former

Scranton branch, the Company received rental income under a sublease agreement from an unrelated financial institution that also expired during the first quarter of 2014. During 2014, the Company expects to begin construction and relocation of one of its branch offices. The Company estimates to spend \$1.6 million for design, construction and equipment with a targeted completion date of late in the fourth quarter of 2014.

## 7. DEPOSITS

The scheduled maturities of certificates of deposit including certificates reciprocated in the Certificate of Deposit Account Registry Service (CDARS) program as of December 31, 2013 were as follows:

| (dollars in thousands) | Amount     | Percent |
|------------------------|------------|---------|
| 2014                   | \$ 56,003  | 49.3 %  |
| 2015                   | 26,507     | 23.3    |
| 2016                   | 22,568     | 19.8    |
| 2017                   | 3,429      | 3.0     |
| 2018                   | 3,076      | 2.7     |
| 2019 and thereafter    | 2,116      | 1.9     |
| Total                  | \$ 113,699 | 100.0 % |

Excluding \$10.3 million of CDARS deposits, certificates of deposit of \$100,000 or more aggregated \$41.2 million and \$41.8 million as of December 31, 2013 and 2012, respectively. Certificates of deposit of \$250,000 or more aggregated \$15.7 million and \$16.2 million at December 31, 2013 and 2012, respectively.

As of December 31, 2013, investment securities with a combined fair value of \$96.9 million and letters of credit with a notional value of \$0.3 million were available to be pledged as qualifying collateral to secure public deposits and trust funds. The Company required \$27.0 million of the qualifying collateral to secure such deposits as of December 31, 2013 and the balance of \$69.9 million was available for other pledging needs.

## 8. SHORT-TERM BORROWINGS

Short-term borrowings consisted of securities sold under agreements to repurchase, or repurchase agreements, in the amount of \$6.2 million and \$8.1 million as of December 31, 2013 and 2012, respectively and overnight borrowings of \$2.5 million as of December 31, 2013. There were no overnight borrowings as of December 31, 2012.

The maximum and average amounts of short-term borrowings outstanding and related interest rates as of the periods indicated are as follows:

| (dollars in thousands) | Maximum<br>outstanding<br>at any<br>month end | Average<br>outstanding | Weighted-<br>average<br>rate during<br>the year | Rate at<br>year-end |
|------------------------|---|------------------------|---|---------------------|
| December 31, 2013      |   |                        |   |                     |
| Overnight borrowings   | \$ 10,544                                     | \$ 3,893               | 0.29 %  | 0.27 %              |

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|                            |           |           |        |        |
|----------------------------|-----------|-----------|--------|--------|
| Repurchase agreements      | 21,653    | 11,629    | 0.19   | 0.14   |
| Total                      | \$ 32,197 | \$ 15,522 |        |        |
| December 31, 2012          |           |           |        |        |
| Overnight borrowings       | \$ -      | \$ 55     | 0.41 % | 0.00 % |
| Repurchase agreements      | 20,721    | 13,027    | 0.25   | 0.27   |
| Total                      | \$ 20,721 | \$ 13,082 |        |        |
| December 31, 2011          |           |           |        |        |
| Repurchase agreements      | \$ 20,912 | \$ 11,939 | 0.44 % | 0.26 % |
| Demand note, U.S. Treasury | 1,000     | 685       | 0.00   | 0.00   |
| Total                      | \$ 21,912 | \$ 12,624 |        |        |

Overnight borrowings may include Fed funds purchased from correspondent banks, open repurchase agreements with the FHLB and borrowings at the Discount Window from the Federal Reserve Bank of Philadelphia (FRB). Repurchase agreements are non-insured interest-bearing liabilities that have a perfected security interest in qualified investment securities of the Company. Repurchase agreements are reflected at the amount of cash received in connection with the transaction.

The carrying value of the underlying qualified investment securities was approximately \$20.2 million and \$24.4 million at December 31, 2013 and 2012, respectively. The Company may be required to provide additional collateral based on the balance of the repurchase agreement and the fair value of the underlying securities. When outstanding, the U. S. Treasury demand note is generally repaid within 1 to 90 days.

At December 31, 2013, the Company had approximately \$159.4 million available to borrow from the FHLB, \$21.0 million from correspondent banks and approximately \$27.6 million that it could borrow at the FRB.

## 9.LONG-TERM DEBT

Long-term debt consisted of a single advance from the FHLB in the amount of \$16.0 million as of December 31, 2013 and 2012 that is scheduled to mature in 2016. The debt is a convertible-select instrument that currently carries a 5.26% fixed-rate of interest. The rate could adjust quarterly should market rates increase beyond the issue's original strike rate. The advance is secured by blanket liens on real estate and commercial and industrial loans with a combined weighted valuation, for collateral purposes, of \$178.1 million as of September 30, 2013 that was the qualifying collateral in effect as of December 31, 2013.

Significant prepayment fees attached to the borrowing are a deterrent from paying off the high-cost advance. However, in the event the underlying market rates rise above the rate currently paid on the borrowing, the rate will convert to a floating-rate instrument and the Company would have the option to repay or renegotiate the converted advance. In February 2012, the Company paid off a \$5.0 million, 3.61% advance that was scheduled to mature in the fourth quarter of 2013. The Company incurred a prepayment fee of \$0.2 million on the early payoff.

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

In the 2012 Omnibus Stock Incentive Plan, the Company has reserved 500,000 shares of its no-par common stock for future issuance. The Company recognizes share-based compensation expense over the requisite service or vesting period. Due to immateriality however, the entire expense, or \$2 thousand, from shares granted in 2012 was

recognized on the date of grant. There were no stock-based awards granted to employees under any of the Company's stock compensation plans in 2011.

In the 2012 Director Stock Incentive Plan, the Company has reserved 500,000 shares of its no-par common stock for future issuance. There were no stock-based awards granted to directors under any of the Company's stock compensation plans in 2012 and 2011.

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

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

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 – restricted stock |         |         |
|------------------------------|---|---------|---------|
|                              | Director                                      | Omnibus | Total   |
| Balance at December 31, 2011 | -   | -       | -       |
| Granted                      | -   | 151     | 151     |
| Forfeited                    | -   | -       | -       |
| Issued                       | -   | -       | -       |
| Balance at December 31, 2012 | -   | 151     | 151     |
| Granted                      | 8,000   | 6,000   | 14,000  |
| Forfeited                    | -   | (1,017) | (1,017) |
| Issued                       | -   | (134)   | (134)   |
| Balance at December 31, 2013 | 8,000   | 5,000   | 13,000  |

For restricted stock, intrinsic value represents the closing price of the underlying stock at the end of the period. As of December 31, 2013, the intrinsic value of the Company's restricted stock under the Director and Omnibus plans was \$26.50 per share.

