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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2013

COMMISSION FILE NUMBER 333-90273

FIDELITY D & D BANCORP, INC.

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

BLAKELY AND DRINKER STREETS

DUNMORE, PENNSYLVANIA 18512

TELEPHONE NUMBER (570) 342-8281

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

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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

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

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

DOCUMENTS INCORPORATED BY REFERENCE

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

Fidelity D & D Bancorp, Inc.
2013 Annual Report on Form 10-K
Table of Contents

FIDELITY D & D BANCORP, INC.

PART I

Forward-Looking Statements

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

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

§ the effects of economic conditions on current customers, specifically the effect of the economy on loan customers’ ability to repay loans;
§ the costs and effects of litigation and of unexpected or adverse outcomes in such litigation;
§ the impact of new laws and regulations, including the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the regulations promulgated there under;
§ impacts of the new capital and liquidity requirements of the Basel III standards and other regulatory pronouncements, regulations and rules;
§ governmental monetary and fiscal policies, as well as legislative and regulatory changes;
§ effects of short- and long-term federal budget and tax negotiations and their effect on economic and business conditions;
§ the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;
§ the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks;
§ the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet;
§ technological changes;
§ acquisitions and integration of acquired businesses;
§ the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities;
§ volatilities in the securities markets;
§ acts of war or terrorism; and
§ disruption of credit and equity markets.

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

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

ITEM 1:BUSINESS

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

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

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

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

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

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

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

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

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

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

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

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

ITEM 1A: RISK FACTORS

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

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

Risks Related to the Company's Business

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

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

The Company is subject to lending risk.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Company is subject to extensive government regulation and supervision.

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

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

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

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

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

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

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

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

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

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

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

The Company continually encounters technological change.

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

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

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

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

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

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

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

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

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

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

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

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

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

Risks Associated with the Company's Common Stock

The Company's stock price can be volatile.

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

Actual or anticipated variations in quarterly results of operations.

Recommendations by securities analysts.

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

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

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

New technology used, or services offered, by competitors.

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

Failure to integrate acquisitions or realize anticipated benefits from acquisitions.

Changes in government regulations.

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

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

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

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

Risks Associated with the Company's Industry

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ITEM 1B: UNRESOLVED STAFF COMMENTS

None

ITEM 2: PROPERTIES

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

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

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

511 Scranton-Carbondale Hwy., Eynon, PA					
400 S. Main St.,					
Scranton, PA	Owned	West Scranton Branch(2)	x	x	x

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

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

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

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

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

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

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

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

ITEM 3: LEGAL PROCEEDINGS

The nature of the Company's business generates some litigation involving matters arising in the ordinary course of business. However, in the opinion of the Company after consulting with legal counsel, no legal proceedings are pending, which, if determined adversely to the Company or the Bank, would have a material effect on the Company's undivided profits or financial condition. No legal proceedings are pending other than ordinary routine litigation incidental to the business of the

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

ITEM 4: MINE SAFETY DISCLOSURES

Not Applicable

PART II

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

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

Salvatore R. DeFrancesco, Jr., Treasurer

Fidelity D & D Bancorp, Inc.

Blakely and Drinker Streets

Dunmore, PA 18512

(570) 342-8281

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

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

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

The Company established a dividend reinvestment plan (DRP) for its shareholders. The DRP provides shareholders with a convenient and economical method of investing cash dividends payable on their common stock and the opportunity to make voluntary optional cash payments to purchase additional shares of the Company's common stock. Participants pay no brokerage commissions or service charges when they acquire additional shares of common stock through the plan. The administrator may purchase shares directly from the Company, in the open market, in negotiated transactions or using a combination of these methods.

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

Securities authorized for issuance under equity compensation plans

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

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

Performance graph

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

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

ITEM 6: SELECTED FINANCIAL DATA

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

(dollars in thousands except per share data)

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

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

* The result of this calculation is not meaningful.

