FIDELITY D & D BANCORP INC
Form 10-K
March 13, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

x **ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007

COMMISSION FILE NUMBER 333-90273

FIDELITY D & D BANCORP, INC.

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

BLAKELY AND DRINKER STREETS

DUNMORE, PENNSYLVANIA 18512

TELEPHONE NUMBER **(570) 342-8281**

SECURITIES REGISTERED UNDER SECTION 12(b) OF THE ACT:
None

SECURITIES REGISTERED UNDER SECTION 12(g) OF THE ACT:
Common Stock, without par value

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

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

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

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

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

Aggregate market value of the voting common stock held by non-affiliates of the registrant equals $54,750,683, as of June 30, 2007, based on a market price of $32.10. The number of shares of common stock outstanding as of February 29, 2008, was 2,075,182.

DOCUMENTS INCORPORATED BY REFERENCE

Excerpts from the Registrant s 2007 Annual Report to Shareholders are incorporated herein by reference in response to Part I. Portions of the Registrant s definitive Proxy Statement to be used in connection with the 2008 Annual Meeting of Shareholders are incorporated herein by reference in partial response to Part II and Part III.

Fidelity D & D Bancorp, Inc.
2007 Annual Report on Form 10-K
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FIDELITY D & D BANCORP, INC.

PART I

ITEM 1: BUSINESS

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

The Bank has offered a full range of traditional banking services since it commenced operations in 1903. The Bank has a personal and corporate trust department and also provides alternative financial and insurance products with asset management services. A complete list of services provided by the Bank is detailed in the section entitled Products and Services contained within the 2007 Annual Report to Shareholders, incorporated by reference. The service area is comprised of the Borough of Dunmore and the surrounding communities within Lackawanna and Luzerne counties.

The banking business is highly competitive, and the profitability of the Company depends principally upon the Company s ability to compete in its market area. The Company competes with, among other sources, the following:

- local community banks
- savings banks
- regional banks
- credit unions
- savings & loans
- insurance companies
- money market funds
- mutual funds
- small loan companies
- other financial service companies

The Company has been able to compete effectively with other financial institutions by emphasizing technology and customer service, including local decision making on loans. These efforts enabled the Bank to establish long-term customer relationships and build customer loyalty by providing products and services designed to address the specific needs of its customers.

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

The Company had 188 full-time equivalent employees on December 31, 2007, which includes exempt officers and part-time employees.

Federal and state banking laws contain numerous provisions that affect various aspects of the business and operations of the Company and the Bank. The Company is subject to, among others, the regulations of the Securities and Exchange Commission (the SEC) and the Federal Reserve Board (the FRB) and the Bank is subject to, among others, the regulations of the Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation (the FDIC). Refer to Part II, Item 7 Supervision and Regulation for descriptions of and references to applicable statutes and regulations which are not intended to be complete descriptions of these provisions or their effects on the Company or the Bank. They are summaries only and

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

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

Annually, the Bank is examined by the Pennsylvania Department of Banking and/or the FDIC. The last examination was conducted by the FDIC as of December 31, 2006. During the preparation and prior to the filing of this Form 10-K, the Bank was in the process of being examined by the Pennsylvania Department of Banking as of December 31, 2007.

The Company s website address is http://www.bankatfidelity.com. The Company makes available through this website the annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K and amendments to those reports as soon as reasonably practical after filing with the SEC. You may read and copy any materials filed with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at (202) 551-8090. The SEC also maintains an internet site that contains reports, proxy and information statements and other information about the Company at http://www.sec.gov.

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

ITEM 1A: RISK FACTORS

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

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

Risks Related to the Company s Business

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

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

The Company is subject to lending risk.

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

As of December 31, 2007, approximately 51% of the Company s loan portfolio consisted of commercial, commercial real estate and real estate construction loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Company s loan portfolio contains a significant number of commercial, commercial real estate and construction loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for possible loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Company s financial condition and results of operations.

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

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

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

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

could have a material adverse effect on the Company s financial condition and results of operations.

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

The Company s success depends primarily on the general economic conditions of the Commonwealth of Pennsylvania and the specific local markets in which the Company operates. Unlike larger national or other regional banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in Lackawanna and Luzerne Counties. The local economic conditions in these areas have a significant impact on the demand for the Company s

products and services as well as the ability of the Company s customers to repay loans, the value of the collateral securing loans and the stability of the Company s deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, an outbreak of hostilities or other international or domestic occurrences, unemployment, changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Company s financial condition and results of operations.

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

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

The Company is subject to extensive government regulation and supervision.

The Company, primarily through the Bank**,** is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect the Company s lending practices, capital structure, investment practices, dividend policy and growth, among other things. Federal or commonwealth regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect the Company in substantial and unpredictable ways. Such changes could subject the Company to additional costs, limit the types of financial services and products the Company may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Company s business, financial condition and results of operations. While the Company has policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur.

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

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

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

From time-to-time, the Company may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services the Company may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Company s system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Company s business, results of operations and financial condition.

The Company s ability to pay dividends depends primarily on dividends from its banking subsidiary, which is subject to regulatory limits.

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

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

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

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

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

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

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

The Company continually encounters technological change.

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

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

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

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

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on the Company s ability to conduct business. Such events could affect the stability of the Company s deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause the Company to incur additional expenses. Severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on the Company s business, which, in turn, could have a material adverse effect on the Company s financial condition and results of operations.

Risks Associated with the Company s Common Stock

The Company s stock price can be volatile.

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

- Actual or anticipated variations in quarterly results of operations.
- Recommendations by securities analysts.
- Operating and stock price performance of other companies that investors deem comparable to the Company.
- News reports relating to trends, concerns and other issues in the financial services industry.
- Perceptions in the marketplace regarding the Company and/or its competitors.
- New technology used, or services offered, by competitors.

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

- Failure to integrate acquisitions or realize anticipated benefits from acquisitions.

- Changes in government regulations.

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

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

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

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

An investment in the Company s common stock is not an insured deposit.

The Company s common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in the Company s common stock is inherently risky for the reasons described in this Risk Factors section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire the Company s common stock, you may lose some or all of your investment.

The Company s articles of incorporation and by-laws, as well as certain banking laws, may have an anti-takeover effect.

Provisions of the Company s articles of incorporation and by-laws, federal banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire the Company, even if doing so would be perceived to be beneficial to the Company s shareholders. The combination of these provisions effectively inhibits a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of the Company s common stock.

