

FIDELITY D & D BANCORP INC  
Form 10-Q  
May 06, 2016  
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2016

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 333-90273

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

PENNSYLVANIA

23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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

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

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

|   |   |
|---|---|
| Large accelerated filer<br><input type="checkbox"/> | Accelerated<br>filer <input type="checkbox"/>                       |
| Non-accelerated filer <input type="checkbox"/>      | Smaller<br>reporting<br>company <input checked="" type="checkbox"/> |
| (Do not check if a smaller<br>reporting company)    |   |

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

YES  NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on April 30, 2016, the latest practicable date, was 2,453,455 shares.

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## PART I – Financial Information

## Item 1: Financial Statements

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

|  | March 31,<br>2016 | December<br>31, 2015 |
|--|-------------------|----------------------|
| (dollars in thousands)   |                   |                      |
| Assets:  |                   |                      |
| Cash and due from banks  | \$ 12,672         | \$ 12,259            |
| Interest-bearing deposits with financial institutions  | 28,419            | 18                   |
| Total cash and cash equivalents  | 41,091            | 12,277               |
| Available-for-sale securities  | 128,673           | 125,232              |
| Federal Home Loan Bank stock   | 1,420             | 2,120                |
| Loans and leases, net (allowance for loan losses of<br>\$9,384 in 2016; \$9,527 in 2015)   | 546,707           | 546,682              |
| Loans held-for-sale (fair value \$1,224 in 2016, \$1,444 in 2015)  | 1,202             | 1,421                |
| Foreclosed assets held-for-sale  | 1,766             | 1,074                |
| Bank premises and equipment, net   | 16,519            | 16,723               |
| Cash surrender value of bank owned life insurance  | 11,169            | 11,082               |
| Accrued interest receivable  | 2,202             | 2,210                |
| Other assets   | 12,633            | 10,537               |
| Total assets   | \$ 763,382        | \$ 729,358           |
| Liabilities:   |                   |                      |
| Deposits:  |                   |                      |
| Interest-bearing   | \$ 510,553        | \$ 477,901           |
| Non-interest-bearing   | 157,358           | 142,774              |
| Total deposits   | 667,911           | 620,675              |
| Accrued interest payable and other liabilities   | 4,397             | 4,128                |
| Short-term borrowings  | 12,765            | 28,204               |
| Total liabilities  | 685,073           | 653,007              |
| 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;<br>2,453,455 in 2016; and 2,443,405 in 2015) | 26,909            | 26,700               |
| Retained earnings  | 48,497            | 47,463               |
| Accumulated other comprehensive income   | 2,903             | 2,188                |
| Total shareholders' equity   | 78,309            | 76,351               |
| Total liabilities and shareholders' equity   | \$ 763,382        | \$ 729,358           |

See notes to unaudited consolidated financial statements

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Consolidated Statements of Income

| (Unaudited)   | Three months ended |                |
|---|--------------------|----------------|
|   | March 31, 2016     | March 31, 2015 |
| (dollars in thousands except per share data)          |                    |                |
| Interest income:                                      |                    |                |
| Loans and leases:                                     |                    |                |
| Taxable   | \$ 5,815           | \$ 5,499       |
| Nontaxable  | 191                | 139            |
| Interest-bearing deposits with financial institutions | 22                 | 16             |
| Investment securities:                                |                    |                |
| U.S. government agency and corporations               | 370                | 260            |
| States and political subdivisions (nontaxable)        | 317                | 313            |
| Other securities                                      | 21                 | 77             |
| Total interest income                                 | 6,736              | 6,304          |
| Interest expense:                                     |                    |                |
| Deposits  | 580                | 557            |
| Securities sold under repurchase agreements           | 8                  | 8              |
| Other short-term borrowings and other                 | 10                 | 1              |
| Long-term debt  | -                  | 131            |
| Total interest expense                                | 598                | 697            |
| Net interest income                                   | 6,138              | 5,607          |
| Provision for loan losses                             | 150                | 150            |
| Net interest income after provision for loan losses   | 5,988              | 5,457          |
| Other income:   |                    |                |
| Service charges on deposit accounts                   | 488                | 415            |
| Interchange fees                                      | 356                | 302            |
| Fees from trust fiduciary activities                  | 170                | 217            |
| Fees from financial services                          | 104                | 127            |
| Service charges on loans                              | 178                | 176            |
| Fees and other revenue                                | 197                | 196            |
| Earnings on bank-owned life insurance                 | 87                 | 85             |
| Gain on sale or disposal of:                          |                    |                |
| Loans   | 107                | 229            |
| Investment securities                                 | -                  | 2              |
| Premises and equipment                                | -                  | 1              |
| Total other income                                    | 1,687              | 1,750          |
| Other expenses:                                       |                    |                |
| Salaries and employee benefits                        | 2,875              | 2,653          |
| Premises and equipment                                | 918                | 941            |
| Advertising and marketing                             | 255                | 387            |

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|                                   |          |          |
|-----------------------------------|----------|----------|
| Professional services             | 389      | 338      |
| FDIC assessment                   | 125      | 107      |
| Loan collection                   | 44       | 30       |
| Other real estate owned           | 22       | 99       |
| Office supplies and postage       | 119      | 101      |
| Automated transaction processing  | 127      | 120      |
| Data processing and communication | 188      | 105      |
| Other                             | 326      | 206      |
| Total other expenses              | 5,388    | 5,087    |
| Income before income taxes        | 2,287    | 2,120    |
| Provision for income taxes        | 586      | 547      |
| Net income                        | \$ 1,701 | \$ 1,573 |
| Per share data:                   |          |          |
| Net income - basic                | \$ 0.69  | \$ 0.65  |
| Net income - diluted              | \$ 0.69  | \$ 0.64  |
| Dividends                         | \$ 0.27  | \$ 0.25  |

See notes to unaudited consolidated financial statements



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

| Consolidated Statements of Comprehensive Income<br>(Unaudited)<br>(dollars in thousands) | Three months<br>ended<br>March 31, |          |
|--|------------------------------------|----------|
|  | 2016                               | 2015     |
| Net income   | \$ 1,701                           | \$ 1,573 |
| Other comprehensive income, before tax:  |                                    |          |
| Unrealized holding gain on available-for-sale securities                                 | 1,084                              | 235      |
| Reclassification adjustment for net gains realized in income                             | -                                  | (2)      |
| Net unrealized gain  | 1,084                              | 233      |
| Tax effect   | (369)                              | (79)     |
| Unrealized gain, net of tax  | 715                                | 154      |
| Other comprehensive income, net of tax   | 715                                | 154      |
| Total comprehensive income, net of tax   | \$ 2,416                           | \$ 1,727 |

See notes to unaudited consolidated financial statements

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Fidelity D & D Bancorp, Inc. and Subsidiary  
 Consolidated Statements of Changes in Shareholders' Equity  
 For the three months ended March 31, 2016 and 2015  
 (Unaudited)

| (dollars in thousands)  | Capital stock |           | Retained  | Accumulated   |           |
|---|---------------|-----------|-----------|---------------|-----------|
|   | Shares        | Amount    | earnings  | other         | Total     |
|   |               |           |           | comprehensive |           |
|   |               |           |           | income        |           |
| Balance, December 31, 2014  | 2,427,767     | \$ 26,272 | \$ 43,204 | \$ 2,743      | \$ 72,219 |
| Net income  |               |           | 1,573     |               | 1,573     |
| Other comprehensive income  |               |           |           | 154           | 154       |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 4,358         | 102       |           |               | 102       |
| Issuance of common stock from vested restricted share grants through stock compensation plans | 7,780         |           |           |               |           |
| Stock-based compensation expense  |               | 87        |           |               | 87        |
| Cash dividends declared   |               |           | (613)     |               | (613)     |
| Balance, March 31, 2015   | 2,439,905     | \$ 26,461 | \$ 44,164 | \$ 2,897      | \$ 73,522 |
| Balance, December 31, 2015  | 2,443,405     | \$ 26,700 | \$ 47,463 | \$ 2,188      | \$ 76,351 |
| Net income  |               |           | 1,701     |               | 1,701     |
| Other comprehensive income  |               |           |           | 715           | 715       |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 3,695         | 111       |           |               | 111       |
| Issuance of common stock from vested restricted share grants through stock compensation plans | 5,855         |           |           |               |           |
| Issuance of common stock through exercise of stock options                                    | 500           | 14        |           |               | 14        |
| Stock-based compensation expense  |               | 84        |           |               | 84        |
| Cash dividends declared   |               |           | (667)     |               | (667)     |
| Balance, March 31, 2016   | 2,453,455     | \$ 26,909 | \$ 48,497 | \$ 2,903      | \$ 78,309 |

See notes to unaudited consolidated financial statements

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Consolidated Statements of Cash Flows

(Unaudited)

(dollars in thousands)

Three months ended  
March 31,  
2016      2015

## Cash flows from operating activities:

|   |          |          |
|---|----------|----------|
| Net income  | \$ 1,701 | \$ 1,573 |
| Adjustments to reconcile net income to net cash provided by operating activities: |          |          |
| Depreciation, amortization and accretion  | 865      | 806      |
| Provision for loan losses   | 150      | 150      |
| Deferred income tax expense   | 556      | 588      |
| Stock-based compensation expense  | 118      | 87       |
| Proceeds from sale of loans held-for-sale   | 6,563    | 10,318   |
| Originations of loans held-for-sale   | (5,738)  | (10,227) |
| Earnings from bank-owned life insurance   | (87)     | (85)     |
| Net gain from sales of loans  | (107)    | (229)    |
| Net gain from sales of investment securities                                      | -        | (2)      |
| Net loss from sale and write-down of foreclosed assets held-for-sale              | -        | 36       |
| Change in:  |          |          |
| Accrued interest receivable   | 8        | (4)      |
| Other assets  | (2,245)  | (954)    |
| Accrued interest payable and other liabilities                                    | (285)    | 117      |
| Net cash provided by operating activities   | 1,499    | 2,174    |

## Cash flows from investing activities:

## Available-for-sale securities:

|   |         |          |
|---|---------|----------|
| Proceeds from sales                                     | -       | 3,573    |
| Proceeds from maturities, calls and principal pay-downs | 3,873   | 6,772    |
| Purchases   | (6,628) | (39,025) |
| Decrease in FHLB stock                                  | 700     | 15       |
| Net increase in loans and leases                        | (1,446) | (4,725)  |
| Acquisition of bank premises and equipment              | (440)   | (664)    |
| Proceeds from sale of foreclosed assets held-for-sale   | -       | 921      |
| Net cash used in investing activities                   | (3,941) | (33,133) |

## Cash flows from financing activities:

|   |          |        |
|---|----------|--------|
| Net increase in deposits                                | 47,237   | 14,798 |
| Net (decrease) increase in short-term borrowings        | (15,439) | 9,804  |
| Proceeds from employee stock purchase plan participants | 111      | 102    |
| Exercise of stock options                               | 14       | -      |
| Dividends paid, net of dividends reinvested             | (667)    | (613)  |

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|  |           |           |
|--|-----------|-----------|
| Net cash provided by financing activities            | 31,256    | 24,091    |
| Net increase (decrease) in cash and cash equivalents | 28,814    | (6,868)   |
| Cash and cash equivalents, beginning                 | 12,277    | 25,851    |
| Cash and cash equivalents, ending                    | \$ 41,091 | \$ 18,983 |

See notes to unaudited consolidated financial statements

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FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(Unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

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

Principles of consolidation

The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation.

For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

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

In the opinion of management, the consolidated balance sheets as of March 31, 2016 and December 31, 2015 and the related consolidated statements of income and consolidated statements of comprehensive income for the three months ended March 31, 2016 and 2015, and consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the three months ended March 31, 2016 and 2015 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature. Certain reclassifications have been made to the 2015 financial statements to conform to the 2016 presentation.

In preparing these consolidated financial statements, the Company evaluated the events and transactions that occurred after March 31, 2016 through the date these consolidated financial statements were issued.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2015, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

#### Critical accounting policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

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 March 31, 2016 is adequate and reasonable. Given the subjective nature of identifying and estimating loan losses, it is likely that well-informed individuals could make different assumptions and could, therefore, calculate a materially different allowance amount. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. Fair values of investment securities are determined by pricing provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. The majority of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value

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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 (AOCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells residential mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these circumstances, pricing may be obtained from other entities and the residential mortgage loans are transferred at the lower of cost or market value and simultaneously sold. For other loans transferred to HFS, pricing may be obtained from other entities or modeled and the other loans are transferred at the lower of cost or market value and then sold. As of March 31, 2016 and December 31, 2015, loans classified as HFS consisted of residential mortgage loans.

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

Foreclosed assets held-for-sale includes other real estate acquired through foreclosure (ORE) and may, from time-to-time, include repossessed assets such as automobiles. ORE is carried at the lower of cost (principal balance at date of foreclosure) or fair value less estimated cost to sell. Any write-downs at the date of foreclosure or within a reasonable period of time after foreclosure are charged to the allowance for loan losses. Expenses incurred to maintain ORE properties, subsequent write downs to the asset's fair value, any rental income received and gains or losses on disposal are included as components of other real estate owned expense in the consolidated statements of income.

For purposes of the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. For each of the three months ended March 31, 2016 and 2015, the Company paid interest of \$0.6 million and \$0.7 million, respectively. The Company did not make an income tax payment in the first quarters of 2016 and 2015. For the three months ended March 31, 2016 and 2015, the Company had a net change in unrealized gains on available for sale securities of \$1.1 million and \$0.2 million, respectively.

Transfers from loans to foreclosed assets held-for-sale amounted to \$0.7 million and \$0.4 million during the three months ended March 31, 2016 and 2015, respectively. During the same respective periods, transfers from loans to loans held-for-sale amounted to \$0.6 million and \$0. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of premises and equipment.

## 2. New accounting pronouncements

In an exposure draft issued in the fourth quarter of 2012, the Financial Accounting Standards Board (FASB) proposed changes to the accounting guidance related to the impairment of financial assets and the recognition of credit losses. The FASB proposal would require financial institutions to reserve for losses for the duration of the credit exposure as opposed to reserving for probable losses. The new methodology would be known as the "current expected credit losses" (CECL) methodology. The FASB is currently in the process of re-deliberating significant issues raised through feedback received from comment letters and outreach activities. Among other things, the guidance in the proposed update regarding an entity's estimate of expected credit losses will be clarified as follows:

- An entity should revert to a historical average loss experience for the future periods beyond which the entity is able to make or obtain reasonable and supportable forecasts;
- An entity should consider all contractual cash flows over the life of the related financial assets;

- When determining the contractual cash flows and the life of the related financial assets:
  - o An entity should consider expected prepayments;
  - o An entity should not consider expected extensions, renewals, and modifications unless the entity reasonably expects that it will execute a troubled debt restructuring with a borrower;
- An entity's estimate of expected credit losses should always reflect the risk of loss, even when that risk is remote. However, an entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero yet the amount of loss would be zero;
- In addition to using a discounted cash flow model to estimate expected credit losses, an entity would not be prohibited from developing an estimate of credit losses using loss-rate methods, probability-of-default methods or a provision matrix using loss factors;
- The final guidance on expected credit losses will include implementation guidance describing the factors that an entity should consider to adjust historical loss experience for current conditions and reasonable and supportable forecast.

FASB expects to issue this proposed accounting standard update in June 2016 with implementation beginning in the fiscal year following December 15, 2019 for public companies. Upon adoption, the change in this accounting guidance could result in an increase in the Company's allowance for loan losses and require the Company to record loan losses more rapidly. Upon final issuance of the standard, the Company will be able to better evaluate the potential impact of this new standard on its consolidated financial statements.

In June 2014, the FASB issued ASU 2014-12, Compensation – Stock Compensation (Topic 718) Accounting for Share-Based



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Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period, an amendment to the stock compensation accounting guidance to clarify that a performance target that affects vesting of a share-based payment and that could be achieved after the requisite service period be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. This amendment is effective for annual reporting periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. Entities may apply the amendments in this update either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. The Company adopted this accounting standard update during the first quarter of 2016 and does not expect this amendment to have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting. The areas for simplification in the update involve several aspects of accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The amendments in this update are effective for annual reporting periods, including interim periods within those annual periods, beginning after December 15, 2016. Early adoption is permitted. Amendments should be applied using either a modified retrospective transition method by means of a cumulative-effect adjustment to equity as of the beginning of the period in which the guidance is adopted, retrospectively, prospectively, or using either a prospective transition method or a retrospective transition method. The Company does not expect this amendment to have a material impact on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP: identify the contract(s) with a customer; identify the performance obligations in the contract; determine the transaction price; allocate the transaction price to the performance obligations in the contract; recognize revenue when (or as) the entity satisfies a performance obligation. The standard is effective for annual periods beginning after December 15, 2017, and interim periods therein, using either of the following transition methods: a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). The Company is evaluating the impact of the adoption of ASU 2014-09 on its consolidated financial statements and has not yet determined the method by which it will adopt the standard effective in the first quarter of 2018.

In January 2016, the FASB issued ASU 2016-01 related to Financial Instruments - Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities. The update applies to all entities that hold financial assets or owe financial liabilities. The amendments in this update make targeted improvements to U.S. GAAP as follows:

- Require equity investments to be measured at fair value with changes in fair value recognized in net income;
- Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment;
-

Require public business entities to use the exit price notion when measuring fair value of financial instruments for disclosure purposes;

- Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset;
- Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities.