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

Critical accounting policies

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

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

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

Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. As described in Notes 1 and 4 of the consolidated financial statements, incorporated by reference in Part II, Item 8, the majority of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (loss) (OCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these circumstances, pricing may be obtained from other entities and the loans are transferred at the lower of cost or market value and simultaneously sold. For a further discussion on the accounting treatment of HFS loans, see the section entitled "Loans held-for-sale," contained within this management's discussion and analysis. As of December 31, 2013 and 2012, loans classified as HFS consisted of residential mortgages.

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

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

Comparison of Financial Condition as of December 31, 2013

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

Executive Summary

Nationally, the unemployment rate declined from 7.9% at December 31, 2012 to 6.7% at December 31, 2013, remaining at the lowest level since 2008. While the unemployment rate has been declining nationally, the unemployment rate in the Scranton-Wilkes-Barre Metropolitan Statistical Area (local) still remains above national and state levels. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at December 31, 2013 was 7.7%, a decline of 1.8 percentage points from 9.5% at December 31, 2012. However, during the same period, the local labor force declined by more than 3%. A sizeable decline in the workforce has the effect of driving the unemployment rate downward and masking the unemployment statistics. In addition, approximately 44% of the labor force decline was comprised of those unemployed who have stopped looking for work. By comparison, nationally, the labor force declined by less than 0.4% and those who have stopped looking for work declined by 14%. The number of foreclosures has been declining on a national level, but was up 60% in our local metropolitan area in 2013 compared to 2012. Foreclosures climbed in the area in all four quarters of the year. The high foreclosure rate is due mostly to the high unemployment rate in the area. Notwithstanding these issues, high levels of unemployment and the prolonged weakness in the local housing and real estate markets may negatively impact the performance and condition of the Company's loan portfolios.

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

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

Financial Condition

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

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

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

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

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

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

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

Funds Provided:

Deposits

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

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

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

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

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

The Company uses the Certificate of Deposit Account Registry Service (CDARS) reciprocal program to obtain FDIC insurance protection for customers who have large deposits that at times may exceed the FDIC maximum amount of $250,000 per person. In the CDARS program, deposits with varying terms and interest rates, originated in the Company's own markets, are exchanged for deposits of other financial institutions that are members in the CDARS network. By placing these deposits in other participating institutions, the deposits of our customers are fully insured by the FDIC. In return for deposits placed with network institutions, the Company receives from network institutions deposits that are approximately equal in amount and are comprised of terms similar to those placed for our customers. Deposits the Company receives, or reciprocal deposits, from other institutions are considered brokered deposits by regulatory definitions. As of December 31, 2013 and 2012, CDARS represented $10.3 million and $10.2 million, respectively, or 2%, of total deposits.

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

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

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

Short-term borrowings

Borrowings are used as a complement to deposit generation as an alternative funding source whereby the Company will borrow under customer repurchase agreements in the local market, advances from the Federal Home Loan Bank of Pittsburgh (FHLB) and other correspondent banks for asset growth and liquidity needs. Short-term borrowings may include overnight balances which the Company may require to fund daily liquidity needs such as deposit and repurchase agreement cash outflow, loan demand and operations. At December 31, 2013, overnight borrowings amounted to $2.5 million. At December 31, 2012, the Company did not have a balance in overnight borrowings.

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

Long-term debt

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

Funds Deployed:

Investment Securities

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

At the time of purchase, management classifies investment securities into one of three categories: trading, available-for-sale (AFS) or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. Most of the securities the Company purchases are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at fair value on the consolidated balance sheets with unrealized gains and losses, net of deferred income taxes, reported separately within shareholders' equity as a component of accumulated other comprehensive income (loss) (OCI). Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity.

