FIDELITY D & D BANCORP INC
Form 10-K
March 10, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2016

COMMISSION FILE NUMBER 333-90273

FIDELITY D & D BANCORP, INC.

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

BLAKELY AND DRINKER STREETS

DUNMORE, PENNSYLVANIA 18512

TELEPHONE NUMBER (570) 342-8281

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

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

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

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

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

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

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

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

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

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant was $59.7 million as of June 30, 2016, based on the closing price of $32.00. The number of shares of common stock outstanding as of February 28, 2017, was 2,467,716.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement to be used in connection with the 2017 Annual Meeting of Shareholders are incorporated herein by reference in partial response to Part III.

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FIDELITY D & D BANCORP, INC.

PART I

Forward-Looking Statements

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

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

§ the effects of economic conditions on current customers, specifically the effect of the economy on loan customers’ ability to repay loans;
§ the costs and effects of litigation and of unexpected or adverse outcomes in such litigation;
§ the impact of new 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 this document and other documents that we file or furnish, from time- to-time, with the Securities and Exchange Commission, including quarterly reports filed on Form 10-Q and any current reports filed or furnished on Form 8-K.

ITEM 1: BUSINESS

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

The Bank has offered a full range of traditional banking services since it commenced operations in 1903. The Bank has a personal and corporate trust department and also provides alternative financial and insurance products with asset management services. A full list of services provided by the Bank is detailed in the section entitled “Products and Services” contained within the 2016 Annual Report to Shareholders, incorporated by reference. The service area is comprised of the Borough of Dunmore and the surrounding communities within Lackawanna and Luzerne counties in Northeastern Pennsylvania. The Company had 167 full-time equivalent employees on December 31, 2016, which includes exempt officers, exempt, non-exempt and part-time employees.

The banking business is highly competitive, and the success and profitability of the Company depends principally on its ability to compete in its market area. Competition includes, among other sources: local community banks; savings banks; regional banks; national banks; credit unions; savings & loans; insurance companies; money market funds; mutual funds; small loan companies and other financial services companies. The Company has been able to compete effectively with other financial institutions by emphasizing customer service enhanced by local decision making. These efforts enable the Company to establish long-term customer relationships and build customer loyalty by providing products and services designed to address their specific needs.

The banking industry is affected by general economic conditions including the effects of inflation, recession, unemployment, real estate values, trends in national and global economies and other factors beyond the Company’s control. The Company’s success is dependent, to a significant degree, on economic conditions in Northeastern Pennsylvania, especially within Lackawanna and Luzerne counties which the Company defines as its primary market area. An economic recession or a delayed economic recovery over a prolonged period of time in the Company’s market could cause an increase in the level of the Company’s non-performing assets and loan losses, and thereby cause operating losses, impairment of liquidity and erosion of capital. There are no concentrations of loans that, if lost, would have a material adverse effect on the continued business of the Company. There is no material concentration within a single industry or a group of related industries that is vulnerable to the risk of a near-term severe impact.

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

During 2016, the national economy continued to improve with the unemployment rate dropping to 4.7% compared to 5.0% at the end of 2015. Conversely, the unemployment rate in the Company’s local statistical market, Scranton-Wilkes-Barre, creeped up to 5.5%, an increase of 17%, from 4.7% at the end of 2015. The local economy has been volatile in recent years. The Company’s credit function strives to mitigate the negative impact of economic conditions by maintaining strict underwriting principles for commercial and consumer lending and ensuring that home mortgage underwriting adheres to the standards of secondary market makers. In addition, the Company strives to accelerate the property foreclosure process thereby lessening the negative financial impact of foreclosed property ownership. Refer to Item 1A, “Risk Factors” for material risks and uncertainties that management believes affect the Company.

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

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

The Bank is examined periodically by the Pennsylvania Department of Banking and Securities and the FDIC.

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

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

ITEM 1A: RISK FACTORS

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

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

Risks Related to the Company's Business

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

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

The Company is subject to lending risk.

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

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

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

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

Company's financial condition and results of operations.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Company is subject to extensive government regulation and supervision.

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

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

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

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

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

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

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

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

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

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

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

The Company continually encounters technological change.

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

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

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

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

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

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

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

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

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

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

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

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

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

The increasing use of social media platforms presents new risks and challenges and our inability or failure to recognize, respond to and effectively manage the accelerated impact of social media could materially adversely impact our business.

There has been a marked increase in the use of social media platforms, including weblogs (blogs), social media websites, and other forms of Internet-based communications which allow individuals access to a broad audience of consumers and other interested persons. Social media practices in the banking industry are evolving, which creates uncertainty and risk of noncompliance with regulations applicable to our business. Consumers value readily available information concerning businesses and their goods and services and often act on such information without further investigation and without regard to its accuracy. Many social media platforms immediately publish the content their subscribers and participants post, often without filters or checks on accuracy of the content posted. Information posted on such platforms at any time may be adverse to our interests and/or may be inaccurate. The dissemination of information online could harm our business, prospects, financial condition, and results of operations, regardless of the information's accuracy. The harm may be immediate without affording us an opportunity for redress or correction.

Other risks associated with the use of social media include improper disclosure of proprietary information, negative comments about our business, exposure of personally identifiable information, fraud, out-of-date information, and improper use by employees and customers. The inappropriate use of social media by our customers or employees could result in negative consequences including remediation costs including training for employees, additional regulatory scrutiny and possible regulatory penalties, litigation or negative publicity that could damage our reputation adversely affecting customer or investor confidence.

Risks Associated with the Company's Common Stock

The Company's stock price can be volatile.

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

Actual or anticipated variations in quarterly results of operations.

Recommendations by securities analysts.

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

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

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

New technology used, or services offered, by competitors.

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

Failure to integrate acquisitions or realize anticipated benefits from acquisitions.

Changes in government regulations.

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

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

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

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

Risks Associated with the Company's Industry

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

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

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

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

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

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

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

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

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as

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“disintermediation,” could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on the Company’s financial condition and results of operations.

The recent change in control of the United States government and issues relating to debt and the deficit may adversely affect the Company.

Due to the Republican Party gaining control of the White House, as well as the Republican Party maintaining control of both the House of Representatives and Senate of the United States in the congressional election, could result in significant changes (or uncertainty) in governmental policies, regulatory environments, spending sentiment and many other factors and conditions, some of which could adversely impact the Company’s business, financial condition and results of operations.

In addition, as a result of past difficulties of the federal government to reach agreement over federal debt and issues connected with the debt ceiling, certain rating agencies placed the United States government's long-term sovereign debt rating on their equivalent of negative watch and announced the possibility of a rating downgrade. The rating agencies, due to constraints related to the rating of the United States, also placed government-sponsored enterprises in which the Company invests and receives lines of credit on negative watch and a downgrade of the United States government's credit rating would trigger a similar downgrade in the credit rating of these government-sponsored enterprises. Furthermore, the credit rating of other entities, such as state and local governments, may also be downgraded should the United States government's credit rating be downgraded. The impact that a credit rating downgrade may have on the national and local economy could have an adverse effect on the Company’s financial condition and results of operations.

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

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

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

ITEM 1B: UNRESOLVED STAFF COMMENTS

None

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ITEM 2: PROPERTIES

As of December 31, 2016, the Company operated 10 full-service banking offices, of which six were owned and four were leased. None of the lessors of the properties leased by the Company are affiliated with the Company and all of the properties are located in the Commonwealth of Pennsylvania. The Company is headquartered at its owner-occupied main branch located on the corner of Blakely and Drinker Streets in Dunmore, PA. We believe each of our facilities is suitable and adequate to meet our current operational needs.

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

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

Kingston, PA					
400 S. Main St.,					
Scranton, PA	Owned	West Scranton Branch(2)	x	x	x

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

(1) Executive and administrative, commercial lending, trust and asset management services are located at the Main Branch.
(2) This office has two automated teller machines (ATMs).
(3) Executive, mortgage and consumer lending, finance, operations and a full-service call center are located in this building. A portion of the building was leased to a non-related entity, but the lessee vacated the property during the first quarter of 2016.

During the first quarter of 2016, the Company closed its Eynon branch, but is under contract to make lease payments on this property until 2020. During 2016, the bank entered into a lease for a new branch in Dallas, Pennsylvania and lease payments will commence when the branch opens for business.

As of December 31, 2016, the Bank maintained four free standing 24-hour ATMs located at the following locations:

- The Shoppes at Montage, 1035 Shoppes Blvd., Moosic, PA;
- Mountain Plaza Shopping Mall, 307 Moosic St., Scranton, PA;
- Antonio's Pizza, 45 Luzerne St., West Pittston, PA;
- 511 Scranton Carbondale Highway, Eynon, PA.

Foreclosed assets held-for-sale include other real estate owned (ORE). The Company had thirteen ORE properties as of December 31, 2016, which stemmed from twelve unrelated borrowers. Upon possession, foreclosed properties are recorded on the Company's balance sheet at the lower of cost or fair value. For a further discussion of ORE properties, see "Foreclosed assets held-for-sale", located in the comparison of financial condition section of managements' discussion and analysis.

ITEM 3: LEGAL PROCEEDINGS

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

ITEM 4: MINE SAFETY DISCLOSURES

Not Applicable

PART II

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

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

Salvatore R. DeFrancesco, Jr., Treasurer

Fidelity D & D Bancorp, Inc.

Blakely and Drinker Streets

Dunmore, PA 18512

(570) 342-8281

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

	2016 Prices High	Low	Dividends paid		2015 Prices High	Low	Dividends paid	
1st Quarter	$ 35.00	$ 31.00	$ 0.27		$ 36.40	$ 32.00	$ 0.25	
2nd Quarter	$ 33.17	$ 31.25	$ 0.29		$ 36.00	$ 33.31	$ 0.27	
3rd Quarter	$ 36.09	$ 31.10	$ 0.29		$ 35.00	$ 32.00	$ 0.27	
4th Quarter	$ 37.75	$ 33.30	$ 0.39	*	$ 38.25	$ 33.53	$ 0.37	*

*Includes a regular quarterly cash dividend of $0.29 and $0.27 for the fourth quarters of 2016 and 2015, respectively, and a special cash dividend of $0.10 during both periods.

Dividends are determined and declared by the Board of Directors of the Company. The Company expects to continue to pay cash dividends in the future; however, future dividends are dependent upon earnings, financial condition, capital strength and other factors of the Company. For a further discussion of regulatory capital requirements see

Note 15, "Regulatory Matters," contained within the notes to the consolidated financial statements, incorporated by reference in Part II, Item 8.

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

The Company had approximately 1,386 shareholders at December 31, 2016 and 1,386 shareholders as of February 28, 2017. The number of shareholders is the actual number of individual shareholders of record. Each security depository is considered a single shareholder for purposes of determining the approximate number of shareholders.