The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is evaluating the impact of the adoption of ASU 2016-01 on its consolidated financial statements, but does not expect it to have a significant impact.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. ASU 2016-02 requires the recognition of a right-of-use asset and related lease liability by lessees for leases classified as operating leases under GAAP. The amendments in this update are effective for the Company for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption of the amendments in this update are permitted. A modified retroactive approach must be applied for leases existing at, or entered into after, the beginning of the earliest comparative period. The Company is currently evaluating the impact of adopting this new guidance on the consolidated financial statements.

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## 3. Accumulated other comprehensive income

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

As of and for the three months ended March 31, 2016

| (dollars in thousands)   | Unrealized<br>gains<br>on<br>available-for-<br>sale securities | Total    |
|--|--|----------|
| Beginning balance  | \$ 2,188   | \$ 2,188 |
| Other comprehensive income before reclassifications, net of tax              | 715  | 715      |
| Amounts reclassified from accumulated other comprehensive income, net of tax | -  | -        |
| Net current-period other comprehensive income                                | 715  | 715      |
| Ending balance   | \$ 2,903   | \$ 2,903 |

As of and for the three months ended March 31, 2015

| (dollars in thousands)   | Unrealized<br>gains<br>on<br>available-for-<br>sale securities | Total    |
|--|--|----------|
| Beginning balance  | \$ 2,743   | \$ 2,743 |
| Other comprehensive income before reclassifications, net of tax              | 155  | 155      |
| Amounts reclassified from accumulated other comprehensive income, net of tax | (1)  | (1)      |
| Net current-period other comprehensive income                                | 154  | 154      |
| Ending balance   | \$ 2,897   | \$ 2,897 |

Details about accumulated other

| comprehensive income components<br><br>(dollars in thousands) | Amount<br>reclassified<br>from<br>accumulated<br>other<br>comprehensive<br>income<br>For the three<br>months ended<br>March 31,<br>2016 2015 |      | Affected line item in the statement<br><br>where net income is presented |
|---|--|------|--|
|   | Unrealized gains on AFS securities   | \$ - |  |
|   | -  | (1)  | Provision for income taxes   |
| Total reclassifications for the period                        | \$ -   | \$ 1 | Net income   |

#### 4. Investment securities

Agency – Government-sponsored enterprise (GSE) and MBS - GSE residential

Agency – GSE and MBS – GSE residential securities consist of short- to long-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), Federal Home Loan Bank (FHLB) and Government National Mortgage Association (GNMA). These securities have interest rates that are fixed and adjustable, have varying short- to long-term maturity dates and have contractual cash flows guaranteed by the U.S. government or agencies of the U.S. government.

Obligations of states and political subdivisions

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

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The amortized cost and fair value of investment securities at March 31, 2016 and December 31, 2015 are summarized as follows:

| (dollars in thousands)                           | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2016                                   |                   |                              |                               |               |
| Available-for-sale securities:                   |                   |                              |                               |               |
| Agency - GSE                                     | \$ 18,369         | \$ 169                       | \$ (10)                       | \$ 18,528     |
| Obligations of states and political subdivisions | 35,122            | 2,500                        | (13)                          | 37,609        |
| MBS - GSE residential                            | 70,488            | 1,540                        | (26)                          | 72,002        |
| Total debt securities                            | 123,979           | 4,209                        | (49)                          | 128,139       |
| Equity securities - financial services           | 294               | 240                          | -                             | 534           |
| Total available-for-sale securities              | \$ 124,273        | \$ 4,449                     | \$ (49)                       | \$ 128,673    |

| (dollars in thousands)                           | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| December 31, 2015                                |                   |                              |                               |               |
| Available-for-sale securities:                   |                   |                              |                               |               |
| Agency - GSE                                     | \$ 18,374         | \$ 36                        | \$ (24)                       | \$ 18,386     |
| Obligations of states and political subdivisions | 34,599            | 2,310                        | (24)                          | 36,885        |
| MBS - GSE residential                            | 68,648            | 1,066                        | (299)                         | 69,415        |
| Total debt securities                            | 121,621           | 3,412                        | (347)                         | 124,686       |
| Equity securities - financial services           | 295               | 251                          | -                             | 546           |
| Total available-for-sale securities              | \$ 121,916        | \$ 3,663                     | \$ (347)                      | \$ 125,232    |

The amortized cost and fair value of debt securities at March 31, 2016 by contractual maturity are summarized below:

| (dollars in thousands)                       | Amortized<br>cost | Fair<br>value  |
|--|-------------------|----------------|
| Available-for-sale securities:               |                   |                |
| Debt securities:                             |                   |                |
| Due in one year or less                      | \$ 3,434          | \$ 3,439       |
| Due after one year through five years        | 13,290            | 13,455         |
| Due after five years through ten years       | 3,712             | 3,902          |
| Due after ten years                          | 33,055            | 35,341         |
| <br>Total debt securities                    | <br>53,491        | <br>56,137     |
| <br>MBS - GSE residential                    | <br>70,488        | <br>72,002     |
| <br>Total available-for-sale debt securities | <br>\$ 123,979    | <br>\$ 128,139 |

Actual maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Agency – GSE and municipal securities are included based on their original stated maturity. MBS – GSE residential, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total. Most of the securities have fixed rates or have predetermined scheduled rate changes and many have call features that allow the issuer to call the security at par before its stated maturity without penalty.

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The following table presents the fair value and gross unrealized losses of investment securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of March 31, 2016 and December 31, 2015:

| (dollars in thousands)                           | Less than 12 months |                   | More than 12 months |                   | Total      |                   |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|  | Fair value          | Unrealized losses | Fair value          | Unrealized losses | Fair value | Unrealized losses |
| March 31, 2016                                   |                     |                   |                     |                   |            |                   |
| Agency - GSE                                     | \$ 1,036            | \$ (10)           | \$ -                | \$ -              | \$ 1,036   | \$ (10)           |
| Obligations of states and political subdivisions | 543                 | (9)               | 1,534               | (4)               | 2,077      | (13)              |
| MBS - GSE residential                            | 8,255               | (22)              | 1,288               | (4)               | 9,543      | (26)              |
| Total  | \$ 9,834            | \$ (41)           | \$ 2,822            | \$ (8)            | \$ 12,656  | \$ (49)           |
| Number of securities                             | 6                   |                   | 3                   |                   | 9          |                   |
| December 31, 2015                                |                     |                   |                     |                   |            |                   |
| Agency - GSE                                     | \$ 8,156            | \$ (24)           | \$ -                | \$ -              | \$ 8,156   | \$ (24)           |
| Obligations of states and political subdivisions | 3,656               | (20)              | 485                 | (4)               | 4,141      | (24)              |
| MBS - GSE residential                            | 36,899              | (299)             | -                   | -                 | 36,899     | (299)             |
| Total  | \$ 48,711           | \$ (343)          | \$ 485              | \$ (4)            | \$ 49,196  | \$ (347)          |
| Number of securities                             | 32                  |                   | 1                   |                   | 33         |                   |

The Company had nine securities in an unrealized loss position at March 31, 2016, including one agency security, five mortgage-backed securities and three municipal securities. The severity of these unrealized losses based on their underlying cost basis were as follows at March 31, 2016: 0.98% for agencies; 0.27% for MBS - GSE; and 0.62% for the municipals. In addition, only three of these securities have been in an unrealized loss position in excess of 12 months. The changes in the prices on these securities are the result of interest rate movement and are temporary in nature.

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

The Company's OTTI evaluation process also follows the guidance set forth in topics related to debt and equity securities. The guidance set forth in the pronouncements require the Company to take into consideration current market conditions, fair value in relationship to cost, extent and nature of changes in fair value, issuer rating changes and trends, volatility of earnings, current analysts' evaluations, all available information relevant to the collectability of debt securities, the ability and intent to hold investments until a recovery of fair value which may be to maturity and other factors when evaluating for the existence of OTTI. The guidance requires that credit-related OTTI be recognized as a realized loss through earnings when there has been an adverse change in the holder's expected cash flows such that the full amount (principal and interest) will probably not be received. This requirement is consistent with the impairment model in the guidance for accounting for debt and equity securities.

For all security types, as of March 31, 2016, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that more likely than not would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI in the Company's security portfolio. In addition, management believes the change in fair value is attributable to changes in interest rates.



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## 5. Loans and leases

The classifications of loans and leases at March 31, 2016 and December 31, 2015 are summarized as follows:

| (dollars in thousands)     | March 31,<br>2016 | December<br>31, 2015 |
|----------------------------|-------------------|----------------------|
| Commercial and industrial  | \$ 103,703        | \$ 102,653           |
| Commercial real estate:    |                   |                      |
| Non-owner occupied         | 95,303            | 95,745               |
| Owner occupied             | 98,523            | 101,652              |
| Construction               | 4,904             | 4,481                |
| Consumer:                  |                   |                      |
| Home equity installment    | 30,017            | 30,935               |
| Home equity line of credit | 48,331            | 48,060               |
| Auto loans and leases      | 29,556            | 29,758               |
| Other                      | 5,770             | 6,208                |
| Residential:               |                   |                      |
| Real estate                | 130,270           | 126,992              |
| Construction               | 10,109            | 10,060               |
| Total                      | 556,486           | 556,544              |
| Less:                      |                   |                      |
| Allowance for loan losses  | (9,384)           | (9,527)              |
| Unearned lease revenue     | (395)             | (335)                |
| Loans and leases, net      | \$ 546,707        | \$ 546,682           |

Net deferred loan costs of \$1.5 million have been included in the carrying values of loans at March 31, 2016 and December 31, 2015, respectively.

Unearned lease revenue represents the difference between the lessor's investment in the property and the gross investment in the lease. Unearned revenue is accrued over the life of the lease using the effective interest method.

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate unpaid principal balance of mortgages serviced amounted to \$269.6 million as of March 31, 2016 and \$269.5 million as of December 31, 2015. Mortgage servicing rights amounted to \$1.2 million both as of March 31, 2016 and December 31, 2015, respectively.

Management is responsible for conducting the Company's credit risk evaluation process, which includes credit risk grading of individual commercial and industrial and commercial real estate loans. Commercial and industrial and commercial real estate loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk

grade is revised or reaffirmed as the case may be. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The Company utilizes an external independent loan review firm that reviews and validates the credit risk program on at least an annual basis. Results of these reviews are presented to management and the board of directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

#### Non-accrual loans

The decision to place loans on non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. Commercial and industrial (C&I) and commercial real estate (CRE) loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest and unsecured consumer loans are charged-off when the loan is 90 days or more past due as to principal and interest. The Company considers all non-accrual loans to be impaired loans.

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Non-accrual loans, segregated by class, at March 31, 2016 and December 31, 2015, were as follows:

| (dollars in thousands)     | March<br>31, 2016 | December<br>31, 2015 |
|----------------------------|-------------------|----------------------|
| Commercial and industrial  | \$ 32             | \$ 30                |
| Commercial real estate:    |                   |                      |
| Non-owner occupied         | 6,178             | 6,193                |
| Owner occupied             | 559               | 988                  |
| Construction               | 218               | 226                  |
| Consumer:                  |                   |                      |
| Home equity installment    | 92                | 167                  |
| Home equity line of credit | 438               | 512                  |
| Auto loans and leases      | 23                | 45                   |
| Other                      | 6                 | 6                    |
| Residential:               |                   |                      |
| Real estate                | 760               | 836                  |
| Total                      | \$ 8,306          | \$ 9,003             |

### Troubled Debt Restructuring

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

Loans modified in a TDR may or may not be placed on non-accrual status. As of March 31, 2016, total TDRs amounted to \$3.0 million, consisting of 10 loans (7 CRE loans, 2 C&I loans and 1 HELOC to 6 unrelated borrowers), of which 2 of the CRE loans, totaling \$0.2 million, were on non-accrual status. The first quarter 2016 balance represents a \$0.6 million increase over the December 31, 2015 balance, which amounted to \$2.4 million (consisting of 7 CRE loans and 2 C&I loans to 5 unrelated borrowers), with none of these loans on non-accrual status. The increase in the first quarter of 2016 was attributed to the addition of a \$0.7 million HELOC into the TDR classification. Of the TDRs outstanding as of March 31, 2016 and December 31, 2015, when modified, the concessions granted consisted of temporary interest-only payments, extensions of maturity date, or a reduction in the rate of interest to a below-market

rate for a contractual period of time. Other than the TDRs that were placed on non-accrual status, the TDRs were performing in accordance with their modified terms.

The following presents by class, information related to loans modified in a TDR:

| (dollars in thousands)                  | Loans modified as TDRs for the:   |  |  |                                   |  |  |
|---|-----------------------------------|--|--|-----------------------------------|--|--|
|   | Three months ended March 31, 2016 |  |  | Three months ended March 31, 2015 |  |  |
|   | Number of contracts               | Recorded investment (as of period end) | Increase in allowance (as of period end) | Number of contracts               | Recorded investment (as of period end) | Increase in allowance (as of period end) |
| Commercial and industrial               |                                   | \$ -                                   | \$ -                                     | 1                                 | \$ 500                                 | \$ 331                                   |
| Commercial real estate - owner occupied |                                   | -                                      | -  | 2                                 | 1,107                                  | 251                                      |
| Consumer home equity line of credit     | 1                                 | 650                                    | 128                                      |                                   | -                                      | -  |
| Total                                   | 1                                 | \$ 650                                 | \$ 128                                   | 3                                 | \$ 1,607                               | \$ 582                                   |

In the above table, the period end balances are inclusive of all partial pay downs and charge-offs since the modification date.

The following presents by class, loans modified as a TDR that subsequently defaulted (i.e. 90 days or more past due following a modification) during the periods indicated:

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Loans modified as a TDR within the previous twelve months that subsequently defaulted during the:

| (dollars in thousands)                  | Three months ended March 31, 2016 |                     |
|---|-----------------------------------|---------------------|
|   | Number of contracts               | Recorded investment |
| Commercial real estate - owner occupied | 2                                 | \$ 156              |

In the above table, the period end balances are inclusive of all partial pay downs and charge-offs since the modification date.

Loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment. Two CRE loans that were classified as TDRs in fourth quarter of 2015 subsequently defaulted during the first quarter of 2016. Both loans defaulted due to inability to meet contractual payments and the Company continued workout efforts to collect from the owners. There were no loans modified as a TDR within the previous twelve months that subsequently defaulted during the three months ended March 31, 2015.

The allowance for loan losses (allowance) may be increased, adjustments may be made in the allocation of the allowance or partial charge-offs may be taken to further write-down the carrying value of the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral is used to establish the allowance. As of March 31, 2016 and 2015, the allowance for impaired loans that have been modified in a TDR was \$0.8 million and \$0.6 million, respectively.

## Past due loans

Loans are considered past due when the contractual principal and/or interest is not received by the due date. An aging analysis of past due loans, segregated by class of loans, as of the period indicated is as follows (dollars in thousands):

|                           | Past due              |                       |                     |                | Current    | Total loans (3) | Recorded investment past due ≥ 90 days and accruing |
|---------------------------|-----------------------|-----------------------|---------------------|----------------|------------|-----------------|---|
|                           | 30 - 59 Days past due | 60 - 89 Days past due | 90 days or more (1) | Total past due |            |                 |   |
| March 31, 2016            |                       |                       |                     |                |            |                 |   |
| Commercial and industrial | \$ 63                 | \$ 6                  | \$ 59               | \$ 128         | \$ 103,575 | \$ 103,703      | \$ 27   |

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|                            |          |        |          |           |            |            |         |
|----------------------------|----------|--------|----------|-----------|------------|------------|---------|
| Commercial real estate:    |          |        |          |           |            |            |         |
| Non-owner occupied         | 643      | 210    | 6,178    | 7,031     | 88,272     | 95,303     | -       |
| Owner occupied             | 237      | -      | 594      | 831       | 97,692     | 98,523     | 35      |
| Construction               | -        | -      | 218      | 218       | 4,686      | 4,904      | -       |
| Consumer:                  |          |        |          |           |            |            |         |
| Home equity installment    | 370      | 22     | 92       | 484       | 29,533     | 30,017     | -       |
| Home equity line of credit | 177      | -      | 438      | 615       | 47,716     | 48,331     | -       |
| Auto loans and leases      | 232      | 42     | 580      | 854       | 28,307     | 29,161     | (2) 557 |
| Other                      | 29       | 5      | 6        | 40        | 5,730      | 5,770      | -       |
| Residential:               |          |        |          |           |            |            |         |
| Real estate                | 59       | 295    | 760      | 1,114     | 129,156    | 130,270    | -       |
| Construction               | -        | -      | -        | -         | 10,109     | 10,109     | -       |
| Total                      | \$ 1,810 | \$ 580 | \$ 8,925 | \$ 11,315 | \$ 544,776 | \$ 556,091 | \$ 619  |

(1) Includes \$8.3 million of non-accrual loans. (2) Net of unearned lease revenue of \$0.4 million. (3) Includes net deferred loan costs of \$1.5 million.