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

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

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

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

	2013		2012	
(dollars in thousands)	Amount	%	Amount	%

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

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

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

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

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

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

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

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

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

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

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

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

Federal Home Loan Bank Stock

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

Loans and leases

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

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

Commercial and industrial

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

Commercial real estate

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

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

Consumer

The consumer loan portfolio increased by $8.2 million, or 9%, from $90.6 million at December 31, 2012 to $98.8 million at December 31, 2013. The increase was primarily attributed to auto loans and leases which increased $4.9 million, or 28%. Home equity activity continues to be consistent as well, showing increases in home equity installment and home equity lines of credit of $1.7 million, or 5%, and $2.7 million, or 8%, respectively. We have continued our efforts to methodically grow our dealership relationships along with promotional activity in our home equity program. In 2014, we expect growth in all sectors of the consumer loan portfolio, the majority from the expansion of the auto lending category.

Residential

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

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

(dollars in thousands)	2013 Amount	%	2012 Amount	%	2011 Amount	%	2010 Amount	%	2009 Amount	%
Commercial and industrial	$ 74,551	15.6 %	$ 65,110	15.0 %	$ 68,372	16.8 %	$ 85,129	20.5 %	$ 77,071	17.9
Commercial real estate:										
Non-owner occupied	89,255	18.7	81,998	18.9	79,475	19.6	87,355	21.0	99,397	23.1
Owner occupied	86,294	18.0	80,509	18.6	76,611	18.9	69,338	16.7	79,013	18.3
Construction	10,765	2.2	10,679	2.5	9,387	2.3	12,501	3.0	11,078	2.6
Consumer:										
Home equity installment	34,480	7.2	32,828	7.6	36,390	9.0	40,089	9.6	48,177	11.2
Home equity line of credit	36,836	7.7	34,169	7.9	32,486	8.0	29,185	7.0	21,851	5.1
Auto and leases	22,261	4.7	17,411	4.0	13,539	3.3	10,734	2.6	9,857	2.3
Other	5,205	1.1	6,139	1.4	5,833	1.4	7,165	1.7	5,760	1.3
Residential:										
Real estate	110,365	23.1	96,765	22.3	80,091	19.7	68,160	16.4	70,958	16.5
Construction	8,188	1.7	7,948	1.8	4,110	1.0	6,145	1.5	7,535	1.7
Gross loans	478,200	100.0 %	433,556	100.0 %	406,294	100.0 %	415,801	100.0 %	430,697	100.
Less:										
Allowance for loan losses	(8,928)		(8,972)		(8,108)		(7,898)		(7,573)	
Unearned lease revenue	(56)		-		-		-		-	

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

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

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

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

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

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

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

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

Loans held-for-sale

Upon origination, most residential mortgages and certain small business administration (SBA) guaranteed loans may be classified as held-for-sale (HFS). In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In low interest rate environments, the Company would be exposed to prepayment risk and, as rates on adjustable-rate loans decrease, interest income would be negatively affected. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as HFS. The carrying value of loans HFS is based on the lower of cost or estimated fair value. If the fair values of these loans decline below their original cost, the difference is written down and charged to current earnings. Subsequent appreciation in the portfolio is credited to current earnings but only to the extent of previous write-downs. As of December 31, 2013 and 2012, loans HFS consisted of residential mortgage loans.

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

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

Allowance for loan losses

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

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

•identification of specific impaired loans by loan category;

•calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;

•determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;

•application of historical loss percentages (trailing twelve-quarter average) to pools to determine the allowance allocation;

•application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio, and/or current economic conditions.

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

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

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

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

During the fourth quarter of 2013, the Company changed its methodology to determine historical loss percentages from a two-year average that was calculated annually to a trailing twelve-quarter average. Management determined that utilizing a trailing twelve-quarter average minimizes the impact of certain anomalies caused by irregular occurrences such as infrequent large loan charge-offs. In addition, during the fourth quarter of 2013, management changed its methodology used to calculate the allowance for loan losses by eliminating certain loans from the calculation that have very little risk of not being collected. Such loans would include the guaranteed portion of all commercial loans that carry a guarantee by the SBA and all loan categories that are fully secured by cash collateral. The change in the averaging convention had an immaterial impact on the December 31, 2013 allowance calculation. In addition, by excluding the cash secured and guarantee portion of SBA loans, as of December 31, 2013 the Company was able to reduce the allowance requirement by approximately $0.2 million.