Risks Associated with the Company s Industry

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

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

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

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

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

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

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

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

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as disintermediation, could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on the Company s financial condition and results of operations.

ITEM 1B: UNRESOLVED STAFF COMMENTS

None

ITEM 2: PROPERTIES

As of December 31, 2007, the Bank operated 12 full-service banking offices, of which three were owned and nine were leased. None of the lessors of the properties leased by the Bank are affiliated with the Company or the Bank and all of the properties are located in the Commonwealth of Pennsylvania. The Company is headquartered at its owner occupied main branch located on the corner of Blakely and Drinker Streets in Dunmore, PA.

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

Location	Owned/leased*	Type of use	Full service	Drive-thru	ATM
Drinker & Blakely Sts., Dunmore, PA	Owned	Main Branch (1)	x	x	x
111 Green Ridge St., Scranton, PA	Leased	Green Ridge Branch (2)	x	x	x
139 Wyoming Ave., Scranton, PA	Leased	Scranton Branch	x		x
1311 Morgan Hwy., Clarks Summit, PA	Leased	Abington Branch (3)	x	x	x
Industrial Park Rd., Dunmore, PA	Owned	Keystone Industrial Park Branch	x	x	x
403 Kennedy Blvd., Pittston, PA	Leased	Pittston Branch	x		x

338 North Washington Ave., Scranton, PA	Owned	Financial Center Branch [(4)]	x		x
4010 Birney Ave., Moosic, PA	Leased	Moosic Branch	x	x	x
801 Wyoming Ave., West Pittston, PA	Leased	West Pittston Branch	x		x
1598 Main St., Peckville, PA	Leased	Peckville Branch	x	x	x
247 Wyoming Ave., Kingston, PA	Leased	Kingston Branch	x	x	x
511 Scranton-Carbondale Hwy., Eynon, PA	Leased	Eynon Branch	x	x	x

*All of the owned properties are free of encumbrances

(1) Executive and administrative, commercial lending, trust and asset management services are located at this facility. This office has two automated teller machines (ATMs).

(2) This office has two ATMs.

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

(4) Executive, mortgage and consumer lending, finance and operational offices are located in this building. A portion of the building is leased to a non-related entity. The Company also owned an adjacent attached building which was leased to a non-related entity. The Company sold this building in 2007.

The Bank maintains several free-standing 24-hour ATMs located at the following locations in Pennsylvania:

- U.S. Mini Marts, Inc., 511 Main St., Childs
- Marywood University, 2300 Adams Ave., Nazareth Hall, Scranton
- Snö Mountain Ski Resort, 1000 Montage Mountain Rd., Moosic
- Convenient Food Mart, 100 Highland Ave., Clarks Summit
- Ice Box Sports Complex, 3 West Olive St., Scranton
- Shops at Montage, 1035 Shoppes Blvd., Moosic

The Company also owned a commercial facility located at 116 118 N. Blakely Street, Dunmore, PA which was leased to a non-related entity. The Company sold this facility in 2007.

The Company also owns property located at Luzerne Street and South Main Avenue, Scranton. This property is currently under construction and will be the site of our West Scranton Branch scheduled to open for business in 2008.

Other real estate owned includes all foreclosed properties listed for sale. Upon possession, foreclosed properties are recorded on the Company s balance sheet at the lower of cost or fair value.

ITEM 3: LEGAL PROCEEDINGS

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

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted during the quarter ended December 31, 2007 to a vote of our security holders through solicitation of proxies or otherwise.

PART II

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

The common stock of the Company is traded on the over-the-counter bulletin board under the symbol FDBC. Shareholders requesting information about the Company s common stock may contact Salvatore R. DeFrancesco, Jr., Treasurer. Requests may be mailed to:

Fidelity D & D Bancorp, Inc.

Blakely and Drinker St.

Dunmore, PA 18512

(570) 342-8281

The following table lists the quarterly cash dividends paid per share and the range of sales prices for the Company s common stock. Such over-the-counter prices do not include retail mark-ups, markdowns or commissions:

	2007 Prices						2006 Prices					
		High		Low		Dividends paid		High		Low		Dividends paid
1st Quarter	$	40.00	$	32.50	$	0.22	$	42.50	$	36.36	$	0.22
2nd Quarter	$	37.75	$	32.00	$	0.22	$	38.00	$	32.50	$	0.22
3rd Quarter	$	34.00	$	27.10	$	0.24	$	35.00	$	32.10	$	0.22
4th Quarter	$	34.00	$	27.00	$	0.25	$	35.50	$	31.25	$	0.22

Dividends are determined and declared by the Board of Directors of the Company. On January 17, 2006, the Board of Directors declared a 10% stock dividend. The new shares were distributed on February 15, 2006 to shareholders of record at the close of business on January 30, 2006. The Company expects to continue to pay cash dividends in the future; however, future dividends are dependent upon earnings, financial condition, capital needs and other factors of the Company. For a further discussion of regulatory capital requirements see Note 14, Regulatory matters, contained within the notes to the consolidated financial statements.

The Company has established a dividend reinvestment plan (DRP) for its shareholders. The plan is designed to make the Company s stock available at no transactional cost to our shareholders. Cash dividends, paid to shareholders who are enrolled in the DRP, are used to purchase shares directly from the Company or shares that are available in the open market.

The Company had approximately 1,335 shareholders at February 29, 2008 and approximately 1,338 at December 31, 2007. The number of shareholders is the actual number of individual shareholders of record. Each security depository is considered a single shareholder for purposes of determining the approximate number of shareholders.

Securities authorized for issuance under equity compensation plans

The information required under this section is incorporated by reference herein, to the information presented in the Company s definitive Proxy Statement for its 2008 Annual Meeting of Shareholders to be filed with the SEC.