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| December 31, 2015          | 30 - 59          | 60 - 89          | Past due                  |                   | Current    | Total<br>loans (3) | Recorded<br>investment<br>past<br>due ≥ 90<br>days<br>and<br>accruing |
|----------------------------|------------------|------------------|---------------------------|-------------------|------------|--------------------|---|
|                            | Days<br>past due | Days<br>past due | 90 days<br>or more<br>(1) | Total<br>past due |            |                    |   |
| Commercial and industrial  | \$ 38            | \$ 32            | \$ 42                     | \$ 112            | \$ 102,541 | \$ 102,653         | \$ 12   |
| Commercial real estate:    |                  |                  |                           |                   |            |                    |   |
| Non-owner occupied         | 549              | 1,282            | 6,476                     | 8,307             | 87,438     | 95,745             | 283   |
| Owner occupied             | -                | 85               | 988                       | 1,073             | 100,579    | 101,652            | -   |
| Construction               | -                | -                | 226                       | 226               | 4,255      | 4,481              | -   |
| Consumer:                  |                  |                  |                           |                   |            |                    |   |
| Home equity installment    | 189              | 92               | 167                       | 448               | 30,487     | 30,935             | -   |
| Home equity line of credit | 109              | 650              | 512                       | 1,271             | 46,789     | 48,060             | -   |
| Auto loans and leases      | 394              | 44               | 76                        | 514               | 28,909     | 29,423 (2)         | 31  |
| Other                      | 66               | -                | 36                        | 102               | 6,106      | 6,208              | 30  |
| Residential:               |                  |                  |                           |                   |            |                    |   |
| Real estate                | 46               | 131              | 836                       | 1,013             | 125,979    | 126,992            | -   |
| Construction               | -                | -                | -                         | -                 | 10,060     | 10,060             | -   |
| Total                      | \$ 1,391         | \$ 2,316         | \$ 9,359                  | \$ 13,066         | \$ 543,143 | \$ 556,209         | \$ 356  |

(1) Includes \$9.0 million of non-accrual loans. (2) Net of unearned lease revenue of \$0.3 million. (3) Includes net deferred loan costs of \$1.5 million.

## Impaired loans

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

At March 31, 2016, impaired loans consisted of accruing TDRs of \$2.8 million, \$8.3 million in non-accrual loans and \$2.7 million in accruing loans. At December 31, 2015, impaired loans consisted of accruing TDRs totaling \$2.4 million, \$9.0 million of non-accrual loans and a \$1.2 million accruing loan. As of December 31, 2015, the non-accrual loans did not include any TDRs compared with two TDRs with a \$0.2 million balance as of March 31, 2016. Payments received from non-accruing impaired loans are first applied against the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income. Payments received from accruing impaired loans are applied to principal and interest, as contractually agreed upon.

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

| (dollars in thousands)     | Unpaid<br>principal<br>balance | Recorded<br>investment<br>with<br>allowance | Recorded<br>investment<br>with no<br>allowance | Total<br>recorded<br>investment | Related<br>allowance |
|----------------------------|--------------------------------|---|--|---------------------------------|----------------------|
| March 31, 2016             |                                |   |  |                                 |                      |
| Commercial and industrial  | \$ 868                         | \$ 824                                      | \$ 44  | \$ 868                          | \$ 614               |
| Commercial real estate:    |                                |   |  |                                 |                      |
| Non-owner occupied         | 7,959                          | 7,470                                       | 566  | 8,036                           | 1,467                |
| Owner occupied             | 2,878                          | 1,832                                       | 885  | 2,717                           | 560                  |
| Construction               | 416                            | -   | 218  | 218                             | -                    |
| Consumer:                  |                                |   |  |                                 |                      |
| Home equity installment    | 142                            | 60  | 32   | 92                              | 5                    |
| Home equity line of credit | 1,129                          | 755   | 333  | 1,088                           | 193                  |
| Auto loans and leases      | 23                             | 22  | 1  | 23                              | 5                    |
| Other                      | 6                              | 6   | -  | 6                               | 2                    |
| Residential:               |                                |   |  |                                 |                      |
| Real estate                | 894                            | 475   | 285  | 760                             | 38                   |
| Construction               | -                              | -   | -  | -                               | -                    |
| Total                      | \$ 14,315                      | \$ 11,444                                   | \$ 2,364                                       | \$ 13,808                       | \$ 2,884             |



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| (dollars in thousands)     | Unpaid principal balance | Recorded investment with allowance | Recorded investment with no allowance | Total recorded investment | Related allowance |
|----------------------------|--------------------------|------------------------------------|---------------------------------------|---------------------------|-------------------|
| December 31, 2015          |                          |                                    |                                       |                           |                   |
| Commercial and industrial  | \$ 555                   | \$ 500                             | \$ 55                                 | \$ 555                    | \$ 331            |
| Commercial real estate:    |                          |                                    |                                       |                           |                   |
| Non-owner occupied         | 7,960                    | 7,209                              | 630                                   | 7,839                     | 1,237             |
| Owner occupied             | 2,588                    | 922                                | 1,505                                 | 2,427                     | 337               |
| Construction               | 422                      | -                                  | 226                                   | 226                       | -                 |
| Consumer:                  |                          |                                    |                                       |                           |                   |
| Home equity installment    | 230                      | -                                  | 167                                   | 167                       | -                 |
| Home equity line of credit | 607                      | 28                                 | 484                                   | 512                       | 1                 |
| Auto                       | 47                       | 43                                 | 2                                     | 45                        | 7                 |
| Other                      | 6                        | 6                                  | -                                     | 6                         | 1                 |
| Residential:               |                          |                                    |                                       |                           |                   |
| Real estate                | 891                      | 433                                | 403                                   | 836                       | 95                |
| Construction               | -                        | -                                  | -                                     | -                         | -                 |
| Total                      | \$ 13,306                | \$ 9,141                           | \$ 3,472                              | \$ 12,613                 | \$ 2,009          |

| (dollars in thousands)     | March 31, 2016              |                            |                                       | March 31, 2015              |                            |                                       |
|----------------------------|-----------------------------|----------------------------|---------------------------------------|-----------------------------|----------------------------|---------------------------------------|
|                            | Average recorded investment | Interest income recognized | Cash basis interest income recognized | Average recorded investment | Interest income recognized | Cash basis interest income recognized |
| Commercial and industrial  | \$ 675                      | \$ 6                       | \$ -                                  | \$ 206                      | \$ 6                       | \$ -                                  |
| Commercial real estate:    |                             |                            |                                       |                             |                            |                                       |
| Non-owner occupied         | 3,859                       | 24                         | -                                     | 1,596                       | 14                         | -                                     |
| Owner occupied             | 2,825                       | 38                         | -                                     | 2,174                       | 13                         | -                                     |
| Construction               | 234                         | -                          | -                                     | 265                         | -                          | -                                     |
| Consumer:                  |                             |                            |                                       |                             |                            |                                       |
| Home equity installment    | 195                         | 2                          | -                                     | 326                         | -                          | -                                     |
| Home equity line of credit | 606                         | 11                         | -                                     | 428                         | 1                          | -                                     |
| Auto                       | 29                          | -                          | -                                     | 1                           | -                          | -                                     |
| Other                      | 9                           | -                          | -                                     | 22                          | -                          | -                                     |
| Residential:               |                             |                            |                                       |                             |                            |                                       |
| Real estate                | 671                         | 2                          | -                                     | 605                         | -                          | -                                     |
| Construction               | -                           | -                          | -                                     | -                           | -                          | -                                     |
| Total                      | \$ 9,103                    | \$ 83                      | \$ -                                  | \$ 5,623                    | \$ 34                      | \$ -                                  |

## Credit Quality Indicators

### Commercial and industrial and commercial real estate

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

The following is a description of each risk rating category the Company uses to classify each of its C&I and CRE loans:

#### Pass

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

#### Special Mention

Loans in this category are graded a six and may be protected but are potentially weak. They constitute a credit risk to the Company, but have not yet reached the point of adverse classification. Some of the following conditions may exist: little or no collateral

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coverage; lack of current financial information; delinquency problems; highly leveraged; available financial information reflects poor balance sheet ratios and profit and loss statements reflect uncertain trends; and document exceptions. Cash flow may not be sufficient to support total debt service requirements.

Substandard

Loans in this category are graded a seven and have a well-defined weakness which may jeopardize the ultimate collectability of the debt. The collateral pledged may be lacking in quality or quantity. Financial statements may indicate insufficient cash flow to service the debt; and/or do not reflect a sound net worth. The payment history indicates chronic delinquency problems. Management is considered to be weak. There is a distinct possibility that the Company may sustain a loss. All loans on non-accrual are rated substandard. Other loans that are included in the substandard category can be accruing, as well as loans that are current or past due. Loans 90 days or more past due, unless otherwise fully supported, are classified substandard. Also, borrowers that are bankrupt or have loans categorized as TDRs can be graded substandard.

Doubtful

Loans in this category are graded an eight and have a better than 50% possibility of the Company sustaining a loss, but the loss cannot be determined because of specific reasonable factors which may strengthen credit in the near-term. Many of the weaknesses present in a substandard loan exist. Liquidation of collateral, if any, is likely. Any loan graded lower than an eight is considered to be uncollectible and charged-off.

Consumer and residential

The consumer and residential loan segments are regarded as homogeneous loan pools and as such are not risk rated. For these portfolios, the Company utilizes payment activity, history and recency of payment in assessing performance. Non-performing loans are considered to be loans past due 90 days or more and accruing and non-accrual loans. All loans not classified as non-performing are considered performing.

The following table presents loans including \$1.5 million of deferred costs, segregated by class, categorized into the appropriate credit quality indicator category as of March 31, 2016 and December 31, 2015, respectively:

Commercial credit exposure

Credit risk profile by creditworthiness category

| (dollars in thousands) | Commercial and industrial |            | Commercial real estate non-owner occupied |            | Commercial real estate owner occupied |            | Commercial real estate construction |            |
|------------------------|---------------------------|------------|---|------------|---------------------------------------|------------|-------------------------------------|------------|
|                        | 3/31/2016                 | 12/31/2015 | 3/31/2016                                 | 12/31/2015 | 3/31/2016                             | 12/31/2015 | 3/31/2016                           | 12/31/2015 |
|                        | Pass                      | \$ 96,513  | \$ 101,342                                | \$ 82,087  | \$ 82,152                             | \$ 94,694  | \$ 96,401                           | \$ 4,686   |
| Special mention        | 6,007                     | 189        | 1,382                                     | 1,480      | 649                                   | 657        | -                                   | -          |

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|             |            |            |           |           |           |            |          |          |
|-------------|------------|------------|-----------|-----------|-----------|------------|----------|----------|
| Substandard | 1,183      | 1,122      | 11,834    | 12,113    | 3,180     | 4,594      | 218      | 226      |
| Doubtful    | -          | -          | -         | -         | -         | -          | -        | -        |
| Total       | \$ 103,703 | \$ 102,653 | \$ 95,303 | \$ 95,745 | \$ 98,523 | \$ 101,652 | \$ 4,904 | \$ 4,481 |

Consumer credit exposure

Credit risk profile based on payment activity

| (dollars in thousands) | Home equity installment |            | Home equity line of credit |            | Auto loans and leases |               | Other     |            |
|------------------------|-------------------------|------------|----------------------------|------------|-----------------------|---------------|-----------|------------|
|                        | 3/31/2016               | 12/31/2015 | 3/31/2016                  | 12/31/2015 | 3/31/2016             | 12/31/2015    | 3/31/2016 | 12/31/2015 |
| Performing             | \$ 29,925               | \$ 30,768  | \$ 47,893                  | \$ 47,548  | \$ 28,581             | \$ 29,347     | \$ 5,764  | \$ 6,172   |
| Non-performing         | 92                      | 167        | 438                        | 512        | 580                   | 76            | 6         | 36         |
| Total                  | \$ 30,017               | \$ 30,935  | \$ 48,331                  | \$ 48,060  | \$ 29,161 (1)         | \$ 29,423 (2) | \$ 5,770  | \$ 6,208   |

(1) Net of unearned lease revenue of \$0.4 million. (2) Net of unearned revenue of \$0.3 million.

Mortgage lending credit exposure

Credit risk profile based on payment activity

| (dollars in thousands) | Residential real estate |            | Residential construction |            |
|------------------------|-------------------------|------------|--------------------------|------------|
|                        | 3/31/2016               | 12/31/2015 | 3/31/2016                | 12/31/2015 |
| Performing             | \$ 129,510              | \$ 126,156 | \$ 10,109                | \$ 10,060  |
| Non-performing         | 760                     | 836        | -                        | -          |
| Total                  | \$ 130,270              | \$ 126,992 | \$ 10,109                | \$ 10,060  |

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### Allowance for loan losses

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

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

- § identification of specific impaired loans by loan category;
- § identification of specific loans that are not impaired, but have an identified potential for loss;
- § calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- § determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;
  - § application of historical loss percentages (trailing twelve-quarter average) to pools to determine the allowance allocation;
- § application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio.
- § Qualitative factor adjustments include:
  - o levels of and trends in delinquencies and non-accrual loans;
  - o levels of and trends in charge-offs and recoveries;
  - o trends in volume and terms of loans;
  - o changes in risk selection and underwriting standards;
  - o changes in lending policies, procedures and practices;
  - o experience, ability and depth of lending management;
  - o national and local economic trends and conditions; and
  - o changes in credit concentrations.

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

in the underlying assumptions used in the methodologies.

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

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

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

As of and for the three months ended March 31, 2016

| (dollars in thousands)                                   | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer       | Residential<br>real estate | Unallocated | Total      |
|--|-------------------------------|---------------------------|----------------|----------------------------|-------------|------------|
| Allowance for Loan Losses:                               |                               |                           |                |                            |             |            |
| Beginning balance  | \$ 1,336                      | \$ 5,014                  | \$ 1,533       | \$ 1,407                   | \$ 237      | \$ 9,527   |
| Charge-offs  | (14)                          | (85)                      | (175)          | (60)                       | -           | (334)      |
| Recoveries   | 9                             | 4                         | 28             | -                          | -           | 41         |
| Provision  | 309                           | (350)                     | 292            | 32                         | (133)       | 150        |
| Ending balance   | \$ 1,640                      | \$ 4,583                  | \$ 1,678       | \$ 1,379                   | \$ 104      | \$ 9,384   |
| Ending balance: individually<br>evaluated for impairment | \$ 614                        | \$ 2,027                  | \$ 205         | \$ 38                      | \$ -        | \$ 2,884   |
| Ending balance: collectively<br>evaluated for impairment | \$ 1,026                      | \$ 2,556                  | \$ 1,473       | \$ 1,341                   | \$ 104      | \$ 6,500   |
| Loans Receivables:                                       |                               |                           |                |                            |             |            |
| Ending balance (2)                                       | \$ 103,703                    | \$ 198,730                | \$ 113,279 (1) | \$ 140,379                 | \$ -        | \$ 556,091 |
| Ending balance: individually<br>evaluated for impairment | \$ 868                        | \$ 10,971                 | \$ 1,209       | \$ 760                     | \$ -        | \$ 13,808  |
| Ending balance: collectively<br>evaluated for impairment | \$ 102,835                    | \$ 187,759                | \$ 112,070     | \$ 139,619                 | \$ -        | \$ 542,283 |

(1) Net of unearned lease revenue of \$0.4 million. (2) Includes \$1.5 million of net deferred loan costs.

As of and for the three months ended March 31, 2015

| (dollars in thousands)     | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer | Residential<br>real estate | Unallocated | Total    |
|----------------------------|-------------------------------|---------------------------|----------|----------------------------|-------------|----------|
| Allowance for Loan Losses: |                               |                           |          |                            |             |          |
| Beginning balance          | \$ 1,052                      | \$ 4,672                  | \$ 1,519 | \$ 1,316                   | \$ 614      | \$ 9,173 |
| Charge-offs                | (24)                          | (67)                      | (92)     | -                          | -           | (183)    |
| Recoveries                 | 9                             | 7                         | 24       | 28                         | -           | 68       |
| Provision                  | 177                           | (97)                      | 62       | (1)                        | 9           | 150      |
| Ending balance             | \$ 1,214                      | \$ 4,515                  | \$ 1,513 | \$ 1,343                   | \$ 623      | \$ 9,208 |

As of and for the year ended  
December 31, 2015

| (dollars in thousands)                                   | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer       | Residential<br>real estate | Unallocated | Total      |
|--|-------------------------------|---------------------------|----------------|----------------------------|-------------|------------|
| Allowance for Loan Losses:                               |                               |                           |                |                            |             |            |
| Beginning balance  | \$ 1,052                      | \$ 4,672                  | \$ 1,519       | \$ 1,316                   | \$ 614      | \$ 9,173   |
| Charge-offs  | (25)                          | (432)                     | (437)          | (15)                       | -           | (909)      |
| Recoveries   | 47                            | 18                        | 95             | 28                         | -           | 188        |
| Provision  | 262                           | 756                       | 356            | 78                         | (377)       | 1,075      |
| Ending balance   | \$ 1,336                      | \$ 5,014                  | \$ 1,533       | \$ 1,407                   | \$ 237      | \$ 9,527   |
| Ending balance: individually<br>evaluated for impairment | \$ 331                        | \$ 1,574                  | \$ 9           | \$ 95                      | \$ -        | \$ 2,009   |
| Ending balance: collectively<br>evaluated for impairment | \$ 1,005                      | \$ 3,440                  | \$ 1,524       | \$ 1,312                   | \$ 237      | \$ 7,518   |
| Loans Receivables:                                       |                               |                           |                |                            |             |            |
| Ending balance (2)                                       | \$ 102,653                    | \$ 201,878                | \$ 114,626 (1) | \$ 137,052                 | \$ -        | \$ 556,209 |
| Ending balance: individually<br>evaluated for impairment | \$ 555                        | \$ 10,492                 | \$ 730         | \$ 836                     | \$ -        | \$ 12,613  |
| Ending balance: collectively<br>evaluated for impairment | \$ 102,098                    | \$ 191,386                | \$ 113,896     | \$ 136,216                 | \$ -        | \$ 543,596 |

(1) Net of unearned lease revenue of \$0.3 million. (2) Includes \$1.5 million of net deferred loan costs.

