

FIDELITY D & D BANCORP INC  
Form 10-Q  
November 13, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2007**

**OR**

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

**For the transition period from                      to**

**Commission file number: 333-90273**

**FIDELITY D & D BANCORP, INC.**

STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

**PENNSYLVANIA**

**23-3017653**

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Address of principal executive offices:

**BLAKELY & DRINKER ST.**

**DUNMORE, PENNSYLVANIA 18512**

TELEPHONE:

**570-342-8281**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subjected to such filing requirements for the past 90 days.

YES  NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

YES  NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. at October 31, 2007, the latest practicable date, was 2,072,929 shares.

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**FIDELITY D & D BANCORP, INC.**

Form 10-Q September 30, 2007

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**PART I Financial Information****Item 1: Financial Statements****FIDELITY D & D BANCORP, INC. AND SUBSIDIARY**

## Consolidated Balance Sheets

|   | September 30, 2007<br>(unaudited) | December 31, 2006<br>(audited) |
|---|-----------------------------------|--------------------------------|
| <b>Assets:</b>  |                                   |                                |
| Cash and due from banks   | \$ 13,187,169                     | \$ 13,732,137                  |
| Interest-bearing deposits with financial institutions   | 183,943                           | 68,711                         |
| <b>Total cash and cash equivalents</b>  | <b>13,371,112</b>                 | <b>13,800,848</b>              |
| Available-for-sale securities   | 120,700,576                       | 98,841,364                     |
| Held-to-maturity securities   | 1,196,077                         | 1,569,372                      |
| Federal Home Loan Bank Stock  | 3,558,300                         | 3,795,100                      |
| Loans and leases, net (allowance for loan losses of \$4,990,855 in 2007 and \$5,444,303 in 2006)  | 420,790,921                       | 417,199,048                    |
| Loans available-for-sale (fair value \$388,121 in 2007; \$123,156 in 2006)  | 382,000                           | 122,000                        |
| Bank premises and equipment, net  | 13,306,479                        | 11,324,465                     |
| Cash surrender value of bank owned life insurance   | 8,408,987                         | 8,177,961                      |
| Other assets  | 4,399,408                         | 4,788,105                      |
| Accrued interest receivable   | 2,880,243                         | 2,502,576                      |
| Foreclosed assets held for sale   | 107,036                           | 197,149                        |
| <b>Total assets</b>   | <b>\$ 589,101,139</b>             | <b>\$ 562,317,988</b>          |
| <b>Liabilities:</b>   |                                   |                                |
| <b>Deposits:</b>  |                                   |                                |
| Interest-bearing  | \$ 368,512,228                    | \$ 336,592,620                 |
| Non-interest-bearing  | 70,544,329                        | 73,741,975                     |
| <b>Total deposits</b>   | <b>439,056,557</b>                | <b>410,334,595</b>             |
| Accrued interest payable and other liabilities  | 4,658,726                         | 4,179,170                      |
| Short-term borrowings   | 28,579,498                        | 33,656,150                     |
| Long-term debt  | 62,917,875                        | 62,536,210                     |
| <b>Total liabilities</b>  | <b>535,212,656</b>                | <b>510,706,125</b>             |
| <b>Shareholders' equity:</b>  |                                   |                                |
| Preferred stock authorized 5,000,000 shares with no par value; none issued  |                                   |                                |
| Capital stock authorized 10,000,000 shares with no par value; issued and outstanding, 2,072,929 shares in 2007 and 2,057,433 shares in 2006 | 19,214,460                        | 18,702,537                     |
| Retained earnings   | 35,851,823                        | 33,874,118                     |

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|  |                |                |
|--|----------------|----------------|
| Accumulated other comprehensive loss       | (1,177,800)    | (964,792)      |
| Total shareholders' equity                 | 53,888,483     | 51,611,863     |
| Total liabilities and shareholders' equity | \$ 589,101,139 | \$ 562,317,988 |

See notes to consolidated financial statements

## FIDELITY D &amp; D BANCORP, INC. AND SUBSIDIARY

## Consolidated Statements of Income

(unaudited)

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2007 | September 30, 2006 | September 30, 2007 | September 30, 2006 |
| <b>Interest income:</b>                                    |                    |                    |                    |                    |
| <b>Loans and leases:</b>                                   |                    |                    |                    |                    |
| Taxable  | \$ 7,223,183       | \$ 7,122,621       | \$ 21,540,100      | \$ 20,500,909      |
| Nontaxable   | 122,594            | 104,193            | 350,463            | 357,813            |
| Interest-bearing deposits with financial institutions      | 2,190              | 2,045              | 6,911              | 6,821              |
| <b>Investment securities:</b>                              |                    |                    |                    |                    |
| U.S. government agency and corporations                    | 1,093,098          | 918,070            | 3,029,358          | 2,789,335          |
| States and political subdivisions (nontaxable)             | 124,922            | 149,611            | 374,273            | 440,929            |
| Other securities   | 278,100            | 239,280            | 804,522            | 668,492            |
| Federal funds sold   | 48,259             | 58,746             | 102,913            | 94,872             |
| <b>Total interest income</b>                               | <b>8,892,346</b>   | <b>8,594,566</b>   | <b>26,208,540</b>  | <b>24,859,171</b>  |
| <b>Interest expense:</b>                                   |                    |                    |                    |                    |
| Deposits   | 3,420,693          | 3,132,402          | 9,977,394          | 8,279,425          |
| Securities sold under repurchase agreements                | 124,089            | 177,668            | 355,122            | 476,543            |
| Other short-term borrowings and other                      | 26,013             | 51,661             | 360,025            | 275,852            |
| Long-term debt   | 899,196            | 919,338            | 2,466,898          | 3,018,121          |
| <b>Total interest expense</b>                              | <b>4,469,991</b>   | <b>4,281,069</b>   | <b>13,159,439</b>  | <b>12,049,941</b>  |
| <b>Net interest income</b>                                 | <b>4,422,355</b>   | <b>4,313,497</b>   | <b>13,049,101</b>  | <b>12,809,230</b>  |
| (Credit) provision for loan losses                         | (60,000)           | 75,000             | (60,000)           | 325,000            |
| <b>Net interest income after provision for loan losses</b> | <b>4,482,355</b>   | <b>4,238,497</b>   | <b>13,109,101</b>  | <b>12,484,230</b>  |
| <b>Other income:</b>                                       |                    |                    |                    |                    |
| Service charges on deposit accounts                        | 784,847            | 698,839            | 2,179,086          | 1,965,620          |
| <b>Gain (loss) on sale of:</b>                             |                    |                    |                    |                    |
| Loans  | 52,821             | 20,707             | 120,717            | 62,550             |
| Investment securities                                      |                    |                    |                    | (166)              |
| Premises and equipment                                     | 1,248              | (16,334)           | 74,881             | (14,774)           |
| Leased assets  |                    |                    |                    | 15,154             |
| Foreclosed assets held-for-sale                            | 405                | (4,416)            | 143,154            | (3,795)            |
| Fees and other service charges                             | 469,440            | 437,479            | 1,333,700          | 1,324,463          |
| <b>Total other income</b>                                  | <b>1,308,761</b>   | <b>1,136,275</b>   | <b>3,851,538</b>   | <b>3,349,052</b>   |
| <b>Other expenses:</b>                                     |                    |                    |                    |                    |
| Salaries and employee benefits                             | 2,201,532          | 2,078,715          | 6,501,861          | 6,059,586          |

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|  |              |              |              |              |
|--|--------------|--------------|--------------|--------------|
| Premises and equipment                   | 807,978      | 810,235      | 2,398,088    | 2,434,645    |
| Advertising                              | 156,848      | 164,855      | 499,473      | 453,132      |
| Other                                    | 1,022,813    | 941,959      | 2,990,345    | 2,919,300    |
| Total other expenses                     | 4,189,171    | 3,995,764    | 12,389,767   | 11,866,663   |
| Income before provision for income taxes | 1,601,945    | 1,379,008    | 4,570,872    | 3,966,619    |
| Provision for income taxes               | 424,023      | 349,032      | 1,189,866    | 966,392      |
| Net income                               | \$ 1,177,922 | \$ 1,029,976 | \$ 3,381,006 | \$ 3,000,227 |
| Per share data:                          |              |              |              |              |
| Net income - basic                       | \$ 0.57      | \$ 0.51      | \$ 1.64      | \$ 1.47      |
| Net income - diluted                     | \$ 0.57      | \$ 0.51      | \$ 1.64      | \$ 1.47      |
| Dividends                                | \$ 0.24      | \$ 0.22      | \$ 0.68      | \$ 0.66      |