Share-based compensation expense 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 years ended December 31, 2013 and 2012 and the unrecognized stock-based compensation expense as of December 31, 2013. There was no unrecognized stock-based compensation expense as of December 31, 2012:

| (dollars in thousands)                 | Years ended  |      |
|--|--------------|------|
|  | December 31, |      |
|  | 2013         | 2012 |
| Stock-based compensation expense:      |              |      |
| Director plan                          | \$ 78        | \$ - |
| Omnibus plan                           | 24           | 2    |
| Total stock-based compensation expense | \$ 102       | \$ 2 |

| (dollars in thousands)                              | As of    |
|---|----------|
|   | December |
|   | 31, 2013 |
| Unrecognized stock-based compensation expense:      |          |
| Director plan                                       | \$ 91    |
| Omnibus plan  | 82       |
| Total unrecognized stock-based compensation expense | \$ 173   |

The unrecognized stock-based compensation expense as of December 31, 2013 will be recognized ratably over the periods ended January 2015 and January 2017 for the Director Plan and the Omnibus Plan, respectively.



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

|  | Options | Weighted-<br>average<br>exercise<br>price | Weighted-<br>average<br>remaining<br>contractual<br>term (years) |
|--|---------|---|--|
| Outstanding and exercisable, December 31, 2010 | 26,980  | \$ 30.08                                  | 5.2  |
| Granted  | -       | -   |  |
| Exercised                                      | -       | -   |  |
| Forfeited                                      | (3,190) | 33.18                                     |  |
| Outstanding and exercisable, December 31, 2011 | 23,790  | 29.67                                     | 4.9  |
| Granted  | -       | -   |  |
| Exercised                                      | -       | -   |  |
| Forfeited                                      | (4,290) | 34.09                                     |  |
| Outstanding and exercisable, December 31, 2012 | 19,500  | 28.69                                     | 5.0  |
| Granted  | -       | -   |  |
| Exercised                                      | -       | -   |  |
| Forfeited                                      | -       | -   |  |
| Outstanding and exercisable, December 31, 2013 | 19,500  | \$ 28.69                                  | 4.0  |

In the above table, the weighted-average exercise price includes options with exercise prices ranging from \$26.05 to \$34.09.

As of December 31, 2013, the intrinsic value for stock options with market prices that exceeded their strike price amounted to \$450. As of December 31, 2012 and 2011, no intrinsic value existed.

In addition to the two stock option plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance under the plan. The 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, 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. At December 31, 2013, 29,956 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and is required to comply with the provisions of current accounting guidance. Therefore, the Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the years ended December 31, 2013, 2012 and 2011, compensation expense related to the ESPP approximated \$10 thousand, \$12 thousand and \$24 thousand, respectively, and is included as a component of salaries and employee benefits in the consolidated statements of income.

The Company also established the dividend reinvestment plan (the DRP) for its shareholders. The DRP is designed to avail the Company's stock at no transactional cost to its shareholders. Cash dividends paid to shareholders who are enrolled in the DRP plus voluntary cash deposits received can be used to purchase shares; directly from the Company, from shares that become available in the open market or in negotiated transactions with third parties. The Company has reserved 500,000 shares of its un-issued capital stock for issuance under the DRP. Until further notice and action of the Company's board of directors, shares purchased directly from the Company via dividends paid through the DRP

will be purchased at 90% of the fair market value as of the purchase date, as defined in the plan. Shares purchased from the open market will be purchased at 100% of the fair market value on the purchase date, as defined in the plan. During the first quarter of 2014, the board of directors amended the DRP to eliminate the 10% purchase price discount to fair market on shares purchased directly from the Company with optional cash payments. As of December 31, 2013, there were 432,415 shares available for future issuance.

## 11. INCOME TAXES

Pursuant to the accounting guidelines related to income taxes, the Company has evaluated its material tax positions as of December 31, 2013 and 2012. Under the “more-likely-than-not” threshold guidelines, the Company believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. In periods subsequent to December 31, 2013, determinations of potentially adverse material tax positions will be evaluated to determine whether an uncertain tax position may have previously existed or has been originated. In the event an adverse tax position is determined to exist, penalty and interest will be accrued, in accordance with the Internal Revenue Service guidelines, and will be recorded as a component of other expenses in the Company’s consolidated statements of income.

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As of December 31, 2013, there were no unrecognized tax benefits that, if recognized, would significantly affect the Company's effective tax rate. Also, there were no penalties and interest recognized in the consolidated statements of income in 2013, 2012 and 2011 as a result of management's evaluation of whether an uncertain tax position may exist nor does the Company foresee a change in its material tax positions that would give rise to the non-recognition of an existing tax benefit during the forthcoming twelve months. Tax returns filed with the Internal Revenue Service are subject to review by law under a three-year statute of limitations. The Company has not received notification from the IRS regarding adverse tax issues from tax returns filed for tax years 2013, 2012 or 2011.

The following temporary differences gave rise to the net deferred tax asset, a component of other assets in the consolidated balance sheets, as of the periods indicated:

| (dollars in thousands)   | As of December 31, |          |
|--|--------------------|----------|
|  | 2013               | 2012     |
| Deferred tax assets:   |                    |          |
| Other-than-temporary impairment on available-for-sale securities | \$ -               | \$ 5,212 |
| Allowance for loan losses  | 3,035              | 3,051    |
| Deferred interest from non-accrual assets                        | 455                | 979      |
| Other  | 247                | 170      |
| Total  | 3,737              | 9,412    |
| Deferred tax liabilities:  |                    |          |
| Loan fees and costs  | (1,276)            | (1,070)  |
| Depreciation   | (348)              | (464)    |
| Unrealized gains on available-for-sale securities                | (639)              | (121)    |
| Mortgage loan servicing rights                                   | (388)              | (304)    |
| Automobile leasing   | (283)              | -        |
| Other  | (34)               | -        |
| Total  | (2,968)            | (1,959)  |
| Deferred tax asset, net  | \$ 769             | \$ 7,453 |

The components of the total provision for income taxes for the years indicated are as follows:

| (dollars in thousands)           | Years ended December 31, |          |          |
|----------------------------------|--------------------------|----------|----------|
|                                  | 2013                     | 2012     | 2011     |
| Current                          | \$ (3,531)               | \$ 2,011 | \$ 1,760 |
| Deferred                         | 6,166                    | (452)    | (115)    |
| Total provision for income taxes | \$ 2,635                 | \$ 1,559 | \$ 1,645 |

The reconciliation between the expected statutory income tax and the actual provision for income taxes is as follows:

|   | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
| (dollars in thousands)                      | 2013                     | 2012     | 2011     |
| Expected provision at the statutory rate    | \$ 3,317                 | \$ 2,197 | \$ 2,275 |
| Tax-exempt income                           | (589)                    | (563)    | (563)    |
| Bank owned life insurance                   | (114)                    | (111)    | (107)    |
| Low income housing credits                  | (10)                     | (10)     | (10)     |
| Nondeductible interest expense              | 14                       | 16       | 21       |
| Nondeductible other expenses and other, net | 17                       | 30       | 29       |
| Actual provision for income taxes           | \$ 2,635                 | \$ 1,559 | \$ 1,645 |

## 12. RETIREMENT PLAN

The Company has a defined contribution profit sharing 401(k) plan covering substantially all of its employees. The plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Contributions to the plan approximated \$0.3 million in 2013, 2012 and 2011.