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

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

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

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

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

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

Non-performing assets

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

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

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

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

In the review of loans for both delinquency and collateral sufficiency, management concluded that there were a number of loans that lacked the ability to repay in accordance with contractual terms. The decision to place loans on non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. Generally, commercial loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by residential real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest, and unsecured consumer loans are charged-off when the loan is 90 days or more past due as to principal and interest. Uncollected interest income accrued on all loans placed on non-accrual is reversed and charged to interest income.

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

A past due loan will be placed on non-accrual at the 90 day point when it is deemed that a customer is non-responsive and uncooperative to collection efforts. At December 31, 2012, there were 65 loans to 57 unrelated borrowers ranging from less than $1 thousand to $3.2 million in the non-accrual category. At December 31, 2013, there were 47 loans to 37 unrelated borrowers ranging from less than $1 thousand to $1.0 million in the non-accrual category. The decrease in non-accrual loans during the twelve months ended December 31, 2013 was related to loans that were charged off, paid off, transferred to ORE or moved back to accrual status.

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

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

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

Payments received from non-accrual loans are recognized on a cash method. Payments are first applied to the outstanding principal balance, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of interest income. For the year of 2013, $78 thousand in cash basis interest income was recognized. If the non-accrual loans that were outstanding as of December 31, 2013 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of $189 thousand during the year ended December 31, 2013.

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

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

As of and for the year ended December 31, 2013

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

As of and for the year ended December 31, 2012

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

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

Foreclosed assets held-for-sale

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

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

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

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

Cash surrender value of bank owned life insurance

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

Results of Operation

Earnings Summary

The Company's earnings depend primarily on net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields earned on interest-earning assets, which consist principally of loans and investment securities. Interest expense is incurred from rates paid on interest-bearing liabilities, which consist of deposits and borrowings. Net interest income is determined by the interest rate spread (the difference between the yields earned on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. Interest rate spread is impacted by: changes in interest rates and market yield curves and their related effect on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in the marketplace.

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

Overview

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

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

Net interest income and interest sensitive assets / liabilities

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

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

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

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

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

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

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

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

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

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

Provision for loan losses

The provision for loan losses represents the necessary amount to charge against current earnings, the purpose of which is to increase the allowance for loan losses (the allowance) to a level that represents management's best estimate of known and inherent losses in the Company's loan portfolio. Loans determined to be uncollectible are charged off against the allowance. The required amount of the provision for loan losses, based upon the adequate level of the allowance, is subject to the ongoing analysis of the loan portfolio. The Company's Special Assets Committee meets periodically to review problem loans. The committee is comprised of management, including credit administration officers, loan officers, loan workout officers and collection personnel. The committee reports quarterly to the Credit Administration Committee of the Board of Directors.

Management continuously reviews the risks inherent in the loan portfolio. Specific factors used to evaluate the adequacy of the loan loss provision during the formal process include:

•specific loans that could have loss potential;

•levels of and trends in delinquencies and non-accrual loans;

•levels of and trends in charge-offs and recoveries;

•trends in volume and terms of loans;

•changes in risk selection and underwriting standards;

•changes in lending policies, procedures and practices;

•experience, ability and depth of lending management;

•national and local economic trends and conditions; and

•changes in credit concentrations.

Provisions for loan losses of $2.6 million were recorded during 2013, compared to $3.3 million during 2012. The Company's non-performing loans declined to $5.8 million as of December 31, 2013, an $8.0 million decrease from year-end 2012. Though credit quality is improving, the additional provision throughout 2013 was necessary to fund the allowance to support growth in the loan portfolio, as well as reinforce the allowance for the potential credit risks that still exist from an uncertain local economic climate. The allowance for loan losses was $8.9 million as of December 31, 2013, compared to $9.0 million for December 31, 2012. For a further discussion on the allowance for loan losses, see “Allowance for loan losses” under the caption “Comparison of financial condition at December 31, 2013 and 2012” above.