**FIDELITY D & D BANCORP, INC. AND SUBSIDIARY**

## Consolidated Statements of Changes in Shareholders' Equity

For the nine months ended September 30, 2007 and 2006

|  | Shares    | Capital stock<br>Amount | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income (loss) | Total         |
|--|-----------|-------------------------|----------------------|--|---------------|
| Balance, December 31, 2005 (audited)   | 1,854,217 | \$ 10,594,901           | \$ 39,363,461        | \$ (1,112,333)   | \$ 48,846,029 |
| Cumulative effect of change in accounting principle, net of tax  |           |                         | (343,717)            |  | (343,717)     |
| Total comprehensive income:  |           |                         |                      |  |               |
| Net income   |           |                         | 3,000,227            |  | 3,000,227     |
| Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects |           |                         |                      | (30,125)   | (30,125)      |
| Comprehensive income   |           |                         |                      |  | 2,970,102     |
| Issuance of common stock through Employee Stock Purchase Plan  | 1,571     | 48,151                  |                      |  | 48,151        |
| Dividends reinvested through Dividend Reinvestment Plan  | 12,023    | 427,003                 |                      |  | 427,003       |
| Stock-based compensation expense   |           | 28,744                  |                      |  | 28,744        |
| Cash dividends declared  |           |                         | (1,349,656)          |  | (1,349,656)   |
| Stock dividend declared  | 185,394   | 7,462,100               | (7,469,548)          |  | (7,448)       |
| Balance, September 30, 2006 (unaudited)  | 2,053,205 | \$ 18,560,899           | \$ 33,200,767        | \$ (1,142,458)   | \$ 50,619,208 |
| Balance, December 31, 2006 (audited)   | 2,057,433 | \$ 18,702,537           | \$ 33,874,118        | \$ (964,792)   | \$ 51,611,863 |
| Total comprehensive income:  |           |                         |                      |  |               |
| Net income   |           |                         | 3,381,006            |  | 3,381,006     |
| Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects |           |                         |                      | (367,665)  | (367,665)     |
| Change in cash flow hedge intrinsic value  |           |                         |                      | 154,657  | 154,657       |
| Comprehensive income   |           |                         |                      |  | 3,167,998     |
| Issuance of common stock through Employee Stock Purchase Plan  | 2,266     | 67,820                  |                      |  | 67,820        |
| Dividends reinvested through Dividend Reinvestment Plan  | 13,230    | 437,145                 |                      |  | 437,145       |
| Stock-based compensation expense   |           | 6,958                   |                      |  | 6,958         |
| Cash dividends declared  |           |                         | (1,403,301)          |  | (1,403,301)   |
| Balance, September 30, 2007 (unaudited)  | 2,072,929 | \$ 19,214,460           | \$ 35,851,823        | \$ (1,177,800)   | \$ 53,888,483 |

See Notes to Consolidated Financial Statements





## FIDELITY DEPOSIT &amp; DISCOUNT BANCORP, INC. AND SUBSIDIARY

## Consolidated Statements of Cash Flows

(unaudited)

|   | Nine Months Ended   |                     |
|---|---------------------|---------------------|
|   | September 30, 2007  | September 30, 2006  |
| Cash flows from operating activities:   |                     |                     |
| Net income  | \$ 3,381,006        | \$ 3,000,227        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                     |                     |
| Depreciation, amortization and accretion  | 929,540             | 1,005,861           |
| (Credit) provision for loan losses  | (60,000)            | 325,000             |
| Deferred income tax expense (benefit)   | 27,890              | (27,073)            |
| Stock-based compensation expense  | 6,958               | 28,744              |
| Loss from investment in limited partnership                                       | 60,300              | 67,500              |
| Proceeds from sale of loans available-for-sale                                    | 12,121,477          | 8,081,253           |
| Originations of loans available-for-sale  | (12,260,760)        | (8,011,308)         |
| Increase in cash surrender value of life insurance                                | (231,026)           | (213,273)           |
| Net gain on sale of loans   | (120,717)           | (62,550)            |
| Net loss on sale of investment securities   |                     | 166                 |
| Net (gain) loss on sale of foreclosed assets held-for-sale                        | (143,154)           | 3,795               |
| Net (gain) loss on disposal of premises and equipment                             | (74,881)            | 14,774              |
| Change in:  |                     |                     |
| Accrued interest receivable   | (377,667)           | (800,347)           |
| Other assets  | (102,938)           | (185,187)           |
| Accrued interest payable and other liabilities                                    | 480,771             | 493,341             |
| <b>Net cash provided by operating activities</b>                                  | <b>3,636,799</b>    | <b>3,720,923</b>    |
| Cash flows from investing activities:   |                     |                     |
| Held-to-maturity securities:  |                     |                     |
| Proceeds from maturities, calls and principal pay-downs                           | 372,503             | 274,397             |
| Available-for-sale securities:  |                     |                     |
| Proceeds from sales   |                     | 1,537,338           |
| Proceeds from maturities, calls and principal pay-downs                           | 9,784,761           | 16,798,981          |
| Purchases   | (31,953,887)        | (22,776,489)        |
| Net decrease in FHLB stock  | 236,800             | 1,368,800           |
| Net increase in loans and leases  | (3,883,909)         | (7,005,816)         |
| Proceeds from sale of premises and equipment                                      | 248,833             | 1,560               |
| Acquisition of bank premises and equipment  | (2,584,363)         | (1,026,158)         |
| Proceeds from sale of foreclosed assets held-for-sale                             | 584,088             | 55,890              |
| <b>Net cash used in investing activities</b>                                      | <b>(27,195,174)</b> | <b>(10,771,497)</b> |
| Cash flows from financing activities:   |                     |                     |
| Net increase in deposits  | 28,721,962          | 40,231,147          |
| Net decrease in short-term borrowings   | (5,076,652)         | (5,946,258)         |
| Repayments of long-term debt  | (19,618,335)        | (34,114,126)        |
| Proceeds from long-term debt advances   | 20,000,000          | 16,000,000          |
| Proceeds from employee stock purchase plan  | 67,820              | 48,151              |
| Dividends paid, net of dividends reinvested                                       | (966,156)           | (922,653)           |
| Cash payments in lieu of fractional shares on stock dividend                      |                     | (7,448)             |

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|  |               |               |
|--|---------------|---------------|
| Net cash provided by financing activities            | 23,128,639    | 15,288,813    |
| Net (decrease) increase in cash and cash equivalents | (429,736)     | 8,238,239     |
| Cash and cash equivalents, beginning                 | 13,800,848    | 12,594,540    |
| Cash and cash equivalents, ending                    | \$ 13,371,112 | \$ 20,832,779 |

See notes to consolidated financial statements

**FIDELITY D & D BANCORP, INC.**

**Notes to Consolidated Financial Statements**

**(unaudited)**

**1. Nature of operations and critical accounting policies**

**Nature of operations**

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

**Principles of consolidation**

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The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation. Prior period amounts are reclassified when necessary to conform to the current period's presentation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

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

In the opinion of management, the consolidated balance sheets as of September 30, 2007 and December 31, 2006 and the related consolidated statements of income for the three- and nine- month periods ended September 30, 2007 and 2006 and changes in shareholders' equity and cash flows for the nine months ended September 30, 2007 and 2006 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2006, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

### **Critical accounting policies**

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

A material estimate that is particularly susceptible to significant change is the determination of the allowance for loan losses (the allowance). Management believes that the allowance, as of September 30, 2007, is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make materially 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. Such agencies may require the Company to recognize adjustments to the allowance based on their judgments 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. The Company receives estimated fair values of investment securities from an independent valuation service. In developing these fair values, the valuation service uses estimates of cash flows, based on historical performance of similar instruments in similar interest rate environments. Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, management may obtain price quotes from more than one source. Available-for-sale (AFS) securities are carried at fair value on the consolidated balance sheet, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity through accumulated other comprehensive income (loss).

The fair value of residential mortgage loans, classified as AFS, is obtained from the Federal National Mortgage Association or the Pennsylvania Housing Finance Authority. To determine the fair value of student loans, classified as AFS, the Bank uses the pricing obtained from the most recent student loans sold from its AFS portfolio. From time-to-time, the Bank may originate Small Business Administration (SBA) loans AFS. The fair value of SBA loans, classified as AFS, is obtained from an outside pricing source. The market to which the Bank sells mortgage and other loans is restricted and price quotes from other sources are not typically obtained. As of September 30, 2007, the AFS loan portfolio consisted of residential mortgages.

## 2. 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 stock outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but reflects the potential dilution that could occur if stock options to issue additional common stock were exercised, which would then result in additional stock outstanding to share in or dilute the earnings of the Company. The Company maintains two share-based compensation plans that may generate additional potential dilutive common shares. Generally, dilution would occur if Company-issued stock options were exercised and converted into common stock.

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options. Under this method, the assumed proceeds received from shares issued, in a hypothetical stock option exercise, are assumed to be used to purchase treasury stock. Pursuant to the guidance of Statement of Financial Accounting Standard (SFAS) No. 128, *Earnings Per Share*, proceeds include: proceeds from the exercise of outstanding stock options; compensation cost for future service that the Company has not yet recognized; 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). For a further discussion on the Company's stock option plans, see Note 3, below.

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

| Nine months ended September 30,             | 2007         | 2006         |
|---|--------------|--------------|
| <b>Basic EPS:</b>                           |              |              |
| Net income available to common shareholders | \$ 3,381,006 | \$ 3,007,227 |
| Weighted-average common shares outstanding  | 2,064,578    | 2,045,872    |
| Basic EPS                                   | \$ 1.64      | \$ 1.47      |
| <b>Diluted EPS:</b>                         |              |              |
| Net income available to common shareholders | \$ 3,381,006 | \$ 3,007,227 |
| Weighted-average common shares outstanding  | 2,064,578    | 2,045,872    |
| Dilutive potential common shares            | 608          | 1,454        |



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Weighted-average common shares and dilutive potential shares

|             |    |           |    |           |
|-------------|----|-----------|----|-----------|
|             |    | 2,065,186 |    | 2,047,326 |
| Diluted EPS | \$ | 1.64      | \$ | 1.47      |

### 3. Stock plans

The Company uses the fair value method of accounting for stock-based compensation provided under SFAS 123R, *Share Based Payment*. SFAS 123R requires that the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. SFAS 123R applies to all share-based payment transactions in which an entity acquires goods or services by issuing (or offering to issue) its shares, share options, or other equity instruments (except for those held by an ESOP) or by incurring liabilities (1) in amounts based (even in part) on the price of the entity's shares or other equity instruments, or (2) that require (or may require) settlement by the issuance of an entity's shares or other equity instruments.