## 13. 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.

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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.

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

December 31, 2013

| (dollars in thousands)        | Carrying<br>amount | Estimated<br>fair value | Quoted<br>prices<br>in active<br>markets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|-------------------------------|--------------------|-------------------------|---|---|---|
| Financial assets:             |                    |                         |   |   |   |
| Cash and cash equivalents     | \$ 13,218          | \$ 13,218               | \$ 13,218   | \$ -  | \$ -  |
| Held-to-maturity securities   | 177                | 195                     | -   | 195   | -   |
| Available-for-sale securities | 97,246             | 97,246                  | 525   | 96,721  | -   |
| FHLB Stock                    | 2,640              | 2,640                   | -   | 2,640   | -   |
| Loans 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  | -   |

December 31, 2012

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| (dollars in thousands)        | Carrying<br>amount | Estimated<br>fair value | Quoted<br>prices<br>in active<br>markets<br>(Level 1) | other<br>observable<br>inputs<br>(Level 2) | other<br>unobservable<br>inputs<br>(Level 3) |
|-------------------------------|--------------------|-------------------------|---|--|--|
| Financial assets:             |                    |                         |   |  |  |
| Cash and cash equivalents     | \$ 21,846          | \$ 21,846               | \$ 21,846   | \$ -                                       | \$ -   |
| Held-to-maturity securities   | 289                | 320                     | -   | 320  | -  |
| Available-for-sale securities | 100,441            | 100,441                 | 466   | 98,150                                     | 1,825  |
| FHLB Stock                    | 2,624              | 2,624                   | -   | 2,624                                      | -  |
| Loans, net                    | 424,584            | 430,861                 | -   | -  | 430,861                                      |
| Loans held-for-sale           | 10,545             | 10,824                  | -   | 10,824                                     | -  |
| Financial liabilities:        |                    |                         |   |  |  |
| Deposit liabilities           | 514,660            | 515,869                 | -   | 515,869                                    | -  |
| Short-term borrowings         | 8,056              | 8,056                   | -   | 8,056                                      | -  |
| Long-term debt                | 16,000             | 18,691                  | -   | 18,691                                     | -  |

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

|  | Total<br>carrying<br>value<br>December<br>31, 2013 | Quoted<br>prices<br>in active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|--|--|--|---|---|
|  |  |  |   |   |
| (dollars in thousands)                           |  |  |   |   |
| Available-for-sale securities:                   |  |  |   |   |
| Agency - GSE                                     | \$ 14,601  | \$ -   | \$ 14,601   | \$ -  |
| Obligations of states and political subdivisions | 32,611   | -  | 32,611  | -   |
| MBS - GSE residential                            | 49,509   | -  | 49,509  | -   |
| Equity securities - financial services           | 525  | 525  | -   | -   |
| Total available-for-sale securities              | \$ 97,246  | \$ 525   | \$ 96,721   | \$ -  |

|  | Total<br>carrying<br>value<br>December<br>31, 2012 | Quoted<br>prices<br>in active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|--|--|--|---|---|
|  |  |  |   |   |
| (dollars in thousands)                           |  |  |   |   |
| Available-for-sale securities:                   |  |  |   |   |
| Agency - GSE                                     | \$ 17,740  | \$ -   | \$ 17,740   | \$ -  |
| Obligations of states and political subdivisions | 29,857   | -  | 29,857  | -   |
| Corporate bonds:                                 |  |  |   |   |
| Pooled trust preferred securities                | 1,825  | -  | -   | 1,825   |
| MBS - GSE residential                            | 50,553   | -  | 50,553  | -   |
| Equity securities - financial services           | 466  | 466  | -   | -   |
| Total available-for-sale securities              | \$ 100,441   | \$ 466   | \$ 98,150   | \$ 1,825  |

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

related services to financial institutions. Assets classified as Level 2 use valuation techniques that are common to bond valuations. That is, in active markets whereby bonds of similar characteristics frequently trade, quotes for similar assets are obtained. For the years ended December 31, 2013 and 2012, there were no transfers to or from Level 1 and Level 2 fair value measurements for financial assets measured on a recurring basis.

The Company sold its entire position of the pooled trust preferred securities in the fourth quarter of 2013. Prior to the date of sale, the Company's pooled trust preferred securities included both observable and unobservable inputs to determine fair value and, therefore, were considered Level 3 inputs. As a result of the sale, the Company did not have assets classified as Level 3 inputs as of December 31, 2013. The accounting pronouncement related to fair value measurement provides guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity such as was the case with the Company's investment in pooled trust preferred securities.

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

Quantitative information about Level 3 fair value measurements as of December 31, 2012:

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



As noted, the Company sold its entire portfolio of pooled trust preferred securities in the fourth quarter of 2013. The following discussion relates to December 31, 2012. Prior to their sale in 2013, the Company owned 13 issues of \$22.3 million, original par value, pooled trust preferred securities. The market for these securities is inactive – no new issues since late 2007, financial institutions with less than \$10 billion in assets qualify for new issue Tier 1 capital treatment which further limits the already low probability of a new issue coming to market, trading is sparse and consummated mostly by speculative hedge funds. Observable pricing market inputs such as broker models, S&P pricing based on interpolated available market activity and Bloomberg fair value models for corporate issues are available, however, such inputs to be used as indicators of fair value would require significant adjustments. Therefore, management determined that a fair value modeled income approach (discounted cash flow) was more representative of fair value than the market approach. This technique strives to maximize the use of observable inputs and minimizes the use of unobservable inputs. The Company used the Moody’s Wall Street Analytics methodology of valuation and analysis of collateralized “TruPS”, and their proprietary software to help analyze and value the Company’s pooled trust preferred securities portfolio. The major unobservable input assumptions used in the cash flow analysis include:

- Credit quality estimated using issuer specific probability of default;
- Correlation analysis or the potential for the tendency of companies to default once other companies in the same industry default: 50% for same industry and 30% for across industries;
- Loss given default or cash lost to investor. Assumed to be 100% with no recovery;
- Cash flows were forecast for the underlying collateral and applied to each tranche to determine the resulting distribution among securities, capturing the credit risk element of the collateral, and to determine the estimated fundamental value of the security. No prepayments were assumed and the tranche coupon rate was used as the discount rate; and
- Finally, the orderly liquid exit values (OLEV) were calculated for valuation purposes. The OLEV estimates a new issuance spread as if the market was both liquid and active utilizing the current risk profile of the security and regression analysis across a large sample of tranches based on historical data. The discount rates determined on an overall basis ranged from 0% to 36% as of December 31, 2012 and were applied to the fundamental cash flow value (as determined above) of the security to determine fair value.