## 6. Earnings per share

Basic earnings per share (EPS) is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but also reflects the potential dilution that could occur from the grant of stock-based compensation awards. The Company maintains two active



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share-based compensation plans that may generate additional potentially dilutive common shares. For granted and unexercised stock options and stock-settled stock appreciation rights (SSARs), dilution would occur if Company-issued stock options or SSARs were exercised and converted into common stock. As of the three months ended March 31, 2016 and 2015, there were 1,638 and 2,545 potentially dilutive shares related to issued and unexercised stock options. There were no potentially dilutive shares related to issued and unexercised SSARs. For restricted stock, dilution would occur from the Company's previously granted but unvested shares. There were 4,983, and 3,887 potentially dilutive shares related to unvested restricted share grants as of the three months ended March 31, 2016 and 2015, respectively.

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options and SSARs and unvested restricted stock. Under the treasury stock method, the assumed proceeds, as defined, received from shares issued in a hypothetical stock option exercise or restricted stock grant, are assumed to be used to purchase treasury stock. Proceeds include: amounts received from the exercise of outstanding stock options; compensation cost for future service that the Company has not yet recognized in earnings; and any windfall tax benefits that would be credited directly to shareholders' equity when the grant generates a tax deduction (or a reduction in proceeds if there is a charge to equity). The Company does not consider awards from share-based grants in the computation of basic EPS.

The following table illustrates the data used in computing basic and diluted EPS for the periods indicated:

|   | Three months ended March<br>31, |           |
|---|---------------------------------|-----------|
|   | 2016                            | 2015      |
| (dollars in thousands except per share data)                        |                                 |           |
| Basic EPS:  |                                 |           |
| Net income available to common shareholders                         | \$ 1,701                        | \$ 1,573  |
| Weighted-average common shares outstanding                          | 2,450,771                       | 2,435,884 |
| Basic EPS   | \$ 0.69                         | \$ 0.65   |
| Diluted EPS:  |                                 |           |
| Net income available to common shareholders                         | \$ 1,701                        | \$ 1,573  |
| Weighted-average common shares outstanding                          | 2,450,771                       | 2,435,884 |
| Potentially dilutive common shares                                  | 6,621                           | 6,432     |
| Weighted-average common and potentially dilutive shares outstanding | 2,457,392                       | 2,442,316 |
| Diluted EPS   | \$ 0.69                         | \$ 0.64   |

## 7. Stock plans

The Company has two stock-based compensation plans (the stock compensation plans) from which it can grant stock-based compensation awards, and applies the fair value method of accounting for stock-based compensation provided under current accounting guidance. The guidelines require the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. The Company's stock compensation plans were shareholder-approved and permit the grant of share-based compensation awards to its employees and directors. The Company believes that the stock-based compensation plans will advance the

development, growth and financial condition of the Company by providing incentives through participation in the appreciation in the value of the Company's common stock. In return, the Company hopes to secure, retain and motivate the employees and directors who are responsible for the operation and the management of the affairs of the Company by aligning the interest of its employees and directors with the interest of its shareholders. In the stock compensation plans, employees and directors are eligible to be awarded stock-based compensation grants which can consist of stock options (qualified and non-qualified), stock appreciation rights (SARs) and restricted stock.

At the 2012 annual shareholders' meeting, the Company's shareholders approved and the Company adopted the 2012 Omnibus Stock Incentive Plan and the 2012 Director Stock Incentive Plan (collectively, the 2012 stock incentive plans). The 2012 stock incentive plans replaced both the expired 2000 Independent Directors Stock Option Plan and the 2000 Stock Incentive Plan (collectively, the 2000 stock incentive plans). Unless terminated by the Company's board of directors, the 2012 stock incentive plans will expire on, and no stock-based awards shall be granted after the year 2022.

In each of the 2012 stock incentive plans, the Company has reserved 500,000 shares of its no-par common stock for future issuance. The Company recognizes share-based compensation expense over the requisite service or vesting period. During 2015, the Company created a Long-Term Incentive Plan (LTIP) that awards restricted stock and stock-settled stock appreciation rights (SSARs) to senior officers based on the attainment of performance goals. The service requirement is the participant's continued employment throughout the LTIP with a three-year vesting period. The restricted stock has a two-year post vesting holding requirement. The SSAR awards have a ten year term from the date of each grant. The Company granted restricted stock and SSARs in February 2016 based on 2015 performance.

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The following table summarizes the weighted-average fair value and vesting of restricted stock grants awarded during the periods ended March 31, 2016 and 2015 under the 2012 stock incentive plans:

|               | March 31, 2016 |  |  | March 31, 2015 |  |  |
|---------------|----------------|--|--|----------------|--|--|
|               | Shares         | Weighted-<br>average<br>grant date<br>fair value |  | Shares         | Weighted-<br>average<br>grant date<br>fair value |  |
|               | granted        |  |  | granted        |  |  |
| Director plan | 5,600          | (1) \$ 32.40                                     |  | 3,200          | (1) \$ 32.25                                     |  |
| Omnibus plan  | 3,155          | (3) 29.22  |  | 3,300          | (2) 32.25  |  |
| Omnibus plan  | 50             | (1) 31.50  |  | 50             | (1) 32.50  |  |
| Total         | 8,805          | \$ 31.26   |  | 6,550          | \$ 32.25   |  |

(1) Vest after 1 year (2) Vest after 4 years – 25% each year (3) Vest after 3 years – 33% each year

The fair value of the 3,155 shares granted on February 2, 2016 was calculated using the grant date stock price with a discount valuation. The Chaffe model was used to calculate the discount. Since the shares vest over three years and then have a further two-year holding period, the historical volatility of the five years prior to the issue date was used to estimate volatility. The five year treasury yield was used as the interest rate. The Company does pay a dividend, but since the shareholder will receive the dividends during vesting and the post-vest restriction period, no dividend yield was used in the calculation as not to inflate the discount. The grant date stock price was \$32.40 and the discount was calculated using an interest rate of 1.276% and a 5 year historical volatility of 9.809%.

A summary of the status of the Company's non-vested restricted stock as of and changes during the period indicated are presented in the following table:

|   | 2012 Stock incentive plans |         |         |   |
|---|----------------------------|---------|---------|---|
|   | Director                   | Omnibus | Total   | Weighted- average grant date fair value |
| Non-vested balance at December 31, 2015 | 3,200                      | 8,840   | 12,040  | \$ 29.50                                |
| Granted                                 | 5,600                      | 3,205   | 8,805   | 31.26                                   |
| Vested                                  | (3,200)                    | (2,655) | (5,855) | 29.42                                   |
| Non-vested balance at March 31, 2016    | 5,600                      | 9,390   | 14,990  | \$ 30.56                                |

The Company granted SSARs under the Omnibus Plan in February 2016. The Company estimated the fair value of SSARs using the Black-Scholes-Merton valuation model on the grant date. The Company used the following assumptions: the risk-free interest rate is the rate equivalent to the expected term of the option interpolated from the U.S. Treasury Yield Curve on the valuation date and historical volatility is calculated by taking the standard deviation of historical returns using weekly and monthly data. The fair value of these SSARs was \$5.21 per share, based on a risk-free interest rate of 1.861%, a dividend yield of 3.577% and a volatility of 23.402% using an expected term of ten

years.

A summary of the status of the Company's SSARs as of and changes during the period indicated are presented in the following table:

|                               | Awards | Weighted-average grant date fair value | Weighted-average remaining contractual term (years) |
|-------------------------------|--------|--|---|
| Outstanding December 31, 2015 | -      | -                                      | -   |
| Granted                       | 19,341 | \$ 5.21                                | 10.0  |
| Exercised                     | -      | -                                      |   |
| Forfeited                     | -      | -                                      |   |
| Outstanding March 31, 2016    | 19,341 | \$ 5.21                                | 9.8   |

None of the SSARs were exercisable at March 31, 2016. SSARs vest over a three year period – 33% per year.

Share-based compensation expense is included as a component of salaries and employee benefits in the consolidated statements of income. The following tables illustrate stock-based compensation expense recognized on non-vested equity awards during the three

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months ended March 31, 2016 and 2015 and the unrecognized stock-based compensation expense as of March 31, 2016:

| (dollars in thousands)                 | Three months<br>ended March<br>31, |       |
|--|------------------------------------|-------|
|  | 2016                               | 2015  |
| Stock-based compensation expense:      |                                    |       |
| Director stock incentive plan          | \$ 39                              | \$ 28 |
| Omnibus stock incentive plan           | 31                                 | 15    |
| Total stock-based compensation expense | \$ 70                              | \$ 43 |

| (dollars in thousands)                              | As of<br>March<br>31,<br>2016 |
|---|-------------------------------|
| Unrecognized stock-based compensation expense:      |                               |
| Director plan                                       | \$ 151                        |
| Omnibus plan  | 345                           |
| Total unrecognized stock-based compensation expense | \$ 496                        |

The unrecognized stock-based compensation expense as of March 31, 2016 will be recognized ratably over the periods ended January 2017 and May 2019 for the Director Plan and the Omnibus Plan, respectively.

Transactions under the Company's stock option plan for the three months ended March 31, 2016 are presented in the following table:

|   | Options | Weighted-average exercise<br>price | Weighted-average remaining<br>contractual term (years) |
|---|---------|------------------------------------|--|
| Outstanding and exercisable,<br>December 31, 2015 | 15,500  | 28.64                              | 2.0  |
| Granted   | -       | -                                  |  |
| Exercised   | (500)   | 27.75                              |  |
| Forfeited   | -       | -                                  |  |
| Outstanding and exercisable,<br>March 31, 2016    | 15,000  | \$ 28.67                           | 1.7  |

During the first quarter of 2016, there were 500 stock options exercised at a price of \$27.75 per share. The intrinsic value of these stock options was \$2,585. The tax deduction realized from the exercise of these options was \$808. There were no stock options exercised during the first quarter of 2015.

In addition to the 2012 stock incentive plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance under the plan. The ESPP was designed to promote broad-based employee ownership of the Company's stock and to motivate employees to improve job performance and enhance the financial results of the Company. Under the ESPP, participation is voluntary whereby employees use automatic payroll withholdings to purchase the Company's capital stock at a discounted price based on the fair market value of the capital stock as measured on either the commencement or termination dates, as defined. As of March 31, 2016, 42,382 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and is required to comply with the provisions of current accounting guidance. The Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the three months ended March 31, 2016 and 2015, compensation expense related to the ESPP approximated \$15 thousand and \$44 thousand, respectively, and is included as a component of salaries and employee benefits in the consolidated statements of income.

#### 8. Fair value measurements

The accounting guidelines establish a framework for measuring and disclosing information about fair value measurements. The guidelines of fair value reporting instituted a valuation hierarchy for disclosure of the inputs used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 - inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 - inputs are quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument;

Level 3 - inputs are unobservable and are based on the Company's own assumptions to measure assets and liabilities at fair value.

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Level 3 pricing for securities may also include unobservable inputs based upon broker-traded transactions.

A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The Company uses fair value to measure certain assets and, if necessary, liabilities on a recurring basis when fair value is the primary measure for accounting. Thus, the Company uses fair value for AFS securities. Fair value is used on a non-recurring basis to measure certain assets when adjusting carrying values to market values, such as impaired loans, other real estate owned (ORE) and other repossessed assets.

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

March 31, 2016

| (dollars in thousands)             | Carrying amount | Estimated fair value | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
|------------------------------------|-----------------|----------------------|---|---|---|
| Financial assets:                  |                 |                      |   |   |   |
| Cash and cash equivalents          | \$ 41,091       | \$ 41,091            | \$ 41,091                                 | \$ -  | \$ -  |
| Available-for-sale securities      | 128,673         | 128,673              | 534                                       | 128,139                                       | -   |
| FHLB stock                         | 1,420           | 1,420                | -   | 1,420   | -   |
| Loans and leases, net              | 546,707         | 546,123              | -   | -   | 546,123   |
| Loans held-for-sale                | 1,202           | 1,224                | -   | 1,224   | -   |
| Accrued interest receivable        | 2,202           | 2,202                | -   | 2,202   | -   |
| Financial liabilities:             |                 |                      |   |   |   |
| Deposits with no stated maturities | 568,182         | 568,182              | -   | 568,182                                       | -   |
| Time deposits                      | 99,729          | 99,428               | -   | 99,428  | -   |
| Short-term borrowings              | 12,765          | 12,765               | -   | 12,765  | -   |
| Accrued interest payable           | 210             | 210                  | -   | 210   | -   |

December 31, 2015

| (dollars in thousands) | Carrying amount | Estimated fair value | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
|------------------------|-----------------|----------------------|---|---|---|
|------------------------|-----------------|----------------------|---|---|---|

Financial assets:

|                                    |           |           |           |         |         |
|------------------------------------|-----------|-----------|-----------|---------|---------|
| Cash and cash equivalents          | \$ 12,277 | \$ 12,277 | \$ 12,277 | \$ -    | \$ -    |
| Available-for-sale securities      | 125,232   | 125,232   | 546       | 124,686 | -       |
| FHLB stock                         | 2,120     | 2,120     | -         | 2,120   | -       |
| Loans and leases, net              | 546,682   | 545,523   | -         | -       | 545,523 |
| Loans held-for-sale                | 1,421     | 1,444     | -         | 1,444   | -       |
| Accrued interest receivable        | 2,210     | 2,210     | -         | 2,210   | -       |
| Financial liabilities:             |           |           |           |         |         |
| Deposits with no stated maturities | 516,473   | 516,473   | -         | 516,473 | -       |
| Time deposits                      | 104,202   | 103,403   | -         | 103,403 | -       |
| Short-term borrowings              | 28,204    | 28,204    | -         | 28,204  | -       |
| Accrued interest payable           | 189       | 189       | -         | 189     | -       |

The carrying value of short-term financial instruments, as listed below, approximates their fair value. These instruments generally have limited credit exposure, no stated or short-term maturities, carry interest rates that approximate market and generally are recorded at amounts that are payable on demand :

- Cash and cash equivalents;
- Non-interest bearing deposit accounts;



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- Savings, interest-bearing checking and money market accounts and
- Short-term borrowings.

Securities: Fair values on investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions.

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

Loans held-for-sale: The fair value of loans held-for-sale is estimated using rates currently offered for similar loans and is typically obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank of Pittsburgh (FHLB).

Certificates of deposit: The fair value of certificates of deposit is based on discounted cash flows using rates which approximate market rates for deposits of similar maturities.

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

|  | Total<br>carrying<br>value<br>March 31,<br>2016 | Quoted<br>prices<br>in active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|--|---|--|---|---|
| (dollars in thousands)                           |   |  |   |   |
| Available-for-sale securities:                   |   |  |   |   |
| Agency - GSE                                     | \$ 18,528                                       | \$ -   | \$ 18,528   | \$ -  |
| Obligations of states and political subdivisions | 37,609  | -  | 37,609  | -   |
| MBS - GSE residential                            | 72,002  | -  | 72,002  | -   |
| Equity securities - financial services           | 534   | 534  | -   | -   |
| Total available-for-sale securities              | \$ 128,673                                      | \$ 534   | \$ 128,139  | \$ -  |

|  | Quoted<br>prices<br>in active | Significant<br>other | Significant<br>other |
|--|-------------------------------|----------------------|----------------------|
|--|-------------------------------|----------------------|----------------------|

| (dollars in thousands)                           | Total<br>carrying<br>value<br>December<br>31, 2015 | markets<br>(Level<br>1) | observable<br>inputs<br>(Level 2) | unobservable<br>inputs<br>(Level 3) |
|--|--|-------------------------|-----------------------------------|-------------------------------------|
| Available-for-sale securities:                   |  |                         |                                   |                                     |
| Agency - GSE                                     | \$ 18,386  | \$ -                    | \$ 18,386                         | \$ -                                |
| Obligations of states and political subdivisions | 36,885   | -                       | 36,885                            | -                                   |
| MBS - GSE residential                            | 69,415   | -                       | 69,415                            | -                                   |
| Equity securities - financial services           | 546  | 546                     | -                                 | -                                   |
| Total available-for-sale securities              | \$ 125,232   | \$ 546                  | \$ 124,686                        | \$ -                                |

Equity securities in the AFS portfolio are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Debt securities in the AFS portfolio are measured at fair value using market quotations provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Assets classified as Level 2 use valuation techniques that are common to bond valuations. That is, in active markets whereby bonds of similar characteristics frequently trade, quotes for similar assets are obtained. For the periods ending March 31, 2016 and December 31, 2015, there were no transfers to or from Level 1 and Level 2 fair value measurements for financial assets measured on a recurring basis.

There were no changes in Level 3 financial instruments measured at fair value on a recurring basis as of and for the periods ending March 31, 2016 and December 31, 2015, respectively.