The Company has two stock-based compensation plans (the stock option plans). The stock option plans were shareholder-approved and permit the grant of share-based compensation awards to its directors, key officers and certain other employees. The Company believes that these stock option plans better align the interest of its directors, key officers and employees with the interest of its shareholders. The Company further believes that the granting of share-based awards, under the provisions of the stock option plans, is necessary to retain the knowledge base, continuity and expertise of its directors, key officers and certain employees.

The Company established the 2000 Independent Directors Stock Option Plan and reserved 55,000 shares of its un-issued capital stock for issuance under the plan. Under the 2000 Independent Directors Stock Option Plan, each outside director is awarded stock options to purchase 500 shares of the Company's common stock on the first business day of January, each year, at the fair market value on date of grant. No stock options were awarded during the first nine months of 2007 or for the year ended December 31, 2006, due to the directors' voluntary election to forego the award. At September 30, 2007 there were 14,850 unexercised stock options outstanding under this plan. On October 2, 2007, the Company amended the 2000 Independent Directors Stock Option Plan. For a further discussion on the amendment, see Note 6, below.

The Company also established the 2000 Stock Incentive Plan and reserved 55,000 shares of its un-issued capital stock for issuance under the plan. Under the 2000 Stock Incentive Plan, key officers and certain other employees are eligible to be awarded qualified stock options to purchase the Company's common stock at the fair market value on the date of grant. No stock options were awarded during the first nine months of 2007. During the first nine months of 2006, 2,200 stock options were issued under this plan at a grant-date fair value of \$6.21 per share. The options vest over a six month period and for the nine months ended September 30, 2006 approximately \$14,000 of stock-based compensation expense was recorded and is included as a component of salaries and employee benefits in the consolidated statements of income. As of September 30, 2007, there were 5,830 unexercised stock options outstanding under this plan. On October 2, 2007, the Company amended the 2000 Stock Incentive Plan. For a further discussion on this amendment, see Note 6, below.

In addition to the two stock option plans above, the Company has established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance under the plan. The plan was designed to promote broad-based employee ownership of the Company's stock. Under the 2002 ESPP, employees may have automatic payroll deductions to purchase the Company's capital stock at a discounted price based on the fair market value of the Company's capital stock on either the commencement date or termination date. At September 30, 2007, 8,317 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and, as such, is required to comply with the provisions of SFAS 123R. The Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the nine months ended September 30, 2007 and 2006, compensation expense related to the ESPP approximated \$7,000 and \$15,000, respectively, and is included as a component of salaries and employee benefits in the consolidated statements of income.

### 4. Derivative instruments

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As part of the Company's overall interest rate risk management strategy, the Company has adopted a policy whereby the Company may periodically use derivative instruments to minimize significant fluctuations in earnings caused by interest rate volatility. This interest rate risk management strategy entails the use of interest rate floors, caps and swaps. During the fourth quarter of 2006, the Company entered into a three-year interest rate floor derivative agreement on \$20,000,000 notional value of its prime-based loan portfolio. The transaction required the payment of a premium by the Company to the seller for the right to receive payments in the event national prime drops below a pre-determined level (strike rate), essentially converting floating rate loans to fixed rate loans when prime drops below the contractual strike rate. When purchased, the Company recorded an asset representing the fair value of the hedge at the time of purchase. The Company has designated this agreement as a cash flow hedge pursuant to SFAS No. 133. Accordingly, the change in the fair value of the instrument related to the hedge's intrinsic value, or approximately \$155,000, is recorded as a component of other comprehensive income (OCI) in the consolidated statement of changes in shareholders' equity and the portion of the change in fair value related to the time value expiration, or approximately \$131,000, is recorded in the consolidated statements of income as a reduction of interest income for the nine months ended September 30, 2007. No gain or loss has been recognized in earnings due to hedge ineffectiveness as of September 30, 2007. As of September 30, 2007, the Company does not expect to reclassify any amount from OCI to earnings over the next twelve months and no hedge has been discontinued.

Also, as of September 30, 2007, the fair value of the derivative contract approximated \$249,000 and is a component of other assets in the consolidated balance sheet.

## 5. Recent accounting pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement 109, *Accounting for Income Taxes*.

The Company adopted FIN 48 during the first quarter of 2007 and has evaluated its material tax positions as of September 30, 2007. The adoption of FIN 48 does not have an immediate effect on its consolidated financial statements. 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 September 30, 2007, 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 recorded as a component of other expenses in the Company's consolidated statements of income.

As of September 30, 2007, there were no unrecognized tax benefits that, if recognized, would significantly affect the Company's effective tax rate. Also, as of September 30, 2007, there were no penalties and interest recognized in the consolidated statements of income as a result of the adoption of FIN 48, 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.

## 6. Subsequent events

On October 2, 2007, the Board of Directors of the Company approved amendments to the 2000 Stock Incentive Plan (the Incentive Plan) and the 2000 Independent Directors Stock Option Plan (the Directors' Plan) (collectively, the Plans).

Various amendment provisions to the Plans concerning the administration of the Plans are intended to qualify the Plans for exemption from the application of Section 409A of the Internal Revenue Code, as contemplated by the recently released final Treasury Regulations under the Code. The Incentive Plan was also amended to provide that no qualified stock options will be granted after the date of the amendment. The Directors' Plan was also amended to remove the automatic stock option grant in January of each year and allow the grant of stock options at any time at the discretion of the Company's Board of Directors. The Directors' Plan also adds a six-month vesting period for options granted.

The Company does not expect the amendments to the Plans to have a material impact on the results of operations or financial condition of the Company.

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

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of September 30, 2007 compared to December 31, 2006 and the results of operations for the three and nine months ended September 30, 2007 and 2006. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2006 Annual Report filed on Form 10-K.

**Forward-looking statements**

This Interim Report on Form 10-Q contains a number of forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These statements may be identified by the use of the words anticipate, believe, could, estimate, expect, intend, may, outlook, plan, project, should, will, would and similar terms and phrases, including references to assumptions. Forward-looking statements include risks and uncertainties.

Forward-looking statements are based on various assumptions and analyses made by us in light of management's experience and its perception of historical trends, current conditions and expected future developments, as well as other factors management believes are appropriate under the circumstances. These statements are not guarantees of future performance and are subject to risks, uncertainties and other factors (many of which are beyond our control) that could cause actual results to differ materially from future results expressed or implied by such forward-looking statements. These factors include, without limitation, the following:

the timing and occurrence or non-occurrence of events may be subject to circumstances beyond our control;

there may be increases in competitive pressure among financial institutions or from non-financial institutions;

changes in the interest rate environment may reduce interest margins;

changes in deposit flows, loan demand or real estate values may adversely affect our business;

changes in accounting principles, policies or guidelines may cause our financial condition to be perceived differently;

general economic conditions, either nationally or locally in some or all areas in which we do business, or conditions in the securities markets or the banking industry may be less favorable than we currently anticipate;

legislative or regulatory changes may adversely affect our business;

technological changes may be more rapid, difficult or expensive than we anticipate;

success or consummation of new business initiatives may be more difficult or expensive than we anticipate;

acts of war or terrorism; or

natural disaster.

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

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

## General

The Company's principal revenues are derived from interest, dividends and fees earned on its interest-earning assets, which are comprised of loans, securities and other short-term investments. The Company's principal expenses consist of interest paid on its interest-bearing liabilities, which are comprised of deposits, short- and long-term borrowings and operating and general expenses. The Company's profitability depends primarily on its net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields on interest-earning assets which consist principally of loans and investment securities. Interest expense is incurred from rates paid on interest-bearing liabilities, which consist of deposits and borrowings. Net interest income is dependent upon the interest-rate spread (i.e., the difference between the yields earned on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. The interest rate spread is significantly impacted by: changes in interest rates and market yield curves and their related impact on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in our marketplace.

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

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

### **COMPARISON OF RESULTS OF OPERATIONS**

#### **THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2007 AND SEPTEMBER 30, 2006**

##### **Overview**

Net income for the third quarter of 2007 was \$1,178,000, or a 14% increase compared to \$1,030,000 recorded in the same quarter in 2006. Diluted earnings per share were \$0.57 and \$0.51 for each of the respective periods. For the nine months ended September 30, 2007, net income was \$3,381,000, or \$1.64 per share compared to \$3,007,000, or \$1.47 per share for the nine months ended September 30, 2006. The increase in net income for both the quarter and nine months ended September 30, 2007, compared to the prior year periods, was the result of increases in net interest income, non-interest income and a decrease in the provision for loan losses, partially offset by increases in non-interest expense and the provision for income taxes.

The increase in net income was the primary cause of the improvements in return on average assets (ROA) and return on average shareholders equity (ROE) to 0.81% and 8.80%, respectively, for the three months ended September 30, 2007 compared to 0.72% and 8.18%, respectively, for the same period in 2006. For the nine months ended September 30, 2007, ROA and ROE were 0.79% and 8.57% compared to 0.71% and 8.12% for the nine month period of 2006.