The following table illustrates the changes in Level 3 financial instruments measured at fair value on a recurring basis for the periods indicated:

| (dollars in thousands)              | As of and for the<br>years ended<br>December 31, |          |
|-------------------------------------|--|----------|
|                                     | 2013   | 2012     |
| Balance at beginning of period      | \$ 1,825   | \$ 1,466 |
| Realized gains (losses) in earnings | 2,873  | (136)    |
| Unrealized gains (losses) in OCI:   |  |          |
| Gains                               | 4,958  | 739      |
| Losses                              | (460)  | (129)    |
| Pay down / settlement               | (9,205)  | (146)    |
| Interest paid-in-kind               | 6  | 28       |
| Accretion                           | 3  | 3        |
| Balance at end of period            | \$ -   | \$ 1,825 |

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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:

|                          | Total<br>carrying<br>value<br>at<br>December<br>31, 2013 | Quoted<br>prices in<br>active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|--------------------------|--|--|---|---|
| (dollars in thousands)   |  |  |   |   |
| Impaired loans           | \$ 1,152   | \$ -   | \$ -  | \$ 1,152  |
| Other real estate owned  | 1,642  | -  | -   | 1,642   |
| Other repossessed assets | 8  | -  | -   | 8   |
| Total                    | \$ 2,802   | \$ -   | \$ -  | \$ 2,802  |

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

From time-to-time, the Company may be required to record at fair value financial instruments on a non-recurring basis, such as impaired loans, 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 vehicle's fair value for an impaired auto loan. At December 31, 2013 and 2012, the range of liquidation expenses and other valuation adjustments applied to impaired loans ranged from -16.00% to -36.15% (weighted-average -24.84%) and -2.30% to -64.40% (weighted average -35.54%), respectively. Due to the multitude of assumptions, many of which are subjective in nature, and the varying inputs and techniques used to determine fair value, the Company recognizes that valuations could differ across a wide spectrum of techniques employed. Accordingly, fair value estimates for impaired loans are classified as Level 3.

For other real estate owned, fair value is generally determined through independent appraisals of the underlying properties which generally include various Level 3 inputs which are not identifiable. The appraisals may be adjusted by management for qualitative reasons and estimated liquidation expenses. Management's assumptions may include consideration of the location and occupancy of the property, along with current economic conditions. Subsequently, as these properties are actively marketed, the estimated fair values may be periodically adjusted through incremental subsequent write-downs. These write-downs usually reflect decreases in estimated values resulting from sales price observations as well as changing economic and market conditions. At December 31, 2013 and 2012, adjustments to the appraisal values for other real estate owned ranged from -18.22% to -72.17% (weighted average -30.79% ) and -16.72% to -94.74% (weighted average -34.89%), respectively.

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

#### Financial Instruments with Off-Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of the Company's involvement in particular classes of financial instruments. Because of the nature of these instruments, the fair values of these off-balance sheet items are not material.

The notional amount of the Company's financial instruments with off-balance sheet risk was as follows:

| (dollars in thousands)                   | December 31, |            |
|--|--------------|------------|
|  | 2013         | 2012       |
| Off-balance sheet financial instruments: |              |            |
| Commitments to extend credit             | \$ 89,751    | \$ 100,930 |
| Standby letters of credit                | 7,718        | 8,644      |

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

The Company's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees. Since commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Company evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if considered necessary by the Company on extension of credit, is based on management's credit assessment of the customer.

Financial standby letters of credit are conditional commitments issued by the Company to guarantee performance of a customer to a third party. Those guarantees are issued primarily to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The Company's performance under the guarantee is required upon presentation by the beneficiary of the financial standby letter of credit. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company was not required to recognize any liability in connection with the issuance of these financial standby letters of credit.

The following table summarizes outstanding financial letters of credit as of December 31, 2013:

| (dollars in thousands) | Less than one year | More than              | Over five years | Total    |
|------------------------|--------------------|------------------------|-----------------|----------|
|                        |                    | one year to five years |                 |          |
| Secured by:            |                    |                        |                 |          |
| Collateral             | \$ 1,306           | \$ 5,000               | \$ 566          | \$ 6,872 |
| Bank lines of credit   | 45                 | 16                     | -               | 61       |
|                        | 1,351              | 5,016                  | 566             | 6,933    |
| Unsecured              | 741                | 44                     | -               | 785      |
| Total                  | \$ 2,092           | \$ 5,060               | \$ 566          | \$ 7,718 |

The Company has not incurred losses on its commitments in 2013, 2012 or 2011.

#### 14.EARNINGS PER SHARE

Basic earnings per share (EPS) is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but also reflects the potential dilution that could occur from the grant of stock-based compensation awards. The Company maintains two active share-based compensation plans that may generate additional potentially dilutive common shares. For granted and unexercised stock options, dilution would occur if Company-issued stock options were exercised and converted into common stock. Since the average share market prices of the Company's common stock, during 2013, 2012, and 2011, were below the strike prices of all unexercised outstanding options, there were no potentially dilutive shares outstanding in any of the reportable periods related to stock options. For restricted stock, dilution would occur from the Company's unvested shares. There were 13,000 and 151 unvested restricted share grants outstanding as of December 31, 2013 and 2012, respectively. There were no restricted stock grants in 2011.

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 years indicated:

|   | Years ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2013                     | 2012      | 2011      |
| (dollars in thousands except per share data)                        |                          |           |           |
| Basic EPS:  |                          |           |           |
| Net income available to common shareholders                         | \$ 7,122                 | \$ 4,902  | \$ 5,045  |
| Weighted-average common shares outstanding                          | 2,353,056                | 2,286,233 | 2,213,631 |
| Basic EPS   | \$ 3.03                  | \$ 2.14   | \$ 2.28   |
| Diluted EPS:  |                          |           |           |
| Net income available to common shareholders                         | \$ 7,122                 | \$ 4,902  | \$ 5,045  |
| Weighted-average common shares outstanding                          | 2,353,056                | 2,286,233 | 2,213,631 |
| Potentially dilutive common shares                                  | 4,674                    | 151       | -         |
| Weighted-average common and potentially dilutive shares outstanding | 2,357,730                | 2,286,384 | 2,213,631 |
| Diluted EPS   | \$ 3.02                  | \$ 2.14   | \$ 2.28   |

## 15.REGULATORY MATTERS

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets. The appropriate risk-weighting pursuant to regulatory guidelines, requires a gross-up in the risk-weighting of investment securities that are rated below investment grade, thus significantly inflating the total risk-weighted assets. This requirement had an adverse impact on the total capital and Tier I capital ratios in 2012. The investment securities rated below investment grade were sold in 2013 thereby eliminating the need to apply a gross-up in the risk-weighting 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 December 31, 2013 and 2012, the Company and the Bank exceeded all capital adequacy requirements to which it was subject.