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

|                         | Total    | Quoted    | Significant | Significant  |
|-------------------------|----------|-----------|-------------|--------------|
|                         | carrying | prices in | other       | other        |
|                         | value    | active    | observable  | unobservable |
|                         | at March | markets   | inputs      | inputs       |
| (dollars in thousands)  | 31, 2016 | (Level    | (Level 2)   | (Level 3)    |
|                         |          | 1)        |             |              |
| Impaired loans          | \$ 8,560 | \$ -      | \$ -        | \$ 8,560     |
| Other real estate owned | 1,243    | -         | -           | 1,243        |
| Total                   | \$ 9,803 | \$ -      | \$ -        | \$ 9,803     |

|                         | Total    | Quoted    | Significant | Significant  |
|-------------------------|----------|-----------|-------------|--------------|
|                         | carrying | prices in | other       | other        |
|                         | value    | active    | observable  | unobservable |
|                         | at       | markets   | inputs      | inputs       |
| (dollars in thousands)  | December | (Level    | (Level 2)   | (Level 3)    |
|                         | 31, 2015 | 1)        |             |              |
| Impaired loans          | \$ 7,132 | \$ -      | \$ -        | \$ 7,132     |
| Other real estate owned | 903      | -         | -           | 903          |
| Total                   | \$ 8,035 | \$ -      | \$ -        | \$ 8,035     |

From time-to-time, the Company may be required to record at fair value financial instruments on a non-recurring basis, such as impaired loans, ORE and other repossessed assets. These non-recurring fair value adjustments involve the application of lower-of-cost-or-market accounting on write downs of individual assets.

The following describes valuation methodologies used for financial instruments measured at fair value on a non-recurring basis.

Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves, a component of the allowance for loan losses, and as such are carried at the lower of net recorded investment or the estimated fair value.

Estimates of fair value of the collateral are determined based on a variety of information, including available valuations from certified appraisers for similar assets, present value of discounted cash flows and inputs that are estimated based on commonly used and generally accepted industry liquidation advance rates and estimates and assumptions developed by management.

Valuation techniques for impaired loans are typically determined through independent appraisals of the underlying collateral or may be determined through present value of discounted cash flows. Both techniques include various Level 3 inputs which are not identifiable. The valuation technique may be adjusted by management for estimated liquidation expenses and qualitative factors such as economic conditions. If real estate is not the primary source of repayment, present value of discounted cash flows and estimates using generally accepted industry liquidation advance rates and other factors may be utilized to determine fair value.

At March 31, 2016 and December 31, 2015, the range of liquidation expenses and other valuation adjustments applied to impaired loans ranged from -23.55% to -94.00% and from -4.92% to -50.00% respectively. The weighted-average of liquidation expenses and other valuation adjustments applied to impaired loans amounted to -32.99% and -27.84% as of March 31, 2016 and December 31, 2015, respectively. Due to the multitude of assumptions, many of which are subjective in nature, and the varying inputs and techniques used to determine fair value, the Company recognizes that valuations could differ across a wide spectrum of techniques employed. Accordingly, fair value estimates for impaired loans are classified as Level 3.

For ORE, fair value is generally determined through independent appraisals of the underlying properties which generally include various Level 3 inputs which are not identifiable. Appraisals form the basis for determining the net realizable value from these properties. Net realizable value is the result of the appraised value less certain costs or discounts associated with liquidation which occurs in the normal course of business. Management's assumptions may include consideration of the location and occupancy of the property, along with current economic conditions. Subsequently, as these properties are actively marketed, the estimated fair values may be periodically adjusted through incremental subsequent write-downs. These write-downs usually reflect decreases in estimated values resulting from sales price observations as well as changing economic and market conditions. At March 31, 2016 and December 31, 2015, the discounts applied to the appraised values of ORE ranged from -15.90% to -99.00% for both periods. As of March 31, 2016 and December 31, 2015, the weighted-average of discount to the appraisal values of ORE amounted to -37.34% and -37.64%, respectively.

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

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of March 31, 2016 compared to December 31, 2015 and a comparison of the results of operations for the three months

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ended March 31, 2016 and 2015. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2015 Annual Report filed on Form 10-K.

Forward-looking statements

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

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

- § the effects of economic conditions on current customers, specifically the effect of the economy on loan customers' ability to repay loans;
- § the costs and effects of litigation and of unexpected or adverse outcomes in such litigation;
- § the impact of new or changes in existing 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 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;
- § the interruption or breach in security of our information systems and other technological risks and attacks resulting in failures or disruptions in customer account management, general ledger processing and loan or deposit updates and potential impacts resulting therefrom including additional costs, reputational damage, regulatory penalties, and financial losses;
- § 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;
- § disruption of credit and equity markets; and
- § the risk that our analyses of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful.

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

events or circumstances after the date of this document.

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

#### Executive Summary

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

As a leading Northeastern Pennsylvania community bank, our goals are to enhance shareholder value while continuing to build a full-service community bank. We focus on growing our core business of retail and business lending and deposit gathering while maintaining strong asset quality and controlling operating expenses. We continue to implement strategies to diversify earning assets and to increase low cost core deposits. These strategies include a greater level of commercial lending and the ancillary business products and services supporting our commercial customers' needs as well as residential lending strategies and an array of consumer

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products. We focus on developing a full banking relationship with existing, as well as new, small- and middle-sized business prospects. In addition, we explore opportunities to selectively expand our franchise footprint, consisting presently of our 10-branch network. During the first quarter of 2016, the Company closed the Eynon branch and took advantage of an opportunity to realize an improved cost structure with minimal disruption to customers. The cost savings will be reallocated to help expand our branch network.

We are impacted by both national and regional economic factors, with commercial, commercial real estate and residential mortgage loans concentrated in Northeastern Pennsylvania, primarily in Lackawanna and Luzerne counties. Although the U.S. economy has shown signs of modest improvement, the general operating environment and our local market area continue to remain challenging. For the near-term, we expect to continue to operate in a low, but slowly-rising interest rate environment. A rising rate environment positions the Company to improve its net interest income performance, but will continue to pressure the interest-rate yield and margin. The Federal Open Market Committee (FOMC) adjusted the short-term federal funds rate up 25 basis points during December 2015. The move represented the first hike in rates by the FOMC in nearly a decade and expectations are for short-term rates to rise gradually throughout 2016, potentially pressuring deposit rate pricing. The treasury yield curve is expected to undergo a bearish flattening over the forecast horizon. The national unemployment rate for March 2016 was 5.0%, unchanged from December 2015. In our region (Scranton, Wilkes-Barre Metropolitan Statistical Area), the unemployment rate increased to 6.4% at March 31, 2016 from 4.7% as of December 31, 2015. The spike in unemployment was due to an increase in the amount of people in the labor force during 2016 while the number of jobs decreased. The fact that more people are entering the labor force is a positive sign for the local economy. Pressure on employment during the first three months of the year is not unusual, as retail and activities such as construction slow down. Year-over-year the unemployment rate decreased with both the labor force and the number of jobs increasing. The median home values in the region fell 1.3% from a year ago, and according to Zillow, an online database advertising firm providing access to its real estate search engines to various media outlets, values are expected to rise 1.3% within the next year. In light of these expectations, we will continue to monitor the economic climate in our region and scrutinize growth prospects with credit quality as a principal consideration.

In addition to the challenging economic environment in which we compete, the regulation and oversight of our business has changed significantly in recent years. As described more fully in Part I, Item 1A, "Risk Factors," and in the "Supervisory and Regulation" section of management's discussion and analysis of financial condition and results of operations in our 2015 Annual Report filed on Form 10-K, certain aspects of the Dodd-Frank Wall Street Reform Act (Dodd-Frank Act) continue to have a significant impact on us. In addition, final rules to implement Basel III regulatory capital reform, approved by the federal bank regulatory agencies in 2013, subject many banks including the Company, to capital requirements which will be phased in. The initial provisions effective for us began on January 1, 2015. The rules also revise the minimum risk-based and leverage capital ratio requirements applicable to the Company and revise the calculation of risk-weighted assets to enhance their risk sensitivity. We will continue to prepare for the impacts that the Dodd-Frank Act and the Basel III capital standards, and related rulemaking will have on our business, financial condition and results of operations.

## General

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

and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in the marketplace.

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

### Comparison of the results of operations

Three months ended March 31, 2016 and 2015

#### Overview

Net income increased \$0.1 million, or 8%, for the first quarter of 2016 to \$1.7 million, or \$0.69 per diluted share, compared to \$1.6 million, or \$0.64 per diluted share, for the same 2015 quarter. During the first quarter of 2016, the Company produced \$0.5



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million higher net interest income compared to the first quarter of 2015. The increase in net interest income offset \$0.3 million more in non-interest expenses and \$0.1 million lower non-interest income during the 2016 period.

Return on average assets (ROA) was 0.92% and 0.91% for the first quarters of 2016 and 2015, respectively. Return on average shareholders' equity (ROE) was 8.83% and 8.74% for the three months ended March 31, 2016 and 2015, respectively. ROA and ROE increased in both periods because of the increase in net income.

Net interest income and interest sensitive assets / liabilities

Net interest income increased \$0.5 million, or 9%, from \$5.6 million for the three months ended March 31, 2015 to \$6.1 million for the three months ended March 31, 2016, with higher interest income and lower interest expense combining for the net increase. Total average interest-earning assets increased \$51.5 million and helped offset the negative impact of a four basis point net reduction in their yields resulting in \$0.4 million of growth in interest income. Most of the increase was due to the loan portfolio, which experienced average balance growth of \$41.2 million, which had the effect of producing \$0.4 million of interest income, more than offsetting the negative impact of an 8 basis point lower yield earned thereon. Both the commercial and residential portfolios contributed to this increase in interest income. Although higher average balances of higher-yielding mortgage-backed securities produced \$0.1 million in additional interest income from investments, this growth was partially offset by the special dividend from the FHLB which boosted investment income in the first quarter of 2015. On the liability side, total interest-bearing liabilities grew \$30.4 million on average but a twelve basis point decline in the average rates paid offset the impact of this growth. The reduction in average rate paid is due to the \$10 million payoff of long-term debt carrying an interest rate of 5.26% during the second quarter of 2015 which reduced interest expense from borrowings in 2016 by \$0.1 million. Interest expense from deposits was largely unchanged from the first quarter of 2015.

The fully-taxable equivalent (FTE) net interest rate spread and margin increased by eight and six basis points, respectively for the three months ended March 31, 2016 compared to the three months ended March 31, 2015. The increase in spread was due to a twelve basis point reduction in rates paid on interest-bearing liabilities due to the payoff of long-term debt during 2015 which was able to offset the lower yield on interest-earning assets. The improvement in margin was due to higher net interest income. The overall cost of funds, which includes the impact of non-interest bearing deposits, declined nine basis points for the quarter ended March 31, 2016 compared to the same period in 2015. The reason for the decrease was the payoff of long-term debt.

During 2016, the Company expects to operate in a volatile yet overall gradually increasing interest rate environment. A rate environment with rising long-term interest rates positions the Company to improve its interest income performance from new and maturing long-term earning assets. Until there is a sustained period of yield curve steepening, with rates rising more sharply at the long end, the interest rate margin may continue to experience compression. However for the remainder of 2016, the Company anticipates net interest income to improve as growth in interest-earning assets would help mitigate an adverse impact of rate movements. The Federal Open Market Committee (FOMC) adjusted the short-term federal funds rate upward in December 2015, but it had a minimal effect on rates paid on funding sources. Continued growth in the loan portfolios complemented with investment security growth is the Company's strategy for 2016, and when coupled with a proactive approach to deposit cost setting strategies should help grow net interest income and contain the interest rate margin at acceptable levels.

The Company's cost of interest-bearing liabilities was 46 basis points for the quarter ended March 31, 2016 or twelve basis points lower than the cost for the same 2015 quarter. The decline in the rate paid on borrowings was the reason for the reduction. Other than retaining maturing long-term CDs, further reductions in deposit rates from the current historic low levels would have an insignificant cost-savings impact. Interest rates along the treasury yield curve have been volatile with stability existing only at the short end. Competition could pressure banks to increase deposit rates. On the asset side, the prime interest rate, the benchmark rate that banks use as a base rate for adjustable rate

loans, began to rise at the end of 2015. Rates were not increased during the first quarter of 2016 but if rates rise later in the year, the effect could pressure net interest income if short-term rates rise more rapidly than longer-term interest rates, thereby compressing the interest rate spread. To help mitigate the impact of the imminent change to the economic landscape, the Company has successfully developed and will continue to strengthen its association with existing customers, develop new business relationships, generate new loan volumes, and retain and generate higher levels of average non-interest bearing deposit balances. Strategically deploying no- and low-cost deposits into interest earning-assets is an effective margin-preserving strategy that the Company expects to continue to pursue and expand to help stabilize net interest margin.

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

The 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 periods indicated. Within the table, interest income was adjusted to a tax-equivalent basis (FTE), using the corporate federal tax rate of 34% to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. This treatment allows a uniform comparison among yields on interest-earning assets. Loans include loans HFS and non-accrual loans but exclude the allowance for loan losses. Net deferred loan cost amortization of \$112 thousand and \$93 thousand for the first quarters of 2016 and 2015, respectively, are included in interest income from loans. The one-time FHLB special dividend of \$57 thousand awarded in the first quarter of 2015 was removed from the annualized yield calculation and then added back to

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interest income. Average balances are based on amortized cost and do not reflect net unrealized gains or losses. Net interest margin is calculated by dividing annualized net interest income - FTE by total average interest-earning assets. Cost of funds includes the effect of average non-interest bearing deposits as a funding source:

| (dollars in thousands)                             | Three months ended |          |                 | March 31, 2015     |          |                 |
|--|--------------------|----------|-----------------|--------------------|----------|-----------------|
|  | Average<br>balance | Interest | Yield /<br>rate | Average<br>balance | Interest | Yield /<br>rate |
| Assets   |                    |          |                 |                    |          |                 |
| Interest-earning assets                            |                    |          |                 |                    |          |                 |
| Interest-bearing deposits                          | \$ 16,740          | \$ 22    | 0.53 %          | \$ 24,679          | \$ 16    | 0.25 %          |
| Investments:                                       |                    |          |                 |                    |          |                 |
| Agency - GSE                                       | 18,450             | 53       | 1.15            | 15,746             | 50       | 1.29            |
| MBS - GSE residential                              | 68,661             | 317      | 1.86            | 53,135             | 210      | 1.60            |
| State and municipal (nontaxable)                   | 34,979             | 496      | 5.70            | 34,691             | 495      | 5.78            |
| Other  | 1,707              | 23       | 5.46            | 1,613              | 79       | 5.46            |
| Total investments                                  | 123,797            | 889      | 2.89            | 105,185            | 834      | 3.00            |
| Loans and leases:                                  |                    |          |                 |                    |          |                 |
| Commercial and commercial real estate (taxable)    | 278,003            | 3,068    | 4.44            | 256,705            | 2,861    | 4.52            |
| Commercial and commercial real estate (nontaxable) | 27,200             | 290      | 4.28            | 18,377             | 211      | 4.65            |
| Consumer   | 65,603             | 911      | 5.58            | 66,897             | 911      | 5.52            |
| Residential real estate                            | 186,905            | 1,836    | 3.95            | 174,513            | 1,727    | 4.01            |
| Total loans and leases                             | 557,711            | 6,105    | 4.40            | 516,492            | 5,710    | 4.48            |
| Federal funds sold                                 | -                  | -        | -               | 419                | -        | 0.26            |
| Total interest-earning assets                      | 698,248            | 7,016    | 4.04 %          | 646,775            | 6,560    | 4.08 %          |
| Non-interest earning assets                        | 48,581             |          |                 | 51,980             |          |                 |
| Total assets                                       | \$ 746,829         |          |                 | \$ 698,755         |          |                 |
| Liabilities and shareholders' equity               |                    |          |                 |                    |          |                 |
| Interest-bearing liabilities                       |                    |          |                 |                    |          |                 |
| Deposits:  |                    |          |                 |                    |          |                 |
| Savings  | \$ 115,864         | \$ 36    | 0.13 %          | \$ 110,291         | \$ 50    | 0.18 %          |
| Interest-bearing checking                          | 154,628            | 102      | 0.26            | 128,575            | 73       | 0.23            |
| MMDA   | 127,635            | 217      | 0.68            | 119,332            | 193      | 0.66            |
| CDs < \$100,000                                    | 52,788             | 100      | 0.76            | 61,319             | 125      | 0.83            |
| CDs > \$100,000                                    | 50,611             | 124      | 0.99            | 42,862             | 115      | 1.09            |
| Clubs  | 1,392              | 1        | 0.16            | 1,470              | 1        | 0.17            |
| Total interest-bearing deposits                    | 502,918            | 580      | 0.46            | 463,849            | 557      | 0.49            |
| Repurchase agreements                              | 14,710             | 8        | 0.22            | 15,793             | 8        | 0.20            |
| Borrowed funds                                     | 2,434              | 10       | 1.55            | 10,001             | 132      | 5.35            |
| Total interest-bearing liabilities                 | 520,062            | 598      | 0.46 %          | 489,643            | 697      | 0.58 %          |
| Non-interest bearing deposits                      | 144,890            |          |                 | 132,327            |          |                 |
| Non-interest bearing liabilities                   | 4,396              |          |                 | 3,811              |          |                 |
| Total liabilities                                  | 669,348            |          |                 | 625,781            |          |                 |