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

Net interest income increased \$109,000 to \$4,422,000 for the third quarter of 2007, from \$4,313,000 recorded in the same period of 2006. The increase in net interest income was principally caused by the increase in interest income on interest-earning assets being greater than the increase in interest expense on interest-bearing liabilities. Interest income increased by \$298,000 during the current year quarter compared to the third quarter of 2006 with increases in both the loan and investment portfolios. While average interest-earning assets increased by more than \$9,000,000 during the period, the rise in interest income was also bolstered by an increase in yield of 11 basis points. Further contributing to the improvement in interest income was a decline in the average balance of non-accrual loans which decreased by approximately \$2,200,000 for the quarter ended September 30, 2007 compared to the same 2006 quarter. Partially offsetting the increase in interest income was an increase in



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interest expense of \$189,000 for the three months ended September 30, 2007 compared to the three months ended September 30, 2006. Interest-bearing deposits increased by approximately \$10,000,000, on average, and the rates paid thereon increased 22 basis points. The increase in deposit rates was primarily from certificate of deposit accounts which increased 53 basis points on the quarter-to-quarter comparison. Rates paid on savings and transaction accounts declined during the period. The Bank will continue its competitive effort to raise deposit levels and reduce its dependency on borrowings. Interest expense on borrowings and repurchase agreements declined \$100,000 in the third quarter of 2007, compared to the third quarter of 2006, due mostly to a \$5,400,000 decline in the average balances.

During the third quarter of 2007, the Bank's tax-equivalent margin and spread were 3.31% and 2.60%, respectively, compared to 3.29% and 2.62% during the third quarter of 2006. The decline in spread was due to rates on interest-bearing liabilities increasing to a higher level than yields earned from interest-earning assets during the third quarter of 2007 compared to the same 2006 quarter. The improvement in margin is from higher net interest income in the third quarter of 2007 compared to the third quarter of 2006.

Similar to the third quarter comparisons, the Bank's tax-equivalent margin and spread for the nine months ended September 30, 2007 were 3.34% and 2.63%, respectively, compared to 3.30% and 2.67% during the same period of 2006. The decline in spread was from interest rates paid on costing liabilities outpacing the yields from earning assets. The cost of interest-bearing deposits increased 51 basis points during the first nine months of 2007 compared to the same period of 2006. However, success in deposit gathering strategies has resulted in a \$13,900,000 increase in average balances of interest-bearing deposits and enabled the Bank to reduce its position on high-cost borrowings by approximately \$11,800,000 on average. As a result, interest expense increased \$1,109,000, or 9%, for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006. Offsetting the increase in interest expense was an increase in interest income of \$1,349,000, or 5%, for the comparable periods. The migration of large non-accrual commercial loans to performing status as well as higher earning yields from all loan categories and the investment portfolio helped increase the yield on interest-earning assets by 31 basis points during the first nine months of 2007 compared to the same 2006 period. The four basis point improvement in the tax-equivalent margin is from higher net interest income which increased \$197,000, or 2%, compared to 2006 on a slightly higher level of average interest-earning assets during the nine months of 2007.

The interest rate environment has improved slightly during the past several months, but continues to remain challenging. The yield curve which has become more positively sloped, with the recent fed rate cut, should help improve the operating environment for the Bank. This in conjunction with our successful deposit gathering strategies, debt reduction, and improved credit quality of the Bank's earning assets should continue to help position the Bank to optimize net interest income during this challenging rate environment and should be further enhanced when the shape of the yield curve returns to an even steeper, more positive slope.

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

|   | Three months ended<br>September 30, |            | Nine months ended<br>September 30, |            | Year ended<br>December 31, |
|---|-------------------------------------|------------|------------------------------------|------------|----------------------------|
|   | 2007                                | 2006       | 2007                               | 2006       | 2006                       |
| <b><u>Average interest-earning assets:</u></b>      |                                     |            |                                    |            |                            |
| Loans and leases                                    | \$ 425,502                          | \$ 420,256 | \$ 423,811                         | \$ 418,354 | \$ 418,390                 |
| Investments   | 116,969                             | 112,107    | 112,063                            | 116,262    | 115,319                    |
| Federal funds sold                                  | 3,626                               | 4,414      | 2,604                              | 2,618      | 2,479                      |
| Interest-bearing deposits                           | 161                                 | 181        | 187                                | 221        | 240                        |
| Total   | \$ 546,259                          | \$ 536,958 | \$ 538,665                         | \$ 537,455 | \$ 536,428                 |
| <b><u>Average interest-bearing liabilities:</u></b> |                                     |            |                                    |            |                            |
| Other interest-bearing deposits                     | \$ 191,526                          | \$ 197,727 | \$ 196,036                         | \$ 185,014 | \$ 185,786                 |
| Certificates of deposit                             | 167,815                             | 151,387    | 156,869                            | 154,008    | 154,474                    |
| Borrowed funds                                      | 67,392                              | 70,175     | 70,552                             | 82,339     | 79,627                     |
| Repurchase agreements                               | 21,152                              | 23,779     | 19,132                             | 24,203     | 23,391                     |
| Total   | \$ 447,885                          | \$ 443,068 | \$ 442,589                         | \$ 445,564 | \$ 443,278                 |
| <b><u>Interest income (FTE):</u></b>                |                                     |            |                                    |            |                            |
| Loans and leases                                    | \$ 7,409                            | \$ 7,281   | \$ 22,071                          | \$ 21,043  | \$ 28,357                  |
| Investments   | 1,568                               | 1,393      | 4,424                              | 4,154      | 5,612                      |
| Federal funds sold                                  | 48                                  | 59         | 103                                | 95         | 123                        |
| Interest-bearing deposits                           | 2                                   | 2          | 7                                  | 7          | 9                          |
| Total   | \$ 9,027                            | \$ 8,735   | \$ 26,605                          | \$ 25,299  | \$ 34,101                  |
| <b><u>Interest expense:</u></b>                     |                                     |            |                                    |            |                            |
| Other interest-bearing deposits                     | \$ 1,468                            | \$ 1,572   | \$ 4,652                           | \$ 3,947   | \$ 5,467                   |
| Certificates of deposit                             | 1,953                               | 1,560      | 5,325                              | 4,332      | 6,026                      |
| Borrowed funds                                      | 925                                 | 971        | 2,827                              | 3,294      | 4,244                      |
| Repurchase agreements                               | 124                                 | 178        | 355                                | 477        | 624                        |
| Total   | \$ 4,470                            | \$ 4,281   | \$ 13,159                          | \$ 12,050  | \$ 16,361                  |
| Net interest income (FTE)                           | \$ 4,557                            | \$ 4,454   | \$ 13,446                          | \$ 13,249  | \$ 17,740                  |

|  | Three months ended<br>September 30, |       | Nine months ended<br>September 30, |       | Year ended<br>December 31, |
|--|-------------------------------------|-------|------------------------------------|-------|----------------------------|
|  | 2007                                | 2006  | 2007                               | 2006  | 2006                       |
| <u>Yield on average interest-earning assets</u>      |                                     |       |                                    |       |                            |
| Loans and leases                                     | 6.91%                               | 6.87% | 6.96%                              | 6.73% | 6.78%                      |
| Investments  | 5.32%                               | 4.93% | 5.28%                              | 4.78% | 4.87%                      |
| Federal funds sold                                   | 5.28%                               | 5.28% | 5.28%                              | 4.84% | 4.97%                      |
| Interest-bearing deposits                            | 5.39%                               | 4.48% | 4.93%                              | 4.12% | 3.82%                      |
| Total  | 6.56%                               | 6.45% | 6.60%                              | 6.29% | 6.36%                      |
| <u>Rates on average interest-bearing liabilities</u> |                                     |       |                                    |       |                            |
| Other interest-bearing deposits                      | 3.04%                               | 3.16% | 3.17%                              | 2.85% | 2.94%                      |
| Certificates of deposit                              | 4.62%                               | 4.09% | 4.54%                              | 3.76% | 3.90%                      |
| Borrowed funds                                       | 5.45%                               | 5.49% | 5.36%                              | 5.35% | 5.33%                      |
| Repurchase agreements                                | 2.33%                               | 2.96% | 2.48%                              | 2.63% | 2.67%                      |
| Total  | 3.96%                               | 3.83% | 3.98%                              | 3.62% | 3.69%                      |
| Net interest spread                                  | 2.60%                               | 2.62% | 2.62%                              | 2.67% | 2.67%                      |
| Net interest margin                                  | 3.31%                               | 3.29% | 3.34%                              | 3.30% | 3.31%                      |

In the tables above, interest income was adjusted to a tax-equivalent basis to recognize the income from the various tax-exempt assets as if the interest was fully taxable. This treatment allows a uniform comparison among the yields on interest-earning assets. The calculations were computed on a fully tax-equivalent basis using the corporate federal tax rate of 34%. Net interest spread represents the difference between the yield on interest-earning assets and the rate on interest-bearing liabilities. Net interest margin represents the ratio of net interest income to total average interest-earning assets.

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 to a level that represents management's best estimate of known and inherent losses in the Bank's loan and lease portfolio. Loans and leases determined to be uncollectible are charged off against the allowance for loan losses.