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Performance graph

The following graph and table compare the cumulative total shareholder return on the Company's common stock against the cumulative total return of the NASDAQ Composite and the SNL index of greater than $500 million in-asset banks traded on the OTC-BB and Pink Sheet (the SNL index) for the period of five fiscal years commencing January 1, 2012, and ending December 31, 2016. As of December 31, 2016, the SNL index consisted of 170 banks. A listing of the banks that comprise the index can be found on the Company's website at www.bankatfidelity.com and then on the bottom of the page clicking on, Investor Relations, Fidelity D & D Bancorp Stock, Stock Information, List of all companies in The SNL U.S. Bank Pink > $500M link at bottom of page. The graph illustrates the cumulative investment return to shareholders, based on the assumption that a $100 investment was made on December 31, 2011, in each of: the Company's common stock, the NASDAQ Composite and the SNL index. All cumulative total returns are computed assuming the reinvestment of dividends into the applicable securities. The shareholder return shown on the graph and table below is not necessarily indicative of future performance:

	Period Ending					
Index	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16
Fidelity D & D Bancorp, Inc.	100.00	103.59	139.86	180.97	195.61	212.46
NASDAQ Composite	100.00	117.45	164.57	188.84	201.98	219.89
SNL Bank Pink > $500M	100.00	110.28	134.03	157.12	174.30	203.22

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ITEM 6: SELECTED FINANCIAL DATA

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

(dollars in thousands except per share data)

Balance sheet data:	2016	2015	2014	2013	2012
Total assets	$ 792,944	$ 729,358	$ 676,485	$ 623,825	$ 601,525
Total investment securities	130,037	125,232	97,896	97,423	100,730
Net loans and leases	588,130	546,682	506,327	469,216	424,584
Loans held-for-sale	2,854	1,421	1,161	917	10,545
Total deposits	703,459	620,675	586,944	529,698	514,660
Short-term borrowings	4,223	28,204	3,969	8,642	8,056
Long-term debt	-	-	10,000	16,000	16,000
Total shareholders' equity	80,631	76,351	72,219	66,060	58,946
Operating data for the year ended:					
Total interest income	$ 27,495	$ 26,014	$ 24,844	$ 23,853	$ 23,994
Total interest expense	2,358	2,529	2,917	2,968	3,354
Net interest income	25,137	23,485	21,927	20,885	20,640
Provision for loan losses	1,025	1,075	1,060	2,550	3,250
Net interest income after provision for loan losses	24,112	22,410	20,867	18,335	17,390
Other-than-temporary impairment	-	-	-	-	(136)
Other income	8,005	7,533	7,354	10,541	7,788
Other operating expense	21,655	21,022	19,703	19,119	18,581
Income before income taxes	10,462	8,921	8,518	9,757	6,461
Provision for income taxes	2,769	1,818	2,166	2,635	1,559
Net income	$ 7,693	$ 7,103	$ 6,352	$ 7,122	$ 4,902
Per share data:					
Net income per share, basic	$ 3.14	$ 2.91	$ 2.63	$ 3.03	$ 2.14
Net income per share, diluted	$ 3.13	$ 2.90	$ 2.62	$ 3.02	$ 2.14
Dividends declared	$ 3,061	$ 2,844	$ 2,667	$ 2,602	$ 2,283

Dividends per share	$ 1.24	$ 1.16	$ 1.10	$ 1.10	$ 1.00
Book value per share	$ 32.86	$ 31.25	$ 29.75	$ 27.62	$ 25.37
Weighted-average shares outstanding	2,453,005	2,439,124	2,412,962	2,353,056	2,286,233
Shares outstanding	2,453,805	2,443,405	2,427,767	2,391,617	2,323,248
Ratios:					
Return on average assets	1.02%	1.00%	0.96%	1.15%	0.81%
Return on average equity	9.64%	9.55%	9.12%	11.70%	8.62%
Net interest margin	3.72%	3.70%	3.75%	3.80%	3.80%
Efficiency ratio	63.09%	64.40%	64.88%	64.99%	63.40%
Expense ratio	1.80%	1.86%	1.89%	1.87%	1.78%
Allowance for loan losses to loans	1.57%	1.71%	1.78%	1.87%	2.07%
Dividend payout ratio	39.79%	40.04%	41.99%	36.54%	46.56%
Equity to assets	10.17%	10.47%	10.68%	10.59%	9.80%
Equity to deposits	11.46%	12.30%	12.30%	12.47%	11.45%

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

Critical accounting policies

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

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

Another material estimate is the calculation of fair values of the Company's investment securities. 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. As described in Notes 1 and 4 of the consolidated financial statements, incorporated by reference in Part II, Item 8, all of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (loss) (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 loans are transferred at the lower of cost or market value and simultaneously sold. For a further discussion on the accounting treatment of HFS loans, see the section entitled "Loans held-for-sale," contained within this management's discussion and analysis.

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

The following discussion and analysis presents the significant changes in the financial condition and in the results of operations of the Company as of December 31, 2016 and 2015 and for each of the years then ended. This discussion should be read in conjunction with the consolidated financial statements and notes thereto included in Part II, Item 8 of this report.

Comparison of Financial Condition as of December 31, 2016

and 2015 and Results of Operations for each of the Years then Ended

Executive Summary

Nationally, the unemployment rate declined from 5.0% at December 31, 2015 to 4.7% at December 31, 2016, which is considered the natural unemployment rate by many analysts. However, the unemployment rate in the Scranton-Wilkes-Barre Metropolitan Statistical Area (local) ticked up in December 2016 after hitting its lowest level since 2007 at the end of 2015. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at December 31, 2016 was 5.5%, an increase of 0.8 percentage points from 4.7% at December 31, 2015. The number of unemployed increased 18% which drove up the unemployment rate. The median home values in the region increased 1.2% 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 grow 1.9% during 2017. For 2017, there is considerable uncertainty about the economic effects of the legislative agenda of the Trump administration and the Republican-controlled Congress, coupled with the affects international pressures could have on the U.S. economy. 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.

During 2016, the Company's assets grew by 9% from deposit growth and retained net earnings, both of which were used to fund growth in the loan and securities portfolios and pay off short-term borrowings. In 2017, we expect to continue to grow all facets of loans, however concentrated mostly within the commercial and consumer portfolios with funding provided primarily by deposit growth supplemented by short-term borrowings when necessary. We expect to grow the investment portfolio weighted heavier in mortgage-backed securities - an interest rate risk strategy in the event rates continue to rise. The cash flow from these securities will provide liquidity to reinvest in higher yielding assets. Funding will be provided from available borrowing capacity, cash on hand, deposits and operations. In addition, significant public fund deposit growth during 2017 may require more investment purchases than planned.

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Branch managers, relationship bankers, mortgage originators and our business service partners are all focused on developing a mutually profitable full banking relationship. We understand our market, offer products and services along with financial advice that is appropriate for our community, clients and prospects. Our mission of being a trusted financial advisor is top of mind and the processes that we have established are driven by this concept. The Company and its experienced bankers continue to focus on the trusted financial advisor model by utilizing the team approach by individuals that are fully engaged and dedicated.

Non-performing assets represented 1.33% of total assets as of December 31, 2016, down from 1.76% at the prior year end. Non-performing assets were lower during 2016 mostly due to less non-accrual loans and accruing TDRs. For 2017, we expect an increase in non-accrual loans and foreclosures as we continue to operate in a volatile economic environment.

We generated $7.7 million in net income in 2016, up $0.6 million from $7.1 million in 2015. In 2016, our larger and better positioned balance sheet contributed to the success of our earnings performance combined with lower debt. The 2017 focus is to manage net interest income after years of a sustained low interest rate environment through a slowly rising rate environment by maintaining a reasonable spread. Rate increases began in December 2015 with a 25 basis point rate hike but with stagnant inflation, uncertain world events and a presidential election, another 25 basis point rate hike in the target federal funds rate didn't occur until December 2016. From a financial condition and performance perspective, our mission for 2017 will be to continue to strengthen our capital position from strategic growth oriented objectives, implement creative marketing and revenue enhancing strategies, grow and cultivate more of our business services and to improve credit risk at tolerable levels thereby improving overall asset quality.

Finally, we closed the Eynon branch during the first quarter of 2016. Since the service area of the Peckville branch covered much of Eynon's service area, there was an opportunity to realize an improved cost structure with minimal disruption to customers. The cost savings was reallocated to help expand our branch network into Luzerne County where we expect to open a new branch during the fourth quarter of 2017.

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. Although we expect interest rates to rise, we anticipate net interest margin to decline in 2017. The Federal Open Market Committee (FOMC) adjusted the short-term federal funds rate up 25 basis points during December 2016. The move represented only the second hike in rates by the FOMC in nearly a decade and expectations are for short-term rates to rise gradually throughout 2017, potentially pressuring deposit rate pricing. The U.S. Treasury yield curve is expected to mildly flatten over 2017. Growth in all loan sectors at prudent loan pricing should mitigate the projected increase in interest expense from higher deposit and borrowing rates and help maintain an acceptable interest rate margin during 2017 and beyond.

Financial Condition

Consolidated assets increased $63.6 million, or 9%, to $792.9 million as of December 31, 2016 from $729.3 million at December 31, 2015. The increase in assets occurred predominantly in the loan portfolio and to a lesser extent the investment portfolio utilizing available cash balances along with growth in deposits of $82.8 million and $4.6 million in retained earnings, net of dividends declared. The growth in deposits also allowed the Company to pay down $24.0 million in short-term borrowings during 2016.

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

(dollars in thousands)

Assets:	2016	%	2015	%	2014	%
Cash and cash equivalents	$ 25,843	3.3 %	$ 12,277	1.7 %	$ 25,851	3.8 %
Investment securities	130,037	16.4	125,232	17.2	97,896	14.5
Federal Home Loan Bank stock	2,606	0.3	2,120	0.3	1,306	0.2
Loans and leases, net	590,984	74.5	548,103	75.1	507,488	75.0
Bank premises and equipment	17,164	2.2	16,723	2.3	14,846	2.2
Life insurance cash surrender value	11,435	1.4	11,082	1.5	10,741	1.6
Other assets	14,875	1.9	13,821	1.9	18,357	2.7
Total assets	$ 792,944	100.0 %	$ 729,358	100.0 %	$ 676,485	100.0 %
Liabilities:						
Total deposits	$ 703,459	88.7 %	$ 620,675	85.0 %	$ 586,944	86.7 %
Short-term borrowings	4,223	0.5	28,204	3.9	3,969	0.6
Long-term debt	-	-	-	-	10,000	1.5
Other liabilities	4,631	0.6	4,128	0.6	3,353	0.5
Total liabilities	712,313	89.8	653,007	89.5	604,266	89.3
Shareholders' equity	80,631	10.2	76,351	10.5	72,219	10.7
Total liabilities and shareholders' equity	$ 792,944	100.0 %	$ 729,358	100.0 %	$ 676,485	100.0 %

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

(dollars in thousands)	Assets	%	Earning assets*	%	Deposits	%	Short-term borrowings	%	Other borrowings	%
2016	$ 63,586	9	$ 62,612	9	$ 82,784	13	$ (23,981)	(85)	$ -	-
2015	52,873	8	50,304	8	33,731	6	24,235	611	(10,000)	(100)
2014	52,660	8	52,213	9	57,246	11	(4,673)	(54)	(6,000)	(38)
2013	22,300	4	30,087	6	15,038	3	586	7	-	-
2012	(5,217)	(1)	(1,690)	-	(1,142)	-	(1,451)	(15)	(5,000)	(24)

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

Funds Provided:

Deposits

The Company is a community based commercial depository financial institution, member FDIC, which offers a variety of deposit products with varying ranges of interest rates and terms. Generally, deposits are obtained from consumers, businesses and public entities within the communities that surround the Company's 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 alternative sources of funding such as short-term borrowings and long-term FHLB advances.