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|  |            |          |            |
|--|------------|----------|------------|
| Shareholders' equity                       | 77,481     |          | 72,974     |
| Total liabilities and shareholders' equity | \$ 746,829 |          | \$ 698,755 |
| Net interest income - FTE                  |            | \$ 6,418 | \$ 5,863   |
| Net interest spread                        |            | 3.58 %   | 3.50 %     |
| Net interest margin                        |            | 3.70 %   | 3.64 %     |
| Cost of funds                              |            | 0.36 %   | 0.45 %     |

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

| (dollars in thousands)                         | Three months ended March 31, |         |        |                       |          |        |
|--|------------------------------|---------|--------|-----------------------|----------|--------|
|  | 2016 compared to 2015        |         |        | 2015 compared to 2014 |          |        |
|  | Increase (decrease) due to   |         |        |                       |          |        |
|  | Volume                       | Rate    | Total  | Volume                | Rate     | Total  |
| Interest income:                               |                              |         |        |                       |          |        |
| Interest-bearing deposits                      | \$ (6)                       | \$ 12   | \$ 6   | \$ 8                  | \$ -     | \$ 8   |
| Investments:                                   |                              |         |        |                       |          |        |
| Agency - GSE                                   | 8                            | (5)     | 3      | -                     | (4)      | (4)    |
| MBS - GSE residential                          | 69                           | 38      | 107    | 16                    | 3        | 19     |
| State and municipal                            | 4                            | -       | 4      | 12                    | (20)     | (8)    |
| Other  | 5                            | (61)    | (56)   | (11)                  | 66       | 55     |
| Total investments                              | 86                           | (28)    | 58     | 17                    | 45       | 62     |
| Loans and leases:                              |                              |         |        |                       |          |        |
| Residential real estate                        | 133                          | (24)    | 109    | 186                   | (54)     | 132    |
| Commercial and CRE                             | 342                          | (83)    | 259    | 138                   | (103)    | 35     |
| Consumer                                       | (13)                         | 13      | -      | 64                    | (1)      | 63     |
| Total loans and leases                         | 462                          | (94)    | 368    | 388                   | (158)    | 230    |
| Federal funds sold                             | -                            | -       | -      | -                     | -        | -      |
| Total interest income                          | 542                          | (110)   | 432    | 413                   | (113)    | 300    |
| Interest expense:                              |                              |         |        |                       |          |        |
| Deposits:                                      |                              |         |        |                       |          |        |
| Savings  | 2                            | (16)    | (14)   | -                     | (5)      | (5)    |
| Interest-bearing checking                      | 17                           | 12      | 29     | 13                    | 18       | 31     |
| Money market                                   | 16                           | 8       | 24     | 50                    | 28       | 78     |
| Certificates of deposit less than \$100,000    | (16)                         | (9)     | (25)   | 6                     | (2)      | 4      |
| Certificates of deposit greater than \$100,000 | 20                           | (11)    | 9      | (21)                  | (19)     | (40)   |
| Clubs  | -                            | -       | -      | -                     | -        | -      |
| Total deposits                                 | 39                           | (16)    | 23     | 48                    | 20       | 68     |
| Repurchase agreements                          | (1)                          | 1       | -      | -                     | -        | -      |
| Borrowed funds                                 | (63)                         | (59)    | (122)  | (84)                  | 5        | (79)   |
| Total interest expense                         | (25)                         | (74)    | (99)   | (36)                  | 25       | (11)   |
| Net interest income                            | \$ 567                       | \$ (36) | \$ 531 | \$ 449                | \$ (138) | \$ 311 |

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;

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- 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.

For the quarters ending March 31, 2016 and 2015, the Company recorded a provision for loan losses of \$0.2 million each period, respectively. The provision funds our allowance for loan losses and its requirement is a function of the allowance's sufficiency to cover all loans. Within the allowance calculation, there is a rolling twelve-quarter average applied to determine the reserve affecting both qualitative factors and loss ratios. During the first quarter of 2016, a significant loss event rolled off of this historical average which offset the need for additional reserves which would have otherwise been required from an additional \$0.7 million TDR and \$4.6 million more non-accrual loans. Except for a \$0.7 million specific reserve for one large non-accrual loan, collateral securing these impaired loans was considered sufficient to cover their respective principal balances. For a discussion on the allowance for loan losses, see "Allowance for loan losses," located in the comparison of financial condition section of management's discussion and analysis contained herein.

### Other income

For the three months ended March 31, 2016, non-interest income amounted to \$1.7 million, a \$0.1 million, or 4%, decrease compared to \$1.8 million recorded for the three months ended March 31, 2015. The decrease in conforming residential lending activity resulted in \$0.1 million fewer gains on the sale of loans at March 31, 2016 compared to the same period of 2015. Trust income and financial services income also saw \$47 thousand and \$23 thousand decreases, respectively. These decreases were partially offset by a combined \$0.1 million in additional service charges on deposits and interchange fees.

### Other operating expenses

For the three months ended March 31, 2016, total other operating expenses increased \$0.3 million, or 6%, compared to the three months ended March 31, 2015. Salary and employee benefits contributed the most to the increase rising \$0.2 million, or 8%, in the first quarter of 2016 compared to the same period in 2015. The increase stems from select staff additions or replacements to previously vacant positions, including senior level and mid-level position replacements that did not occur until second quarter of 2015, annual merit increases, one-time salary increases awarded to employees in the normal course of performance management, higher recognized employee incentives and an increase in group insurance from higher claims processing. Professional services increased during the period by \$0.1 million, or 15%. The increase was due to a combination of additional legal services and additional compliance review services. Data processing and communications expense increased \$0.1 million during the three months ended March 31, 2016 compared to 2015 like period because of fees incurred from outsourcing the Company's data processing during the third quarter of 2015. Other expenses increased \$0.1 million during the first quarter of 2016 due to a credit of \$0.1 million against the shares tax due to a donation made during the first quarter of 2015. The Company does not expect to receive the same tax credit for 2016 until the end of the year. Offsetting these items, the lack of the previously mentioned donation during the first quarter of 2016 caused advertising and marketing expenses to decrease by \$0.1 million. Other real estate owned (ORE) expense also decreased \$0.1 million during the first

quarter of 2016 compared to the same period in 2015 because the Company was holding a few large properties that carried large expenses during the first quarter of 2015 that were subsequently sold. Also, there were losses on sales of ORE and write-downs in 2015 totaling \$35 thousand and none of the properties in 2016 were sold or needed to be written down.

The ratios of non-interest expense less non-interest income to average assets, known as the expense ratio, at March 31, 2016 and 2015 were 1.99% and 1.93%, respectively. The expense ratio, which excludes non-recurring expenses, increased due mostly to lower non-interest income.



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Comparison of financial condition at

March 31, 2016 and December 31, 2015

Overview

Consolidated assets increased \$34.0 million, or 5%, to \$763.4 million as of March 31, 2016 from \$729.4 million at December 31, 2015. The increase in assets was funded through growth in deposits of \$47.2 million and a \$2.0 million increase in shareholders' equity which was partially offset by the \$15.4 million decrease in short-term borrowings. The increase in the funding sources was used to fund investment security growth and pay down short-term borrowings with the balance retained in cash for future liquidity needs from seasonal depositors.

Funds Deployed:

Investment securities

At the time of purchase, management classifies investment securities into one of three categories: trading, available-for-sale (AFS) or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. Most of the securities the Company purchases are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at fair value on the consolidated balance sheets with unrealized gains and losses, net of deferred income taxes, reported separately within shareholders' equity as a component of accumulated other comprehensive income (AOCI). 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 March 31, 2016, the carrying value of investment securities amounted to \$128.7 million, or 17% of total assets, compared to \$125.2 million, or 17% of total assets, at December 31, 2015. On March 31, 2016, 56% of the carrying value of the investment portfolio was comprised of U.S. Government Sponsored Enterprise residential mortgage-backed securities (MBS – GSE residential or mortgage-backed securities) that amortize and provide monthly cash flow that the Company can use for reinvestment, loan demand, unexpected deposit outflow, facility expansion or operations.

Investment securities were comprised of AFS securities as of March 31, 2016. The AFS securities were recorded with a net unrealized gain of \$4.4 million as of March 31, 2016 compared to a net unrealized gain of \$3.3 million as of December 31, 2015, or a net improvement of \$1.1 million during 2016. The direction and magnitude of the change in value of the Company's investment portfolio is attributable to the direction and magnitude of the change in interest rates along the treasury yield curve. Generally, the values of debt securities move in the opposite direction of the changes in interest rates. As interest rates along the treasury yield curve fall, especially at the intermediate and long end, the values of debt securities tend to increase. Whether or not the value of the Company's investment portfolio will continue to exceed its amortized cost will be largely dependent on the direction and magnitude of interest rate movements and the duration of the debt securities within the Company's investment portfolio. When interest rates rise, the market values of the Company's debt securities portfolio could be subject to market value declines.

Quarterly, management performs a review of the investment portfolio to determine the causes of declines in the fair value of each security. The Company uses inputs provided by independent third parties to determine the fair value of its investment securities portfolio. Inputs provided by the third parties are reviewed and corroborated by

management. Evaluations of the causes of the unrealized losses are performed to determine whether impairment exists and whether the impairment is temporary or other-than-temporary. Considerations such as the Company's intent and ability to hold the securities to maturity, recoverability of the invested amounts over the intended holding period, the length of time and the severity in pricing decline below cost, the interest rate environment, the receipt of amounts contractually due and whether or not there is an active market for the securities, for example, are applied, along with an analysis of the financial condition of the issuer for management to make a realistic judgment of the probability that the Company will be unable to collect all amounts (principal and interest) due in determining whether a security is other-than-temporarily impaired. If a decline in value is deemed to be other-than-temporary, the amortized cost of the security is reduced by the credit impairment amount and a corresponding charge to current earnings is recognized. During the three months ended March 31, 2016 and 2015, the Company did not incur other-than-temporary impairment charges from its investment securities portfolio.

During the first three months of 2016, the carrying value of total investments increased \$3.4 million, or 3%. The Company attempts to maintain a well-diversified and proportionate investment portfolio that is structured to complement the strategic direction of the Company. Its growth typically supplements the lending activities but also considers the current and forecasted economic conditions, the Company's liquidity needs and interest rate risk profile. At the end of 2014, the Company began to restructure its investment portfolio by selling mortgage-backed securities with the longest duration and lowest coupon rates as well as intermediate term agency bonds. The proceeds were used to reduce the Company's long-term debt with the balance retained in cash that was reinvested along with available cash holdings during the first half of 2015. The Company expects to grow the portfolio and increase its relative size with a bias toward mortgage-backed securities. If rates rise, the strategy will provide a good source of cash flow to reinvest into higher yielding interest-sensitive assets.

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A comparison of investment securities at March 31, 2016 and December 31, 2015 is as follows:

| (dollars in thousands)                 | March 31, 2016 |         | December 31, 2015 |         |
|--|----------------|---------|-------------------|---------|
|  | Amount         | %       | Amount            | %       |
| MBS - GSE residential                  | \$ 72,002      | 56.0 %  | \$ 69,415         | 55.4 %  |
| State & municipal subdivisions         | 37,609         | 29.2    | 36,885            | 29.5    |
| Agency - GSE                           | 18,528         | 14.4    | 18,386            | 14.7    |
| Equity securities - financial services | 534            | 0.4     | 546               | 0.4     |
| Total                                  | \$ 128,673     | 100.0 % | \$ 125,232        | 100.0 % |

## Federal Home Loan Bank Stock

Investment in Federal Home Loan Bank (FHLB) stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB of Pittsburgh. Excess stock is repurchased from the Company at par if the amount of borrowings decline to a predetermined level. In addition, the Company earns a return or dividend based on the amount invested. The dividends received from the FHLB totaled \$14 thousand and \$74 thousand for the three months ended March 31, 2016 and 2015, respectively. The Company received a \$57 thousand one-time special dividend during the first quarter of 2015. The balance in FHLB stock was \$1.4 million and \$2.1 million as of March 31, 2016 and December 31, 2015, respectively.

## Loans held-for-sale (HFS)

Upon origination, most residential mortgages and certain Small Business Administration (SBA) guaranteed loans may be classified as held-for-sale (HFS). In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In low interest rate environments, the Company would be exposed to prepayment risk and, as rates on adjustable-rate loans decrease, interest income would be negatively affected. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as HFS. Occasionally, residential mortgage and/or other nonmortgage loans may be transferred from the loan portfolio to 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 March 31, 2016 and December 31, 2015, loans HFS consisted of residential mortgages with carrying amounts of \$1.2 million and \$1.4 million, respectively, which approximated their fair values. During the quarter ended March 31, 2016, residential mortgage loans with principal balances of \$6.5 million were sold into the secondary market and the Company recognized net gains of \$0.1 million, compared to \$10.2 million and \$0.2 million, respectively during the quarter ended March 31, 2015. A decrease in residential mortgage origination activities caused the decrease in gains from loan sales in the first quarter of 2016 compared to the same 2015 period.

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 March 31, 2016 and December 31, 2015, the servicing portfolio balance of sold residential mortgage loans was \$269.6 million and \$269.5 million, respectively.

#### Loans and leases

The Company remains proactive in the desire to maintain, develop and grow relationships. Relationship managers along with their service partners have developed and continue to sharpen their skills to provide the opportunity of being trusted financial advisors. The loan portfolio remains stable with a modest growth based upon the condition of our local economy and our desire to manage risk. The expectation for the remainder of the year continues to be controlled growth within the confines of the marketplace.

#### Commercial and industrial and commercial real estate

Compared to year-end 2015, the commercial and industrial (C&I) loan portfolio increased \$1.1 million, or 1%, from \$102.6 million to \$103.7 million and the commercial real estate (CRE) loan portfolio retracted \$3.2 million, or 2%, from \$201.9 million to \$198.7 million as of March 31, 2016. Both the modest increase and reduction in both categories were anticipated due to the payoffs of multiple credit facilities. The Company anticipates the commercial loan portfolio to increase approximately 5% by year end.

#### Consumer

The consumer loan portfolio realized a nominal reduction of \$1.3 million, or 1.1%, from a high of \$115.0 million at December 31, 2015 to \$113.7 million at March 31, 2016. The reduction is largely tied to amortization which is expected to be neutralized by volume derived from seasonal consumer loan campaigns scheduled over the remainder of 2016.

#### Residential

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The residential loan portfolio grew \$3.3 million, or 2.4%, from \$137.1 million at December 31, 2015 to \$140.4 million at March 31, 2016. The held to maturity loan portfolio grew due mostly to residential construction and non-conforming loan originations.

The composition of the loan portfolio at March 31, 2016 and December 31, 2015, is summarized as follows:

| (dollars in thousands)     | March 31, 2016 |         | December 31, 2015 |         |
|----------------------------|----------------|---------|-------------------|---------|
|                            | Amount         | %       | Amount            | %       |
| Commercial and industrial  | \$ 103,703     | 18.7 %  | \$ 102,653        | 18.4 %  |
| Commercial real estate:    |                |         |                   |         |
| Non-owner occupied         | 95,303         | 17.1    | 95,745            | 17.2    |
| Owner occupied             | 98,523         | 17.7    | 101,652           | 18.3    |
| Construction               | 4,904          | 0.9     | 4,481             | 0.8     |
| Consumer:                  |                |         |                   |         |
| Home equity installment    | 30,017         | 5.4     | 30,935            | 5.6     |
| Home equity line of credit | 48,331         | 8.7     | 48,060            | 8.7     |
| Auto and leases            | 29,556         | 5.3     | 29,758            | 5.3     |
| Other                      | 5,770          | 1.0     | 6,208             | 1.1     |
| Residential:               |                |         |                   |         |
| Real estate                | 130,270        | 23.4    | 126,992           | 22.8    |
| Construction               | 10,109         | 1.8     | 10,060            | 1.8     |
| Gross loans                | 556,486        | 100.0 % | 556,544           | 100.0 % |
| Less:                      |                |         |                   |         |
| Allowance for loan losses  | (9,384)        |         | (9,527)           |         |
| Unearned lease revenue     | (395)          |         | (335)             |         |
| Net loans                  | \$ 546,707     |         | \$ 546,682        |         |
| Loans held-for-sale        | \$ 1,202       |         | \$ 1,421          |         |

#### 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.

Through March 31, 2016, 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

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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 non-accrual status as well as a review of certain loans to which the lenders or the Credit Administration function have assigned a criticized or classified risk rating.

Net charge-offs were \$0.3 million as of March 31, 2016, \$0.7 million for the year ended December 31, 2015 and \$0.1 million as of March 31, 2015. During the period ended March 31, 2016, no specific loan class significantly underperformed as charge-offs were taken across a variety of consumer, commercial and residential loans. For a discussion on the provision for loan losses, see the "Provision for loan losses," located in the results of operations section of management's discussion and analysis contained herein.

The allowance for loan losses was \$9.4 million as of March 31, 2016, \$9.5 million as of December 31, 2015 and \$9.2 million as of March 31, 2015. 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. In contrast, an abrupt significant increase in the U.S. Prime lending rate could adversely impact the debt service capacity of existing borrowers' ability to repay.