The required amount of the provision for loan losses, based upon the adequate level of the allowance for loan losses, is subject to ongoing analysis of the loan portfolio. The Bank's Special Asset Committee meets periodically to review problem loans and leases. The committee is comprised of Bank management, including the chief risk officer, 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 and lease 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

Changes in credit concentrations

The provision for loan losses for the three and nine months ended September 30, 2006 was \$75,000 and \$325,000, respectively, compared to a credit for loan losses of \$60,000 for each of the respective periods of 2007. In 2007, the Company did not need to make provisions and had to reduce the allowance for loan losses due to a substantially reduced level of internally criticized and classified assets during the three, nine and twelve months ended September 30, 2007. These reductions occurred as a result of some adversely rated loans which either were upgraded due to credit improvement or were repaid.

The Bank's non-performing loans, which consists of loans past due 90 days or more which are accruing, plus non-accruing loans, increased \$1,245,000, or 36%, to \$4,684,000 since December 31, 2006. However, non-performing loans on a comparative year-to-year basis declined by \$396,000, from \$5,079,000 at September 30, 2006 to \$4,684,000 at September 30, 2007. The non-accrual component of non-performing loans showed a \$565,000 increase while the 90 day delinquencies declined \$961,000 in the same period. The increase at September 30, 2007 in the non-accrual loans occurred mainly because of one commercial loan, which is secured by a first lien mortgage on real estate, migrated to non-accrual status. The decline in the 90 day delinquencies results from both payments received to bring loans current and movement of a loan to non-accrual status.

No provisions for loan losses were necessary during the first three quarters of 2007. After taking into account charge-offs, recoveries, and a \$60,000 reduction of the allowance, the allowance for loan losses was \$4,991,000 at September 30, 2007 as compared to \$5,843,000 at September 30, 2006. Although the non-accruals mentioned above increased from September 30, 2006 and also from December 31, 2006, other adversely criticized and classified loans were substantially reduced from the same periods, which lead to an excess reserve position, which in turn had to be placed back into earnings according to Company policy.

#### Other income

Total other (non-interest) income improved \$172,000, or 15%, for the three months ended September 30, 2007 compared to the three months ended September 30, 2006. Contributing to the increase were growth in deposit, financial services and trust related fees, increases from sales of mortgage loans into the secondary market and a 2006 loss from the disposal of premises and equipment that did not recur in 2007. The growth in deposit fees was primary caused by overdraft charges.

For the nine months ended September 30, 2007, other income increased \$502,000, or 15%, compared to the nine months ended September 30, 2006. The Bank recognized net gains of \$143,000 from sales of foreclosed properties and experienced growth in deposit and financial services revenue of \$251,000, on a combined basis. The gain from the sale of foreclosed properties was the result of excess collateral value compared to the net book value of the sold foreclosed property. The growth in deposit fees was due principally from overdraft charges. Also contributing to the increase was a first quarter 2007 gain from the sale of an owned commercial facility previously leased to a non-related third party.

#### Other operating expenses

For the quarter ended September 30, 2007, other (non-interest) expenses increased \$193,000, or 5%, compared to the same 2006 quarter. Salaries and related employee benefits increased \$123,000, or 6%, due to higher salary and recognition of performance-based incentives. The \$81,000 increase in other expenses was caused by moderate increases in professional services, donations, ATM and other branch-related expenses.

For the nine months ended September 30, 2007, other expenses increased \$523,000, or 4%, compared to the nine months ended September 30, 2006. Salary and related employee benefits increased \$442,000, or 7%, due to pay increases and recognition of performance-based incentives. Advertising increased \$46,000, or 10%, during the period caused principally by the activities associated with the grand opening and relocation project of one of the Bank's branch offices. Other expenses increased \$71,000, or 2%, for the comparative periods due mostly to increased professional fees, mortgage appraisals, ATM and other branch related expenses.

Income tax provision

Compared to 2006, income before provision for income taxes for the third quarter and the first nine months of 2007 increased \$223,000 and \$604,000, respectively. The effective federal income tax rate was 26.5% and 26.0% for the three and nine months ended September 30, 2007, compared to 25.3% and 24.4% for each of the respective 2006 periods. The effective tax rate increase is attributable to higher pre-tax earnings and a net decrease in tax-free income, collectively representing a smaller portion of pre-tax earnings.

**COMPARISON OF FINANCIAL CONDITION AT**  
**SEPTEMBER 30, 2007 AND DECEMBER 31, 2006**

*Overview*

Consolidated assets increased \$26,783,000, or 5%, during the nine months ended September 30, 2007. The net asset increase was due to increases in total deposits of \$28,722,000 and shareholders' equity of \$2,277,000 partially offset by a net reduction in borrowings of \$4,695,000.

*Investment securities*

At the time of purchase, the Bank classifies investment securities into one of three categories: trading, AFS or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. Management classifies most securities as AFS even though it has no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and adjust the balance sheet in response to capital levels, liquidity needs, structuring strategies and/or changes in market conditions. Securities AFS are carried at net fair market value in the consolidated balance sheet with an adjustment to stockholders' equity, net of tax, which is presented under the caption Accumulated other comprehensive income (loss). Securities designated as HTM are carried at amortized cost.

At September 30, 2007, the carrying value of investment securities totaled \$121,897,000, or 21% of total assets compared to \$100,411,000, or 18% of total assets at December 31, 2006. Also as of September 30, 2007, approximately 47% of the carrying value of the investment portfolio was comprised of mortgage-backed securities that amortize and provide monthly cash flow. Agency, corporate and municipal bonds comprised 31%, 12% and 10%, respectively, of the investment portfolio at September 30, 2007.

As illustrated in the following table of amortized cost and fair market value of investment securities, the portfolio is comprised of HTM and AFS securities with carrying values of \$1,196,000 and \$120,701,000, respectively. At September 30, 2007, the AFS debt securities were recorded with a net unrealized loss in the amount of \$2,207,000 and equity securities were recorded with an unrealized gain of \$187,000 (dollars in thousands):

|  | Amortized<br>cost |    | Gross unrealized<br>gains |    | Gross unrealized<br>losses |    | Fair<br>value |
|--|-------------------|----|---------------------------|----|----------------------------|----|---------------|
| <b><u>Held-to-maturity securities:</u></b>       |                   |    |                           |    |                            |    |               |
| Mortgage-backed securities                       | \$ 1,196          | \$ | 24                        | \$ | \$                         | \$ | 1,220         |
| <b><u>Available-for-sale securities:</u></b>     |                   |    |                           |    |                            |    |               |
| U.S. government agencies and corporations        | \$ 38,204         | \$ | 61                        | \$ | 863                        | \$ | 37,402        |
| Obligations of states and political subdivisions | 12,139            |    | 23                        |    | 79                         |    | 12,083        |
| Corporate bonds                                  | 15,223            |    |                           |    | 227                        |    | 14,996        |
| Mortgage-backed securities                       | 56,876            |    | 32                        |    | 1,154                      |    | 55,754        |



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|                          |            |        |          |            |
|--------------------------|------------|--------|----------|------------|
| Total debt securities    | 122,442    | 116    | 2,323    | 120,235    |
| Equity securities        | 279        | 187    |          | 466        |
| Total available-for-sale | \$ 122,721 | \$ 303 | \$ 2,323 | \$ 120,701 |

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The amortized cost and fair value of debt securities at September 30, 2007 by contractual maturity are as follows (dollars in thousands):

|  | Amortized<br>cost |    | Market<br>value |
|--|-------------------|----|-----------------|
| <u>Held-to-maturity securities:</u>      |                   |    |                 |
| Mortgage-backed securities               | \$ 1,196          | \$ | 1,220           |
| <u>Available-for-sale securities:</u>    |                   |    |                 |
| <u>Debt securities:</u>                  |                   |    |                 |
| Due in one year or less                  | \$ 1,000          | \$ | 993             |
| Due after one year through five years    | 5,999             |    | 5,985           |
| Due after five years through ten years   | 19,256            |    | 19,207          |
| Due after ten years                      | 39,311            |    | 38,296          |
| Total debt securities                    | 65,566            |    | 64,481          |
| Mortgage-backed securities               | 56,876            |    | 55,754          |
| Total available-for-sale debt securities | \$ 122,442        | \$ | 120,235         |

Expected maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Federal agency and municipal securities are included based on their original stated maturity. Mortgage-backed securities, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total.

Management evaluates securities for other-than-temporary impairment on a quarterly basis or more frequently when economic conditions or market conditions warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

At September 30, 2007, the AFS debt securities portfolio was carried at a net unrealized loss of \$2,207,000 compared to a net unrealized loss of \$1,656,000 at December 31, 2006, or a deterioration of \$551,000. A large portion of the unrealized losses was for a continuous period of more than 12 months. Management believes the cause of these unrealized losses is directly related to changes in market interest rates. As of September 30, 2007, most of the deterioration of the AFS debt portfolio is from investments that are guaranteed by the U.S. government or one of its agencies. In analyzing an issuer's financial condition, management considers whether the securities are issued by the U.S. government, its agencies or other governments, whether downgrades by bond rating agencies have occurred and, if necessary, reviews of the issuer's financial condition. Because the decline in market values is attributable to changes in interest rates and not credit quality, and the Company has the ability and intent to hold those securities until recovery of fair value, which may be maturity, management views these unrealized losses to be temporary.