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

(dollars in thousands)	2016 Amount	%		2015 Amount	%	
Interest-bearing checking	$ 161,563	23.0	%	$ 132,598	21.4	%
Savings and clubs	120,512	17.1		115,668	18.6	
Money market	117,478	16.7		125,433	20.2	
Certificates of deposit	92,753	13.2		104,202	16.8	
Total interest-bearing	492,306	70.0		477,901	77.0	
Non-interest bearing	211,153	30.0		142,774	23.0	
Total deposits	$ 703,459	100.0	%	$ 620,675	100.0	%

Total deposits increased $82.8 million, or 13%, from $620.7 million at December 31, 2015 to $703.5 million at December 31, 2016. A large portion of this increase was from a $48.7 million non-interest bearing temporary deposit received at year end and transferred to a trust escrow account in January. The remaining $34.1 million came from $19.7 million growth in non-interest-bearing deposits, an additional $29.0 million in interest-bearing checking and $4.8 million more savings and clubs, partially offset by $8.0 million less in money market accounts and an $11.4 million decline 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 expects asset growth for 2017 funded primarily by growth in deposits plus utilization of available borrowing capacity. Transactional deposit and CD growth is projected as a result of our relationship strategy complimented by the purchase of a bank branch that is expected to occur during the first quarter of 2017. Seasonal public deposit fluctuations are expected to remain volatile and at times may partially offset this deposit growth.

Customers' interest in long-term time deposit products continues to be weak with a sustaining preference for non-maturing transaction deposits. The Company's portfolio of CDs continues to decrease; having declined $11.4 million, or 11%, from year-end 2015. The Company expects CDs to increase 14% in 2017 mostly as a result of the Company's acquisition of all of the deposits of a bank branch. The Company's relationship strategy resulted in a successful bid for over $10 million in public CDs to one customer in the third quarter of 2015, 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 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

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

The maturity distribution of certificates of deposit at December 31, 2016 is as follows:

(dollars in thousands)	Three months or less	More than three months to six months	More than six months to twelve months	More than twelve months	Total
CDs of $100,000 or more	$ 3,939	$ 4,721	$ 18,861	$ 18,790	$ 46,311
CDARS	-	-	1,132	-	1,132
Total CDs of $100,000 or more	3,939	4,721	19,993	18,790	47,443
CDs of less than $100,000	6,932	5,982	9,601	22,795	45,310
Total CDs	$ 10,871	$ 10,703	$ 29,594	$ 41,585	$ 92,753

Including CDARS, approximately 55% of the CDs, with a weighted-average interest rate of 0.67%, are scheduled to mature in 2017 and an additional 16%, with a weighted-average interest rate of 0.94%, are scheduled to mature in 2018. 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 other than from the branch purchase during 2017, but will 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.

Short-term borrowings

Borrowings are used as a complement to deposit generation as an alternative funding source whereby the Company will borrow under customer repurchase agreements in the local market, short-term advances from the FHLB and other correspondent banks for asset growth and liquidity needs.

The components of short-term borrowings are as follows:

(dollars in thousands)	As of December 31, 2016	2015
Overnight borrowings	$ -	$ 22,289
Securities sold under repurchase agreements	4,223	5,915
Total	$ 4,223	$ 28,204

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 $24.0 million during 2016. Less borrowing was needed because of growth in deposits during 2016. A $48.7 million temporary deposit at the end of 2016 prevented the Company from having to use overnight borrowings at year-end. Short-term borrowings are expected to increase in 2017 to fund asset growth above deposit balance growth.

Information with respect to the Company’s short-term borrowing’s maximum and average outstanding balances and interest rates are contained in Note 8, “Short-term Borrowings,” of the notes to consolidated financial statements incorporated by reference in Part II, Item 8.

Long-term debt

As of December 31, 2016 and 2015, the Company had no long-term debt. At the end of the second quarter of 2015, the Company paid off its long-term debt, due to its high interest rate relative to other available borrowing sources, and incurred a $0.6 million prepayment fee. As of December 31, 2016, the Company had the ability to borrow an additional $194.3 million from the FHLB. During the first quarter of 2017, the Company borrowed $10 million from the FHLB maturing in 2 years to fund investment security purchases.

Funds Deployed:

Investment Securities

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

At the time of purchase, management classifies investment securities into one of three categories: trading, available-for-sale (AFS) or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. All 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 December 31, 2016, the carrying value of investment securities amounted to $130.0 million, or 16% of total assets, compared to $125.2 million, or 17% of total assets, at December 31, 2015. On December 31, 2016, 55% 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 December 31, 2016. The AFS securities were recorded with a net unrealized gain of $2.1 million as of December 31, 2016 compared to a net unrealized gain of $3.3 million as of December 31, 2015, or a net reduction of $1.2 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 decline, especially at the intermediate and long end, the values of debt securities tend to rise. 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.

As of December 31, 2016, the Company had $103.0 million in public deposits, or 15% of total deposits. These public deposits require the Company to maintain pledged securities. As of December 31, 2016, the balance of pledged securities required for deposit and repurchase agreement accounts was $119.5 million, of which approximately $18 million was pledged for a temporary deposit and was reduced immediately after year end.

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 years ended December 31, 2016 and 2015, the Company did not incur other-than-temporary impairment charges from its investment securities portfolio.

During 2016, the carrying value of total investments increased $4.8 million, or 4%. 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

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conditions, the Company's liquidity needs and interest rate risk profile. The Company expects to grow the portfolio and increase its relative size with a preference 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. During the first quarter of 2017, the Company purchased approximately $20 million of securities, primarily MBS - GSE residential, funded by $10 million in debt maturing in two years and another $10 million in borrowings laddered out from six months to one year matching a spread expected to produce a suitable after-tax return.

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

(dollars in thousands)	2016 Amount	%	2015 Amount	%
MBS - GSE residential	$ 70,937	54.5 %	$ 69,415	55.4 %
State & municipal subdivisions	40,191	30.9	36,885	29.5
Agency - GSE	18,276	14.1	18,386	14.7
Equity securities - financial services	633	0.5	546	0.4
Total	$ 130,037	100.0 %	$ 125,232	100.0 %

As of December 31, 2016, there were no investments from any one issuer with an aggregate book value that exceeded 10% of the Company's shareholders' equity.

The distribution of debt securities by stated maturity and tax-equivalent yield at December 31, 2016 are as follows:

	One year or less		More than one year to five years		More than five years to ten years		More than ten years		Total	
(dollars in thousands)	$	%	$	%	$	%	$	%	$	%
MBS - GSE residential	$ -	- %	$ 2,363	3.85 %	$ 5,259	3.59 %	$ 63,315	3.41 %	$ 70,937	3.44 %
State & municipal subdivisions	-	-	-	-	1,794	5.96	38,397	5.18	40,191	5.21
Agency - GSE	4,017	1.17	14,259	1.46	-	-	-	-	18,276	1.39
Total debt securities	$ 4,017	1.17 %	$ 16,622	1.79 %	$ 7,053	4.17 %	$ 101,712	4.06 %	$ 129,404	3.68 %

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

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 $54 thousand and $123 thousand for the years ended December 31, 2016 and 2015, respectively. The reason for the decrease was the Company received a $57 thousand one-time special dividend during the first quarter of 2015. The balance in FHLB stock was $2.6 million and $2.1 million as of December 31, 2016 and 2015, respectively. During 2017, the balance of FHLB stock is expected to increase to support anticipated borrowing activities.

Loans and leases

In 2016, the $41.4 million, or 7%, growth in gross loans and leases came from the residential mortgage and consumer lending categories. Consumer loan growth contributed the most to the growth in the loan portfolio from an increase in auto loans. We anticipate modest 7.1% overall portfolio growth for 2017.

In 2016, the Company originated $25.2 million of commercial and industrial loans and $19.4 million of commercial real estate loans compared to $28.7 million and $11.1 million, respectively, net of loan participations in 2015. Also, during 2016, the Company originated $68.8 million of residential real estate loans compared to $61.9 million in 2015. Included in mortgage loans were $12.7 million of residential real estate construction lines in 2016 and $10.9 million in 2015. In 2016, the Company originated $52.1 million of consumer loans compared to $25.0 million in 2015. Of the consumer loan originations, $42.6 million were dealer loans in the auto loans and leases portfolio in 2016 compared to $14.2 million in 2015. In addition for 2016, the Company had originations of lines of credit in the amounts of $91.5 million for commercial borrowers and $17.2 million in home equity and other consumer lines of credit.

Commercial and industrial and commercial real estate

Compared to year-end 2015, the commercial and industrial (C&I) loan portfolio decreased $4.2 million, or 4%, from $102.7 million to $98.5 million and the commercial real estate (CRE) loan portfolio increased $2.4 million, or 1%, from $201.9 million to $204.3 million as of December 31, 2016. This portfolio experienced strong origination activity during 2016

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despite a modest net decrease of $1.8 million, or 1%, which was the result of the expected payoffs of several large credit facilities, as well as several larger credits that were not funded at year end. For 2017, we expect up to approximately $8 million in advances on these credit facilities that closed in 2016.

We anticipate 4% growth in the commercial loan portfolio during 2017. The Company will remain dedicated to a teamwork approach, utilizing the knowledge of our relationship managers and branch personnel to grow existing relationships and targeting new prospects.

Consumer

The consumer loan portfolio grew $35.3 million, or 31%, from $114.9 million at December 31, 2015 to $150.2 million at December 31, 2016. Growth in the portfolio was primarily driven by a $27.1 million increase in auto loans and leases. Auto loan and lease growth was the result of a focused effort to grow this line of business. Additionally, a slight reduction in home equity installment loans outstanding was more than offset by growth in home equity lines of credit and other consumer loan products.

Residential

The residential loan portfolio grew $7.9 million, or 6%, from $137.1 million at December 31, 2015 to $145.0 million at December 31, 2016. The Company's mortgage loan modification program which offered refinancing to qualified customers generated approximately $10 million and lifted the held to maturity portfolio which grew $7.5 million, or 6%, from $127.0 million at December 31, 2015 to $134.5 million at December 31, 2016.