Other income

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

Other operating expenses

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

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

Provision for income taxes

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

Comparison of Financial Condition as of December 31, 2012

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

Financial Condition

Overview

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

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

Funds Provided:

Deposits

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

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

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

Short-term borrowings

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

Long-term debt

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

Accrued interest payable and other liabilities

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

Funds Deployed:

Investment Securities

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

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

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

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

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

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

Loans

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

Commercial and industrial

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

Commercial real estate

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

Consumer loans

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

Residential

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

Loans held-for-sale

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

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

Allowance for loan losses

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

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

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

Non-performing assets

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

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

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

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

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

During 2011, the Company collected approximately $77 thousand of interest income recognized on the cash basis. There was $20 thousand in interest income recognized on the cash basis in 2012. If the non-accrual loans that were outstanding as of December 31, 2012 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of $0.6 million for the period ended December 31, 2012.

Bank premises and equipment, net

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

Foreclosed assets held-for-sale

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

Results of Operations

Earnings Summary

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

Net interest income

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

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

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

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

Provision for loan losses

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

Other income

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

Other expenses

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

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

Provision for income taxes

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

Off-Balance Sheet Arrangements and Contractual Obligations

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers and in connection with the overall interest rate management strategy. These instruments involve, to a varying degree, elements of credit, interest rate and liquidity risk. In accordance with GAAP, these instruments are either not recorded in the consolidated financial statements or are recorded in amounts that differ from the notional amounts. Such instruments primarily include lending commitments and lease obligations.

Lending commitments include commitments to originate loans and commitments to fund unused lines of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

In addition to lending commitments, the Company has contractual obligations related to operating lease commitments. Operating lease commitments are obligations under various non-cancelable operating leases on buildings and land used for office space and banking purposes.

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

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

(1) Includes certificates in the CDARS program.

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

Related Party Transactions

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

Impact of Accounting Standards and Interpretations

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

Impact of Inflation and Changing Prices

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

Capital Resources

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classification are also subject to qualitative judgments by the regulators about components, asset risk-weightings and other factors.

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with prescribed risk-weightings. The appropriate risk-weighting, pursuant to regulatory guidelines, require an increase in the weights applied to securities that are rated below investment grade, thereby inflating the total risk-weighted assets. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and certain off-balance sheet items. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I capital to total risk-weighted assets (Tier I Capital) of 4% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. The Company's Total Risk Adjusted Capital Ratio was 15.2%, Tier I Capital Ratio was 13.9% and Leverage Ratio was 10.3% as of December 31, 2013. Additional information with respect to capital requirements is contained in Note 15, "Regulatory Matters", within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

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

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

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

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

Liquidity

Liquidity management ensures that adequate funds will be available to meet customers' needs for borrowings, deposit withdrawals and maturities, facility expansion and normal operating expenses. Sources of liquidity are cash and cash equivalents, asset maturities and pay-downs within one year, loans HFS, investments AFS, growth of core deposits and repurchase agreements, utilization of borrowing capacities from the FHLB, correspondent banks, CDARs, the Discount Window of the Federal Reserve Bank of Philadelphia (FRB) and proceeds from the issuance of capital stock. Though regularly scheduled investment and loan payments are dependable sources of daily liquidity, sales of both loans HFS and investments AFS, deposit activity and investment and loan prepayments are significantly influenced by general economic conditions and the interest rate environment. During low and declining interest rate environments, prepayments from interest-sensitive assets tend to accelerate and provide significant liquidity that can be used to invest in other interest-earning assets but at lower market rates. Conversely, in periods of high or rising interest rates, prepayments from interest-sensitive assets tend to decelerate causing cash flow from mortgage loans and mortgage-backed securities to decrease. Rising interest rates may also cause deposit inflow to accelerate but priced at higher market interest rates. Rising rates may also cause deposit outflow due to higher rates offered by the Company's competition for similar products. The Company closely monitors activity in the capital markets and takes appropriate action to ensure that the liquidity levels are adequate for funding, investing and operating activities.