To be categorized as well capitalized, the Company and the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the following table. The Company's and the Bank's actual capital amounts and ratios are also presented in the table. No amounts were deducted from capital for interest-rate risk in either 2013 or 2012.

| (dollars in thousands)                   | Actual    | For capital |             | To be well |             |              |
|--|-----------|-------------|-------------|------------|-------------|--------------|
| As of December 31, 2013:                 | Amount    | Ratio       | adequacy    | purposes   | capitalized | under prompt |
|  |           |             | Amount      | Ratio      | action      | corrective   |
|  |           |             |             |            | provisions  | provisions   |
|  |           |             |             |            | Amount      | Ratio        |
| Total capital (to risk-weighted assets)  |           |             |             |            |             |              |
| Consolidated                             | \$ 70,669 | 15.2% ≥     | \$ 37,255 ≥ | 8.0%       | N/A         | N/A          |
| Bank                                     | \$ 70,373 | 15.1% ≥     | \$ 37,251 ≥ | 8.0% ≥     | \$ 46,563 ≥ | 10.0%        |
| Tier I capital (to risk-weighted assets) |           |             |             |            |             |              |
| Consolidated                             | \$ 64,706 | 13.9% ≥     | \$ 18,628 ≥ | 4.0%       | N/A         | N/A          |
| Bank                                     | \$ 64,512 | 13.9% ≥     | \$ 18,625 ≥ | 4.0% ≥     | \$ 27,938 ≥ | 6.0%         |
| Tier I capital (to average assets)       |           |             |             |            |             |              |
| Consolidated                             | \$ 64,706 | 10.3% ≥     | \$ 25,089 ≥ | 4.0%       | N/A         | N/A          |
| Bank                                     | \$ 64,512 | 10.3% ≥     | \$ 25,073 ≥ | 4.0% ≥     | \$ 31,341 ≥ | 5.0%         |



As of December 31, 2012:

Total capital (to risk-weighted assets)

|              |           |       |             |        |             |         |
|--------------|-----------|-------|-------------|--------|-------------|---------|
| Consolidated | \$ 64,042 | 13.5% | ≥ \$ 37,929 | ≥ 8.0% | N/A         | N/A     |
| Bank         | \$ 63,856 | 13.5% | ≥ \$ 37,918 | ≥ 8.0% | ≥ \$ 47,398 | ≥ 10.0% |

Tier I capital (to risk-weighted assets)

|              |           |       |             |        |             |        |
|--------------|-----------|-------|-------------|--------|-------------|--------|
| Consolidated | \$ 57,999 | 12.2% | ≥ \$ 18,965 | ≥ 4.0% | N/A         | N/A    |
| Bank         | \$ 57,893 | 12.2% | ≥ \$ 18,959 | ≥ 4.0% | ≥ \$ 28,439 | ≥ 6.0% |

Tier I capital (to average assets)

|              |           |      |             |        |             |        |
|--------------|-----------|------|-------------|--------|-------------|--------|
| Consolidated | \$ 57,999 | 9.7% | ≥ \$ 24,060 | ≥ 4.0% | N/A         | N/A    |
| Bank         | \$ 57,893 | 9.6% | ≥ \$ 24,042 | ≥ 4.0% | ≥ \$ 30,053 | ≥ 5.0% |

The Bank can pay dividends to the Company equal to the Bank's retained earnings which approximated \$55.8 million at December 31, 2013. However, such dividends are limited due to the capital requirements discussed above.

#### 16.RELATED PARTY TRANSACTIONS

During the ordinary course of business, loans are made to executive officers, directors, greater than 5% shareholders and associates of such persons. These transactions are executed on substantially the same terms and at the rates prevailing at the time for comparable transactions with others. These loans do not involve more than the normal risk of collectability or present other unfavorable features. A summary of loan activity with officers, directors, associates of such persons and shareholders who own more than 5% of the Company's outstanding shares is as follows:

|                        | Years ended December 31, |          |          |
|------------------------|--------------------------|----------|----------|
| (dollars in thousands) | 2013                     | 2012     | 2011     |
| Balance, beginning     | \$ 3,033                 | \$ 2,241 | \$ 2,478 |
| Additions              | 1,470                    | 2,369    | 1,630    |
| Collections            | (1,682)                  | (1,577)  | (1,867)  |
| Balance, ending        | \$ 2,821                 | \$ 3,033 | \$ 2,241 |

Aggregate loans to directors and associates exceeding 2.5% of shareholders' equity included in the table above are as follows:

Years ended December 31,

| (dollars in thousands) | 2013     | 2012     | 2011     |
|------------------------|----------|----------|----------|
| Number of persons      | 1        | 1        | 1        |
| Balance, beginning     | \$ 2,105 | \$ 1,910 | \$ 2,201 |
| Additions              | 816      | 1,251    | 864      |
| Collections            | (1,038)  | (1,056)  | (1,155)  |
| Balance, ending        | \$ 1,883 | \$ 2,105 | \$ 1,910 |

As of December 31, 2013, 2012 and 2011, deposits from executive officers, directors and associates of such persons approximated \$11.1 million, \$11.7 million and \$10.7 million, respectively.

## 17. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The following is a summary of quarterly results of operations for the years indicated:

| (dollars in thousands except per share data)       | 2013          |                |               |                | Total     |
|--|---------------|----------------|---------------|----------------|-----------|
|  | First quarter | Second quarter | Third quarter | Fourth quarter |           |
| Interest income                                    | \$ 5,968      | \$ 5,912       | \$ 5,954      | \$ 6,019       | \$ 23,853 |
| Interest expense                                   | (735)         | (732)          | (748)         | (753)          | (2,968)   |
| Net interest income                                | 5,233         | 5,180          | 5,206         | 5,266          | 20,885    |
| Provision for loan losses                          | (550)         | (600)          | (450)         | (950)          | (2,550)   |
| Gain on sale and recovery of investment securities | 119           | 9              | 138           | 2,902          | 3,168     |
| Other income                                       | 1,949         | 2,042          | 1,770         | 1,612          | 7,373     |
| Other expenses                                     | (4,880)       | (4,606)        | (4,644)       | (4,989)        | (19,119)  |
| Income before taxes                                | 1,871         | 2,025          | 2,020         | 3,841          | 9,757     |
| Provision for income taxes                         | (477)         | (512)          | (515)         | (1,131)        | (2,635)   |
| Net income   | \$ 1,394      | \$ 1,513       | \$ 1,505      | \$ 2,710       | \$ 7,122  |
| Net income per share - basic                       | \$ 0.60       | \$ 0.64        | \$ 0.64       | \$ 1.15        | \$ 3.03   |
| Net income per share - diluted                     | \$ 0.60       | \$ 0.64        | \$ 0.64       | \$ 1.14        | \$ 3.02   |