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

(dollars in thousands)	2016 Amount	%		2015 Amount	%		2014 Amount	%		2013 Amount	%		2012 Amount	%
Commercial and industrial	$ 98,477	16.5	%	$ 102,653	18.4	%	$ 80,301	15.6	%	$ 74,551	15.6	%	$ 65,110	15.0
Commercial real estate:														
Non-owner occupied	93,364	15.6		95,745	17.2		94,771	18.4		89,255	18.7		81,998	18.9
Owner occupied	106,960	17.8		101,652	18.3		95,780	18.5		86,294	18.0		80,509	18.6
Construction	3,987	0.7		4,481	0.8		5,911	1.1		10,765	2.2		10,679	2.5
Consumer:														
Home equity installment	28,466	4.8		30,935	5.6		32,819	6.4		34,480	7.2		32,828	7.6
Home equity line of credit	51,609	8.6		48,060	8.7		42,188	8.2		36,836	7.7		34,169	7.9

Auto and leases	56,841	9.5	29,758	5.3	27,972	5.4	22,261	4.7	17,411	4.0
Other	13,301	2.2	6,208	1.1	6,501	1.3	5,205	1.1	6,139	1.4
Residential:										
Real estate	134,475	22.5	126,992	22.8	119,154	23.1	110,365	23.1	96,765	22.3
Construction	10,496	1.8	10,060	1.8	10,298	2.0	8,188	1.7	7,948	1.8
Gross loans	597,976	100.0 %	556,544	100.0 %	515,695	100.0 %	478,200	100.0 %	433,556	100.[illegible]
Less:										
Allowance for loan losses	(9,364)		(9,527)		(9,173)		(8,928)		(8,972)	
Unearned lease revenue	(482)		(335)		(195)		(56)		-	
Net loans	$ 588,130		$ 546,682		$ 506,327		$ 469,216		$ 424,584	
Loans held-for-sale	$ 2,854		$ 1,421		$ 1,161		$ 917		$ 10,545	

The following table sets forth the maturity distribution of select components of the loan portfolio at December 31, 2016. Excluded from the table are residential real estate and consumer loans:

(dollars in thousands)	One year or less	More than one year to five years	More than five years	Total
Commercial and industrial	$ 20,860	$ 29,702	$ 47,915	$ 98,477
Commercial real estate	22,639	84,317	93,368	200,324
Commercial real estate construction *	3,987	-	-	3,987
Residential real estate construction *	10,496	-	-	10,496
Total	$ 57,982	$ 114,019	$ 141,283	$ 313,284

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

The following table sets forth the total amount of C&I and CRE loans due after one year which have predetermined interest rates (fixed) and floating or adjustable interest rates (variable) as of December 31, 2016:

(dollars in thousands)	One to five years	More than five years	Total
Fixed interest rate	$ 8,594	$ 37,067	$ 45,661
Variable interest rate	105,425	104,216	209,641
Total	$ 114,019	$ 141,283	$ 255,302

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

There are no concentrations of loans to a number of borrowers engaged in similar industries exceeding 10% of total loans that are not otherwise disclosed as a category in the tables above. There are no concentrations of loans that, if resulted in a loss, would have a material adverse effect on the business of the Company. The Company's loan portfolio does not have a material concentration within a single industry or group of related industries that is vulnerable to the risk of a near-term severe negative business impact. As of December 31, 2016, approximately 73% of the total loan portfolio was secured by real estate, down slightly from 76% as of December 31, 2015. The Company considers this segment concentration to be normal. The banking industry is affected by general economic conditions including, among other things, the effects of real estate values. The Company's credit function strives to mitigate the negative impact of economic conditions by maintaining strict underwriting principles for all loan types and ensuring mortgage lending adheres to standards of secondary market compliance.

Loans held-for-sale

Upon origination, most residential mortgages and certain Small Business Administration (SBA) guaranteed loans may be classified as held-for-sale (HFS). In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In low interest rate environments, the Company would be exposed to prepayment risk and, as rates on adjustable-rate loans decrease, interest income would be negatively affected. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as HFS. 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 December 31, 2016 and 2015, loans HFS consisted of residential mortgages with carrying amounts of $2.9 million and $1.4 million, respectively, which approximated their fair values. During the year ended December 31, 2016, residential mortgage loans with principal balances of $51.3 million were sold into the secondary market and the Company recognized net gains of $1.0 million, compared to $47.3 million and $1.0 million, respectively during the year ended December 31, 2015. During 2015, the Company also sold five SBA guaranteed loans and recognized net gains on these sales of $0.2 million. The Company did not sell any SBA guaranteed loans in 2016.

The Company retains mortgage servicing rights (MSRs) on loans sold into the secondary market. MSRs are retained so that the Company can foster personal relationships with its loyal customer base. At December 31, 2016 and 2015, the servicing portfolio balance of sold residential mortgage loans was $285.2 million and $269.5 million, respectively. At December 31, 2016 and 2015, the servicing portfolio balance of sold SBA loans was $4.1 million and $4.4 million, respectively.

Allowance for loan losses

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

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

- identification of specific impaired loans by loan category;
- calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;

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

Through December 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 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 $1.2 million as of the year ended December 31, 2016, $0.7 million as of the year ended December 31, 2015 and $0.8 million as of December 31, 2014. During the year ended December 31, 2016, no specific loan class significantly underperformed as charge-offs were taken across a variety of consumer, commercial and residential loans. Compared to December 31, 2015, charge-offs increased by $0.5 million for the twelve months of 2016, of which $0.4 million was taken in the commercial loan portfolio and was mostly related to three large charge-offs to three commercial loans to unrelated borrowers. The remaining $0.1 million was taken in the consumer and mortgage portfolios across a number of 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 December 31, 2016, $9.5 million as of December 31, 2015 and $9.2 million as of December 31, 2014. 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 table sets forth the activity in the allowance for loan losses and certain key ratios for the periods indicated:

(dollars in thousands)	2016		2015		2014		2013		2012	
Balance at beginning of period	$ 9,527		$ 9,173		$ 8,928		$ 8,972		$ 8,108	
Charge-offs:										
Commercial and industrial	(224)		(25)		(309)		(56)		(185)	
Commercial real estate	(592)		(432)		(239)		(2,091)		(1,335)	
Consumer	(504)		(437)		(361)		(400)		(737)	
Residential	(60)		(15)		(93)		(218)		(231)	
Total	(1,380)		(909)		(1,002)		(2,765)		(2,488)	
Recoveries:										
Commercial and industrial	55		47		32		30		26	
Commercial real estate	37		18		91		30		46	
Consumer	100		95		30		110		30	
Residential	-		28		34		1		-	
Total	192		188		187		171		102	
Net charge-offs	(1,188)		(721)		(815)		(2,594)		(2,386)	
Provision for loan losses	1,025		1,075		1,060		2,550		3,250	
Balance at end of period	$ 9,364		$ 9,527		$ 9,173		$ 8,928		$ 8,972	
Allowance for loan losses to total loans	1.57	%	1.71	%	1.78	%	1.87	%	2.07	%
Net charge-offs to average total loans outstanding	0.21	%	0.13	%	0.16	%	0.56	%	0.56	%
Average total loans	$ 568,953		$ 534,903		$ 495,758		$ 461,539		$ 426,636	
Loans 30 - 89 days past due and accruing	$ 2,241		$ 3,707		$ 3,932		$ 5,268		$ 2,920	
Loans 90 days or more past due and accruing	$ 19		$ 356		$ 1,060		$ 155		$ 1,723	
Non-accrual loans	$ 7,370		$ 9,003		$ 4,215		$ 5,668		$ 12,121	
Allowance for loan losses to loans 90 days or more past due and accruing	492.84	x	26.76	x	8.65	x	57.60	x	5.21	x
Allowance for loan losses to non-accrual loans	1.27	x	1.06	x	2.18	x	1.58	x	0.74	x
Allowance for loan losses to non-performing loans	1.27	x	1.02	x	1.74	x	1.53	x	0.65	x

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

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

	2016		2015		2014		2013		2012	
(dollars in thousands)	Allowance	Category % of Loans	Allowance	Category % of Loans	Allowance	Category % of Loans	Allowance	Category % of Loans	Allowance	Category % of Loans
Category										
Commercial real estate	$ 4,706	34 %	$ 5,014	36 %	$ 4,672	38 %	$ 4,253	39 %	$ 4,908	40 %
Commercial and industrial	1,075	17	1,336	18	1,052	16	944	15	922	15
Consumer	1,834	25	1,533	21	1,519	21	1,482	21	1,639	21
Residential real estate	1,622	24	1,407	25	1,316	25	1,613	25	1,503	24
Unallocated	127	-	237	-	614	-	636	-	-	-
Total	$ 9,364	100 %	$ 9,527	100 %	$ 9,173	100 %	$ 8,928	100 %	$ 8,972	100 %

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The allocation of the allowance for the commercial loan portfolio, which is comprised of commercial real estate and commercial and industrial loans, accounted for approximately 61.7%, or $5.8 million, of the total allowance for loan losses at December 31, 2016, which represents a 4.9 percentage point decrease from December 31, 2015. The decrease in the commercial real estate and commercial and industrial allocation from December 31, 2015 to December 31, 2016 was mostly related to the payoff of one large commercial non-owner occupied real estate loan into the non-accrual category. The allocation to the consumer and mortgage categories of loans increased by $0.3 million and $0.2 million as of December 31, 2016, respectively. These increases were mostly related to the movement of one large HELOC and one large residential loan into the non-accrual category in the fourth quarter of 2016. However, management views this allocation as adequate compared to the actual historical net charge-offs and qualitative adjustments. The unallocated amount represents the portion of the allowance not specifically identified with a loan or groups of loans. Management provided the amount to support growth in the loan portfolio and reinforce the allowance for identified and potential credit risks that still exist from an uncertain local economic climate.

Non-performing assets

The Company defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, troubled debt restructured loans (TDRs), other real estate owned (ORE) and repossessed assets. At December 31, 2016, non-performing assets represented 1.33% of total assets compared with 1.76% as of December 31, 2015, as a result of a reduction in non-accrual loans by $1.6 million, accruing TDRs by $0.6 million and loans over 90 days past due and accruing by $0.3 million. The net reduction in non-accrual loans occurred in the second quarter of 2016 and was primarily the result of the payoff of one large commercial real estate loan for $5.0 million and the addition of two other commercial real estate loans totaling $3.1 million. These decreases were partially offset by an increase in other real estate owned of $0.2 million for the same period. Most of the non-performing loans are collateralized, thereby mitigating the Company's potential for loss.