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

| (dollars in thousands)   | As of and for<br>the<br>three months<br>ended<br>March 31,<br>2016 | As of and for<br>the<br>twelve<br>months ended<br>December 31,<br>2015 | As of and for<br>the<br>three months<br>ended<br>March 31,<br>2015 |   |            |
|--|--|--|--|---|------------|
| Balance at beginning of period   | \$ 9,527   | \$ 9,173   | \$ 9,173   |   |            |
| Charge-offs:   |  |  |  |   |            |
| Commercial and industrial  | (14)   | (25)   | (24)   |   |            |
| Commercial real estate   | (85)   | (432)  | (67)   |   |            |
| Consumer   | (175)  | (437)  | (92)   |   |            |
| Residential  | (60)   | (15)   | -  |   |            |
| Total  | (334)  | (909)  | (183)  |   |            |
| Recoveries:  |  |  |  |   |            |
| Commercial and industrial  | 9  | 47   | 9  |   |            |
| Commercial real estate   | 4  | 18   | 7  |   |            |
| Consumer   | 28   | 95   | 24   |   |            |
| Residential  | -  | 28   | 28   |   |            |
| Total  | 41   | 188  | 68   |   |            |
| Net charge-offs  | (293)  | (721)  | (115)  |   |            |
| Provision for loan losses  | 150  | 1,075  | 150  |   |            |
| Balance at end of period   | \$ 9,384   | \$ 9,527   | \$ 9,208   |   |            |
| Allowance for loan losses to total loans                                 | 1.69   | %  | 1.71   | % | 1.77       |
| Net charge-offs to average total loans outstanding                       | 0.21   | %  | 0.13   | % | 0.09       |
| Average total loans  | \$ 557,711   |  | \$ 534,903   |   | \$ 516,492 |
| Loans 30 - 89 days past due and accruing                                 | \$ 2,390   |  | \$ 3,707   |   | \$ 2,135   |
| Loans 90 days or more past due and accruing                              | \$ 619   |  | \$ 356   |   | \$ 505     |
| Non-accrual loans  | \$ 8,306   |  | \$ 9,003   |   | \$ 3,816   |
| Allowance for loan losses to loans 90 days or more past due and accruing | 15.16  | x  | 26.76  | x | 18.23      |
| Allowance for loan losses to non-accrual loans                           | 1.13   | x  | 1.06   | x | 2.41       |
| Allowance for loan losses to non-performing loans                        | 1.05   | x  | 1.02   | x | 2.13       |

## 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) and repossessed assets. At March 31, 2016, non-performing assets represented 1.77% of total assets compared with 1.76% as of December 31, 2015. Although



non-accrual loans decreased in the first quarter of 2016, past due loans over 90 days, TDRs and ORE all increased over the same time period, causing an increase in the ratio. Most of the non-performing loans are collateralized, thereby mitigating the Company's potential for loss.

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

| (dollars in thousands)                         | March 31,<br>2016 | December<br>31, 2015 | March 31,<br>2015 |
|--|-------------------|----------------------|-------------------|
| Loans past due 90 days or more and accruing    | \$ 619            | \$ 356               | \$ 505            |
| Non-accrual loans *                            | 8,306             | 9,003                | 3,816             |
| Total non-performing loans                     | 8,925             | 9,359                | 4,321             |
| Troubled debt restructurings                   | 2,857             | 2,423                | 2,358             |
| Other real estate owned and repossessed assets | 1,766             | 1,074                | 1,433             |
| Total non-performing assets                    | \$ 13,548         | \$ 12,856            | \$ 8,112          |
| <br>   |                   |                      |                   |
| Total loans, including loans held-for-sale     | \$ 557,293        | \$ 557,630           | \$ 520,855        |
| Total assets                                   | \$ 763,382        | \$ 729,358           | \$ 702,507        |
| Non-accrual loans to total loans               | 1.49%             | 1.61%                | 0.73%             |
| Non-performing loans to total loans            | 1.60%             | 1.68%                | 0.83%             |
| Non-performing assets to total assets          | 1.77%             | 1.76%                | 1.15%             |

\* In the table above, the amount includes non-accrual TDRs of \$0.2 million as of March 31, 2016 and \$0.9 million as of March 31, 2015. There were no non-accrual TDRs as of December 31, 2015.

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, which consists of accruing loans that are over 90 days past due as well as all non-accrual loans, decreased \$0.4 million, or 5%, from \$9.3 million at December 31, 2015 to \$8.9 million at March 31, 2016. At March 31, 2016, the portion of accruing loans that was over 90 days past due totaled \$0.6 million and consisted of nine loans to nine unrelated borrowers ranging from \$6 thousand to \$0.2 million. At December 31, 2015, the portion of accruing loans that was over 90 days past due totaled \$0.4 million and consisted of eight loans to seven unrelated borrowers ranging from less than \$1 thousand to \$0.2 million. The Company seeks payments from all past due customers through an aggressive customer communication process. A past due loan will be placed on non-accrual at the 90 day point when it is deemed that a customer is non-responsive and uncooperative to collection efforts.

At March 31, 2016, there were 45 loans to 38 unrelated borrowers ranging from less than \$1 thousand to \$5.0 million in the non-accrual category. At December 31, 2015, there were 51 loans to 46 unrelated borrowers on non-accrual ranging from less than \$1 thousand to \$5.1 million. Non-accrual loans decreased during the period ending March 31, 2016 for the following reasons: \$0.8 million in new non-accrual loans plus capitalized expenditures on these loans

were added; \$0.3 million were paid down or paid off; \$0.2 million were charged off; \$0.7 million were transferred to ORE, and \$0.3 million was moved back to accrual status.

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The composition of non-performing loans as of March 31, 2016 is as follows:

|                            | Gross<br>loan<br>balances | Past due<br>90 days<br>or<br>more and<br>still<br>accruing | Non-<br>accrual<br>loans | Total non-<br>performing<br>loans | % of<br>gross<br>loans |
|----------------------------|---------------------------|--|--------------------------|-----------------------------------|------------------------|
| (dollars in thousands)     |                           |  |                          |                                   |                        |
| Commercial and industrial  | \$ 103,703                | \$ 27  | \$ 32                    | \$ 59                             | 0.06%                  |
| Commercial real estate:    |                           |  |                          |                                   |                        |
| Non-owner occupied         | 95,303                    | -  | 6,178                    | 6,178                             | 6.48%                  |
| Owner occupied             | 98,523                    | 35   | 559                      | 594                               | 0.60%                  |
| Construction               | 4,904                     | -  | 218                      | 218                               | 4.45%                  |
| Consumer:                  |                           |  |                          |                                   |                        |
| Home equity installment    | 30,017                    | -  | 92                       | 92                                | 0.31%                  |
| Home equity line of credit | 48,331                    | -  | 438                      | 438                               | 0.91%                  |
| Auto loans and leases *    | 29,161                    | 557  | 23                       | 580                               | 1.99%                  |
| Other                      | 5,770                     | -  | 6                        | 6                                 | 0.10%                  |
| Residential:               |                           |  |                          |                                   |                        |
| Real estate                | 130,270                   | -  | 760                      | 760                               | 0.58%                  |
| Construction               | 10,109                    | -  | -                        | -                                 | -                      |
| Loans held-for-sale        | 1,202                     | -  | -                        | -                                 | -                      |
| Total                      | \$ 557,293                | \$ 619   | \$ 8,306                 | \$ 8,925                          | 1.60%                  |

\*Net of unearned lease revenue of \$0.4 million.

Payments received from non-accrual loans are recognized on a cost recovery method. Payments are first applied to the outstanding principal balance, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of interest income. If the non-accrual loans that were outstanding as of March 31, 2016 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of \$0.3 million.

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 \$3.0 million at March 31, 2016, an increase of \$0.6 million, from \$2.4 million at December 31, 2015, due to the addition of one home equity line of credit (HELOC) being classified as a TDR during the quarter. The \$3.0 million in TDRs as of March 31, 2016, consisted of nine commercial loans (7 CRE and 2 C&I) and one consumer loan (HELOC) to six unrelated borrowers.

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

As of and for the three months  
ended March 31, 2016

| (dollars in thousands)      | Accruing<br>Commercial<br>& Commercial<br>industrial real estate |          | Consumer<br>HELOC | Non-accruing<br>Commercial<br>real estate | Total    |
|-----------------------------|--|----------|-------------------|---|----------|
|                             |  |          |                   |   |          |
| Troubled Debt Restructures: |  |          |                   |   |          |
| Beginning balance           | \$ 525   | \$ 1,898 | \$ -              | \$ -                                      | \$ 2,423 |
| Additions                   | -  | -        | 650               | -   | 650      |
| Transfers                   | -  | (156)    | -                 | 156                                       | -        |
| Pay downs / payoffs         | -  | (60)     | -                 | -   | (60)     |
| Ending balance              | \$ 525   | \$ 1,682 | \$ 650            | \$ 156                                    | \$ 3,013 |

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As of and for the year ended December 31, 2015

| (dollars in thousands)      | Accruing<br>Commercial<br>& Commercial<br>industrial real estate |          | Non-accruing<br>Commercial<br>real estate | Total    |
|-----------------------------|--|----------|---|----------|
|                             |  |          |   |          |
| Troubled Debt Restructures: |  |          |   |          |
| Beginning balance           | \$ 25  | \$ 728   | \$ 875                                    | \$ 1,628 |
| Additions                   | 500  | 1,267    | -   | 1,767    |
| Sold                        | -  | -        | (604)                                     | (604)    |
| Pay downs / payoffs         | -  | (97)     | (71)                                      | (168)    |
| Charge offs                 | -  | -        | (200)                                     | (200)    |
| Ending balance              | \$ 525   | \$ 1,898 | \$ -                                      | \$ 2,423 |

If applicable, a TDR loan classified as non-accrual would require a minimum of six months of payments before consideration for a return to accrual status. The concessions granted consisted of temporary interest-only payments or a reduction in the rate of interest to a below-market rate for a contractual period of time. The Company believes concessions have been made in the best interests of the borrower and the Company. If loans characterized as a TDR perform according to the restructured terms for a satisfactory period of time, the TDR designation may be removed in a new calendar year if the loan yields a market rate of interest.

## Foreclosed assets held-for-sale

Foreclosed assets held-for-sale aggregated \$1.8 million at March 31, 2016 and \$1.1 million at December 31, 2015. The following table sets forth the activity in the ORE component of foreclosed assets held-for-sale:

| (dollars in thousands)         | March 31,<br>2016 |    | December<br>31, 2015 |     |
|--------------------------------|-------------------|----|----------------------|-----|
|                                | Amount            | #  | Amount               | #   |
| Balance at beginning of period | \$ 1,074          | 14 | \$ 1,961             | 12  |
| Additions                      | 692               | 6  | 466                  | 10  |
| Pay downs                      | -                 |    | (1)                  |     |
| Write downs                    | -                 |    | (37)                 |     |
| Sold                           | -                 |    | (1,315)              | (8) |
| Balance at end of period       | \$ 1,766          | 20 | \$ 1,074             | 14  |

As of March 31, 2016, ORE consisted of twenty properties from eighteen unrelated borrowers totaling \$1.8 million. Six of these properties (\$0.7 million) were added in 2016; six were added in 2015 (\$0.4 million); three were added in 2014 (\$0.1 million); two were added in 2013 (\$0.2 million); two were added in 2012 (\$0.3 million); and one was added in 2011 (\$0.1 million). In addition, of the twenty properties, eleven (\$1.3 million) were either listed for sale or awaiting listing, while the remaining properties (nine totaling \$0.5 million) are either in litigation, awaiting closing, have disposition plans or are undergoing renovations.

There was no other repossessed assets held-for-sale at March 31, 2016 or December 31, 2015.

#### Other assets

The \$2.1 million increase in other assets was due mostly to \$1.4 million in higher residual values associated with recording new automobile leases, net of lease disposals, a \$0.3 million increase in construction in process, a \$0.5 million investment receivable that has not been settled yet and \$0.3 million higher prepaid expenses.

#### 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 10 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. Cash flow from deposits 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

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alternative sources of funding such as short-term borrowings and long-term FHLB advances.

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

| (dollars in thousands)    | March 31, 2016 |       | December 31, 2015 |       |   |
|---------------------------|----------------|-------|-------------------|-------|---|
|                           | Amount         | %     | Amount            | %     |   |
| Money market              | \$ 138,685     | 20.8  | % \$ 125,433      | 20.2  | % |
| Interest-bearing checking | 152,433        | 22.8  | 132,598           | 21.4  |   |
| Savings and clubs         | 119,706        | 17.9  | 115,668           | 18.6  |   |
| Certificates of deposit   | 99,729         | 14.9  | 104,202           | 16.8  |   |
| Total interest-bearing    | 510,553        | 76.4  | 477,901           | 77.0  |   |
| Non-interest bearing      | 157,358        | 23.6  | 142,774           | 23.0  |   |
| Total deposits            | \$ 667,911     | 100.0 | % \$ 620,675      | 100.0 | % |

Total deposits increased \$47.2 million, or 8%, from \$620.7 million at December 31, 2015 to \$667.9 million at March 31, 2016. Growth in public fund accounts caused the increase from year end due to the seasonal timing of public tax deposits. Public non-interest bearing checking, public interest-bearing checking and public money market accounts increased \$14.8 million, \$21.8 million and \$12.4 million. Tax deposits are usually received mid-quarter and retained for a short period of time with disbursements occurring shortly after they are received. The increase in public fund accounts was partially offset by a \$4.5 million reduction in CDs. The Company will continue to execute on its relationship development strategy, explore the demographics within its marketplace and develop creative programs for its customers. The Company's focus of building a relationship of trust with its customers brought a few large deposits into the bank during 2015, with similar expectations for 2016. Although these deposits fluctuate depending on customer needs, the Company plans to continue to form these types of relationships with customers in order to grow the deposit base to fund loan growth. The Company expects moderate asset growth for the remainder of 2016 funded primarily by growth in transactional deposits.

Customers' appetite for long-term time deposit products continues to be non-existent with a sustaining preference for non-maturing transaction deposits. The Company's portfolio of CDs continues to decrease; having declined \$4.5 million, or 5%, from year-end 2015. The Company expects CDs to continue to decline in 2016. The Company's relationship strategy resulted in a successful bid for a large public CD account, but otherwise the low rate environment has basically enticed customers to vacate the CD marketplace. If rates continue to rise, demand for CDs may also increase thereby possibly increasing funding costs. The Company will continue to pursue strategies to grow and retain retail and business customers including the development of creative CD campaigns with an emphasis on deepening and broadening existing and creating new relationships.

The Company uses the Certificate of Deposit Account Registry Service (CDARS) reciprocal program to obtain FDIC insurance protection for customers who have large deposits that at times may exceed the FDIC maximum amount of \$250,000 per person. In the CDARS program, deposits with varying terms and interest rates, originated in the Company's own markets, are exchanged for deposits of other financial institutions that are members in the CDARS network. By placing the deposits in other participating institutions, the deposits of our customers are fully insured by the FDIC. In return for deposits placed with network institutions, the Company receives from network institutions deposits that are approximately equal in amount and are comprised of terms similar to those placed for our



customers. Deposits the Company receives, or reciprocal deposits, from other institutions are considered brokered deposits by regulatory definitions. As of March 31, 2016 and December 31, 2015, CDARS represented \$1.1 million, or less than 1%, and \$3.4 million, or 1%, respectively, of total deposits.

Excluding CDARS, certificates of deposit accounts of \$100,000 or more amounted to \$50.0 million and \$50.8 million at March 31, 2016 and December 31, 2015, respectively. Certificates of deposit of \$250,000 or more amounted to \$28.1 million and \$31.7 million as of March 31, 2016 and December 31, 2015, respectively.

Including CDARS, approximately 48% of the CDs, with a weighted-average interest rate of 0.70%, are scheduled to mature in 2016 and an additional 23%, with a weighted-average interest rate of 0.73%, are scheduled to mature in 2017. 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. As noted, the widespread preference continues for customers with maturing CDs to hold their deposits in readily available transaction accounts. The Company does not expect significant CD growth during 2016, but will continue to develop CD promotional programs when the Company deems that it is economically feasible to do so or when demand exists. As with all promotions, the Company will consider the needs of the customers and simultaneously be mindful of the liquidity levels and the interest rate sensitivity exposure of the Company.

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## 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, short-term advances from the FHLB and other correspondent banks for asset growth and liquidity needs.

Repurchase agreements are non-insured interest-bearing liabilities that have a perfected security interest in qualified investments of the Company as required by the FDIC Depositor Protection Act of 2009. Repurchase agreements are offered through a sweep product. A sweep account is designed to ensure that on a daily basis, an attached DDA is adequately funded and excess funds are transferred, or swept, into an interest-bearing overnight repurchase agreement account. Due to the constant inflow and outflow of funds of the sweep product, their balances tend to be somewhat volatile, similar to a DDA. Customer liquidity is the typical cause for variances in repurchase agreements. In addition, short-term borrowings may include overnight balances which the Company may require to fund daily liquidity needs such as deposit and repurchase agreement cash outflow, loan demand and operations. Short-term borrowings decreased \$15.4 million during 2016. Less borrowing was needed because of growth in public deposits during the first quarter of 2016.