Performance graph

The following graph and table compare the cumulative total shareholder return on the Company s common stock against the cumulative total return of the NASDAQ Composite and the SNL index of greater than $500 million in-asset banks traded on the OTC-BB and Pink Sheet (the SNL index) for the period of five fiscal years commencing January 1, 2003, and ending December 31, 2007. The graph illustrates the cumulative investment return to shareholders, based on the assumption that a $100 investment was made on December 31, 2002, in each of: the Company s common stock, the NASDAQ Composite and the SNL index. All cumulative total returns are computed assuming the reinvestment of dividends into the applicable securities. The shareholder return shown on the graph and table below is not necessarily indicative of future performance:

	Period ending					
Index	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**
Fidelity D & D Bancorp, Inc.	100.00	99.07	93.07	116.78	106.30	93.11
NASDAQ Composite	100.00	150.01	162.89	165.13	180.85	198.60
SNL > $500M OTC-BB and Pink Sheet Banks	100.00	139.37	163.02	173.49	190.35	175.39

ITEM 6: SELECTED FINANCIAL DATA

Set forth below are our selected consolidated financial and other data. This financial data is derived in part from, and should be read in conjunction with, the Company s consolidated financial statements and related footnotes:

	2007	2006	2005	2004	2003
Balance sheet data:					
Total assets	$ 587,412,555	$ 562,317,988	$ 544,060,698	$ 536,675,138	$ 575,215,466
Total investment securities	122,984,160	100,410,736	97,678,573	115,668,818	139,654,074
Net loans	421,424,379	417,199,048	403,144,095	381,546,375	366,981,640
Loans available-for-sale	827,250	122,000	428,584	576,378	19,863,577
Total deposits	425,708,361	410,334,595	379,498,640	365,615,335	401,442,546
Short-term borrowings	39,656,354	33,656,150	28,772,997	50,534,046	54,756,978
Long-term debt	62,708,677	62,536,210	83,704,188	71,119,188	71,876,034
Total shareholders equity	55,191,294	51,611,863	48,846,029	46,366,760	43,931,899
Operating data for the year ended:					
Total interest income	$ 35,279,357	$ 33,529,710	$ 29,020,261	$ 27,395,491	$ 28,462,093
Total interest expense	17,660,075	16,361,109	11,720,986	11,180,135	14,237,129
Net interest income	17,619,282	17,168,601	17,299,275	16,215,356	14,224,964
(Credit) provision for loan losses	(60,000)	325,000	830,000	2,150,000	3,715,000
Net interest income after (credit) provision for loan losses	17,679,282	16,843,601	16,469,275	14,065,356	10,509,964
Other income	5,205,215	4,522,138	4,150,502	4,153,277	4,182,739
Other operating expense	16,636,760	15,878,376	14,561,968	13,818,565	12,902,963
Income before provision for income taxes	6,247,737	5,487,363	6,057,809	4,400,068	1,789,740
Provision for income taxes	1,636,165	1,362,080	1,466,112	1,035,594	146,492
Net Income	$ 4,611,572	$ 4,125,283	$ 4,591,697	$ 3,364,474	$ 1,643,248
Per share data:					
Net income per share, basic	$ 2.23	$ 2.01	$ 2.26	$ 1.67	$ 0.82
Net income per share, diluted	$ 2.23	$ 2.01	$ 2.25	$ 1.67	$ 0.82
Dividends declared	$ 1,921,533	$ 1,801,361	$ 1,624,263	$ 1,610,423	$ 1,601,898
Dividends per share	$ 0.93	$ 0.88	$ 0.80	$ 0.80	$ 0.80
Book value per share	$ 26.62	$ 25.09	$ 23.95	$ 22.92	$ 21.91
Weighted-average number of shares outstanding*	2,066,683	2,047,975	2,031,211	2,013,798	2,002,443
Number of shares outstanding at year-end*	2,072,929	2,057,433	2,039,639	2,023,529	2,005,347
Ratios:					
Return on average assets	0.80%	0.73%	0.86%	0.61%	0.29%
Return on average equity	8.65%	8.31%	9.64%	7.51%	3.63%
Net interest margin	3.34%	3.31%	3.51%	3.20%	2.74%
Efficiency ratio	71.61%	71.67%	65.99%	64.45%	72.32%
Expense ratio	2.01%	2.02%	1.93%	1.69%	1.68%
Allowance for loan losses to total loans	1.13%	1.29%	1.46%	1.54%	1.28%

Dividend payout ratio	41.67%	43.67%	35.37%	47.87%	97.48%
Equity to assets	9.40%	9.18%	8.98%	8.64%	7.64%
Equity to deposits	12.96%	12.58%	12.87%	12.68%	10.94%

* The number of shares and the weighted-average number of shares outstanding prior to 2006, have been adjusted to reflect the effect of the 10% stock dividend paid on February 15, 2006.

ITEM 7: MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

This Annual Report on Form 10-K 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, po 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 it 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 report. 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 Item 1A, above, and in other documents that we file, from time-to-time with the SEC, including quarterly reports on Form 10-Q and any current reports on Form 8-K.

Critical accounting policies

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

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at December 31, 2007 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different

assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company s allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company s investment securities. 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. As described in Notes 1 and 3 of the consolidated financial statements, the large majority of the Company s investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheet, with unrealized gains and losses, net of income tax, reported separately within shareholders equity through accumulated other comprehensive income (loss).

The fair value of residential mortgage loans, classified as AFS, is obtained from the Federal National Mortgage Association (FNMA). 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. The market to which the Bank sells mortgage and other loans is restricted and price quotes from other sources are not typically obtained. For a further discussion on the accounting treatment of AFS loans, see the section entitled Loans available-for-sale, contained within management s discussion and analysis. As of December 31, 2007, loans classified as AFS consisted of residential mortgages.

All significant accounting policies are contained in Note 1, Nature of operations and summary of significant accounting policies, within the notes to consolidated financial statements and incorporated by reference in Part II, Item 8.

The following discussion and analysis presents the significant changes in the financial condition and in the results of operations of the Company as of December 31, 2007 and December 31, 2006 and for each of the years then ended. This discussion should be read in conjunction with the consolidated financial statements and notes included in Part II, Item 8 of this report.

Comparison of Financial Condition as of December 31, 2007

and 2006 and Results of Operations for each of the Years then Ended

Financial Condition

Overview

Compared to 2006, the interest rate environment improved during 2007. The yield curve, which continues to steepen, should help widen the interest-rate spreads, bolster margins and improve the operating performance of the Bank. This, in conjunction with our successful deposit gathering tactics, improved credit quality and hedging strategy should continue to help position the Bank to optimize net interest income during this downward, challenging yet improving interest rate environment. The Bank will continue to monitor cash inflows from prepayments of

interest-earning assets, which tend to accelerate during down interest rate cycles. We are proactively seeking means by which to redeploy excess funds should this occur, including but not limited to debt reduction, loan funding and structured investment strategies.