Excluding the net unrealized loss, the investment portfolio grew \$22,043,000, or 22%, during the first nine months of 2007. The Company utilized growth in deposits to grow the portfolio as well as to reduce short-term borrowings. The current interest rate environment, though improving, has been essentially a sustained period of yield curve inversion that continues to preclude structured investment portfolio growth. As such, the Company will attempt to replace investment securities that mature, pay-down, are called or amortize with bonds that provide incremental earnings above the Bank's funding sources. In addition, cash flows from investments may be used to repay debt and fund growth in the loan portfolio.



Loans available-for-sale (AFS)

Generally, upon origination, certain residential mortgages, the guaranteed portions of Small Business Administration loans and student loans are classified as AFS. 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 a declining interest rate environment, the Bank would be exposed to prepayment risk and, as rates on adjustable rate loans decrease, interest income would be negatively affected. To better manage prepayment and interest rate risk, loans that meet these conditions may be considered for sale in the secondary market. Consideration is also given to the Company's current liquidity position and expected future liquidity needs. Loans AFS are carried at the lower of cost or estimated fair value. If the fair values of these loans fall below their amortized cost, the difference is written down and charged to current earnings. Subsequent appreciation in the portfolio, if any, is credited to current earnings but only to the extent of previous write-downs.

At September 30, 2007, loans AFS amounted to \$382,000 with a corresponding fair value of \$388,000, compared to \$122,000 and \$123,000, respectively, at December 31, 2006. During the third quarter of 2007, residential mortgages with principal balances of \$4,795,000 were sold into the secondary market with net gains of approximately \$53,000 recognized.

Loans and leases

The Bank originates commercial and industrial (commercial) and commercial real estate loans, residential, consumer, home equity and construction loans. The relative volume of originations is dependent upon customer demand, current interest rates and the perception and duration of future interest levels. The broad spectrum of products provides diversification which helps manage, to an extent, interest rate risk and credit concentration risk. Credit risk is further managed through underwriting policies and procedures and loan monitoring practices. Interest rate risk is managed using various asset/liability modeling techniques and analyses. The interest rates on most commercial loans are adjustable with reset intervals of five years or less.

The majority of our loan portfolio is collateralized, at least in part, by real estate in the greater Lackawanna and Luzerne Counties of Pennsylvania. Commercial lending activities generally involve a greater degree of credit risk than residential lending because they typically have larger balances and are more affected by adverse conditions in the economy. Because payments on commercial loans depend upon the successful operation and management of the properties and the businesses which operate from within them, repayment of such loans may be affected by factors outside the borrower's control. Such factors may include adverse conditions in the real estate market, the economy, the industry or changes in government regulations. As such, commercial loans require more ongoing evaluation and monitoring which occurs from the loan officers' interaction with the Bank's credit administration and outsourced loan review functions.

Gross loans increased \$3,138,000, or 0.7% to \$425,781,000 at September 30, 2007 compared to \$422,643,000 at December 31, 2006. The increase in residential real estate is from transfers of real estate construction funding to permanent financing. The composition of the loan portfolio as of September 30, 2007 and December 31, 2006 is summarized as follows:

|                                       | September 30, 2007 |      | December 31, 2006 |      |
|---------------------------------------|--------------------|------|-------------------|------|
|                                       | Amount             | %    | Amount            | %    |
| Commercial and commercial real estate | \$ 218,861,143     | 51.4 | \$ 218,213,216    | 51.6 |
| Residential real estate               | 117,098,994        | 27.5 | 112,742,692       | 26.7 |
| Consumer and home equity              | 78,051,965         | 18.3 | 77,729,520        | 18.4 |

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|                           |                |       |                |       |
|---------------------------|----------------|-------|----------------|-------|
| Real estate construction  | 11,235,730     | 2.6   | 13,369,712     | 3.2   |
| Direct financing leases   | 533,944        | 0.1   | 588,211        | 0.1   |
| Gross loans               | 425,781,776    | 100.0 | 422,643,351    | 100.0 |
| Allowance for loan losses | (4,990,855)    |       | (5,444,303)    |       |
| Net loans                 | \$ 420,790,921 |       | \$ 417,199,048 |       |

Allowance for loan losses

Management continually evaluates the credit quality of the Bank's loan and lease 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 levels are 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 objective and quantifiable evidence;

Determination of homogenous pools by loan category and eliminating the impaired loans.

Application of historical loss percentages (five-year average) to pools to determine the allowance allocation; and

Application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio.

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. The changes in the allocations from period to period are also based upon the credit risk grading assigned from periodic reviews of the loan and lease portfolios.

Net charge-offs for the nine months ended September 30, 2007 were \$393,000, compared to \$466,000 for the same period in 2006. Net charge-offs of commercial loans were \$340,000 for the nine months ended September 30, 2007 compared to net charge-offs of \$289,000 for the same period of 2006. Real estate loans had net recoveries of \$15,000 in the first nine months of 2007 as compared to net charge-offs of \$65,000 in the first nine months of 2006. Consumer loan net charge-offs were \$68,000 in the nine months ended September 30, 2007 as compared to \$112,000 for the same period of 2006. There were no lease financing charge-offs during 2007.

Management believes that the current balance in the allowance for loans losses of \$4,991,000 is sufficient to withstand the identified potential credit quality issues that may arise and are inherent to the portfolio. Currently, management is unaware of any potential problem loans that have not been addressed. Potential problem loans are those where there is known information that leads management to believe repayment of

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principal and/or interest is in jeopardy. However, there could be instances which become identified over the year that may require charge-offs and/or increases to the allowance. The ratio of allowance for loan losses to total loans was 1.17% at September 30, 2007 compared to 1.29% at December 31, 2006 and 1.41% at September 30, 2006. The reduced level of the allowance was driven by a reduction in the level of internally criticized and classified loans during 2007, which in turn reduced the need for loan loss provisions.

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

|  | As of and for the<br>nine months ended<br>September 30, 2007 | As of and for the<br>twelve months ended<br>December 31, 2006 | As of and for the<br>nine months ended<br>September 30, 2006 |
|--|--|---|--|
| Balance at beginning of period   | \$ 5,444,303   | \$ 5,984,649  | \$ 5,984,649   |
| (Credit) provision for loan losses                                       | (60,000)   | 325,000   | 325,000  |
| <b>Charge-offs:</b>  |  |   |  |
| Commercial   | 356,989  | 660,471   | 350,203  |
| Residential real estate  | 1,585  | 109,164   | 65,759   |
| Consumer   | 188,171  | 285,379   | 226,812  |
| Total  | 546,745  | 1,055,014   | 642,774  |
| <b>Recoveries:</b>   |  |   |  |
| Commercial   | 16,979   | 64,173  | 60,732   |
| Residential real estate  | 16,560   | 532   | 502  |
| Consumer   | 119,758  | 124,763   | 115,229  |
| Lease financing  |  | 200   | 200  |
| Total  | 153,297  | 189,668   | 176,663  |
| Net charge-offs  | 393,448  | 865,346   | 466,111  |
| Balance at end of period   | \$ 4,990,855   | \$ 5,444,303  | \$ 5,843,538   |
| Total loans, end of period   | \$ 426,163,776   | \$ 422,765,351  | \$ 415,494,402   |
| <b>Net charge-offs to:</b>   |  |   |  |
| Loans, end of period   | 0.09%  | 0.20%   | 0.11%  |
| Allowance for loan losses  | 7.88%  | 15.89%  | 7.98%  |
| Provision for loan losses  | x  | 2.66x   | 1.43x  |
| <b>Allowance for loan losses to:</b>                                     |  |   |  |
| Total loans  | 1.17%  | 1.29%   | 1.41%  |
| Non-accrual loans  | 1.07x  | 1.62x   | 1.43x  |
| Non-performing loans   | 1.07x  | 1.58x   | 1.15x  |
| Net charge-offs  | 12.68x   | 6.29x   | 12.54x   |
| Loans 30-89 days past due and still accruing                             | \$ 2,907,941   | \$ 2,570,825  | \$ 2,525,382   |
| Loans 90 days past due and accruing                                      | \$ 35,891  | \$ 80,603   | \$ 997,148   |
| Non-accrual loans  | \$ 4,647,858   | \$ 3,357,718  | \$ 4,082,222   |
| Allowance for loan losses to loans 90 days or more past due and accruing | 139.06x  | 67.54x  | 5.86x  |

The \$2,908,000 of loans in the 30-89 days past due category as of September 30, 2007 consists of several loan relationships that migrated beyond the 30 days, but payments are expected, returning them to fully current status.





The internally criticized and classified loans are addressed in the allowance for loan loss allocation either through the general loan loss allocation, a specific reserve or through the qualitative factor adjustments. Management believes the allocation of the allowance for loan losses on these loans is adequate to absorb the potential for losses and therefore did not require additional loan loss provisions.

Non-performing assets

The Bank defines non-performing assets as accruing loans which are past due 90 days or more, non-accrual loans, restructured loans, other real estate owned and repossessed assets. As of September 30, 2007, non-performing assets represented 0.81% of total assets compared to 0.65% at December 31, 2006 and 0.93% at September 30, 2006.

The non-accrual loans component of the non-performing assets increased by a net \$1,290,000 during the first nine months of 2007 to \$4,648,000 at September 30, 2007. Additions to the non-accrual loans totaling \$2,823,000 occurred during the first nine months of 2007, as a number of loan relationships migrated to delinquent status and were placed on non-accrual. However, these additions were partially offset by payoffs or pay downs of \$906,000, \$146,000 of loans returned to accruing status, charge-offs of \$129,000 and \$352,000 of loans that were transferred to other real estate owned. The Bank's Special Assets Committee has reviewed non-accrual loans at September 30, 2007 and found the collateral to be adequate or has made reserve allocations where deemed appropriate.