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

| (dollars in thousands)                      | March 31, 2016 |         | December 31, 2015 |         |
|---|----------------|---------|-------------------|---------|
|   | Amount         | %       | Amount            | %       |
| Overnight borrowings                        | \$ -           | - %     | \$ 22,289         | 79.0 %  |
| Securities sold under repurchase agreements | 12,765         | 100.0   | 5,915             | 21.0    |
| Total                                       | \$ 12,765      | 100.0 % | \$ 28,204         | 100.0 % |

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

Management of interest rate risk and market risk analysis.

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

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

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

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

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

To manage this interest rate sensitivity gap position, an asset/liability model commonly known as cumulative gap analysis is used to monitor the difference in the volume of the Company's interest sensitive assets and liabilities that mature or re-price within given time intervals. A positive gap (asset sensitive) indicates that more assets will re-price during a given period compared to liabilities, while a

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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 March 31, 2016, the Company maintained a one-year cumulative gap of positive (asset sensitive) \$68.2 million, or 9%, of total assets. The effect of this positive gap position provided a mismatch of assets and liabilities which may expose the Company to interest rate risk during periods of falling interest rates. Conversely, in an increasing interest rate environment, net interest income could be positively impacted because more assets than liabilities will re-price upward during the one-year period.

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

The following table illustrates the Company's interest sensitivity gap position at March 31, 2016:

| (dollars in thousands)                        | Three<br>months<br>or less | More than<br>three<br>months to<br>twelve<br>months | More than<br>one year<br>to three<br>years | More than<br>three years | Total      |
|---|----------------------------|---|--|--------------------------|------------|
| Cash and cash equivalents                     | \$ 28,432                  | \$ -  | \$ -                                       | \$ 12,659                | \$ 41,091  |
| Investment securities (1)(2)                  | 6,344                      | 15,471  | 39,641                                     | 68,637                   | 130,093    |
| Loans and leases(2)                           | 195,090                    | 88,020  | 143,225                                    | 121,574                  | 547,909    |
| Fixed and other assets                        | -                          | 11,169  | -  | 33,120                   | 44,289     |
| Total assets                                  | \$ 229,866                 | \$ 114,660  | \$ 182,866                                 | \$ 235,990               | \$ 763,382 |
| Total cumulative assets                       | \$ 229,866                 | \$ 344,526  | \$ 527,392                                 | \$ 763,382               |            |
| Non-interest-bearing transaction deposits (3) | \$ -                       | \$ 15,752   | \$ 43,242                                  | \$ 98,364                | \$ 157,358 |
| Interest-bearing transaction deposits (3)     | 170,184                    | 20,712  | 148,378                                    | 71,550                   | 410,824    |
| Certificates of deposit                       | 17,546                     | 39,347  | 26,707                                     | 16,129                   | 99,729     |
| Repurchase agreements                         | 12,765                     | -   | -  | -                        | 12,765     |
| Other liabilities                             | -                          | -   | -  | 4,397                    | 4,397      |
| Total liabilities                             | \$ 200,495                 | \$ 75,811   | \$ 218,327                                 | \$ 190,440               | \$ 685,073 |
| Total cumulative liabilities                  | \$ 200,495                 | \$ 276,306  | \$ 494,633                                 | \$ 685,073               |            |

|                          |           |           |             |           |
|--------------------------|-----------|-----------|-------------|-----------|
| Interest sensitivity gap | \$ 29,371 | \$ 38,849 | \$ (35,461) | \$ 45,550 |
| Cumulative gap           | \$ 29,371 | \$ 68,220 | \$ 32,759   | \$ 78,309 |

|                                |      |      |      |       |
|--------------------------------|------|------|------|-------|
| Cumulative gap to total assets | 3.8% | 8.9% | 4.3% | 10.3% |
|--------------------------------|------|------|------|-------|

(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.

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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 March 31, 2016 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 March 31, 2016 levels:

|   | % change |         |
|---|----------|---------|
|   | Rates    | Rates   |
|   | +200     | -200    |
| Earnings at risk:                                     |          |         |
| Net interest income                                   | 6.0 %    | (2.6) % |
| Net income  | 15.8     | (6.5)   |
| Economic value at risk:                               |          |         |
| Economic value of equity                              | (3.4)    | (23.8)  |
| Economic value of equity as a percent of total assets | (0.4)    | (3.0)   |

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may normally change beyond the Company's policy guideline for a short period of time as long as the risk-based capital ratio (after adjusting for the excess equity exposure) is greater than 10%. At March 31, 2016, the Company's risk-based capital ratio was 15.1%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning April 1, 2016, under alternate interest rate scenarios using the income simulation model described above:

| (dollars in thousands)             | Net<br>interest<br>income | \$<br>variance | %<br>variance |
|------------------------------------|---------------------------|----------------|---------------|
| Simulated change in interest rates |                           |                |               |
| +200 basis points                  | \$ 26,238                 | \$ 1,478       | 6.0 %         |
| +100 basis points                  | 25,450                    | 690            | 2.8           |
| Flat rate                          | 24,760                    | -              | -             |
| -100 basis points                  | 24,252                    | (508)          | (2.1)         |
| -200 basis points                  | 24,124                    | (636)          | (2.6)         |

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

### Liquidity

Liquidity management ensures that adequate funds will be available to meet customers' needs for borrowings, deposit withdrawals and maturities, facility expansion and normal operating expenses. Sources of liquidity are cash and cash equivalents, asset maturities and pay-downs within one year, loans HFS, investments AFS, growth of core deposits and repurchase agreements, utilization of borrowing capacities from the FHLB, correspondent banks, CDARs, the Discount Window of the Federal Reserve Bank of Philadelphia (FRB) and proceeds from the issuance of capital stock. Though regularly scheduled investment and loan payments are dependable sources of daily liquidity, sales of both loans HFS and investments AFS, deposit activity and investment and loan prepayments are significantly influenced by general economic conditions including 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 prepayment cash flows from mortgage loans and mortgage-backed securities to decrease. Rising interest rates may also cause deposit inflow but priced at higher market interest rates or could also cause deposit outflow due to higher rates offered by the Company's competition for similar products. The Company closely

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monitors activity in the capital markets and takes appropriate action to ensure that the liquidity levels are adequate for funding, investing and operating activities.

The Company's contingency funding plan (CFP) sets a framework for handling liquidity issues in the event circumstances arise which the Company deems to be less than normal. The Company established guidelines for identifying, measuring, monitoring and managing the resolution of potentially serious liquidity crises. The CFP outlines required monitoring tools, acceptable alternative 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 Asset/Liability Committee. As of March 31, 2016, the Company had not experienced any adverse issues that would give rise to its inability to raise liquidity in an emergency situation.

During the three months ended March 31, 2016, the Company acquired \$28.8 million of cash. During the period, the Company's operations provided approximately \$1.5 million mostly from \$6.6 million of net cash inflow from the components of net interest income and \$0.8 million in proceeds of loans HFS over originations; partially offset by net non-interest expense/income related payments of \$4.5 million and a \$1.4 million increase in the residual value from the Company's automobile leasing activities. Cash inflow from interest-earning assets and growth in deposits were used to replace maturing and cash runoff of investment securities, reduce short-term borrowings and net dividend payments. The Company received a large amount of public deposits during the first quarter of 2016 which are expected to be taken out during the second quarter of 2016. The seasonal nature of deposits from municipalities and other public funding sources requires the Company to be prepared for the inherent volatility and the unpredictable timing of cash outflow from this customer base. Accordingly, the use of short-term overnight borrowings could be used to fulfill funding gap needs. The CFP is a tool to help the Company ensure that alternative funding sources are available to meet its liquidity needs.

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

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

In addition to lending commitments, the Company has contractual obligations related to operating lease commitments. Operating lease commitments are obligations under various non-cancelable operating leases on buildings and land used for office space and banking purposes. The Company's position with respect to lending commitments and significant contractual lease obligations, both on a short- and long-term basis has not changed materially from December 31, 2015.

As of March 31, 2016, the Company maintained \$41.1 million in cash and cash equivalents and \$129.9 million of investments AFS and loans HFS. Also as of March 31, 2016, the Company had approximately \$190.6 million available to borrow from the FHLB, \$21.0 million from correspondent banks, \$29.9 million from the FRB and \$36.5 million from the CDARS program. The combined total of \$449.0 million represented 59% of total assets at March 31,



2016. Management believes this level of liquidity to be strong and adequate to support current operations.

#### Capital

During the quarter ended March 31, 2016, total shareholders' equity increased \$2.0 million, or 3%, due principally from the \$1.7 million in net income added into retained earnings and \$0.7 million in after-tax unrealized gains in the Company's investment portfolio. Capital was further enhanced by \$0.1 million from investments in the Company's common stock via the Employee Stock Purchase (ESPP) and \$0.1 million from stock options exercised and stock-based compensation expense from the ESPP and unvested restricted stock and SSARS. These items were partially offset by \$0.7 million of cash dividends declared on the Company's common stock. The Company's dividend payout ratio, defined as the rate at which current earnings is paid to shareholders, was 39% for the three months ended March 31, 2016. The balance of earnings is retained to further strengthen the Company's capital position.

As of March 31, 2016, the Company reported a net unrealized gain position of \$2.9 million, net of tax, from the securities AFS portfolio compared to a net unrealized gain of \$2.2 million as of December 31, 2015. The improvement during 2016 was from all security types. Management believes that changes in fair value of the Company's securities are due to changes in interest rates and not in the creditworthiness of the issuers. Generally, when U.S. Treasury rates rise, investment securities' pricing declines and fair values of investment securities also decline. While volatility has existed in the yield curve within the past twelve months, a rising rate environment is inevitable and during the period of rising rates, the Company expects pricing in the bond portfolio to decline. 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 can issue stock to participants in the DRP and ESPP plans. The DRP

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affords the Company the option to acquire shares in open market purchases and/or issue shares directly from the Company to plan participants. During 2016, the Company purchased all of the shares in the open market to fulfill the needs of the DRP. Both the DRP and the ESPP plans have been a consistent source of capital from the Company's loyal employees and shareholders and their participation in these plans will continue to help strengthen the Company's balance sheet.

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

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I common equity to total risk-weighted assets (Tier I Common Equity) of 4.5%, Tier I capital to total risk-weighted assets (Tier I Capital) of 6% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. As of March 31, 2016 and 2015, the Company and the Bank exceeded all capital adequacy requirements to which it was subject.

In July 2013, the federal bank regulatory agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. Under the final rules, which became effective for the Company on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements increased for both the quantity and quality of capital held by the Company. The rules require all banks and bank holding companies to maintain a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets (Tier I capital) from 4.0% to 6.0%, require a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Based Capital) of 8.0%, and require a minimum Tier I capital to average total assets (Leverage Ratio) of 4.0%. A new capital conservation buffer, comprised of common equity Tier I capital, is also established above the regulatory minimum capital requirements. The rule increases the minimum Tier 1 capital to risk-based assets requirement with a capital conservation buffer to 8.5% by 2019 and increases the minimum total capital requirement with a capital conservation buffer to 10.5% by 2019 and assigns higher risk-weightings to certain assets: certain past due and commercial real estate loans and some equity exposures.

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The Company continues to closely monitor and evaluate alternatives to enhance its capital ratios as the regulatory and economic environments change. The following table depicts the capital amounts and ratios of the Company and the Bank as of March 31, 2016:

| (dollars in thousands)<br>As of March 31, 2016 | Actual    |         | For capital       |        | To be well  |                   |
|--|-----------|---------|-------------------|--------|-------------|-------------------|
|  | Amount    | Ratio   | adequacy purposes | Ratio  | capitalized | under prompt      |
|  |           |         | Amount            |        | corrective  | action provisions |
|  |           |         |                   |        | Amount      | Ratio             |
| Total capital (to risk-weighted assets)        |           |         |                   |        |             |                   |
| Consolidated                                   | \$ 82,227 | 15.1% ≥ | \$ 43,438 ≥       | 8.0%   | N/A         | N/A               |
| Bank   | \$ 81,747 | 15.1% ≥ | \$ 43,389 ≥       | 8.0% ≥ | \$ 54,237 ≥ | 10.0%             |
| Tier 1 common equity (to risk-weighted assets) |           |         |                   |        |             |                   |
| Consolidated                                   | \$ 75,406 | 13.9% ≥ | \$ 24,434 ≥       | 4.5%   | N/A         | N/A               |
| Bank   | \$ 74,934 | 13.8% ≥ | \$ 24,406 ≥       | 4.5% ≥ | 35,254 ≥    | 6.5%              |
| Tier I capital (to risk-weighted assets)       |           |         |                   |        |             |                   |
| Consolidated                                   | \$ 75,406 | 13.9% ≥ | \$ 44,916 ≥       | 6.0%   | N/A         | N/A               |
| Bank   | \$ 74,934 | 13.8% ≥ | \$ 44,876 ≥       | 6.0% ≥ | \$ 59,835 ≥ | 8.0%              |
| Tier I capital (to average assets)             |           |         |                   |        |             |                   |
| Consolidated                                   | \$ 75,406 | 10.1% ≥ | \$ 29,944 ≥       | 4.0%   | N/A         | N/A               |
| Bank   | \$ 74,934 | 10.0% ≥ | \$ 29,918 ≥       | 4.0% ≥ | \$ 37,397 ≥ | 5.0%              |

As of December 31, 2015:

|  |           |         |             |        |             |       |
|--|-----------|---------|-------------|--------|-------------|-------|
| Total capital (to risk-weighted assets)        |           |         |             |        |             |       |
| Consolidated                                   | \$ 81,074 | 15.0% ≥ | \$ 43,278 ≥ | 8.0%   | N/A         | N/A   |
| Bank   | \$ 80,547 | 14.9% ≥ | \$ 43,306 ≥ | 8.0% ≥ | \$ 54,132 ≥ | 10.0% |
| Tier 1 common equity (to risk-weighted assets) |           |         |             |        |             |       |
| Consolidated                                   | \$ 74,163 | 13.7% ≥ | \$ 24,344 ≥ | 4.5%   | N/A         | N/A   |

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|  |           |         |             |        |             |      |
|--|-----------|---------|-------------|--------|-------------|------|
| Bank                                     | \$ 73,744 | 13.6% ≥ | \$ 24,360 ≥ | 4.5% ≥ | \$ 35,186 ≥ | 6.5% |
| Tier I capital (to risk-weighted assets) |           |         |             |        |             |      |
| Consolidated                             | \$ 74,163 | 13.7% ≥ | \$ 43,723 ≥ | 6.0%   | N/A         | N/A  |
| Bank                                     | \$ 73,744 | 13.6% ≥ | \$ 43,635 ≥ | 6.0%   | \$ 58,180 ≥ | 8.0% |
| Tier I capital (to average assets)       |           |         |             |        |             |      |
| Consolidated                             | \$ 74,163 | 10.2% ≥ | \$ 29,149 ≥ | 4.0%   | N/A         | N/A  |
| Bank                                     | \$ 73,744 | 10.1% ≥ | \$ 29,090 ≥ | 4.0%   | \$ 36,362 ≥ | 5.0% |

The Company advises readers to refer to the Supervision and Regulation section of Management's Discussion and Analysis of Financial Condition and Results of Operation, of its 2015 Form 10-K for a discussion on the regulatory environment and recent legislation and rulemaking.

Item 4. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out by the Company's management, with the participation of its President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934. Based on such evaluation, the President and Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports the Company files or furnishes under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations, and are effective. The Company made no changes in its internal controls over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, these controls during the last fiscal quarter ended March 31, 2016.

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PART II - Other Information

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

Management of the Company does not believe there have been any material changes to the risk factors that were disclosed in the 2015 Form 10-K filed with the Securities and Exchange Commission on March 15, 2016.

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

None

Item 3. Default Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

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

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

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

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

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

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

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

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

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

\*10.7 Change of Control Agreement with Salvatore R. DeFrancesco, Registrant and The Fidelity Deposit and Discount Bank, dated March 21, 2006. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 27, 2006.

\*10.8 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated March 23, 2011. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

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

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

\*10.12 Change in Control and Severance Agreement between the Registrant, The Fidelity Deposit and Discount Bank and Eugene J. Walsh, dated June 26, 2015. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on June 29, 2015.

\*10.13 Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Salvatore R. DeFrancesco, Jr. dated as of March 17, 2016. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 18, 2016.

11 Statement regarding computation of earnings per share. Included herein in Note No. 6, "Earnings per share," contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.

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

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

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

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

101 Interactive data files: The following, from Fidelity D&D Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2016, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of March 31, 2016 and December 31, 2015; Consolidated Statements of Income for the three months ended March 31, 2016 and 2015; Consolidated Statements of Comprehensive Income for the three months ended March 31, 2016 and 2015; Consolidated Statements of Changes in Shareholders' Equity for the three months ended March 31, 2016 and 2015; Consolidated Statements of Cash Flows for the three months ended March 31, 2016 and 2015 and the Notes to the Consolidated Financial Statements.

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\* Management contract or compensatory plan or arrangement.

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Signatures

FIDELITY D & D BANCORP, INC.

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

Fidelity D & D Bancorp, Inc.

Date: May 6, 2016 /s/Daniel J. Santaniello  
Daniel J. Santaniello,

President and Chief Executive Officer

Fidelity D & D Bancorp, Inc.

Date: May 6, 2016 /s/Salvatore R. DeFrancesco, Jr.  
Salvatore R. DeFrancesco, Jr.,

Treasurer and Chief Financial Officer



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EXHIBIT INDEX

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\* Incorporated by Reference

\*\* Pursuant to Rule 406T of Regulation S-T, the interactive data files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.