| (dollars in thousands except per share data)       | 2012          |                |               |                | Total     |
|--|---------------|----------------|---------------|----------------|-----------|
|  | First quarter | Second quarter | Third quarter | Fourth quarter |           |
| Interest income                                    | \$ 6,052      | \$ 5,991       | \$ 5,974      | \$ 5,977       | \$ 23,994 |
| Interest expense                                   | (938)         | (838)          | (804)         | (774)          | (3,354)   |
| Net interest income                                | 5,114         | 5,153          | 5,170         | 5,203          | 20,640    |
| Provision for loan losses                          | (700)         | (600)          | (700)         | (1,250)        | (3,250)   |
| Gain on sale and recovery of investment securities | 254           | 7              | 3             | 64             | 328       |
| Other-than-temporary impairment                    | (105)         | (31)           | -             | -              | (136)     |
| Other income                                       | 1,840         | 1,927          | 1,891         | 1,802          | 7,460     |
| Other expenses                                     | (4,751)       | (4,709)        | (4,479)       | (4,642)        | (18,581)  |
| Income before taxes                                | 1,652         | 1,747          | 1,885         | 1,177          | 6,461     |
| Provision for income taxes                         | (395)         | (430)          | (486)         | (248)          | (1,559)   |
| Net income   | \$ 1,257      | \$ 1,317       | \$ 1,399      | \$ 929         | \$ 4,902  |
| Net income per share                               | \$ 0.56       | \$ 0.57        | \$ 0.61       | \$ 0.40        | \$ 2.14   |

| 2011  |        |       |        |
|-------|--------|-------|--------|
| First | Second | Third | Fourth |

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| (dollars in thousands except per share data)       | quarter  | quarter  | quarter  | quarter  | Total     |
|--|----------|----------|----------|----------|-----------|
| Interest income                                    | \$ 6,550 | \$ 6,597 | \$ 6,376 | \$ 6,080 | \$ 25,603 |
| Interest expense                                   | (1,316)  | (1,279)  | (1,128)  | (1,038)  | (4,761)   |
| Net interest income                                | 5,234    | 5,318    | 5,248    | 5,042    | 20,842    |
| Provision for loan losses                          | (475)    | (375)    | (500)    | (450)    | (1,800)   |
| Gain on sale and recovery of investment securities | 1        | 15       | 13       | 34       | 63        |
| Other-than-temporary impairment                    | (75)     | -        | (5)      | (166)    | (246)     |
| Other income                                       | 1,394    | 1,442    | 1,433    | 1,614    | 5,883     |
| Other expenses                                     | (4,472)  | (4,680)  | (4,413)  | (4,487)  | (18,052)  |
| Income before taxes                                | 1,607    | 1,720    | 1,776    | 1,587    | 6,690     |
| Provision for income taxes                         | (380)    | (431)    | (449)    | (385)    | (1,645)   |
| Net income   | \$ 1,227 | \$ 1,289 | \$ 1,327 | \$ 1,202 | \$ 5,045  |
| Net income per share                               | \$ 0.56  | \$ 0.59  | \$ 0.59  | \$ 0.54  | \$ 2.28   |

## 18. CONTINGENCIES

The nature of the Company's business generates litigation involving matters arising in the ordinary course of business. However, in the opinion of management of the Company after consulting with the Company's legal counsel, no legal proceedings are pending, which, if determined adversely to the Company or the Bank, would have a material effect on the Company's shareholders' equity or results of operations. No legal proceedings are pending other than ordinary routine litigation incident to the business of the Company and the Bank. In addition, to management's knowledge, no government authorities have initiated or contemplated any material legal actions against the Company or the Bank.

## 19. RECENT ACCOUNTING PRONOUNCEMENTS

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

## 20. PARENT COMPANY ONLY

The following is the condensed financial information for Fidelity D & D Bancorp, Inc. on a parent company only basis as of and for the years indicated:

| Condensed Balance Sheets<br>(dollars in thousands) | As of December 31, |           |
|--|--------------------|-----------|
|  | 2013               | 2012      |
| Assets:  |                    |           |
| Cash   | \$ 2               | \$ 2      |
| Investment in subsidiary                           | 65,716             | 58,577    |
| Securities available-for-sale                      | 523                | 466       |
| Other assets                                       | -                  | -         |
| Total  | \$ 66,241          | \$ 59,045 |
| Liabilities and shareholders' equity:              |                    |           |
| Liabilities  | \$ 181             | \$ 99     |
| Capital stock and retained earnings                | 64,821             | 58,710    |
| Accumulated other comprehensive income             | 1,239              | 236       |
| Total  | \$ 66,241          | \$ 59,045 |

| Condensed Income Statements<br>(dollars in thousands) | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2013                     | 2012     | 2011     |
| Income:   |                          |          |          |
| Equity in undistributed earnings of subsidiary        | \$ 6,173                 | \$ 3,996 | \$ 4,184 |
| Dividends from subsidiary                             | 1,190                    | 1,131    | 1,043    |

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|                                       |          |          |          |
|---------------------------------------|----------|----------|----------|
| Gain on sale of investment securities | -        | -        | 27       |
| Other income                          | 20       | 20       | 19       |
| Total income                          | 7,383    | 5,147    | 5,273    |
| Operating expenses                    | 388      | 347      | 317      |
| Income before taxes                   | 6,995    | 4,800    | 4,956    |
| Credit for income taxes               | 127      | 102      | 89       |
| Net income                            | \$ 7,122 | \$ 4,902 | \$ 5,045 |