At September 30, 2007 the 90-day past due loans that were still accruing totaled \$36,000, compared to \$81,000 at December 31, 2006 and \$997,000 at September 30, 2006.

There were no repossessed assets at September 30, 2007. Other real estate owned was \$107,000 at September 30, 2007. An offer to purchase the property is currently pending.

Non-performing loans are defined as accruing loans that are past due 90 days or more and non-accruing loans. The non-performing loans were \$4,684,000 at September 30, 2007, an increase of \$1,245,000 from year-end 2006, but a decline of \$396,000 compared to September 30, 2006. The bank's Special Assets Department has developed specific action plans to reduce each of the Company's non-performing loans. The ratio of non-accrual loans to net loans was 1.10%, at September 30, 2007 compared to 1.00% at September 30, 2006. It was up slightly from the year-end ratio of 0.80%. At September 30, 2007, the ratio of non-performing loans to net loans was 1.11% compared to 0.82% at December 31, 2006 and 1.24% at September 30, 2006. The ratio of non-performing assets to total assets was 0.81% at September 30, 2007 and 0.65% at December 31, 2006, both down from 0.93% at September 30, 2006.

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

|   | September 30, 2007 | December 31, 2006 | September 30, 2006 |
|---|--------------------|-------------------|--------------------|
| Loans past due 90 days or more and accruing | \$ 35,891          | \$ 80,603         | \$ 997,148         |
| Non-accrual loans                           | 4,647,858          | 3,357,718         | 4,082,222          |

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|  |                |                |                |
|--|----------------|----------------|----------------|
| Total non-performing loans   | 4,683,749      | 3,438,321      | 5,079,370      |
| Restructured loans   |                |                |                |
| Other real estate owned  | 107,036        | 197,149        | 131,849        |
| Reposessed assets  |                |                |                |
| Total non-performing assets  | \$ 4,790,785   | \$ 3,635,470   | \$ 5,211,219   |
| Net loans including AFS  | \$ 421,172,921 | \$ 417,321,048 | \$ 410,072,053 |
| Total assets   | \$ 589,101,139 | \$ 562,317,988 | \$ 562,840,483 |
| Non-accrual loans to net loans   | 1.10%          | 0.80%          | 1.00%          |
| Non-performing assets to net loans, foreclosed real estate and reposessed assets | 1.14%          | 0.87%          | 1.27%          |
| Non-performing assets to total assets  | 0.81%          | 0.65%          | 0.93%          |
| Non-performing loans to net loans  | 1.11%          | 0.82%          | 1.24%          |

Bank premises and equipment, net

Bank premises and equipment increased \$1,982,000, or 18%, since December 31, 2006. The increase was due mostly to current year capital expenditures and the transfer of capitalized costs from other assets, both in conjunction with the completion of the Company's branch relocation project. These items were partially offset by the sale and disposal of property and equipment including the sale of an owned commercial facility previously leased to a non-related third party.

Other assets

The decrease in other assets of \$389,000, or 8%, from December 31, 2006 to September 30, 2007 was principally due to the net reduction of \$542,000 in capitalized costs that were transferred to bank premises and equipment in conjunction with the completion of the Company's branch relocation project. This was partially offset by an increase in prepaid expenses which represents charges that are paid but deferred until the expense is incurred.

Deposits

The Bank is a community-based commercial financial institution that offers a variety of deposit accounts with a range of interest rates and terms. Deposit products include passbook and statement savings accounts, interest-bearing checking (NOW), money market, non-interest bearing, or demand deposit accounts (DDAs), and certificates of deposit accounts. The flow of deposits is significantly influenced by general economic conditions, changes in prevailing interest rates, pricing and competition. Most of the Bank's deposits are obtained from the communities surrounding its 12 branch offices. The Bank attempts to attract and retain deposit customers via sales and marketing efforts with new products, quality service, competitive rates, and maintaining long-standing customer relationships. To determine deposit product interest rates, the Bank considers local competition, market yields and the rates charged for alternative sources of funding such as borrowings. To be competitive in our markets and continue to bolster our deposit base, we have increased rates on most deposit products; however, we have not increased rates above market rates, as we only consider cost effective rate-setting tactics in all interest rate environments.

Compared to December 31, 2006 total deposits increased \$28,722,000, or 7%, during the nine months ended September 30, 2007. The growth in total deposits was primarily due to increases in certificates of deposit, money market and NOW accounts partially offset by reductions in savings and DDAs. The growth in the certificates of deposits was due to increases in the personal and the public fund sector. The increase in money market accounts of \$15,869,000, or 22%, was due to the continued success in deposit-gathering strategies in conjunction with promotional interest rates, partially offset by a decrease in savings accounts.

The following table represents the components of deposits as of September 30, 2007 and December 31, 2006:

|                  | September 30, 2007 |      | December 31, 2006 |      |
|------------------|--------------------|------|-------------------|------|
|                  | Amount             | %    | Amount            | %    |
| Money market     | \$ 88,228,034      | 20.1 | \$ 72,359,157     | 17.6 |
| NOW              | 66,903,423         | 15.2 | 65,121,770        | 15.9 |
| Savings and club | 42,075,206         | 9.6  | 45,300,838        | 11.0 |

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|                         |                |       |                |       |
|-------------------------|----------------|-------|----------------|-------|
| Certificates of deposit | 171,305,565    | 39.0  | 153,810,855    | 37.5  |
| Total interest-bearing  | 368,512,228    | 83.9  | 336,592,620    | 82.0  |
| Non-interest-bearing    | 70,544,329     | 16.1  | 73,741,975     | 18.0  |
| Total deposits          | \$ 439,056,557 | 100.0 | \$ 410,334,595 | 100.0 |

Certificates of deposit of \$100,000 or more aggregated \$73,273,000 and \$63,020,000 at September 30, 2007 and December 31, 2006, respectively.

Borrowings

Borrowings are used as a complement to deposit generation as an alternative funding source whereby the Bank will borrow under customer repurchase agreements in the local market and advances from the Federal Home Loan Bank of Pittsburgh (FHLB) and correspondent banks for asset growth and liquidity needs. Borrowings included \$62,918,000 and \$62,536,000 in long-term advances from the FHLB at September 30, 2007 and December 31, 2006, respectively. To help reduce the Bank's reliance on overnight funding, during the second quarter of 2007 \$16,000,000 of advances that had matured or converted, and carried a weighted-average interest rate of 4.78%,

were replaced with fixed- and capped floating- rate advances amounting to an aggregate of \$20,000,000 that mature in 2009 and carry an initial weighted-average interest rate of 5.40%. Also included in borrowings were short-term repurchase agreements of \$20,565,000 and \$22,224,000, as of the respective periods. Repurchase agreements are non-insured interest-bearing liabilities that have a security interest in qualified investment securities of the Bank and are offered in both sweep and fixed-term products. A sweep account is designed to ensure that, on a daily basis, an attached DDA is adequately funded and excess DDA funds are transferred, or swept into an overnight interest-bearing repurchase agreement account. The balance in customer repurchase agreement accounts can fluctuate daily because the daily sweep product is dependent on the level of available funds in depositor accounts. In addition, short-term borrowings may include overnight balances which the Bank may require from time-to-time to fund daily liquidity needs. As of September 30, 2007, the Bank had \$7,000,000 in overnight balances compared to \$10,395,000 at December 31, 2006.

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

#### *Management of interest rate risk and market risk analysis*

The Company is subject to the interest rate risks inherent in our 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, taken together 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 periods. A positive gap (asset sensitive) indicates that more assets will re-price during a given period compared to liabilities, while a negative gap (liability sensitive) has the opposite effect. The Company employs computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest sensitive assets and liabilities in order to determine what impact these rate changes will have upon the net interest spread. At September 30, 2007, the Company maintained a negative one-year cumulative gap of \$56,694,000 or -9.6% of total assets. The effect of this negative gap position provided a mismatch of assets and liabilities which may expose the Bank to interest rate risk during periods of rising interest rates. Conversely, in a declining interest rate environment, net interest income could be positively impacted because more liabilities than assets will re-price downward during a one-year period.

Certain shortcomings are inherent in the method of analysis discussed above and presented in the next table. Although certain assets and liabilities may have similar maturities or periods of re-pricing, they may react in different degrees to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. Certain assets, such as adjustable-rate mortgages, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the table. The ability of many borrowers to service their adjustable-rate debt may decrease in the event of an interest rate increase.