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

(dollars in thousands)	2016	2015	2014	2013	2012
Loans past due 90 days or more and accruing	$ 19	$ 356	$ 1,060	$ 155	$ 1,723
Non-accrual loans *	7,370	9,003	4,215	5,668	12,121
Total non-performing loans	7,389	9,359	5,275	5,823	13,844
Troubled debt restructurings	1,823	2,423	753	1,045	1,103
Other real estate owned and repossessed assets	1,306	1,074	1,972	2,086	1,607
Non-accrual securities	-	-	-	-	1,132
Total non-performing assets	$ 10,518	$ 12,856	$ 8,000	$ 8,954	$ 17,686
Total loans, including loans held-for-sale	$ 600,348	$ 557,630	$ 516,661	$ 479,061	$ 444,101
Total assets	$ 792,944	$ 729,358	$ 676,485	$ 623,825	$ 601,525
Non-accrual loans to total loans	1.23%	1.61%	0.82%	1.18%	2.73%
Non-performing loans to total loans	1.23%	1.68%	1.02%	1.22%	3.12%
Non-performing assets to total assets	1.33%	1.76%	1.18%	1.44%	2.94%

* In the table above, the amount includes non-accrual TDRs of $1.5 million, $0.9 million, $1.0 million and $1.1 million as of 2016, 2014, 2013 and 2012, respectively. 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 $2.0 million, or 21%, from $9.4 million at December 31, 2015 to $7.4 million at December 31, 2016. This decrease is attributed to the payoff of one large non-accrual loan in the commercial real estate portfolio. At December 31, 2016, the portion of accruing loans that was over 90 days past due totaled $19 thousand and consisted of 4 auto loans with recourse to four unrelated borrowers, ranging from $1 thousand to $9 thousand. 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.

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At December 31, 2016, there were 46 loans to 39 unrelated borrowers ranging from less than $1 thousand to $2.3 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 twelve month period ending December 31, 2016 for the following reasons: $7.2 million in new non-accrual loans plus capitalized expenditures on these loans were added; $5.8 million were paid down or paid off; $0.6 million were charged off; $1.0 million were transferred to ORE, and $1.4 million was moved back to accrual status.

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

(dollars in thousands)	Gross loan balances	Past due 90 days or more and still accruing	Non-accrual loans	Total non-performing loans	% of gross loans
Commercial and industrial	$ 98,477	$ -	$ 11	$ 11	0.01%
Commercial real estate:					
Non-owner occupied	93,364	-	1,407	1,407	1.51%
Owner occupied	106,960	-	3,078	3,078	2.88%
Construction	3,987	-	193	193	4.84%
Consumer:					
Home equity installment	28,466	-	31	31	0.11%
Home equity line of credit	51,609	-	737	737	1.43%
Auto loans and leases *	56,359	19	25	44	0.08%
Other	13,301	-	6	6	0.05%
Residential:					
Real estate	134,475	-	1,882	1,882	1.40%
Construction	10,496	-	-	-	-
Loans held-for-sale	2,854	-	-	-	-
Total	$ 600,348	$ 19	$ 7,370	$ 7,389	1.23%

*Net of unearned lease revenue of $0.5 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 December 31, 2016 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of $0.1 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 $3.4 million at December 31, 2016, a net increase of $1.0 million, from $2.4 million at December 31, 2015, due to the addition of one home equity line of credit (HELOC) for $0.6 million and a residential real estate loan totaling $0.9 million, partially offset by the payoff of a C&I loan categorized as a TDR of $0.5 million. The $3.4 million in TDRs as of December 31, 2016, consisted of seven commercial loans (6 CRE and 1 C&I), one residential mortgage and one consumer loan (HELOC) to six unrelated borrowers. As of December 31, 2016, two TDRs, the residential mortgage and the HELOC, were on non-accrual.

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

As of and for the year ended December 31, 2016

	Accruing		Non-accruing			
(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer HELOC	Commercial real estate	Residential real estate	Total
Troubled Debt Restructures:						
Beginning balance	$ 525	$ 1,898	$ -	$ -	-	$ 2,423
Additions	-	4	650	-	881	1,535
Transfers	-	(20)	-	20	-	-
Pay downs / payoffs	(500)	(84)	-	-	-	(584)
Charge offs	-	-	-	(20)	-	(20)
Ending balance	$ 25	$ 1,798	$ 650	$ -	881	$ 3,354

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As of and for the year ended December 31, 2015

(dollars in thousands)	Accruing Commercial & industrial	Accruing Commercial real estate	Non-accruing Commercial 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 $1.3 million at December 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)	2016 Amount	#	2015 Amount	#
Balance at beginning of period	$ 1,074	14	$ 1,961	12
Additions	1,056	11	466	10
Pay downs	(18)		(1)	
Write downs	(80)		(37)	
Sold	(734)	(12)	(1,315)	(8)
Balance at end of period	$ 1,298	13	$ 1,074	14

As of December 31, 2016, ORE consisted of thirteen properties from twelve unrelated borrowers totaling $1.3 million. Five of these properties ($0.8 million) were added in 2016; three were added in 2015 ($0.2 million); two were added in 2014 ($0.1 million); one was added in 2013 ($0.1 million); one was added in 2012 ($100); and one was added in 2011 ($0.1 million). In addition, of the thirteen properties, two ($0.2 million) had a signed sales agreement, four ($0.7 million) were listed for sale, and one ($0.2 million) was being shown to interested parties while the remaining properties (six totaling $0.2 million) are either in litigation, being prepared for auction, in the process of eviction or disposal, or being prepared to be listed for sale.

As of December 31, 2016, the Company acquired one other repossessed assets held-for-sale, with a balance of $8 thousand. There were no other repossessed assets held-for-sale at December 31, 2015.

Cash surrender value of bank owned life insurance

The Company maintains bank owned life insurance (BOLI) for a chosen group of employees at the time of purchase, namely its officers, where the Company is the owner and sole beneficiary of the policies. BOLI is classified as a non-interest earning asset. Increases in the cash surrender value are recorded as components of non-interest income. The BOLI is profitable from the appreciation of the cash surrender values of the pool of insurance and its tax-free advantage to the Company. This profitability is used to offset a portion of current and future employee benefit costs. Given the regulatory capital capacity to support carrying additional BOLI along with expected rising costs and added employee benefit program, the Company’s Board of Directors approved the purchase of up to $8.0 million in additional BOLI during the first quarter of 2017. The BOLI can be liquidated if necessary with associated tax costs. However, the Company intends to hold this pool of insurance, because it provides income that enhances the Company’s capital position. Therefore, the Company has not provided for deferred income taxes on the earnings from the increase in cash surrender value.

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Premises and equipment

Net of depreciation, premises and equipment increased $0.4 million during 2016. Additions of $1.8 million were partially offset by $1.4 million more depreciation expense. The additions were primarily due to renovations to the Kingston branch. The higher depreciation expense was the result of a full year of depreciation for a new branch and renovations to an existing branch which were completed during the second quarter of 2015. In 2017, we expect premises and equipment to increase by $1.8 million, net of depreciation, primarily due to the building of a new Dallas branch scheduled for completion during the fourth quarter.

Other assets

The $0.8 million increase in other assets was due mostly to $2.1 million in higher residual values associated with recording new automobile leases, net of lease disposals and a $0.8 million higher prepaid dealer reserve, partially offset by $1.6 million higher net deferred tax liability, $0.3 million less in construction in process and $0.2 million less in prepaid expenses.

Results of Operation

Earnings Summary

The Company’s earnings depend primarily on net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields earned on interest-earning assets, which consist principally of loans and investment securities. Interest expense is incurred from rates paid on interest-bearing liabilities, which consist of deposits and borrowings. Net interest income is determined by the 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.

Overview

For the year ended December 31, 2016, the Company generated net income of $7.7 million, or $3.13 per diluted share, compared to $7.1 million, or $2.90 per diluted share, for the year ended December 31, 2015. The $0.6 million, or 8%, increase in net income stemmed from $1.7 million more net interest income and $0.5 million in additional non-interest income which more than offset a $0.6 million rise in non-interest expenses.

For the year ended December 31, 2016, return on average assets (ROA) and return on average shareholders' equity (ROE) were 1.02% and 9.64%, respectively, compared to 1.00% and 9.55% for the same period in 2015. The increase in ROA and ROE was caused by net income growth during 2016.

Net interest income and interest sensitive assets / liabilities

Net interest income increased $1.7 million, or 7%, from $23.4 million for the year ended December 31, 2015 to $25.1 million for the year ended December 31, 2016, with higher interest income and lower interest expense combining for the net increase. Total average interest-earning assets increased $42.9 million and helped offset the negative impact of a three basis point net reduction in earning asset yields resulting in $1.5 million of growth in interest income. In the loan portfolio, the Company experienced average balance growth of $34.1 million, which had the effect of producing $1.5 million of interest income, more than offsetting the $0.5 million negative impact of an eight basis point lower yield earned thereon. Although all loan portfolios showed more interest income from growth, the mortgage and commercial loan portfolios made the biggest impact. In the investment portfolio, an increase in the average balances and yields of mortgage-backed securities produced $0.5 million in additional interest income which was partially offset by a $0.1 million decrease in other investments from a special dividend from the FHLB that was received in 2015. On the liability side, total interest-bearing liabilities grew $22.4 million on average but a five basis point decline in the rates paid offset the impact of this growth. The reduction in average rate paid was due to the $10 million payoff of long- term debt carrying an interest rate of 5.26% during 2015 which reduced interest expense from borrowings by $0.2 million. These borrowings were replaced by lower-costing deposits which had $29.2 million higher average balances resulting in $0.1 million added interest expense. Interest expense increased from growth in interest-bearing checking and money market accounts mostly due to higher average balances from successful relationship-building efforts, promotions, cross-selling, transfers from unpopular CDs, and contractual and negotiated rates.

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The fully-taxable equivalent (FTE) net interest rate spread and margin both increased by two basis points for the year ended December 31, 2016 compared to the year ended December 31, 2015. The increase in the spread was due to a five basis point reduction in rates paid on interest-bearing liabilities due to the payoff of long-term debt which was enough to offset the three basis point lower yields earned on interest-earning assets. Net interest margin improved because net interest income increased on a larger average portfolio of interest-earning assets. The overall cost of funds, which includes the impact of non-interest bearing deposits, declined five basis points for the year ended December 31, 2016 compared to the same period in 2015. The principal reason for the decrease was the payoff of long-term debt and growth in average non-interest bearing deposits.

During 2017, the Company expects to operate in a gradually increasing interest rate environment. A rate environment with rising interest rates positions the Company to improve its interest income performance from new and maturing 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 2017, 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 only once in both 2015 and 2016, but it had a minimal effect on rates paid on funding sources. The focus for 2017 is to manage net interest income after years of a sustained low interest rate environment by maintaining a reasonable spread. Interest expense is projected to increase for 2017 from growth in deposits and borrowings and an increase in the rates paid on both. Continued growth in the loan portfolios complemented with investment security growth is expected to boost interest income, and when coupled with a proactive approach to deposit cost setting strategies should help contain the interest rate margin at acceptable levels.