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| Statements of Comprehensive Income<br>(dollars in thousands) | Years ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2013                     | 2012     | 2011     |
| Bancorp net loss   | \$ (241)                 | \$ (225) | \$ (183) |
| Equity in net income of subsidiary                           | 7,363                    | 5,127    | 5,228    |
| Net income   | 7,122                    | 4,902    | 5,045    |

|   |          |          |          |
|---|----------|----------|----------|
| Other comprehensive income, before tax:                   |          |          |          |
| Unrealized holding gains on available-for-sale securities | 58       | 27       | 17       |
| Reclassification adjustment for gains realized in income  | -        | -        | (27)     |
| Net unrealized gains (losses)                             | 58       | 27       | (10)     |
| Tax effect  | (20)     | (9)      | 3        |
| Unrealized gain (loss), net of tax                        | 38       | 18       | (7)      |
| Equity in other comprehensive income of subsidiary        | 965      | 1,328    | 2,714    |
| Other comprehensive income, net of tax                    | 1,003    | 1,346    | 2,707    |
| Total comprehensive income, net of tax                    | \$ 8,125 | \$ 6,248 | \$ 7,752 |

| Condensed Statements of Cash Flows<br>(dollars in thousands)        | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2013                     | 2012     | 2011     |
| Cash flows from operating activities:                               |                          |          |          |
| Net income  | \$ 7,122                 | \$ 4,902 | \$ 5,045 |
| Adjustments to reconcile net income to net cash used in operations: |                          |          |          |
| Equity in earnings of subsidiary                                    | (7,363)                  | (5,127)  | (5,228)  |
| Stock-based compensation expense                                    | 112                      | 15       | 24       |
| Gain on sale of investment securities                               | -                        | -        | (27)     |
| Changes in other assets and liabilities, net                        | 62                       | 20       | 14       |
| Net cash used in operating activities                               | (67)                     | (190)    | (172)    |
| Cash flows provided by investing activities:                        |                          |          |          |
| Dividends received from subsidiary                                  | 1,190                    | 1,131    | 1,043    |
| Proceeds from sales of investment securities                        | -                        | -        | 55       |
| Net cash provided by investing activities                           | 1,190                    | 1,131    | 1,098    |
| Cash flows used in financing activities:                            |                          |          |          |
| Dividends paid, net of dividend reinvestment                        | (1,596)                  | (1,493)  | (1,478)  |
| Cash contributions from dividend reinvestment plan                  | 395                      | 486      | 485      |
| Withholdings to purchase capital stock                              | 78                       | 67       | 67       |
| Net cash used in financing activities                               | (1,123)                  | (941)    | (926)    |
| Net change in cash  | -                        | -        | -        |

|                 |      |      |      |
|-----------------|------|------|------|
| Cash, beginning | 2    | 2    | 2    |
| Cash, ending    | \$ 2 | \$ 2 | \$ 2 |

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Item 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A: CONTROLS AND PROCEDURES

As of the end of the period covered by this Annual Report on Form 10-K, an evaluation was carried out by the Company's management, with the participation of its President and Chief Executive Officer and the 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 the 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 December 31, 2013.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, provides smaller companies and debt-only issuers with a permanent exemption from the Sarbanes-Oxley internal control audit requirements. Without this exemption, these companies would have been required to comply with the internal control audit requirements for fiscal years ended on or after June 15, 2010. The permanent exemption applies to entities that are commonly referred to as non-accelerated filers and smaller reporting companies, such as the Company. Generally speaking, a non-accelerated filer and a smaller reporting company have public float, or market capitalization of less than \$75.0 million. The permanent exemption applies only to the Sarbanes-Oxley internal control audit requirements. Non-accelerated filers and smaller reporting companies are still required to disclose management's assessment of the effectiveness of internal control over financial reporting.

Management's Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed under the supervision of the Company's President and Chief Executive Officer and the Chief Financial Officer, and implemented in conjunction with management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's consolidated financial statements for external purposes in accordance with generally accepted accounting principles.

There are inherent limitations in the effectiveness of any internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013. This assessment was based on criteria for effective internal control over financial reporting described in "Internal Control – Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management determined that, as of December 31, 2013, the Company maintained effective internal control over financial reporting.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the SEC that permit the Company to provide only management's report in this annual report.

Item 9B:OTHER INFORMATION

None

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### PART III

#### Item 10: DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required in this item is incorporated by reference herein, to the information presented in the Company's definitive Proxy Statement for its 2014 Annual Meeting of Shareholders to be filed with the SEC.

#### Section 16(a) Beneficial Ownership Reporting Compliance

The information required in this item is incorporated by reference herein, to the information presented in the Company's definitive Proxy Statement for its 2014 Annual Meeting of Shareholders to be filed with the SEC.

#### Code of Ethics

Pursuant to Item 406 of Regulation S-K, the Company adopted a written code of ethics that applies to our directors, officers and employees, including our chief executive officer and chief financial officer, which is available on our website at <http://www.bankatfidelity.com> through the Investor Relations link and then under the headings "Other Information", "Governance Documents." In addition, copies of our code of ethics will be provided to shareholders upon written request to Fidelity D & D Bancorp, Inc., Blakely and Drinker Streets, Dunmore, PA 18512 at no charge.

#### Item 11: EXECUTIVE COMPENSATION

The information required in this item is incorporated by reference herein, to the information presented in the Company's definitive Proxy Statement for its 2014 annual meeting of shareholders to be filed with the SEC.

#### Item 12: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required in this item is incorporated by reference herein, to the information presented in the Company's definitive Proxy Statement for its 2014 annual meeting of shareholders to be filed with the SEC.

#### Item 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required in this item is set forth in Footnote No. 16 "Related Party Transactions", of Part II, Item 8 "Financial Statements and Supplementary Data", and the information required by Item 407(a) of Regulation S-K is incorporated by reference herein to the information presented in the Company's definitive Proxy Statement for its 2013 annual meeting of shareholders to be filed with the SEC.

#### Item 14: PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated by reference herein, to the information presented in the Company's definitive Proxy Statement for its 2014 annual meeting of shareholders to be filed with the SEC.

### PART IV

#### Item 15: EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) (1) Financial Statements - The following financial statements are included by reference in Part II, Item 8 hereof:

Report of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets  
Consolidated Statements of Income  
Consolidated Statements of Comprehensive Income  
Consolidated Statements of Changes in Shareholders' Equity  
Consolidated Statements of Cash Flows  
Notes to Consolidated Financial Statements  
(2) Financial Statement Schedules

Financial Statement Schedules are omitted because the required information is either not applicable, the data is not significant or the required information is shown in the respective financial statements or in the notes thereto or elsewhere herein.

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(3) Exhibits

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

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

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

\*10.1 Registrant's 2012 Dividend Reinvestment and Stock Repurchase Plan. Incorporated by reference to Exhibit 4.1 to Registrant's Registration Statement No. 333-183216 on Form S-3 filed with the SEC on August 10, 2012 as amended February 3, 2014.

\*10.2 Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

\*10.3 Amendment, dated October 2, 2007, to the Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 10.2 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

\*10.4 Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

\*10.5 Amendment, dated October 2, 2007, to the Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 10.1 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

\*10.6 Registrant's 2002 Employee Stock Purchase Plan. Incorporated by reference to Appendix A to Definitive proxy Statement filed with the SEC on March 28, 2002.