Consolidated assets increased $25,095,000, or 4%, during the year ended December 31, 2007 to $587,413,000. The increase resulted from increases in total deposits of $15,374,000, total borrowings of $6,173,000 and total shareholders equity of $3,579,000. During 2007, the carrying values of the investment and loan portfolios increased $22,573,000 and $4,931,000, respectively, while premises and equipment, net plus construction in process, a component of other assets in the consolidated balance sheet, increased $1,287,000. Cash decreased $3,392,000 since December 31, 2006.

The following table is a comparison of condensed balance sheet accounts and percentage to total assets at December 31, 2007, 2006 and 2005 (thousands of dollars):

	2007		2006		2005	
	Amount	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**
Assets:						
Cash and cash equivalents	$ 10,409	1.8%	$ 13,801	2.4%	$ 12,594	2.3%
Investment securities	122,984	20.9	100,411	17.9	97,679	18.0
Federal Home Loan Bank Stock	3,303	0.6	3,795	0.7	4,628	0.8
Loans and leases, net	422,252	71.9	417,321	74.2	403,573	74.2
Bank premises and equipment	12,965	2.2	11,324	2.0	11,683	2.2
Life insurance cash surrender value	8,489	1.4	8,178	1.5	7,892	1.4
Other assets	7,011	1.2	7,488	1.3	6,012	1.1
Total assets	$ 587,413	100.0%	$ 562,318	100.0%	$ 544,061	100.0%
Liabilities:						
Total deposits	$ 425,708	72.5%	$ 410,335	73.0%	$ 379,499	69.7%
Short-term borrowings	39,656	6.7	33,656	6.0	28,773	5.3
Long-term debt	62,709	10.7	62,536	11.1	83,704	15.4
Other liabilities	4,149	0.7	4,179	0.7	3,239	0.6
Total liabilities	532,222	90.6	510,706	90.8	495,215	91.0
Shareholders equity	55,191	9.4	51,612	9.2	48,846	9.0
Total liabilities and shareholders equity	$ 587,413	100.0%	$ 562,318	100.0%	$ 544,061	100.0%

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

	Assets	**%**	**Earning assets ***	**%**	**Deposits**	**%**	**Short-term borrowings**	**%**	**Other borrowings**	**%**
2007	$ 25,094,567	4	$ 26,073,807	5	$ 15,373,766	4	$ 6,000,204	18	$ 172,467	
2006	18,257,290	3	21,202,050	4	30,835,955	8	4,883,153	17	(21,167,978)	(25)
2005	7,385,560	1	2,784,580	1	13,883,305	4	(21,761,049)	(43)	12,585,000	18
2004	(38,540,328)	(7)	(35,884,098)	(7)	(35,827,211)	(9)	(4,222,932)	(8)	(756,846)	(1)
2003	(2,777,850)	(1)	(3,007,038)	(1)	(12,345,630)	(3)	3,543,964	7	8,876,034	14

* Earning assets exclude loans placed on non-accrual status.

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 savings accounts, interest-bearing checking (NOW), money market, non-interest bearing deposits (DDAs) and certificate of deposit accounts. Certificate of deposit accounts, or CDs, are deposits with stated maturities ranging from seven days to five years. 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. We attempt 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. Though we continue to experience intense competition for deposits, we set deposit rates based on liquidity needs, balance sheet structure and cost effective strategies that takes into consideration the current interest rate environment.

The following table represents the components of total deposits as of December 31, 2007 and 2006 (thousands of dollars):

	2007		2006	
	Amount	Percent	Amount	Percent
Money market	$ 87,892	20.6%	$ 72,359	17.6%
NOW	54,695	12.9	65,122	15.9
Savings and clubs	40,125	9.4	45,301	11.0
Certificates of deposit	178,200	41.9	153,811	37.5
Total interest-bearing	360,912	84.8	336,593	82.0
Non-interest-bearing	64,796	15.2	73,742	18.0
Total deposits	$ 425,708	100.0%	$ 410,335	100.0%

Total deposits increased $15,373,000, or 4%, during 2007 to $425,708,000. The growth in deposits was from increases in money market and certificate of deposit accounts of $15,533,000 and $24,389,000, or 21% and 16%, respectively, partially offset by declines in NOW, savings and DDAs of $10,427,000, $5,176,000 and $8,946,000, respectively. Certificate of deposit accounts continue to grow as customers are locking in rates during the current declining interest rate environment. The ongoing increase in money market accounts, net of the decline in savings and club accounts, is from success in our deposit-gathering strategies in conjunction with promotional interest rates tailored to depositors needs. DDAs decreased 12% compared to December 31, 2006; however, management believes this outflow to be related to customer transaction timing and therefore temporary rather than permanent. Management continues to monitor the activity in this account and will develop strategies and implement campaigns to attract and retain this important source of cost-lowering funds.

The maturity distribution of certificate of deposit accounts at December 31, 2007 is as follows:

	Three months or less	Three to six Months	Six to twelve months	Over twelve months	Total
CDs of $100,000 or more	$ 28,196,901	$ 6,108,435	$ 23,724,159	$ 22,827,030	$ 80,856,525
CDs of less than $100,000	11,748,231	8,898,664	35,234,358	41,462,764	97,344,017
Total CDs	$ 39,945,132	$ 15,007,099	$ 58,958,517	$ 64,289,794	$ 178,200,542

Approximately 64% of these CDs are scheduled to mature in one year. Renewing CDs may re-price to higher or lower market rates depending on the direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative products. To help reduce the financial impact of the unpredictable and highly volatile interest rate environment, management intends to continue to deploy strategies that will diversify the deposit mix across the entire spectrum of products offered. As always, consideration will be given to customer retention.

Short-term borrowings

In addition to deposits, other funding sources available to the Bank are overnight funds purchased from the Federal Home Loan Bank of Pittsburgh (FHLB), fed funds purchased from correspondent banks and repurchase agreements with individuals, businesses and public entities. The Bank uses overnight funding for asset growth, deposit run-off and short-term liquidity needs. Investment security pre-refunding strategies and late-year deposit outflow resulted in an increase in overnight borrowings of $8,555,000 as of December 31, 2007 compared to December 31, 2006.