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

During the twelve months ended December 31, 2013, the Company used $8.6 million of cash. During the period, the Company grew its loan portfolio from net sales of loans HFS proceeds, growth in deposits, and net cash inflow from scheduled maturity, prepayment and sales of investment securities, operations and available cash on hand. The growth in the loan portfolio occurred in all sectors with the commercial portfolio leading the growth. The Company expects to continue ot grow the commercial loan portfolio in 2014 using growth in deposits, repos and operations. The seasonal nature of deposit balances from municipalities and other public funding sources requires the Company to be prepared for the inherent volatility and the unpredictable timing of cash outflow from this customer base. The CFP is a tool to help the Company ensure that alternative funding sources are available to meet its liquidity needs.

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

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

Management of interest rate risk and market risk analysis

The adequacy and effectiveness of an institution's interest rate risk management process and the level of its exposures are critical factors in the regulatory evaluation of an institution's sensitivity to changes in interest rates and capital adequacy. Management believes the Company's interest rate risk measurement framework is sound and provides an effective means to measure, monitor, analyze, identify and control interest rate risk in the balance sheet.

The Company is subject to the interest rate risks inherent in its lending, investing and financing activities. Fluctuations of interest rates will impact interest income and interest expense along with affecting market values of all interest-earning assets and interest-bearing liabilities, except for those assets or liabilities with a short term remaining to maturity. Interest rate risk management is an integral part of the asset/liability management process. The Company has instituted certain procedures and policy guidelines to manage the interest rate risk position. Those internal policies enable the Company to react to changes in market rates to protect net interest income from significant fluctuations. The primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on net interest income along with creating an asset/liability structure that maximizes earnings.

Asset/Liability Management. One major objective of the Company when managing the rate sensitivity of its assets and liabilities is to stabilize net interest income. The management of and authority to assume interest rate risk is the responsibility of the Company's Asset/Liability Committee (ALCO), which is comprised of senior management and members of the board of directors. ALCO meets quarterly to monitor the relationship of interest sensitive assets to interest sensitive liabilities. The process to review interest rate risk is a regular part of managing the Company. Consistent policies and practices of measuring and reporting interest rate risk exposure, particularly regarding the treatment of non-contractual assets and liabilities, are in effect. In addition, there is an annual process to review the interest rate risk policy with the board of directors which includes limits on the impact to earnings from shifts in interest rates.

Interest Rate Risk Measurement. Interest rate risk is monitored through the use of three complementary measures: static gap analysis, earnings at risk simulation and economic value at risk simulation. While each of the interest rate risk measurements has limitations, collectively, they represent a reasonably comprehensive view of the magnitude of interest rate risk in the Company and the distribution of risk along the yield curve, the level of risk through time and the amount of exposure to changes in certain interest rate relationships.

Static Gap. The ratio between assets and liabilities re-pricing in specific time intervals is referred to as an interest rate sensitivity gap. Interest rate sensitivity gaps can be managed to take advantage of the slope of the yield curve as well as forecasted changes in the level of interest rate changes.

To manage this interest rate sensitivity gap position, an asset/liability model commonly known as cumulative gap analysis is used to monitor the difference in the volume of the Company's interest sensitive assets and liabilities that mature or re-price within given time intervals. A positive gap (asset sensitive) indicates that more assets will re-price during a given period compared to liabilities, while a negative gap (liability sensitive) indicates the opposite effect. The Company employs computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest-sensitive assets and liabilities in order to determine what impact these rate changes will have upon the net interest spread. At December 31, 2013, the Company maintained a one-year cumulative gap of positive (asset sensitive) $76.4 million, or 12%, of total assets. The effect of this positive gap position provided a mismatch of assets and liabilities which may expose the Company to interest rate risk during periods of falling interest rates. Conversely, in an increasing interest rate environment, net interest income could be positively impacted because more assets than liabilities will re-price upward during the one-year period.