The Company’s cost of interest-bearing liabilities was 46 basis points for the year ended December 31, 2016 or five basis points lower than the cost for the year ended December 31, 2015. 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 relative 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, rose 25 basis points at the end of 2016. If rates continue to rise in 2017, 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 years indicated. Within the table, interest income was adjusted to a tax-equivalent basis, using the corporate federal tax rate of 34% to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. This treatment allows a uniform comparison among yields on interest-earning assets. Loans include loans HFS and non-accrual loans but exclude the allowance for loan losses. Net deferred loan cost amortization of $0.5 million in 2016, $0.4 million in 2015 and $0.3 million in 2014, respectively, are included in interest income from loans. Average balances are based on amortized cost and do not reflect net unrealized gains or losses. Net interest margin is calculated by dividing net interest income-FTE by total average interest-earning assets. Cost of funds includes the effect of average non-interest bearing deposits as a funding source:

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(dollars in thousands)	2016			2015			2014		
Assets	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Interest-earning assets									
Interest-bearing deposits	$ 12,489	$ 67	0.53 %	$ 9,961	$ 26	0.27 %	$ 10,074	$ 26	0.26 %
Investments:									
Agency - GSE	18,279	237	1.29	17,779	227	1.27	16,321	233	1.43
MBS - GSE residential	69,437	1,472	2.12	63,964	953	1.49	52,903	855	1.62
State and municipal (nontaxable)	35,776	2,010	5.62	35,370	2,040	5.77	33,839	2,011	5.94
Other	1,686	83	4.93	1,687	150	8.89	2,571	120	4.67
Total investments	125,178	3,802	3.04	118,800	3,370	2.84	105,634	3,219	3.05
Loans and leases:									
Commercial and commercial real estate (taxable)	275,214	12,235	4.45	264,127	11,844	4.48	251,922	11,604	4.61
Commercial and commercial real estate (nontaxable)	26,244	1,141	4.35	22,199	992	4.47	15,810	816	5.16
Consumer	74,482	3,828	5.14	67,623	3,760	5.56	65,460	3,661	5.59
Residential real estate	193,013	7,546	3.91	180,954	7,106	3.93	162,566	6,534	4.02
Total loans and leases	568,953	24,750	4.35	534,903	23,702	4.43	495,758	22,615	4.56
Federal funds sold	-	-	-	103	-	0.26	221	1	0.26
Total interest-earning assets	706,620	28,619	4.05 %	663,767	27,098	4.08 %	611,687	25,861	4.23 %

Non-interest earning assets	49,226			49,075			49,172		
Total assets	$ 755,846			$ 712,842			$ 660,859		
							-		
Liabilities and shareholders' equity									
Interest-bearing liabilities									
Deposits:									
Savings	$ 118,097	$ 148	0.13 %	$ 113,394	$ 200	0.18 %	$ 111,676	$ 216	0.19 %
Interest-bearing checking	157,324	483	0.31	131,004	315	0.24	107,063	196	0.18
MMDA	130,017	818	0.63	121,921	764	0.63	97,162	568	0.58
CDs < $100,000	49,105	377	0.77	59,804	464	0.78	66,871	603	0.90
CDs > $100,000	48,938	480	0.98	48,039	490	1.02	41,130	450	1.09
Clubs	1,598	3	0.18	1,692	3	0.19	1,615	3	0.16
Total interest-bearing deposits	505,079	2,309	0.46	475,854	2,236	0.47	425,517	2,036	0.48
Repurchase agreements	10,239	20	0.19	10,268	18	0.17	11,349	21	0.18
Borrowed funds	2,805	29	1.02	9,618	275	2.87	18,600	860	4.62
Total interest-bearing liabilities	518,123	2,358	0.46 %	495,740	2,529	0.51 %	455,466	2,917	0.64 %
Non-interest bearing deposits	152,826			138,388			131,691		
Non-interest bearing liabilities	5,120			4,306			4,075		
Total liabilities	676,069			638,434			591,232		
Shareholders' equity	79,777			74,408			69,627		
Total liabilities and shareholders' equity	$ 755,846			$ 712,842			$ 660,859		
Net interest income		$ 26,261			$ 24,569			$ 22,944	
Net interest spread			3.59 %			3.57 %			3.59 %
Net interest margin			3.72 %			3.70 %			3.75 %
Cost of funds			0.35 %			0.40 %			0.50 %

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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:

	Years ended December 31,					
(dollars in thousands)	2016 compared to 2015			2015 compared to 2014		
	Increase (decrease) due to					
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Interest-bearing deposits	$ 9	$ 32	$ 41	$ -	$ -	$ -
Investments:						
Agency - GSE	6	4	10	20	(26)	(6)
MBS - GSE residential	87	432	519	168	(70)	98
State and municipal	15	(34)	(19)	57	(36)	21
Other	-	(68)	(68)	(48)	79	31
Total investments	108	334	442	197	(53)	144
Loans and leases:						
Residential real estate	477	(37)	440	726	(154)	572
Commercial and CRE	665	(175)	490	831	(475)	356
Consumer	365	(297)	68	119	(20)	99
Total loans and leases	1,507	(509)	998	1,676	(649)	1,027
Federal funds sold	-	-	-	(1)	-	(1)
Total interest income	1,624	(143)	1,481	1,872	(702)	1,170
Interest expense:						
Deposits:						
Savings	9	(61)	(52)	3	(19)	(16)
Interest-bearing checking	70	98	168	48	72	120
Money market	55	(1)	54	149	46	195
Certificates of deposit less than $100,000	(80)	(7)	(87)	(60)	(79)	(139)
Certificates of deposit greater than $100,000	9	(19)	(10)	70	(31)	39
Clubs	-	-	-	-	1	1
Total deposits	63	10	73	210	(10)	200
Repurchase agreements	-	2	2	(2)	(1)	(3)
Borrowed funds	(129)	(117)	(246)	(327)	(258)	(585)
Total interest expense	(66)	(105)	(171)	(119)	(269)	(388)
Net interest income	$ 1,690	$ (38)	$ 1,652	$ 1,991	$ (433)	$ 1,558

Provision for loan losses

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

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

- specific loans that could have loss potential;
- levels of and trends in delinquencies and non-accrual loans;
- levels of and trends in charge-offs and recoveries;
- trends in volume and terms of loans;

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· 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 twelve months ended December 31, 2016 and 2015, the Company recorded a provision for loan losses of $1.0 million and $1.1 million, respectively. The provision decreased $0.1 million despite approximately $41 million growth in gross loans because $35.3 million of this growth occurred from high quality auto loans. At the same time, non-performing loans as a percentage of total loans fell 45 basis points to 1.23% at December 31, 2016 from 1.68% at December 31, 2015 indicating improvement in year-over-year asset quality. 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 year ended December 31, 2016, non-interest income amounted to $8.0 million, a $0.5 million, or 6%, increase compared to $7.5 million recorded for the year ended December 31, 2015. A majority of this increase was due to $0.4 million higher deposit service charges resulting from a new fee structure that was implemented during 2016. Debit card interchange fees and financial services revenue also contributed $0.2 million and $0.1 million, respectively, to the increase. Partially offsetting these items was $0.2 million fewer gains on the sale of loans and $0.1 million fewer gains on the sales of investment securities. During the first quarter of 2017, the Company will assume the trust accounts of a bank and as a result expects trust fiduciary fees to increase by approximately $0.4 million for the year.

Other operating expenses

For the year ended December 31, 2016, total other operating expenses totaled $21.6 million an increase of $0.6 million, or 3%, compared to $21.0 million for the year ended December 31, 2015. Salary and employee benefits contributed the most to the increase rising $1.1 million, or 11%, in 2016 compared to 2015. The basis of the increase includes annual merit increases, staff additions in various areas, hiring new management level positions, replacing an existing management position at a higher level, higher recognized employee incentives, more stock-based compensation expense and an increase in group insurance from higher claims. Data processing and communications expense increased $0.4 million during 2016 compared to 2015 because of additional costs incurred from outsourcing the Company's data processing during the third quarter of 2015. The increase of $0.2 million in PA shares tax during 2016 was partially offset by a decrease of $0.1 million in donations. During 2016, the Company did not get approved by the state to make $150 thousand in educational improvement tax credit (EITC) donations that were made in 2015. As a result, the Company also did not get the associated tax credits which are used against the PA shares tax. Partially offsetting these increases in expenses was a $0.6 million prepayment fee paid on the early payoff of long-term debt during 2015. There was also a $0.2 million decrease in advertising and promotions due to expenses incurred in 2015 for two branch grand re-openings. Professional services decreased $0.1 million as a result of one-time expenses that occurred in 2015.

The ratios of non-interest expense less non-interest income to average assets, known as the expense ratio, at December 31, 2016 and 2015 were 1.80% and 1.86%, respectively. The expense ratio, which excludes non-recurring expenses, decreased because of higher average assets during the year ended December 31, 2016 compared to the year ended December 31, 2015 which were able to absorb the higher expenses.

Provision for income taxes

The Company's effective income tax rate approximated 26.5% in 2016 and 20.4% in 2015. The difference between the effective rate and the enacted statutory corporate rate of 34% is due mostly to the effect of tax exempt income in relation to the level of pre-tax income. In 2016, the Company had a higher amount of tax exempt income and a higher amount of pre-tax income subject to the 34% statutory income tax rate compared to the year ended December 31, 2015. The provision for income taxes increased $1.0 million, or 52%, from $1.8 million at December 31, 2015 to $2.8 million at December 31, 2016. The increase was the result of an IRS audit adjustment which resulted in recording a $0.4 million credit for income taxes during the second quarter of 2015. This adjustment coupled with a higher effective tax rate for 2016 from additional income increasing the level of pre-tax income caused the higher provision for income taxes.

Comparison of Financial Condition as of December 31, 2015

and 2014 and Results of Operations for each of the Years then Ended

Executive Summary

Nationally, the unemployment rate declined from 5.6% at December 31, 2014 to 5.0% at December 31, 2015, remaining at the lowest level since 2008. The unemployment rate in the Scranton-Wilkes-Barre Metropolitan Statistical Area (local) dipped in December 2015 to its lowest level since before the recession. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at December 31, 2015 was 4.6%, a decline of 0.9 percentage points from 5.5% at December 31, 2014. Both the labor force and employment increased to bring down the unemployment rate which was a good sign.

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During 2015, our assets grew by 8% from deposit growth and retained net earnings, both of which were used to fund growth in the loan and securities portfolios. Short-term borrowings were used to pay-off high cost long-term debt. Non-performing assets represented 1.76% of total assets as of December 31, 2015, up from 1.18% as of December 31, 2014. Although non-performing assets increased during 2015, it was mostly due to the movement of one large commercial real estate loan to non-accrual status.

We generated $7.1 million in net income in 2015, up $0.7 million from $6.4 million in 2014. In 2015, our larger and better positioned balance sheet contributed to the success of our earnings performance combined with the payoff of high-costing long-term debt.