Repurchase agreements are offered in both sweep and fixed-term products. These agreements are non-insured interest-bearing liabilities that have a security interest in qualified pledged investments of the Bank. 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 interest-bearing overnight repurchase agreement account. In addition, the sweep is designed to transfer funds to the DDA as necessary to cover checks presented for payment. Due to the nature of the sweep product, these accounts tend to be more volatile than the fixed-term product because the daily sweep is dependent on the level of available funds in depositor accounts. Customer liquidity and investment needs and changes in interest rates are the typical causes for variances in repurchase agreements, which during 2007 declined to $20,504,000 from $22,224,000 at December 31, 2006. At December 31, 2007 and 2006, sweep accounts represented 62% and 70%, respectively, of total repurchase agreements.

Overnight borrowings and repurchase agreements are included with short-term borrowings on the consolidated balance sheet. For a further discussion on short-term borrowings, see Note 7, Short-term borrowings, contained in the notes to consolidated financial statements in Part II, Item 8.

Long-term debt

Long-term debt consists of borrowings from the FHLB. The weighted-average rate in effect on funds borrowed at December 31, 2007, was 5.26% compared to 5.15% as of December 31, 2006. The 2007 weighted-average rate was 133 basis points below the tax-equivalent yield of 6.59% on average earning assets for the year ended December 31, 2007. Rates on $42,000,000 of the total long-term advances are currently fixed but will adjust quarterly should market rates increase beyond the issues original or strike rates. As of December 31, 2007, the weighted-average rate on this convertible debt was 5.35%. Significant prepayment penalties attached to the borrowings are a disincentive from paying off the high cost advances. However, in the event underlying market rates drift above the rates currently paid on these borrowings, the FHLB rate will convert to floating and the Bank has the option, at that time, to repay or to renegotiate the converted advance. To help reduce the Bank s reliance on overnight funding, during 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. The new advances aggregated of $20,000,000 that mature in 2009 and carried an initial weighted-average interest rate of 5.40%. As of December 31, 2007, the weighted-average interest rate on these advances amounted to 5.13%.

At December 31, 2007, the Bank had the ability to borrow an additional $122,133,000 from the FHLB by utilizing the numerous funding products available at a variety of terms.

Investments

The Bank s investment policy is designed to complement its lending activities, generate a favorable return without incurring undue interest rate and credit risk, manage interest rate sensitivity, provide monthly cash flow and manage liquidity at acceptable levels. In establishing investment strategies, the Bank considers its business, growth or restructuring plans, the economic environment, the interest rate sensitivity position, the types of securities held, permissible purchases, credit quality, maturity and re-pricing terms, call or average-life intervals and investment concentrations. The policy prescribes permissible investment categories that meet the policy standards and management is responsible for structuring and executing the specific investment purchases within these policy parameters. Management buys and sells investment securities from time-to-time depending on market conditions, business trends, liquidity needs, capital levels and structuring strategies. Investment security purchases provide a way to quickly invest excess liquidity in order to generate additional earnings. The Bank generally earns a positive interest spread by assuming interest rate risk and using deposits and/or borrowings to purchase securities with longer maturities.

At the time of purchase, management 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. Most of the securities purchased are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at net fair values in the consolidated balance sheet with an adjustment to shareholders equity, net of tax, presented under the caption Accumulated other comprehensive income (loss). Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity. As of December 31, 2007 and December 31, 2006, the aggregate fair value of securities HTM exceeded their respective aggregate amortized cost by $33,000 and $29,000, respectively.

Total investments increased $22,574,000, net of a $23,000 decline in the market value of AFS investments. The increase in the investment portfolio during 2007 was the result of investing excess liquidity stemming from deposit inflows and late-year overnight borrowings used as a pre-refunding strategy. The carrying value of investment securities, at December 31, 2007, was $122,984,000, or 21%, of total assets compared to $100,411,000, or 18%, as of December 31, 2006. Mortgage-backed securities, which amortize and provide monthly cash flow, continue to dominate the composition of the total investment portfolio representing 48% at December 31, 2007, compared to 43% at December 31, 2006.

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A comparison of investments at December 31, for the three previous periods is as follows:

	2007		2006		2005	
	Amount	Percent	Amount	Percent	Amount	Percent
U.S. government agencies	$ 35,243,890	28.7%	$ 33,891,985	33.8%	$ 31,125,909	31.9%
Mortgage-backed securities	58,767,109	47.8	42,900,005	42.7	42,615,197	43.6
State & municipal subdivisions	12,133,443	9.8	12,576,684	12.5	13,401,874	13.7
Preferred term securities	16,335,486	13.3	10,570,993	10.5	10,083,084	10.3
Equity securities	504,232	0.4	471,069	0.5	452,509	0.5
Total	$ 122,984,160	100.0%	$ 100,410,736	100.0%	$ 97,678,573	100.0%

The distribution of debt securities by stated maturity date at December 31, 2007 is as follows:

	One year or less	One through five years	Five through ten years	More than ten years	Total
U.S. government agencies	$ 997,5000	$ 5,012,356	$ 16,076,875	$ 13,157,159	$ 35,243,890
Mortgage-backed securities	18,120	3,315,644	6,272,027	49,161,318	58,767,109
State & municipal subdivisions			1,292,533	10,840,910	12,133,443
Preferred term securities				16,335,486	16,335,486
Total debt securities	$ 1,015,620	$ 8,328,000	$ 23,641,435	$ 89,494,873	$ 122,479,928

AFS securities are stated net of unrealized gains and losses. As of December 31, 2007, AFS debt securities were recorded with a net unrealized loss in the amount of $1,663,000. At December 31, 2007, AFS equity securities were recorded at $505,000 including an unrealized gain of $176,000.

The tax-equivalent yield on debt securities by stated maturity date at December 31, 2007, is as follows:

	One year or less	One through five years	Five through ten years	More than ten years	Total
U.S. government agencies	3.00%	4.83%	4.90%	5.99%	5.25%
Mortgage-backed securities	6.00	4.11	4.32	5.22	5.06
State & municipal subdivisions			5.55	5.71	5.69
Preferred term securities				6.25	6.25
Total debt securities	3.05%	4.54%	4.78%	5.59%	5.34%

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

Loans and leases

Gross loans and leases increased $3,606,000, or 1%, from $422,643,000 at December 31, 2006, to $426,249,000 at December 31, 2007. Gross loans represented 73% and 75% of total assets at December 31, 2007 and December 31, 2006, respectively.