\*10.7 Change of Control Agreement with Salvatore R. DeFrancesco, 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 Fidelity D & D Bancorp, Inc., 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 Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Timothy P. O'Brien, dated March 23, 2011. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

\*10.10 2012 Omnibus Stock Incentive Plan. Incorporated by reference to Appendix A to Registrant's Definitive Proxy Statement filed with the SEC on March 30, 2012.

\*10.11 2012 Director Stock Incentive Plan. Incorporated by reference to Appendix B to Registrant's Definitive Proxy Statement filed with the SEC on March 30, 2012.

\*10.12 Change in Control and Severance Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Raymond J. Fox, dated January 14, 2013. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on January 14, 2013.

11 Statement regarding computation of earnings per share. Included herein in Note 14 "Earnings per Share", contained within the notes to consolidated financial statements, and incorporated herein by reference.

12 Statement regarding computation of ratios. Included herein in Item 6, "Selected Financial Data."

13 Annual Report to Shareholders. Incorporated by reference to the 2013 Annual Report to Shareholders filed with the SEC on Form ARS.

21 Subsidiaries of the Registrant.

23 Consent of Independent Registered Public Accounting Firm.

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 Annual Report on Form 10-K for the year ended December 31, 2013, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of December 31, 2013 and 2012; Consolidated Statements of Income for the years ended December 31, 2013, 2012 and 2011; Consolidated Statements of Comprehensive Income for the years ended December 31, 2013, 2012 and 2011; Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2013, 2012 and 2011; and Consolidated Statements of Cash Flows for the years ended December 31, 2013, 2012 and 2011.

(b)The exhibits required to be filed by this Item are listed under Item 15(a) 3, above.

(c)Not applicable.

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\* Management contract or compensatory plan or arrangement.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and 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.  
(Registrant)

Date: March 18, 2014 By: /s/ Daniel J. Santaniello  
Daniel J. Santaniello,  
President and Chief  
Executive Officer

Date: March 18, 2014 By: /s/ Salvatore R.  
DeFrancesco, Jr.  
Salvatore R. DeFrancesco,  
Jr.,  
Treasurer and Chief  
Financial Officer

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

DATE

By: /s/ Daniel J. Santaniello                      March 18, 2014  
Daniel J. Santaniello, President and  
Chief  
Executive Officer

By: /s/ Salvatore R. DeFrancesco, Jr.              March 18, 2014  
Salvatore R. DeFrancesco, Jr.,  
Treasurer  
and Chief Financial Officer

By: /s/ Patrick J. Dempsey                              March 18, 2014





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| 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 on 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, 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 Fidelity D & D Bancorp, Inc., 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 Fidelity D & D Bancorp, Inc., 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.  | *    |



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|---|----|
| 10.12 Change in Control and Severance Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Raymond J. Fox, dated January 14, 2013. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on January 14, 2013.   | *  |
| 11 Statement regarding computation of earnings per share. Included herein Note 14, "Earnings per Share", contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.   | 84 |
| 12 Statement regarding computation of ratios. Included herein in Item 6, "Selected Financial Data".   | 16 |
| 13 Annual Report to Shareholders. Incorporated by reference to the 2013 Annual Report to Shareholders filed with* the SEC on Form ARS.  |    |
| 21 Subsidiaries of the Registrant.  | 95 |
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| 31.1 Rule 13a-14(a) Certification of Principal Executive Officer.   | 97 |
| 31.2 Rule 13a-14(a) Certification of Principal Financial Officer.   | 98 |
| 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.   | 99 |
| 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.   | 99 |
| 101 Interactive data files: The following, from Fidelity D&D Bancorp, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2013, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of December 31, 2013 and 2012; Consolidated Statements of Income for the years ended December 31, 2013, 2012 and 2011; Consolidated Statements of Comprehensive Income for the years ended December 31, 2013, 2012 and 2011; Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2013, 2012 and 2011; and Consolidated Statements of Cash Flows for the years ended December 31, 2013, 2012 and 2011. |    |

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\*Incorporated by Reference

Exhibit 21

Subsidiaries of the Registrant

| Subsidiary                                      | State of Incorporation |
|---|------------------------|
| The Fidelity<br>Deposit and<br>Discount<br>Bank | Pennsylvania           |

Exhibit 23

Consent of Independent Registered Public Accounting Firm

We hereby consent to the incorporation by reference in Fidelity D & D Bancorp, Inc.'s Annual Report on Form 10-K filed with the Securities and Exchange Commission of our report dated March 18, 2014 relating to the consolidated financial statements of Fidelity D & D Bancorp, Inc. and Subsidiary as of December 31, 2013 and 2012, and for each of the years in the three-year period ended December 31, 2013, which report appears in the Registrant's Annual Report to Shareholders for the year ended December 31, 2013 and in the registrant's registration numbers: 333-183216, 333-181488, 333-181489, 333-152806, 333-113339 and 333-64356.

/s/ ParenteBeard LLC

ParenteBeard LLC

Wilkes-Barre, Pennsylvania

March 18, 2014

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Exhibit 31.1

CERTIFICATION

I, Daniel J. Santaniello, certify that:

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

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

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

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

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

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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

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

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

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

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

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Date: March 18, 2014

By: /s/ Daniel J.  
Santaniello

Daniel J.  
Santaniello,  
President

and Chief  
Executive  
Officer

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Exhibit 31.2

CERTIFICATION

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

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

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

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

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

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

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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

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

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

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

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

Date: March 18, 2014

By: /s/ Salvatore R.  
DeFrancesco, Jr.  
Salvatore R.  
DeFrancesco, Jr.  
Treasurer  
and Chief  
Financial  
Officer

Exhibit 32.1

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350  
AS ADDED BY  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of Fidelity D & D Bancorp, Inc. (the “Company”) for the year ended December 31, 2013, as filed with the Securities and Exchange Commission (the “Report”), I, Daniel J. Santaniello, President and Chief Executive Officer of the Company, certify, pursuant to Title 18 U.S.C. §1350, as added by §906 of the Sarbanes-Oxley Act of 2002, that:

- 1.The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2.To my knowledge, the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

Date: March 18, 2014    By: /s/ Daniel J.  
Santaniello  
Daniel J.  
Santaniello,  
President  
and Chief  
Executive  
Officer

Exhibit 32.2

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350  
AS ADDED BY  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of Fidelity D & D Bancorp, Inc. (the “Company”) for the year ended December 31, 2013, as filed with the Securities and Exchange Commission (the “Report”), I, Salvatore R.

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DeFrancesco, Jr., Treasurer and Chief Financial Officer of the Company, certify, pursuant to Title 18 U.S.C. §1350, as added by §906 of the Sarbanes-Oxley Act of 2002, that:

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

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

Date: March 18, 2014    By: /s/ Salvatore R.  
DeFrancesco, Jr.  
Salvatore R.  
DeFrancesco,  
Jr.  
Treasurer  
and Chief  
Financial  
Officer