Financial Condition

Consolidated assets increased $52.9 million, or 8%, to $729.4 million as of December 31, 2015 from $676.5 million at December 31, 2014. The increase in assets occurred predominantly in the loan portfolio and to a lesser extent the investment portfolio utilizing available cash balances along with growth in deposits of $33.7 million and $4.3 million in retained earnings, net of dividends declared. Short-term borrowings were used to fund the payoff of $10.0 million in long-term debt with the balance providing additional funding for the loan and investment portfolios.

Funds Provided:

Deposits

Total deposits increased $33.7 million, or 6%, from $586.9 million at December 31, 2014 to $620.6 million at December 31, 2015. Growth in transaction accounts of $34.2 million, or 7%, offset a slight decline in CDs. Money market deposits increased in part due to promotions which granted higher rates for a specific amount of time. The promotional events created opportunities to cross-sell all of the banks financial products and provided communication channels for establishing trust and financial service relationships thereby creating a stronger bond with existing customers and creating bonds with potential customers. The Company’s focus of building a relationship of trust with its customers brought a few large deposits into the bank during 2015.

The market interest rate profile continued to be low with intermediate and long-term market rates falling below the 2013 levels. Customers’ appetite for long-term deposit products continued to be non-existent with a sustaining preference for non-maturing transaction deposits. The Company’s portfolio of CDs continued to decrease; having declined $0.4 million, or less than 1%, from year-end 2014. However, the Company took in $10 million in CDs from one public entity during 2015 so the run-off was much larger. The Company’s relationship strategy resulted in a successful bid for a large public CD account, but otherwise the low rate environment basically enticed customers to vacate the CD marketplace.

As of December 31, 2015 and 2014, CDARS represented $3.4 million, or 1%, and $7.7 million, or 1%, respectively, of total deposits.

Short-term borrowings

Short-term borrowings increased $24.2 million during 2015. These borrowings were used to pay off $10.0 million in long-term debt during the second quarter and also replaced declining balances in public deposits stemming from the Pennsylvania state budget impasse holding back state funding during the fourth quarter.

Long-term debt

As of December 31, 2014, long-term debt consisted of a single advance from the FHLB of $10.0 million bearing an interest rate of 5.26% scheduled to mature in 2016. At the end of the second quarter of 2015, the Company paid off the long-term debt, due to its high interest rate relative to other available borrowing sources, and incurred a $0.6 million prepayment fee. The pay-off was funded with short-term borrowings and for 2016 reduced interest expense from long-term debt by approximately $0.4 million. As of December 31, 2015, the Company had the ability to borrow an additional $186.4 million from the FHLB.

Funds Deployed:

Investment Securities

As of December 31, 2015, the carrying value of investment securities amounted to $125.2 million, or 17% of total assets, compared to $97.9 million, or 14% of total assets, at December 31, 2014.

Investment securities were comprised of AFS securities as of December 31, 2015. The AFS securities were recorded with a net unrealized gain of $3.3 million as of December 31, 2015 compared to a net unrealized gain of $4.1 million as of December 31, 2014, or a net reduction of $0.8 million during 2015.

During the years ended December 31, 2015 and 2014, the Company did not incur other-than-temporary impairment charges from its investment securities portfolio.

During 2015, the carrying value of total investments increased $27.3 million, or 28%. At the end of 2014, the Company began to restructure its investment portfolio by selling mortgage-backed securities with the longest duration and lowest

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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.

As of December 31, 2015, there were no investments from any one issuer with an aggregate book value that exceeded 10% of the Company's shareholders' equity.

The distribution of debt securities by stated maturity and tax-equivalent yield at December 31, 2015 were as follows:

	One year or less		More than one year to five years		More than five years to ten years		More than ten years		Total	
(dollars in thousands)	$	%	$	%	$	%	$	%	$	%
MBS - GSE residential	$ -	- %	$ 1,130	4.06 %	$ 8,129	2.98 %	$ 60,156	2.36 %	$ 69,415	2.46 %
State & municipal subdivisions	-	-	-	-	1,833	5.94	35,052	5.41	36,885	5.44
Agency - GSE	2,016	0.48	15,338	1.46	1,032	3.45	-	-	18,386	1.46
Total debt securities	$ 2,016	0.48 %	$ 16,468	1.63 %	$ 10,994	3.49 %	$ 95,208	3.44 %	$ 124,686	3.15 %

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

Federal Home Loan Bank Stock

The dividends received from the Federal Home Loan Bank (FHLB) totaled $123 thousand and $90 thousand for the years ended December 31, 2015 and 2014, respectively. The dividends were higher in 2015 because the Company received a $57 thousand one-time special dividend during the first quarter. The balance in FHLB stock was $2.1 million and $1.3 million as of December 31, 2015 and 2014, respectively.

Loans and leases

Net of loan participations, in 2015 the Company originated $28.7 million of commercial and industrial loans and $11.1 million of commercial real estate loans compared to $24.4 million and $15.1 million, respectively, in 2014. Also, during 2015, the Company originated $61.9 million of residential real estate loans and $25.0 million of consumer loans, compared to $53.7 million and $33.0 million, respectively, in 2014. Included in mortgage loans were

$10.9 million of residential real estate construction lines in 2015 and $11.0 million in 2014. In addition for 2015, the Company had originations of lines of credit in the amounts of $50.7 million for commercial borrowers and $17.5 million in home equity and other consumer lines of credit.

Commercial and industrial and commercial real estate

Compared to year-end 2014, the commercial and industrial (C&I) loan portfolio increased $22.4 million, or 28%, from $80.3 million to $102.7 million and the commercial real estate (CRE) loan portfolio increased $5.4 million, or 3%, from $196.5 million to $201.9 million as of December 31, 2015. This growth can be attributed to several factors including, customer retention, additional managerial relationship building efforts and marketing efforts to attract new relationships.

Consumer

The consumer loan portfolio grew $5.5 million, or 5%, from $109.5 million at December 31, 2014 to $115.0 million at December 31, 2015. Growth in the portfolio was accelerated by seasonal home equity line of credit campaigns combined with consistent demand for automobile loans and leases. Auto loan and lease growth was the result of focus on maintaining relationships with auto dealers.

Residential

The residential loan portfolio grew $7.6 million, or 6%, from $129.5 million at December 31, 2014 to $137.1 million at December 31, 2015. The held to maturity portfolio grew $7.8 million, or 7%, from $119.2 million at December 31, 2014 to $127.0 million at December 31, 2015. The held to maturity loan portfolio grew due to a mortgage loan modification program and incremental new loan originations throughout the year. The majority of modifications were 20 years or less in maturity to customers with high credit quality, documented payment history, and strong loan to value profiles.

As of December 31, 2015, approximately 76% of the total loan portfolio was secured by real estate, down slightly from 78% as of December 31, 2014. The Company considered this segment concentration to be normal.

Loans held-for-sale

As of December 31, 2015 and 2014, loans HFS consisted of residential mortgages with carrying amounts of $1.4 million and $1.2 million, respectively, which approximated their fair values. During the year ended December 31, 2015, residential mortgage loans with principal balances of $47.3 million were sold into the secondary market and the Company recognized net gains of $1.0 million, compared to $35.1 million and $0.6 million, respectively during the year ended December 31, 2014. An increase in residential mortgage origination activities caused the increase in gains from loan sales in 2015 compared to 2014. During 2015, the Company also recognized net gains of $0.2 million on the sale of nonmortgage loans.

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At December 31, 2015 and 2014, the servicing portfolio balance of sold residential mortgage loans was $269.5 million and $256.8 million, respectively.

Allowance for loan losses

In order to substantiate flat reserve allocations for certain risk ratings on a recurring basis, management analyzed historical loss experience in those risk rating pools. Management considered peer or industry averages in support of flat rates. However, the lack of consistency in those allowance methodologies rendered flat rate correlation to be inapplicable. As a result, commencing on January 1, 2015 and going forward, the Bank applied the following updates to the Allowance for Loan and Lease Losses calculation:

- Pass-5 rated loans are included in the loan pools that do not include impaired loans. The Bank reasoned that Pass-5 rated loans did not present any substantive difference in historic loss experience than loans of similar or less risk. Previously, Pass-5 rated loans carried a flat 2% reserve allocation. The impact of this change reduced the reserve requirement by about $175 thousand.
- Special Mention – 6 rated loans were changed from a flat 5% reserve allocation. Management evaluated historical losses for 6 rated loans based on the greater of either the three (3) year moving average of historical loss experience in the 6 rated loan category OR an adjusted charge-off method. In the adjusted charge-off method, the bank categorized any charge-off for any commercial loan in terms of what the risk rating on that charge-off (or charge-down) was in the same period 2 years prior. Such loans were compared against the appropriate pool of loans by assigning the charged-off loan in the appropriate pool in the current period depending upon its risk rating 2 years prior. Each pool was then calculated for each commercial loan type to develop a relative percentage. These relative percentages were quantified in rolling 12 quarter averages and applied against the appropriate risk rating class. However, since Special Mention – 6 rated loans are by nature a transitional grade of risk rating, the actual losses incurred in this risk rating class was near 0%. Therefore, management applied a loss factor that, in its opinion, fairly represents the actual risk of loss from loans so rated. The impact of this change reduced the reserve requirement by about $23 thousand.
- Substandard – 7 rated loans were changed from a flat 15% reserve allocation to pools that are based on historical losses. Going forward, expected loss percentages will be based on the greater of either the three (3) year moving average of historical loss experience in the 7 rated loan category OR an adjusted charge-off method. In the adjusted charge-off method, the bank categorized any charge-off for any commercial loan in terms of what the risk rating on that charge-off (or charge-down) was in the same period 2 years prior. Such loans were compared against the appropriate pool of loans by assigning the charged-off loan in the appropriate pool in the current period depending upon its risk rating 2 years prior. Each pool was then calculated for each commercial loan type to develop a relative percentage. These relative percentages were quantified in rolling 12 quarter averages and applied against the appropriate risk rating class. The impact of this change reduced the reserve requirement by about $421 thousand.
- Qualitative factors were universally applied to all loans in all loan pools. Previously, this was not done for Special Mention - 6 rated and Substandard – 7 rated loans. The impact of this change increased the reserve requirement by about $93 thousand.

Net charge-offs were $0.7 million and $0.8 million for the years ended December 31, 2015 and 2014, respectively. During the period ended December 31, 2015, no specific loan class significantly underperformed as charge-offs were taken across a variety of consumer, commercial and commercial real estate loans.

The allowance for loan losses was $9.5 million as of December 31, 2015 and $9.2 million as of December 31, 2014.

The allocation of the allowance for the commercial loan portfolio, which is comprised of commercial real estate and commercial and industrial loans, accounted for approximately 66.6%, or $6.4 million, of the total allowance for loan losses at December 31, 2015, which represented a 4.2 percentage point increase from December 31, 2014. The increase in the commercial real estate and commercial and industrial allocation from December 31, 2014 to December 31, 2015 was mostly related to the addition of one large commercial non-owner occupied real estate loan into the non-accrual category.