In 2007, the Bank originated $32,919,000 of commercial loans, $24,032,000 of residential mortgage loans and $28,062,000 of consumer loans. This compares to $17,152,000, $21,431,000 and $29,565,000, respectively, in 2006. Included in mortgage loans is $12,515,000 of real estate construction lines in 2007 and $11,111,000 in 2006. In addition for 2007, the Bank originated lines of credit in the amounts of $18,564,000 for commercial borrowers and $6,296,000 in home equity and other consumer lines of credit.

Though loan originations increased in 2007 compared to 2006, and despite operating in an overall higher interest rate environment, payoffs and pay-downs were high in 2007 almost offsetting the originations. As a result, there was only a subtle increase in the loan portfolio. With the recent steepening of the yield curve and the hiring of a new senior lender, management anticipates growth in all sectors of the loan portfolio during 2008. During 2008, the Company will channel efforts to develop total banking relationships with new customers and strengthen relationships with our existing base of loyal customers.

Commercial and Commercial Real Estate Loans:

Though commercial and commercial real estate (CRE) originations were relatively strong, they were fully offset by scheduled principal curtailments and pre-payments, thereby resulting in a commercial loan decline of $2,155,000 to $216,058,000 from $218,213,000, or almost 1% during 2007. The Company has recently hired a new senior lender and has restructured its existing team of commercial loan officers to better serve our existing customer base and strategically penetrate the markets for new business relationships.

Residential Real Estate Loans:

Residential real estate loans increased $4,235,000, or 4%, to $116,978,000 in 2007. Though operating in a higher interest rate environment, which tends to reduce the level of prepayment and refinance activity, the Company was able to continue to grow its residential real estate loan portfolio on the strength of its very dedicated staff of loan originators and transfers of construction loans to permanent financing.

Consumer Loans:

Consumer loans increased $4,269,000, or 6%, during 2007. The increase in this sector is mainly from less refinance and payoff activity caused by a relatively higher interest rate environment. This enabled the portfolio to grow despite a minor decline in loan originations.

Real Estate Construction Loans:

Real estate construction loans decreased by $2,666,000, or 20%, at December 31, 2007 compared to December 31, 2006. These loans fund residential and commercial construction projects and then convert to a residential mortgage or to a commercial real estate loan usually within one year from the origination date. Generally, the converted loans will bear the same terms as the residential or the commercial construction loans. The decline in 2007 was caused by more residential construction loans converting to permanent mortgage loans; however, both categories remain strong.

Direct Financing Leases:

The balance represents tax-free leasing arrangements provided to municipal customers. For 2007, the activity represents scheduled run-off.

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

	2007	2006	2005	2004	2003
Commercial and CRE	$ 216,057,882	$ 218,213,216	$ 216,288,597	$ 221,968,137	$ 221,275,922
Residential real estate	116,978,378	112,742,692	103,920,613	91,294,401	77,077,315
Consumer	81,998,093	77,729,520	74,070,328	61,487,608	62,919,070
Real estate construction	10,703,249	13,369,712	14,198,858	10,620,472	7,267,616
Direct financing leases	511,178	588,211	650,348	2,211,978	3,685,802
Gross loans	426,248,780	422,643,351	409,128,744	387,582,596	372,225,725
Less:					
Unearned discount				48,423	247,119
Allowance for loan losses	4,824,401	5,444,303	5,984,649	5,987,798	4,996,966
Net loans	$ 421,424,379	$ 417,199,048	$ 403,144,095	$ 381,546,375	$ 366,981,640
Loans available-for-sale	$ 827,250	$ 122,000	$ 428,584	$ 576,378	$ 19,863,577

A comparison of gross loans by percent at year-end for the five previous periods is as follows:

	2007	2006	2005	2004	2003
Commercial and CRE	50.7%	51.6%	52.9%	57.3%	59.5%
Residential real estate	27.5	26.7	25.4	23.5	20.7
Consumer	19.2	18.4	18.1	15.9	16.9
Real estate construction	2.5	3.2	3.5	2.7	1.9
Direct financing leases	0.1	0.1	0.1	0.6	1.0
Gross loans	100.0%	100.0%	100.0%	100.0%	100.0%

The following table sets forth the maturity distribution of select components of the loan portfolio at December 31, 2007. Excluded from the table are residential real estate loans, consumer loans and direct financing leases (dollars in thousands):

	One-year or less	One to five years	More than five years	Total
Commercial and CRE	$ 35,289	$ 72,576	$ 108,193	$ 216,058
Real estate construction	10,703			10,703
Total	$ 45,992	$ 72,576	$ 108,193	$ 226,761

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

The following table sets forth the sensitivity changes in interest rates for commercial and CRE loans at December 31, 2007 (dollars in thousands):

	One to five years	More than five years	Total
Fixed interest rate	$ 36,571	$ 29,561	$ 66,132
Variable interest rate	26,721	9,340	36,061
Total	$ 63,292	$ 38,901	$ 102,193

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

There are no concentrations of loans to a number of borrowers engaged in similar activities exceeding 10% of total loans that are not otherwise disclosed as a category in the tables above. There are no concentrations of loans that, if lost, would have a material adverse effect on the business of the Bank. The Bank s loan portfolio does not have a material concentration within a single industry or group of related industries that is vulnerable to the risk of a near-term severe negative business impact.

Loans available-for-sale

Generally, upon origination, certain residential mortgages, the guaranteed portions of SBA loans and student loans are classified as AFS. Should market rates increase, 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. Consideration is given to the current liquidity position and projected future liquidity needs. To better manage interest rate and prepayment risk, loans meeting these conditions may be classified as AFS. The carrying value of loans AFS is at the lower of cost or estimated fair value. If the fair values of these loans fall below their original cost, the difference is written down and charged to current earnings. Any subsequent appreciation in the portfolio is credited to current earnings but only to the extent of previous write-downs.

Loans AFS at December 31, 2007, were $827,000, with a corresponding fair value of $843,000 compared to $122,000 and $123,000, respectively, at December 31, 2006. During 2007, residential mortgages and student loans with principal balances of $16,210,000 and $57,000, respectively, were sold into the secondary market and combined gains of approximately $159,000 were recognized. There were no sold SBA loans during 2007.

The Bank retains mortgage servicing rights (MSRs) on loans sold into the secondary market. MSRs are retained so that the Bank can continue the personal relationship developed with its customers. At December 31, 2007 and 2006, the servicing portfolio balance of sold residential mortgage loans was $61,023,000 and $53,112,000, respectively.

Allowance for loan losses

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

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

- identification of specific impaired loans by loan category;
- calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- determination of 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 allocations in the commercial loan portfolio from period to period are based upon the credit risk grading system and from periodic reviews of the loan and lease portfolios.

Each quarter, management performs an assessment of the allowance and the provision for loan losses. The Company s Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based on Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan, (SFAS 114). The Special Assets Committee s focus is on ensuring the pertinent facts are considered and the SFAS 114 reserve amounts are reasonable. The assessment process includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the

Company s Credit Administration function have assigned a criticized or classified risk rating.

Total charge-offs, net of recoveries, for the year ended December 31, 2007, were $560,000, compared to $865,000 in 2006. Combined consumer loan and lease financing net charge-offs increased slightly from $161,000 at December 31, 2006 to $237,000 through December 31, 2007. Commercial loan net charge-offs were $597,000 for the year 2006 compared to $357,000 for 2007. Mortgage loans showed net recoveries of $35,000 in 2007 compared to net charge-offs of $108,000 in 2006. This reversal from net mortgage charge-offs in 2006 to net recoveries in 2007 was the result of recording one large mortgage loan recovery of $107,000 on a loan which had been charged-off in a prior year. For further discussion on the provision for loan losses, see the Provision for loan losses, located in the results of operations section of management s discussion and analysis contained herein.

For a further discussion of delinquencies and net charge-offs, see the section entitled Non-performing assets. Additional discussion is in Note 1, Nature of operations and summary of significant accounting policies Allowance for loan losses, and Note 4, Loans and leases, contained in the notes to consolidated financial statements, and incorporated herein by reference.

Management believes that the current balance in the allowance for loan losses of $4,824,000 is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but are inherent to the portfolio. Currently, management is unaware of any potential problem loans that have not been reviewed. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status nor past due 90 days or more. However, there could be certain instances which become identified over the upcoming year that may require additional charge-offs and/or increases to the allowance. The ratio of allowance for loan losses to total loans was 1.13% at December 31, 2007 compared to 1.29% at December 31, 2006.

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

	2007	2006	2005	2004	2003
Balance at beginning of period	$ 5,444	$ 5,985	$ 5,988	$ 4,997	$ 3,900
Charge-offs:					
Commercial and all other	376	661	1,077	775	1,334
Real estate	90	109	21	266	503
Consumer	256	285	288	480	1,167
Lease financing			8	85	92
Total	722	1,055	1,394	1,606	3,096
Recoveries:					
Commercial and all other	18	64	395	226	204
Real estate	125	1	11	20	34
Consumer	19	124	155	178	230
Lease financing				23	10
Total	162	189	561	447	478
Net charge-offs	560	866	833	1,159	2,618
(Credit) provision for loan losses	(60)	325	830	2,150	3,715
Balance at end of period	$ 4,824	$ 5,444	$ 5,985	$ 5,988	$ 4,997
Net charge-offs to average net loans outstanding	0.13%	0.21%	0.22%	0.30%	0.68%
Allowance for loan losses to net charge-offs	8.62x	6.29x	7.18x	5.17x	1.91x
Allowance for loan losses to total loans	1.13%	1.29%	1.46%	1.54%	1.28%
Loans 30 - 89 days past due and accruing	$ 4,698	$ 2,571	$ 1,609	$ 4,317	$ 3,975
Loans 90 days or more past due and accruing	$ 26	$ 81	$ 197	$ 557	$ 958
Non-accruing loans	$ 3,811	$ 3,358	$ 9,453	$ 9,904	$ 7,323
Allowance for loan losses to loans 90 days or more past due and accruing	189.41x	67.54x	30.39x	10.75x	5.22x
Allowance for loan losses to non-accruing loans	1.27x	1.62x	0.63x	0.60x	0.68x
Allowance for loan losses to non-performing loans	1.58x	1.58x	0.62x	0.57x	0.60x
Average net loans	$ 419,586	$ 412,523	$ 385,800	$ 381,366	$ 383,226

The allowance for loan losses can generally absorb losses throughout the loan and lease portfolios. However, in some instances an allocation is made for specific loans or groups of loans. Allocation of the allowance for loan losses for different categories of loans is based on the methodology used by the Bank, as previously explained. The changes in the allocations from year-to-year are based upon year-end reviews of the loan and lease portfolios.

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

	2007	%	2006	%	2005	%	2004	%	2003	%
Category										
Residential real estate	$ 636,899	13.2	$ 578,117	10.6	$ 595,092	9.9	$ 451,349	7.5	$ 354,207	7.1
Consumer	960,505	19.9	1,157,091	21.2	1,180,175	19.7	966,081	16.1	884,689	17.7
Commercial and commercial real estate	2,979,372	61.7	3,549,870	65.2	4,035,950	67.4	4,330,285	72.3	3,699,488	74.0
Direct financing leases	9,355	0.2	14,058	0.3	14,828	0.3	40,891	0.7	42,706	0.9
Real estate construction	52,634	1.1	59,617	1.1	59,953	1.0	46,465	0.8	15,876	0.3
Unallocated	185,636	3.9	85,550	1.6	98,651	1.7	152,727	2.6		
Total	$ 4,824,401	100.0%	$ 5,444,303	100.0%	$ 5,984,649	100.0%	$ 5,987,798	100.0%	$ 4,996,966	100.0%

The allocation of the allowance for the commercial loan portfolio comprised 62%, or $2,979,000, of the total allowance for loan losses at December 31, 2007, of which approximately 18% is reserved for non-performing commercial loan relationships. Collateral values were prudently valued to provide a conservative and realistic value of the collateral supporting these loans. The allocations to the other categories of loans are adequate compared to the actual three-year historical net charge-offs.

Non-performing assets

The Bank defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, restructured loans, other real estate owned (ORE) and repossessed assets. As of December 31, 2007, non-performing assets represented 0.67% of total assets compared to 0.65% at December 31, 2006.