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

The following table reflects the re-pricing of the balance sheet or "gap" position at December 31, 2013:

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

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

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

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

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

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

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

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

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

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may normally change beyond the Company's policy guideline for a short period of time as long as the risk-based capital ratio (after adjusting for the excess equity exposure) is greater than 10%. At December 31, 2013, the Company's risk-based capital ratio was 15.2%.

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

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

Simulation models require assumptions about certain categories of assets and liabilities. The models schedule existing assets and liabilities by their contractual maturity, estimated likely call date or earliest re-pricing opportunity. MBS – GSE residential securities and amortizing loans are scheduled based on their anticipated cash flow including estimated prepayments. For investment securities, the Company uses a third-party service to provide cash flow estimates in the various rate environments. Savings, money market and interest-bearing checking accounts do not have stated maturities or re-pricing terms and can be withdrawn or re-price at any time. This may impact the margin if more expensive alternative sources of deposits are required to fund loans or deposit runoff. Management projects the re-pricing characteristics of these accounts based on historical performance and assumptions that it believes reflect their rate sensitivity. The model reinvests all maturities, repayments and prepayments for each type of asset or liability into the same product for a new like term at current product interest rates. As a result, the mix of interest-earning assets and interest bearing-liabilities is held constant.

Supervision and Regulation

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

Recent Legislation and Rulemaking

Regulatory Capital Changes

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

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

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

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

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

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

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

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

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

JOBS Act

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

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

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

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

Dodd-Frank Wall Street Reform and Consumer Protection Act.

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

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

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

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

Prohibition Against Charter Conversions of Troubled Institutions. Dodd-Frank prohibits a depository institution from converting from a state to federal charter or vice versa while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the conversion application with its current federal regulator which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating thereto.

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

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

Limits on Interchange Fees. Dodd-Frank amends the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over $10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. The interchange rules became effective on October 1, 2011.

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

Future Federal and State Legislation and Rulemaking

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

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

Future Outlook

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

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

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

Item 7A: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Item 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

Fidelity D & D Bancorp, Inc.:

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

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

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

/s/ ParenteBeard LLC

ParenteBeard LLC

Wilkes-Barre, Pennsylvania

March 18, 2014

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

(dollars in thousands)	As of December 31, 2013	2012
Assets:		
Cash and due from banks	$ 13,197	$ 12,657
Interest-bearing deposits with financial institutions	21	9,189
Total cash and cash equivalents	13,218	21,846
Available-for-sale securities	97,246	100,441
Held-to-maturity securities	177	289
Federal Home Loan Bank stock	2,640	2,624
Loans and leases, net (allowance for loan losses of $8,928 in 2013; $8,972 in 2012)	469,216	424,584
Loans held-for-sale (fair value $937 in 2013, $10,824 in 2012)	917	10,545
Foreclosed assets held-for-sale	2,086	1,607
Bank premises and equipment, net	13,602	14,127
Cash surrender value of bank owned life insurance	10,402	10,065
Accrued interest receivable	2,068	1,985
Other assets	12,253	13,412
Total assets	$ 623,825	$ 601,525
Liabilities:		
Deposits:		
Interest-bearing	$ 406,779	$ 388,625
Non-interest-bearing	122,919	126,035
Total deposits	529,698	514,660
Accrued interest payable and other liabilities	3,425	3,863
Short-term borrowings	8,642	8,056
Long-term debt	16,000	16,000
Total liabilities	557,765	542,579
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-
Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 2,391,617 in 2013; and 2,323,248 in 2012)	25,302	23,711
Retained earnings	39,519	34,999
Accumulated other comprehensive income	1,239	236
Total shareholders' equity	66,060	58,946

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

See notes to consolidated financial statements