The following table illustrates the Company's interest sensitivity gap position at September 30, 2007 (dollars in thousands):

|  | Three months<br>or less | Three to<br>twelve months | One to<br>three years | Over<br>three years | Total      |
|--|-------------------------|---------------------------|-----------------------|---------------------|------------|
| Cash and cash equivalents                                | \$ 239                  | \$                        | \$                    | \$ 13,132           | \$ 13,371  |
| Investment securities <sup>(1)(2)</sup>                  | 17,352                  | 10,071                    | 30,931                | 67,101              | 125,455    |
| Loans <sup>(2)</sup>                                     | 108,385                 | 64,828                    | 104,590               | 143,370             | 421,173    |
| Fixed and other assets                                   |                         | 8,409                     |                       | 20,693              | 29,102     |
| Total assets   | \$ 125,976              | \$ 83,308                 | \$ 135,521            | \$ 244,296          | \$ 589,101 |
| Total cumulative assets                                  | \$ 125,976              | \$ 209,284                | \$ 344,805            | \$ 589,101          |            |
| Non-interest-bearing transaction deposits <sup>(3)</sup> | \$                      | \$ 7,059                  | \$ 19,398             | \$ 44,087           | \$ 70,544  |
| Interest-bearing transaction deposits <sup>(3)</sup>     | 103,781                 |                           | 37,265                | 56,161              | 197,207    |
| Certificates of deposit                                  | 65,319                  | 50,392                    | 52,428                | 3,167               | 171,306    |
| Repurchase agreements                                    | 20,414                  | 151                       |                       |                     | 20,565     |
| Short-term borrowings                                    | 8,014                   |                           |                       |                     | 8,014      |
| Long-term debt   | 10,212                  | 636                       | 20,070                | 32,000              | 62,918     |
| Other liabilities  |                         |                           |                       | 4,659               | 4,659      |
| Total liabilities  | \$ 207,740              | \$ 58,238                 | \$ 129,161            | \$ 140,074          | \$ 535,213 |
| Total cumulative liabilities                             | \$ 207,740              | \$ 265,978                | \$ 395,139            | \$ 535,213          |            |
| Interest sensitivity gap                                 | \$ (81,764)             | \$ 25,070                 | \$ 6,360              | \$ 104,222          |            |
| Cumulative gap   | \$ (81,764)             | \$ (56,694)               | \$ (50,334)           | \$ 53,888           |            |
| Cumulative gap to total assets                           | (13.88)%                | (9.62)%                   | (8.54)%               | 9.15%               |            |

(1) Includes FHLB stock and the net unrealized gains/losses on securities AFS.

(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 are included in the periods in which they are scheduled to be repaid based on scheduled amortization. For amortizing loans and mortgage-backed securities, annual prepayment rates are assumed reflecting historical experience as well as management's knowledge and experience of its loan products.

(3) The Bank's demand and savings accounts are 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 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.* 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.* 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 rates 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 200 basis points upward or downward movement in interest rates on net interest income, net income and the change in the economic value (portfolio equity). This analysis assumed that interest-earning asset and interest-bearing liability levels at September 30, 2007 remained constant. The impact of the rate movements was developed by simulating the effect of rates changing over a twelve-month period from the September 30, 2007 levels:

|   | Rates +200 | Rates -200 |
|---|------------|------------|
| Earnings at risk:                                     |            |            |
| Percent change in:                                    |            |            |
| Net interest income                                   | (6.7)%     | 3.0%       |
| Net income  | (19.3)     | 8.2        |
| Economic value at risk:                               |            |            |
| Percent change in:                                    |            |            |
| Economic value of equity                              | (29.0)     | 4.9        |
| Economic value of equity as a percent of total assets | (3.1)      | 0.5        |

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may normally change beyond the Company's policy guideline for a short period of time as long as the risk-based capital ratio (after adjusting for the excess equity exposure) is greater than 10%. At September 30, 2007, the Company's risk-based capital ratio was 13.5%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning October 1, 2007 under alternate interest rate scenarios using the income simulation model described above (dollars in thousands):

| Change in interest rates | Net interest income | \$ variance | % variance |
|--------------------------|---------------------|-------------|------------|
| +200 basis points        | \$ 17,201           | \$ (1,232)  | (6.7)%     |
| +100 basis points        | 17,847              | (586)       | (3.2)      |
| Flat rate                | 18,433              |             |            |
| -100 basis points        | 18,954              | 521         | 2.8        |
| -200 basis points        | 18,985              | 552         | 3.0        |

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. Mortgage-backed securities and amortizing loans are scheduled based on their anticipated cash flow including estimated prepayments. For investment securities, the Bank uses a third-party service to provide cash flow estimates in the various rate environments. Savings accounts, including passbook, statement savings, money market and NOW accounts, do not have a stated maturity or re-pricing term and can be withdrawn or re-priced 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 provided by management. As a result, the mix of interest-

earning assets and interest bearing-liabilities is held constant.

*Derivative Financial Instruments.* As part of the Bank's overall interest rate risk management strategy, the Company has adopted a policy whereby the Bank may periodically use derivative instruments to minimize significant fluctuations in earnings caused by interest rate volatility. This interest rate risk management strategy entails the use of interest rate floors, caps and swaps. The Bank entered into an interest rate floor agreement in 2006 and is reflected in the scenarios for earnings and economic value at risk and the net interest income in the two immediately preceding tables.

### Liquidity

Liquidity management ensures that adequate funds will be available to meet customers' needs for borrowings, deposit withdrawals and maturities and normal operating expenses of the Bank. Current sources of liquidity are cash and cash equivalents, asset maturities and pay-downs within one year, loans and investments AFS, growth of core deposits, growth of repurchase agreements, increases in other borrowed funds from correspondent banks and issuance of capital stock. Although regularly scheduled investment and loan payments are dependable sources of daily funds, the sales of both loans and investments AFS, deposit activity, and investment and loan prepayments are significantly influenced by general economic conditions and the level of interest rates.

As of September 30, 2007, the Company maintained approximately \$13,371,000 in cash and cash equivalents, \$120,701,000 of investments AFS and \$382,000 of loans AFS. In addition, as of September 30, 2007, the Company had approximately \$112,018,000 available to borrow from the FHLB and \$23,000,000 available from other correspondent banks. This combined total of \$269,472,000 represented 46% of total assets at September 30, 2007. Management believes this level of liquidity to be strong and adequate to support current operations.

### Capital

During the nine months ended September 30, 2007, shareholders' equity increased from net income, stock issuance from the Company's various sponsored stock plans and an increase in the intrinsic value of the Bank's cash flow hedge. The increase was partially offset by an increase in the unrealized loss on AFS securities and the declaration of cash dividends. 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, risk-weightings and other factors.

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 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%.



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As of September 30, 2007, the Company and the Bank met all capital adequacy requirements to which they were subject. The following table depicts the capital amounts and ratios of the Company and the Bank as of September 30, 2007:

|   | Actual        |       | For capital adequacy purposes |        |                 |         | To be well capitalized under prompt corrective action provisions |       |
|---|---------------|-------|-------------------------------|--------|-----------------|---------|--|-------|
|   | Amount        | Ratio | Amount                        | Ratio  | Amount          | Ratio   | Amount   | Ratio |
| <b>Total capital (to risk-weighted assets)</b>  |               |       |                               |        |                 |         |  |       |
| Consolidated                                    | \$ 60,108,329 | 13.5% | ≥ \$ 35,528,634               | ≥ 8.0% |                 |         | N/A  | N/A   |
| Bank  | \$ 59,748,497 | 13.5% | ≥ \$ 35,526,635               | ≥ 8.0% | ≥ \$ 44,408,294 | ≥ 10.0% |  |       |
| <b>Tier I capital (to risk-weighted assets)</b> |               |       |                               |        |                 |         |  |       |
| Consolidated                                    | \$ 55,033,232 | 12.4% | ≥ \$ 17,764,317               | ≥ 4.0% |                 |         | N/A  | N/A   |
| Bank  | \$ 54,749,252 | 12.3% | ≥ \$ 17,763,318               | ≥ 4.0% | ≥ \$ 26,644,976 | ≥ 6.0%  |  |       |
| <b>Tier I capital (to average assets)</b>       |               |       |                               |        |                 |         |  |       |
| Consolidated                                    | \$ 55,033,232 | 9.5%  | ≥ \$ 23,119,373               | ≥ 4.0% |                 |         | N/A  | N/A   |
| Bank  | \$ 54,749,252 | 9.5%  | ≥ \$ 23,103,707               | ≥ 4.0% | ≥ \$ 28,879,634 | ≥ 5.0%  |  |       |

### Item 4. Controls and Procedures

The Company maintains controls and procedures designed to ensure that information required to be disclosed in the reports that 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 rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those controls and procedures as of the end of the period covered by this report, the Chief Executive and Chief Financial Officers of the Company concluded that the Company's disclosure controls and procedures were adequate.

The Company assesses the adequacy of its internal control over financial reporting quarterly and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. Based on this assessment, the Company's management concluded that there have been no changes in the Company's internal controls or in other factors that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II - Other Information

### Item 1. Legal Proceedings

The nature of the Company's business generates some litigation involving matters arising in the ordinary course of business. However, in the opinion of the Company, after 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 1A. Risk Factors**

Management of the Company does not believe there have been any material changes in the risk factors that were disclosed in the Form 10-K filed with the Securities and Exchange Commission on March 20, 2007.

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

None

**Item 3. Default Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

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

*\*10.1 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Steven C. Ackmann, dated July 11, 2007.* Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on July 13, 2007.

*\*10.2 Amendment to Registrant's 2000 Stock Incentive Plan.* Incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed with the SEC on October 4, 2007.

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

*11 Statement regarding computation of earnings per share.* Included herein in Note 2, Earnings per share, contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.

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

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

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

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

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\* Management contract or compensatory plan or arrangement.

**FIDELITY D & D BANCORP, INC.**



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

**FIDELITY D & D BANCORP, INC.**

Date: November 6, 2007

/s/ Steven C. Ackmann  
Steven C. Ackmann,  
President and Chief Executive Officer

Date: November 6, 2007

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

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