The following table sets forth non-performing assets at December 31 (dollars in thousands):

	2007	2006	2005	2004	2003
Net loans, including loans available-for-sale	$ 422,252	$ 417,321	$ 403,573	$ 382,123	$ 386,846
Loans past due 90 days or more and accruing	$ 26	$ 81	$ 197	$ 557	$ 958
Non-accrual loans	3,811	3,358	9,453	9,904	7,323
Total non-performing loans	3,837	3,439	9,650	10,461	8,281
Restructured loans					
Other real estate owned	107	197		163	394
Repossessed assets			19	50	73
Total non-performing assets	$ 3,944	$ 3,636	$ 9,669	$ 10,674	$ 8,748
Non-accrual loans to net loans	0.90%	0.80%	2.34%	2.59%	1.89%
Non-performing assets to net loans, foreclosed real estate and repossessed assets	0.93%	0.87%	2.40%	2.79%	2.26%
Non-performing assets to total assets	0.67%	0.65%	1.78%	1.99%	1.52%
Non-performing loans to net loans	0.91%	0.82%	2.39%	2.74%	2.14%

In the review of loans for both delinquency and collateral sufficiency, management concluded that there were a number of loans that lacked the ability to repay in accordance with contractual terms. The decision to place loans or leases on a non-accrual status is made on an individual basis after considering factors pertaining to each specific loan.

The majority of non-performing assets for the period is attributed to non-accruing commercial business loans and non-accruing real estate loans in the process of foreclosure. Most of these loans are collateralized, thereby mitigating the Bank s potential for loss. In 2006, non-performing loans were $3,439,000 compared to $3,837,000 at year-end 2007. There were no repossessed assets at December 31, 2007 or 2006. ORE at December 31, 2007 consisted of one property which had an agreement to sell pending. At year-end 2006, five residential properties were owned, all of which were sold. The Special

Assets Department had developed specific action plans for each of the Company s non-performing loans. During 2007, many of those plans came to a conclusion resulting in repayments of non-performing loans. The non-accrual loans aggregated $3,811,000 at December 31, 2007, an increase of $453,000 from year-end 2006. During 2007 approximately $3,075,000 of loans were placed in non-accrual status. These were partially offset by payoffs or pay-downs of $1,888,000, charge-offs of $236,000, $352,000 in transfers to ORE and $146,000 of loans that returned to performing status. Loans past due 90 days or more and accruing declined 68%, to $26,000, at December 31, 2007. The non-accrual loans rose by 14 % to $3,811,000 and ORE declined by 46 % to $107,000. These three items comprise the non-performing assets of $3,944,000. The percentage of non-performing assets to total assets was 0.67% at December 31, 2007, a minor change from 0.65% at December 31, 2006. Non-performing loans to net loans were 0.91% at December 31, 2007, and 0.82% at December 31, 2006.

Repossessed assets consist of previously financed vehicles held-for-sale. Subsequent to the loan or lease maturity, the borrower or lessee defaulted on their contract and the Company repossessed the unit. Repossessed assets are sold through either a private or public sale and any deficiency balance from the sale of the asset is charged to the allowance for loan losses. The Bank terminated its automobile leasing business in 2005.

Payments received on non-accrual loans are recognized on a cash basis. Payments are first applied against the outstanding principal balance, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of interest income. During 2007, the Bank collected $93,000 of interest income recognized on the cash basis. If the non-accrual loans that were outstanding as of December 31, 2007 had been performing in accordance with their original terms, the Bank would have recognized interest income with respect to such loans of $391,000 for the year ended December 31, 2007.

Bank premises and equipment, net

Net of accumulated depreciation and disposals, premises and equipment increased $1,640,467. During 2007, the Bank purchased or transferred from construction in process, a component of other assets in the consolidated balance sheet, approximately $3,293,000 compared to $852,000 in 2006. The increase was principally from the completion of the Company s Green Ridge branch relocation construction project.

Foreclosed assets held-for-sale

Other Real Estate Owned

ORE was $107,000 at December 31, 2007 consisting of one property, the sale of which is pending. The five residential properties which were owned at year end 2006 have all been sold.

Cash surrender value of bank owned life insurance

The Bank maintains bank owned life insurance (BOLI) for a chosen group of employees, namely its officers, where the Bank is the owner and sole beneficiary of the policies. BOLI is classified as a non-interest earning asset. Increases in the cash surrender value are recorded as

non-interest income. The BOLI is profitable from the appreciation of the cash surrender values of the pool of insurance and its tax-free advantage to the Bank. This profitability is used to offset a portion of current and future employee benefit costs. The BOLI can be liquidated, if necessary, with associated tax costs. However, the Bank intends to hold this pool of insurance, because it provides income that enhances the Bank s capital position. Therefore, the Bank has not provided for deferred income taxes on the earnings from the increase in cash surrender value.

Other assets

The decrease in other assets of $384,000, or 8%, from December 31, 2006 was due mostly to the reduction of capitalized interim construction costs for the Bank s branch expansion and other projects and a decrease in the net deferred tax asset, partially offset by an increase in the market value of the Bank s derivative contract. See Note 10, Income Taxes, for an analysis of the net deferred tax asset. For a further discussion on the Bank s derivative contract, see Note 1, Nature of operations and summary of significant accounting policies, and Note 12, Fair value of financial instruments and derivatives, contained within the notes to consolidated financial statements in Part II, Item 8.

Results of Operations

Earnings Summary

The Company s results of operations depend primarily on 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 determined by the Company s 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 BOLI, net gains or losses from the sales of loans and securities AFS and from the sales of ORE. 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 where the properties are located as well as the Company s underwriting standards. Economic conditions affect the market value of the underlying collateral as well as the levels of adequate cash flow and revenue generation from income-producing commercial properties.

Overview

Net income for the year ended December 31, 2007 was $4,612,000, compared to $4,125,000 for the year ended December 31, 2006. During the same periods, diluted earnings per common share was $2.23 and $2.01, respectively. For the year ended December 31, 2007, the Company s return on average assets (ROA) and return on average shareholders equity (ROE) were 0.80% and 8.65%, respectively, compared to 0.73% and 8.31% for the year ended December 31, 2006. The improvement in net income was primarily from a 3%, or $451,000, increase in net interest income, a 15%, or $683,000, rise in non-interest income, partially offset be a 5%, or $758,000, increase in operating expenses. Also contributing to the improvement was a credit for loan losses of $60,000 during the twelve months ended December 31, 2007 compared to a provision of $325,000 in 2006. The improvement in ROA and ROE was largely due to the improvement in net income.

Net interest income

The following table sets forth a comparison of average balances of assets and liabilities and their related net tax equivalent yields and rates for 2007, 2006 and 2005 (dollars in thousands):

2007