Non-performing assets

At December 31, 2015, non-performing assets represented 1.76% of total assets compared with 1.18% as of December 31, 2014. This was a result of an increase in non-accrual loans and TDRs. This increase was offset by a decrease in past due loans over 90-days and accruing and a decrease in ORE.

Non-performing loans, which consists of accruing loans that are over 90 days past due as well as all non-accrual loans, increased $4.1 million, or 77%, from $5.3 million at December 31, 2014 to $9.4 million at December 31, 2015. This increase was related mostly to the preemptive addition of one large commercial non-owner occupied loan to the non-accrual category of non-performing loans. 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. At December 31, 2014, the portion of accruing loans that was over 90 days past due totaled $1.1 million and consisted of eleven loans to seven unrelated borrowers ranging from $2 thousand to $0.4 million.

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At December 31, 2014, there were 46 loans to 41 unrelated borrowers ranging from less than $1 thousand to $0.9 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. At December 31, 2014, non-accrual loans totaled $4.2 million compared with $9.0 million at December 31, 2015, an increase of $4.8 million. Non-accrual loans increased during the period ending December 31, 2015 for the following reasons: $7.5 million in new non-accrual loans plus capitalized expenditures on these loans were added; $0.9 million were paid down or paid off; $0.6 million were charged off; $0.5 million were transferred to ORE, $0.1 million was moved back to accrual status and $0.6 million were sold in the secondary market.

If the non-accrual loans that were outstanding as of December 31, 2015 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of $159 thousand.

TDRs aggregated $2.4 million at December 31, 2015, an increase of $0.8 million, from $1.6 million at December 31, 2014, due to the addition of five loans (4 CRE and 1 C&I) from 3 unrelated borrowers being classified as TDRs throughout the year.

Foreclosed assets held-for-sale

Foreclosed assets held-for-sale aggregated $1.1 million at December 31, 2015 and $2.0 million at December 31, 2014. As of December 31, 2015, ORE consisted of fourteen properties from thirteen unrelated borrowers totaling $1.1 million. Six of these properties ($0.4 million) were added in 2015; 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 fourteen properties, nine ($0.8 million) were either listed for sale or awaiting listing, while the remaining properties (five totaling $0.3 million) are either in litigation, awaiting closing, have disposition plans or are undergoing renovations.

There were no other repossessed assets held-for-sale at December 31, 2015. At December 31, 2014, other repossessed assets consisted of an automobile with a book value of $11 thousand which was sold during 2015.

Premises and equipment

Net of depreciation, premises and equipment increased $1.9 million during 2015. The increase was due to the opening of a new branch and renovations to an existing branch which were completed during the second quarter of 2015.

Other assets

The $3.8 million decrease in other assets was due mostly to a $4.3 million decline in the net deferred tax assets due to an income tax refund and a $1.7 million decrease in construction in process due to the opening of a new branch during the second quarter of 2015. These items were partially offset by $2.1 million in higher residual values associated with recording new automobile leases, net of lease disposals.

Results of Operations

Overview

For the year ended December 31, 2015, the Company generated net income of $7.1 million, or $2.90 per diluted share, compared to $6.4 million, or $2.62 per diluted share, for the year ended December 31, 2014. For the year ended

December 31, 2015, the Company produced $1.6 million higher net interest income compared to the year ended December 31, 2014. The increase in net interest income combined with higher non-interest income was enough to offset a $1.3 million rise in non-interest expenses. Net income was boosted higher by a reduction in the amount required to fund the income tax provision in 2015 compared to 2014.

For the year ended December 31, 2015, ROA and ROE were 1.00% and 9.55%, respectively, compared to 0.96% and 9.12% for the same period in 2014. The increase in ROA and ROE was caused by higher net income during 2015.

Net interest income and interest sensitive assets / liabilities

Net interest income increased $1.6 million, or 7%, from $21.9 million for the year ended December 31, 2014 to $23.5 million for the year ended December 31, 2015, with higher interest income and lower interest expense combining for the net increase. Total average interest-earning assets increased $52.1 million and helped offset the negative impact of a fifteen basis point net reduction in their yields resulting in $1.2 million of growth in interest income. In the loan portfolio, the Company experienced average balance growth of $39.1 million, which had the effect of producing $1.1 million of interest income, more than offsetting the $0.6 million negative impact of a 13 basis point lower yield earned thereon. Though all loan portfolios showed more interest income from growth, the mortgage loan portfolio had the most accretive impact due to the Company's mortgage modification program. This program offered mortgage customers, both secondary-market compliant and held for portfolio, shorter-termed loans with current interest rates for a flat fee. Higher average balances of municipal and mortgage-backed securities produced $0.1 million in additional interest income from investments despite lower yields. On the liability side, total interest-bearing liabilities grew $40.3 million on average but a thirteen basis point decline in the average rates paid offset the impact of this growth. The reduction in average rate paid was 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 by $0.6 million. This decrease was partially offset by an increase of $0.2 million in interest expense paid on deposits due to higher average balances. Interest expense from interest-bearing transaction deposits increased $0.3 million mostly due to higher average balances from successful relationship-building efforts, promotions, cross-selling, transfers from unpopular certificates of deposit, or CDs, and contractual and negotiated rates. The increase in interest expense from transaction deposits was partially offset by a $0.1 million decline in interest expense from CDs due to lower rates paid.

The fully-taxable equivalent (FTE) net interest rate spread and margin decreased by two and five basis points, respectively for the year ended December 31, 2015 compared to the year ended December 31, 2014. The decrease in the spread was due to the yields on interest-earning assets declining faster than the rates paid on interest-bearing liabilities. Though net interest income improved by $1.6 million, net interest margin declined due to lower yields earned on a higher average balance of interest-earning assets which was not fully offset by the reduction in interest expense. The overall cost of funds, which includes the impact of non-interest bearing deposits, declined ten basis points for the year ended December 31, 2015 compared to the same period in 2014. The principal reason for the decrease was the payoff of long-term debt.

The Company's cost of interest-bearing liabilities was 51 basis points for the year ended December 31, 2015 or thirteen basis points lower than the cost for the year ended December 31, 2014. The decline in the rate paid on borrowings was the reason for the reduction.

Provision for loan losses

For the years ended December 31, 2015 and 2014, the Company recorded a provision for loan losses of $1.1 million each period, respectively. During 2015, the Company identified $1.7 million in several new TDRs and $4.1 million in additional non-performing loans. Except for $0.2 million of provision provided for one large non-accrual loan, collateral securing these impaired loans was considered sufficient to cover their respective net active principal balances. Further, the Company improved its reserve methodology in 2015 to better align loss estimates with actual historical data. Since the Company's loss history has trended down in recent years, this offset the need for additional reserves that may otherwise have been required from a $40.4 million net increase in the total 2015 loan portfolio. Consequently, provision expense remained constant at $1.1 million for both 2015 and 2014, respectively.

Other income

For the year ended December 31, 2015, non-interest income amounted to $7.5 million, a $0.2 million, or 2%, increase compared to $7.3 million recorded during the year ended December 31, 2014. The increase in residential lending activity caused an additional $0.5 million in gains on the sale of loans at December 31, 2015 compared to the same period of 2014. Trust income and interchange fees also contributed a combined $0.1 million to the increase. Partially offsetting these items was $0.5 million fewer gains on the sale of investment securities. The company sold securities at the end of 2014 and used the proceeds to pay off $6.0 million of long-term debt.

Other operating expenses

For the year ended December 31, 2015, total other operating expenses increased $1.3 million, or 7%, compared to the year ended December 31, 2014. Salary and employee benefits contributed the most to the increase rising $0.6 million, or 6%, in 2015 compared to 2014. The basis of the increase included annual merit increases, staff additions, including the hiring of an executive officer during the second quarter of 2015, hiring new management level positions, replacing an existing management position, higher recognized employee incentives and an increase in group insurance from higher claims accruals. Premises and equipment increased during the period by $0.1 million, or 3%. Additional depreciation expense caused this increase due to assets placed in service for the new branch which opened during the second quarter of 2015. Advertising and marketing experienced a $0.2 million, or 16%, increase due to a grand opening and re-opening celebration for 2 branches as well as a cash bonus associated with checking/savings summer and fall campaigns. There was also $0.1 million more in donations made to educational improvement programs in 2015. Professional services were up $0.3 million, or 19%, during 2015 compared to 2014 due to the implementing of an enterprise risk management program, an architectural design study completed in 2015 and higher audit expense due to a trust audit and additional compliance review services. Data processing and communications expense increased $0.2 million during 2015 compared to 2014 because of fees incurred from outsourcing the Company's data processing. The Company also incurred $0.1 million more long-term debt prepayment fees in 2015 than 2014. The Company paid off $10.0 million of long-term debt in 2015 compared to a pay down of $6.0 million during 2014. During 2015, the Company incurred $81 thousand in losses on the reacquisition of previously sold loans that were not recognized in 2014. Offsetting these items, other real estate owned (ORE) expense decreased $0.1 million during 2015 compared to the same period in 2014. ORE expense decreased mostly due to a few subsequent write-downs taken on ORE properties during 2014.

The ratios of non-interest expense less non-interest income to average assets, known as the expense ratio, at December 31, 2015 and 2014 were 1.86% and 1.89%, respectively. The expense ratio, which excludes non-recurring expenses, decreased due mostly to higher average assets during the year ended December 31, 2015 compared to the year ended December 31, 2014 which were able to absorb the higher expenses.

Provision for income taxes

The Company's effective income tax rate approximated 20.4% in 2015 and 25.4% in 2014. The difference between the effective rate and the enacted statutory corporate rate of 34% was due mostly to the effect of tax exempt income in relation to the level of pre-tax income. In 2015, the Company had a higher amount of tax exempt income and a higher amount of pre-tax income subject to the 34% statutory income tax rate compared to the year ended December 31, 2014. The provision for income taxes decreased $0.4 million, or 16%, from $2.2 million at December 31, 2014 to $1.8 million at December 31, 2015. During an audit by the Internal Revenue Service, management discovered additional tax basis on trust preferred securities that were sold during 2013 that was inadvertently omitted from the basis reported on the 2013 tax return. After the basis was corrected, the tax loss that was realized during 2013 and carried back to the 2011 and 2012 tax returns increased. An audit adjustment was made which resulted in recording a $0.4 million credit for income taxes during the second quarter of 2015. This adjustment coupled with a lower effective tax rate for 2015 from additional expenses reducing the level of pre-tax income caused the lower provision for income taxes.

Off-Balance Sheet Arrangements and Contractual Obligations

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

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

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

The following table presents, as of December 31, 2016, the Company's significant determinable contractual obligations and significant commitments by payment date. The payment amounts represent those amounts contractually due to the recipient, excluding interest: