

FIDELITY D & D BANCORP INC
Form 10-Q
August 08, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from _____ to _____

Commission file number: 001-38229

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

PENNSYLVANIA

23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

YES NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on July 31, 2018, the latest practicable date, was 3,752,005 shares.

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FIDELITY D & D BANCORP, INC.

Form 10-Q June 30, 2018

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PART I – Financial Information

Item 1: Financial Statements

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

	June 30, 2018	December 31, 2017
(dollars in thousands)		
Assets:		
Cash and due from banks	\$ 15,903	\$ 14,143
Interest-bearing deposits with financial institutions	2,069	1,682
Total cash and cash equivalents	17,972	15,825
Available-for-sale securities	164,403	157,385
Federal Home Loan Bank stock	3,490	2,832
Loans and leases, net (allowance for loan losses of \$9,527 in 2018; \$9,193 in 2017)	676,161	628,767
Loans held-for-sale (fair value \$1,328 in 2018, \$2,221 in 2017)	1,305	2,181
Foreclosed assets held-for-sale	539	973
Bank premises and equipment, net	16,189	16,576
Cash surrender value of bank owned life insurance	20,315	20,017
Accrued interest receivable	3,130	2,786
Goodwill	209	209
Other assets	18,888	16,086
Total assets	\$ 922,601	\$ 863,637
Liabilities:		
Deposits:		
Interest-bearing	\$ 565,894	\$ 551,515
Non-interest-bearing	212,364	178,631
Total deposits	778,258	730,146
Accrued interest payable and other liabilities	7,234	6,402
Short-term borrowings	29,553	18,502
FHLB advances	18,704	21,204
Total liabilities	833,749	776,254
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-
Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 3,752,005 in 2018; and 3,734,478 in 2017)	29,016	28,361
Retained earnings	61,119	57,218
Accumulated other comprehensive (loss) income	(1,283)	1,804
Total shareholders' equity	88,852	87,383
Total liabilities and shareholders' equity	\$ 922,601	\$ 863,637

See notes to unaudited consolidated financial statements

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Consolidated Statements of Income

(Unaudited)

(dollars in thousands except per share data)

	Three months ended		Six months ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Interest income:				
Loans and leases:				
Taxable	\$ 7,029	\$ 6,566	\$ 13,728	\$ 12,726
Nontaxable	221	217	433	427
Interest-bearing deposits with financial institutions	42	4	84	10
Restricted regulatory securities	38	37	78	56
Investment securities:				
U.S. government agency and corporations	803	658	1,578	1,277
States and political subdivisions (nontaxable)	396	367	766	713
Other securities	6	5	11	11
Total interest income	8,535	7,854	16,678	15,220
Interest expense:				
Deposits	886	643	1,690	1,229
Securities sold under repurchase agreements	3	5	10	12
Other short-term borrowings and other	57	80	64	137
FHLB advances	66	59	132	97
Total interest expense	1,012	787	1,896	1,475
Net interest income	7,523	7,067	14,782	13,745
Provision for loan losses	425	225	725	550
Net interest income after provision for loan losses	7,098	6,842	14,057	13,195
Other income:				
Service charges on deposit accounts	540	549	1,093	1,092
Interchange fees	506	425	975	825
Fees from trust fiduciary activities	326	308	727	503
Fees from financial services	195	119	372	265
Service charges on loans	136	176	307	396
Fees and other revenue	247	229	479	439
Earnings on bank-owned life insurance	146	157	298	264
Gain (loss) on sale or disposal of:				
Loans	168	168	354	452
Available-for-sale debt securities	-	-	6	-
Equity securities	107	-	44	-
Premises and equipment	-	-	(1)	-
Total other income	2,371	2,131	4,654	4,236
Other expenses:				
Salaries and employee benefits	3,420	3,239	6,787	6,324
Premises and equipment	929	912	1,897	1,897
Advertising and marketing	217	345	621	580

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Professional services	480	528	882	926
Data processing and communication	368	280	722	583
Automated transaction processing	193	184	378	358
Office supplies and postage	104	107	208	230
FDIC assessment	65	68	133	133
PA shares tax	195	47	236	211
Loan collection	28	47	51	107
Other real estate owned	5	109	65	146
Other	158	185	390	353
Total other expenses	6,162	6,051	12,370	11,848
Income before income taxes	3,307	2,922	6,341	5,583
Provision for income taxes	539	739	1,045	1,420
Net income	\$ 2,768	\$ 2,183	\$ 5,296	\$ 4,163
Per share data (1):				
Net income - basic	\$ 0.74	\$ 0.59	\$ 1.41	\$ 1.12
Net income - diluted	\$ 0.73	\$ 0.59	\$ 1.40	\$ 1.12
Dividends	\$ 0.24	\$ 0.21	\$ 0.48	\$ 0.41

See notes to unaudited consolidated financial statements

(1) On August 15, 2017, the Company declared a three-for-two stock split effected in the form of a 50% stock dividend. Per share data for the three and six months ended June 30, 2017 has been restated for the effects thereof.

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Fidelity D & D Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income (Unaudited) (dollars in thousands)	Three months ended		Six months ended	
	June 30, 2018	2017	June 30, 2018	2017
Net income	\$ 2,768	\$ 2,183	\$ 5,296	\$ 4,163
Other comprehensive (loss) income, before tax:				
Unrealized holding (loss) gain on available-for-sale debt securities	(892)	687	(3,369)	714
Reclassification adjustment for net gains realized in income	-	-	(6)	-
Net unrealized (loss) gain	(892)	687	(3,375)	714
Tax effect	188	(234)	709	(243)
Unrealized (loss) gain, net of tax	(704)	453	(2,666)	471
Other comprehensive (loss) income, net of tax	(704)	453	(2,666)	471
Total comprehensive income, net of tax	\$ 2,064	\$ 2,636	\$ 2,630	\$ 4,634

See notes to unaudited consolidated financial statements

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Fidelity D & D Bancorp, Inc. and Subsidiary
 Consolidated Statements of Changes in Shareholders' Equity
 For the six months ended June 30, 2018 and 2017
 (Unaudited)

(dollars in thousands)	Capital stock		Retained	Accumulated other comprehensive	Total
	Shares	Amount	earnings	income (loss)	
Balance, December 31, 2016	2,453,805	\$ 27,155	\$ 52,095	\$ 1,381	\$ 80,631
Net income			4,163		4,163
Other comprehensive income				471	471
Issuance of common stock through Employee Stock Purchase Plan	4,085	126			126
Issuance of common stock through Dividend Reinvestment Plan	2,478	90			90
Issuance of common stock from vested restricted share grants through stock compensation plans	9,657				
Issuance of common stock through exercise of stock options	519	15			15
Stock-based compensation expense		179			179
Cash dividends declared			(1,539)		(1,539)
Balance, June 30, 2017	2,470,544	\$ 27,565	\$ 54,719	\$ 1,852	\$ 84,136
Balance, December 31, 2017	3,734,478	\$ 28,361	\$ 57,218	\$ 1,804	\$ 87,383
Net income			5,296		5,296
Other comprehensive loss				(2,666)	(2,666)
Effect of adopting ASU 2016-01			421	(421)	-
Issuance of common stock through Employee Stock Purchase Plan	6,783	149			149
Issuance of common stock from vested restricted share grants through stock compensation plans	9,994				
Issuance of common stock through exercise of stock options	750	14			14
Stock-based compensation expense		492			492
Cash dividends declared			(1,816)		(1,816)
Balance, June 30, 2018	3,752,005	\$ 29,016	\$ 61,119	\$ (1,283)	\$ 88,852

See notes to unaudited consolidated financial statements

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Consolidated Statements of Cash Flows

(Unaudited)

(dollars in thousands)

Six months ended June
30,
2018 2017

Cash flows from operating activities:

Net income	\$ 5,296	\$ 4,163
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	1,504	1,528
Provision for loan losses	725	550
Deferred income tax expense	511	585
Stock-based compensation expense	432	288
Excess tax benefit from exercise of stock options	4	1
Proceeds from sale of loans held-for-sale	16,452	20,700
Originations of loans held-for-sale	(15,134)	(17,279)
Earnings from bank-owned life insurance	(298)	(264)
Net gain from sales of loans	(354)	(452)
Net gain from sales of investment securities	(50)	-
Net loss from sale and write-down of foreclosed assets held-for-sale	13	75
Net loss from disposal of equipment	1	-
Change in:		
Accrued interest receivable	(344)	(456)
Other assets	(2,104)	(3,542)
Accrued interest payable and other liabilities	892	938
Net cash provided by operating activities	7,546	6,835

Cash flows from investing activities:

Available-for-sale securities:

Proceeds from sales	11,425	-
Proceeds from maturities, calls and principal pay-downs	10,397	8,285
Purchases	(32,734)	(31,487)
Increase in FHLB stock	(658)	(1,423)
Net increase in loans and leases	(49,115)	(39,785)
Purchase of life insurance policies	-	(8,000)
Purchases of bank premises and equipment	(821)	(472)
Net cash acquired in acquisition of bank branch	-	11,817
Proceeds from sale of bank premises and equipment	-	6
Proceeds from sale of foreclosed assets held-for-sale	1,097	463
Net cash used in investing activities	(60,409)	(60,596)

Cash flows from financing activities:

Net increase (decrease) in deposits	48,112	(9,832)
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Net increase in short-term borrowings	11,051	30,232
Proceeds from issuance of FHLB advances	-	23,704
Repayment of FHLB advances	(2,500)	-
Proceeds from employee stock purchase plan participants	149	126
Exercise of stock options	14	15
Dividends paid, net of dividends reinvested	(1,816)	(1,450)
Net cash provided by financing activities	55,010	42,795
Net increase (decrease) in cash and cash equivalents	2,147	(10,966)
Cash and cash equivalents, beginning	15,825	25,843
Cash and cash equivalents, ending	\$ 17,972	\$ 14,877

See notes to consolidated financial statements

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Consolidated Statements of Cash Flows (continued)

(Unaudited)

Six months ended

June 30,

2018 2017

(dollars in thousands)

Supplemental Disclosures of Cash Flow Information

Cash payments for:

Interest

\$ 1,838 \$ 1,319

Income tax

- 900

Supplemental Disclosures of Non-cash Investing Activities:

Net change in unrealized gains on available-for-sale securities

(3,375) 714

Transfers from loans to foreclosed assets held-for-sale

676 202

Transfers from loans to loans held-for-sale

320 2,318

Acquisition of West Scranton Branch from Wayne Bank

Non-cash assets acquired:

Loans

\$ 1,574

Bank premises and equipment

264

Goodwill

209

Accrued interest receivable and other assets

4

Total non-cash assets acquired

\$ 2,051

Liabilities assumed:

Deposits

\$ 13,809

Accrued interest payable and other liabilities

59

Total liabilities assumed

\$ 13,868

See notes to unaudited consolidated financial statements

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FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(Unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

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

Principles of consolidation

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

For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

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

In the opinion of management, the consolidated balance sheets as of June 30, 2018 and December 31, 2017 and the related consolidated statements of income and consolidated statements of comprehensive income for the three and six months ended June 30, 2018 and 2017, and consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the six months ended June 30, 2018 and 2017 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature. Certain reclassifications have been made to the 2017 financial statements to conform to the 2018 presentation.

On August 15, 2017, the Company declared a three-for-two stock split effected in the form of a 50% stock dividend on its common stock outstanding to shareholders as of September 18, 2017 and distributed on September 28, 2017. All share and per share information included in the accompanying consolidated financial statements and footnotes has been retroactively adjusted to reflect this stock split.

In preparing these consolidated financial statements, the Company evaluated the events and transactions that occurred after June 30, 2018 through the date these consolidated financial statements were issued.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2017, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

Critical accounting policies

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

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at June 30, 2018 is adequate and reasonable. Given the subjective nature of identifying and estimating loan losses, it is likely that well-informed individuals could make different assumptions and could, therefore, calculate a materially different allowance amount. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

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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. All of the Company's debt securities are classified as available-for-sale (AFS). AFS debt 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 (AOCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells residential mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these circumstances, pricing may be obtained from other entities and the residential mortgage loans are transferred at the lower of cost or market value and simultaneously sold. For other loans transferred to HFS, pricing may be obtained from other entities or modeled and the other loans are transferred at the lower of cost or market value and then sold. As of June 30, 2018 and December 31, 2017, loans classified as HFS consisted of residential mortgage loans.

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

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

Goodwill is recorded on the consolidated balance sheets as the excess of liabilities assumed over identifiable assets acquired on the acquisition date. Goodwill is recorded at its net carrying value which represents estimated fair value. The goodwill is deductible for tax purposes over a 15 year period.

The Company holds separate supplemental executive retirement (SERP) agreements for certain officers and an amount is credited to each participant's SERP account monthly while they are actively employed by the bank until retirement. A deferred tax asset is provided for the non-deductible SERP expense. The Company also entered into separate split dollar life insurance arrangements with three executives providing post-retirement benefits and accrues monthly expense for this benefit. The split dollar life insurance expense is not deductible for tax purposes. Monthly expenses for the SERP and post-retirement split dollar life benefit are recorded as components of salaries and employee benefit expense on the consolidated statements of income.

For purposes of the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of premises and equipment.

Revenue Recognition

As of January 1, 2018, the Company adopted ASU 2014-09, Revenue from Contracts with Customers (Topic 606) and all subsequent ASUs that modified Topic 606. The Company has elected to use the modified retrospective approach

with prior period financial statements unadjusted and presented with historical revenue recognition methods. The implementation of the new standard had no material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary.

The majority of the Company's revenues are generated through interest earned on securities and loans, which is explicitly excluded from the scope of the guidance. In addition, certain non-interest income streams such as fees associated with mortgage servicing rights, loan service charges, life insurance earnings, rental income and gains/losses on the sale of loans and securities are not in the scope of the new guidance. The main types of contracts with customers that are in the scope of the new guidance are:

- Service charges on deposit accounts – Deposit service charges represent fees charged by the Company for the performance obligation of providing services to a customer's deposit account. The transaction price for deposit services includes both fixed and variable amounts based on the Company's fee schedules. Revenue is recognized and payment is received either at a point in time for transactional fees or on a monthly basis for non-transactional fees.
- Interchange fees – Interchange fees represent fees charged by the Company for customers using debit cards. The contract is between the Company and the processor and the performance obligation is the ability of customers to use debit cards to make purchases at a point in time. The transaction price is a percentage of debit card usage and the processor pays the Company and revenue is recorded throughout the month as the performance obligations are being met.

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- Fees from trust fiduciary activities – Trust fees represent fees charged by the Company for the management, custody and/or administration of trusts. These are mostly monthly fees based on the market value of assets in the trust account at the prior month end. Payment is generally received a few weeks after month end through a direct charge to customers' accounts. Estate fees are recognized and charged as the Company reaches each of six different stages of the estate administration process.
- Fees from financial services – Financial service fees represent fees charged by the Company for the performance obligation of providing various services for an investment account. Revenue is recognized twice monthly for fees on sales transactions and on a monthly basis for advisory fees and quarterly for trail fees.
- Gain/loss on ORE sales – Gain/loss on the sale of ORE is recognized at the closing date when the sales proceeds are received. In seller-financed ORE transactions, the contract is made subject to our normal underwriting standards and pricing. The Company does not have any obligation or right to repurchase any sales of ORE.

Contract balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before the payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity already received payment (or payment is due) from the customer. The Company's non-interest income streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company typically does not enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of June 30, 2018 and December 31, 2017, the Company did not have any significant contract balances.

Remaining performance obligations

The Company's performance obligations have an original expected duration of less than one year and follow the relevant guidance for recognizing revenue over time. There is no variable consideration subject to constraint that is not included in information about transaction price.

Contract acquisition costs

In connection with the adoption of Topic 606, an entity is required to capitalize and subsequently amortize into expense, certain incremental costs of obtaining a contract if these costs are expected to be recovered. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, sales commission). The Company utilizes the practical expedient which allows entities to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. Upon adoption of Topic 606, the Company did not capitalize any contract acquisition costs.

2. New accounting pronouncements

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2016-13, Financial Instruments – Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments. The amendments in this update require financial assets measured at amortized cost basis to be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. Previously, when credit losses were measured under GAAP, an entity only considered past events and current conditions when measuring the incurred loss. The amendments in this update broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The measurement of expected credit losses is based on relevant information about past events, including

historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgement in determining the relevant information and estimation methods that are appropriate under the circumstances. The amendments in this update also require that credit losses on available-for-sale debt securities be presented as an allowance for credit losses rather than a writedown. The amendments in this update are effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2019 for public companies. Early adoption is permitted beginning after December 15, 2018, including interim periods within those fiscal years. An entity will apply the amendments in this update through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption (modified-retrospective approach). Upon adoption, the change in this accounting guidance could result in an increase in the Company's allowance for loan losses and require the Company to record loan losses more rapidly. The Company is currently evaluating the impact of ASU 2016-13 on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP: identify the contract(s) with a customer; identify the performance obligations in the contract; determine the transaction price; allocate the

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transaction price to the performance obligations in the contract; recognize revenue when (or as) the entity satisfies a performance obligation.

The Company adopted this guidance on January 1, 2018 using the modified retrospective approach. The adoption of ASU 2014-09 did not materially change the method in which the Company recognizes revenue. As a result, the Company changed the process for recognizing revenue for estate fees within fees from trust fiduciary services. The Company concluded the cumulative adjustment to retained earnings for estates in process was immaterial and the income was recognized during the first quarter of 2018. See “Revenue Recognition” in footnote 1 for more information.

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

- Require equity investments to be measured at fair value with changes in fair value recognized in net income;
- Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment;
- Require public business entities to use the exit price notion when measuring fair value of financial instruments for disclosure purposes;
- Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset;
- Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities.

The Company adopted this guidance on January 1, 2018. The adoption did not have a material impact on the consolidated financial statements. As a result of this guidance, the Company reclassified \$0.4 million in net unrealized gains on equity securities from accumulated other comprehensive income to retained earnings on January 1, 2018 and the Company measured the fair value of its loan portfolio using the exit price notion. See “Fair Value Measurements” in footnote 8 for more information about the fair value measurement of the loan portfolio.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. ASU 2016-02 requires the recognition of a right-of-use asset and related lease liability by lessees for leases classified as operating leases under GAAP. The Company is expected to make an election to exclude leases less than 12 months from the provisions of this ASU. The amendments in this update are effective for the Company for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption of the amendments in this update is permitted. A modified retroactive approach must be applied for leases existing at, or entered into after, the beginning of the earliest comparative period. The Company has several lease agreements, such as branch locations, which are currently considered operating leases, and therefore not recognized on the Company’s consolidated balance sheets. Therefore, the adoption of ASU 2016-02 is expected to impact the Company’s consolidated balance sheets, along with our regulatory capital ratios. Upon adoption, this change in accounting guidance could also potentially impact debt covenant agreements with our customers. The Company is currently evaluating the amount of the impact of ASU 2016-02 on its consolidated financial statements.

In July 2018, the FASB issued ASU 2018-10, Codification Improvements to Topic 842, Leases and ASU 2018-11, Leases (Topic 842) Targeted Improvements to clarify how to apply certain aspects of ASU 2016-02 and to simplify adoption and reduce costs. ASU 2018-11 allows companies the option to apply the provisions of the new lease standard prospectively as of the effective date, without adjusting comparative periods, and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The Company

anticipates using this additional transition method. The amendments in this update are effective upon adoption of Topic 842.

In August 2016, the FASB released ASU 2016-15, Statement of Cash Flows (Topic 230) to clarify the presentation of certain cash receipts and payments on the statement of cash flows. The update addressed eight specific cash flow issues with the objective of reducing the existing diversity in practice. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The amendments in this update should be applied using a retrospective transition method to each period presented. The Company adopted ASU 2016-15 on January 1, 2018 and it did not have a significant impact on the Company's consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles-Goodwill and Other (Topic 350) to simplify the test for goodwill impairment. To simplify the subsequent measurement of goodwill, the FASB eliminated Step 2 from the goodwill impairment test. Under the amendments in this update, an entity should perform its annual goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting units fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity should apply the amendments in his update on a prospective basis. The amendments in this update are effective for the Company for its annual goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company adopted this standard in 2017 and it did not have an impact on its consolidated financial statements. The Company did not have any

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goodwill prior to adoption of this update.

In March 2017, the FASB issued ASU 2017-08, Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20) Premium Amortization on Purchased Callable Debt Securities to amend the amortization period for certain purchased callable debt securities held at a premium. The amendments in this update shorten the amortization period for the premium to the earliest call date. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. An entity should apply the amendments in this update on a modified retrospective basis through a cumulative effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company adopted this standard in 2017 and it did not have an effect on its consolidated financial statements.

In February 2018, the FASB released ASU 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220) to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Act. The amendments in this update also require certain disclosures about stranded tax effects. The guidance is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted for periods for which financial statements have not yet been issued or available for issuance, including in the period the Act was enacted. The Company elected to early adopt and reclassify the stranded income tax effects of the Act from accumulated other comprehensive income to retained earnings during the fourth quarter of 2017. The reclassification increased AOCI and decreased retained earnings by \$0.3 million, with zero net effect on total shareholders' equity.

3. Accumulated other comprehensive income

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

As of and for the six months ended June 30, 2018

(dollars in thousands)	Unrealized gains (losses) on available-for-sale debt securities
Beginning balance	\$ 1,804
Other comprehensive loss before reclassifications, net of tax	(2,661)
Amounts reclassified from accumulated other comprehensive income, net of tax	(5)
Effect of adopting ASU 2016-01, net of tax*	(421)
Net current-period other comprehensive loss	(3,087)
Ending balance	\$ (1,283)

*The Company adopted ASU 2016-01 on January 1, 2018. As a result, unrealized gains on equity securities were reclassified from accumulated other comprehensive income to retained earnings.

As of and for the three months ended June 30, 2018

Unrealized gains
(losses) on

(dollars in thousands)	available-for-sale debt securities
Beginning balance	\$ (579)
Other comprehensive loss before reclassifications, net of tax	(704)
Amounts reclassified from accumulated other comprehensive income, net of tax	-
Net current-period other comprehensive income	(704)
Ending balance	\$ (1,283)

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As of and for the six months ended June 30, 2017

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities
Beginning balance	\$ 1,381
Other comprehensive income before reclassifications, net of tax	471
Amounts reclassified from accumulated other comprehensive income, net of tax	-
Net current-period other comprehensive income	471
Ending balance	\$ 1,852

As of and for the three months ended June 30, 2017

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities
Beginning balance	\$ 1,399
Other comprehensive income before reclassifications, net of tax	453
Amounts reclassified from accumulated other comprehensive income, net of tax	-
Net current-period other comprehensive income	453
Ending balance	\$ 1,852

Details about accumulated other

comprehensive income components (dollars in thousands)	Amount reclassified from accumulated other comprehensive income				Affected line item in the statement where net income is presented
	For the three months ended June 30, 2018	For the six months ended June 30, 2017	For the three months ended June 30, 2018	For the six months ended June 30, 2017	
Unrealized gains on AFS debt securities	\$ -	\$ -	\$ 6	\$ -	Gain on sale of investment securities
Income tax effect	-	-	(1)	-	Provision for income taxes

Total reclassifications for the period \$ - \$ - \$ 5 \$ - Net income

4. Investment securities

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

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

Obligations of states and political subdivisions

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

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The amortized cost and fair value of investment securities at June 30, 2018 and December 31, 2017 are summarized as follows:

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
June 30, 2018				
Available-for-sale debt securities:				
Agency - GSE	\$ 5,918	\$ 5	\$ (46)	\$ 5,877
Obligations of states and political subdivisions	45,233	1,336	(208)	46,361
MBS - GSE residential	114,877	231	(2,943)	112,165
Total available-for-sale debt securities	\$ 166,028	\$ 1,572	\$ (3,197)	\$ 164,403

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2017				
Available-for-sale securities:				
Agency - GSE	\$ 9,120	\$ 3	\$ (24)	\$ 9,099
Obligations of states and political subdivisions	42,300	2,036	(30)	44,306
MBS - GSE residential	103,386	519	(753)	103,152
Total debt securities	154,806	2,558	(807)	156,557
Equity securities - financial services	294	534	-	828
Total available-for-sale securities	\$ 155,100	\$ 3,092	\$ (807)	\$ 157,385

The Company adopted ASU 2016-01, Financial Instruments – Overall (Topic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities effective January 1, 2018. The Company sold all of its equity securities during the first half of 2018.

The amortized cost and fair value of debt securities at June 30, 2018 by contractual maturity are summarized below:

(dollars in thousands)	Amortized cost	Fair value
Available-for-sale securities:		

Debt securities:

Due in one year or less	\$ -	\$ -
Due after one year through five years	2,816	2,880
Due after five years through ten years	8,523	8,547
Due after ten years	39,812	40,811
MBS - GSE residential	114,877	112,165
Total available-for-sale debt securities	\$ 166,028	\$ 164,403

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

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The following table presents the fair value and gross unrealized losses of debt securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of June 30, 2018 and December 31, 2017:

(dollars in thousands)	Less than 12 months		More than 12 months		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
June 30, 2018						
Agency - GSE	\$ 4,871	\$ (46)	\$ -	\$ -	\$ 4,871	\$ (46)
Obligations of states and political subdivisions	9,864	(113)	2,038	(95)	11,902	(208)
MBS - GSE residential	78,856	(1,849)	26,912	(1,094)	105,768	(2,943)
Total	\$ 93,591	\$ (2,008)	\$ 28,950	\$ (1,189)	\$ 122,541	\$ (3,197)
Number of securities	73		21		94	
December 31, 2017						
Agency - GSE	\$ 6,020	\$ (14)	\$ 1,008	\$ (10)	\$ 7,028	\$ (24)
Obligations of states and political subdivisions	425	(1)	2,109	(29)	2,534	(30)
MBS - GSE residential	61,349	(437)	15,309	(316)	76,658	(753)
Total	\$ 67,794	\$ (452)	\$ 18,426	\$ (355)	\$ 86,220	\$ (807)
Number of securities	45		14		59	

The Company had ninety-four debt securities in an unrealized loss position at June 30, 2018, including five agency securities, sixty-seven mortgage-backed securities and twenty-two municipal securities. The severity of these unrealized losses based on their underlying cost basis was as follows at June 30, 2018: 0.94% for agencies; 2.71% for total MBS-GSE; and 1.72% for municipals. Of these securities, seventeen mortgage-backed securities and four municipal securities had been in an unrealized loss position in excess of 12 months. The changes in the prices on these securities in an unrealized loss position in excess of 12 months are the result of interest rate movement and management believes they are temporary in nature.

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

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

For all security types, as of June 30, 2018, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that, more likely than not, would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI in the Company's security portfolio. In addition, management believes the change in fair value is attributable to changes in interest rates.

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5. Loans and leases

The classifications of loans and leases at June 30, 2018 and December 31, 2017 are summarized as follows:

(dollars in thousands)	June 30, 2018	December 31, 2017
Commercial and industrial	\$ 126,006	\$ 113,601
Commercial real estate:		
Non-owner occupied	90,494	92,851
Owner occupied	113,103	109,383
Construction	5,988	6,228
Consumer:		
Home equity installment	29,017	27,317
Home equity line of credit	53,911	53,273
Auto loans and leases	105,588	83,510
Other	5,744	5,604
Residential:		
Real estate	144,864	136,901
Construction	11,831	9,931
Total	686,546	638,599
Less:		
Allowance for loan losses	(9,527)	(9,193)
Unearned lease revenue	(858)	(639)
Loans and leases, net	\$ 676,161	\$ 628,767

Net deferred loan costs of \$2.4 million and \$2.1 million have been included in the carrying values of loans at June 30, 2018 and December 31, 2017, respectively.

Unearned lease revenue represents the difference between the lessor's investment in the property and the gross investment in the lease. Unearned revenue is accrued over the life of the lease using the effective interest method. The residual value of leases is fully guaranteed by the dealerships. Residual values, a component of other assets on the balance sheet, amounted to \$10.4 million and \$9.4 million at June 30, 2018 and December 31, 2017, respectively.

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate unpaid principal balance of mortgages serviced amounted to \$302.3 million as of June 30, 2018 and \$299.3 million as of December 31, 2017. Mortgage servicing rights amounted to \$1.2 million and \$1.3 million as of June 30, 2018 and December 31, 2017, respectively.

Management is responsible for conducting the Company's credit risk evaluation process, which includes credit risk grading of individual commercial and industrial and commercial real estate loans. Commercial and industrial and commercial real estate loans are assigned credit risk grades based on the Company's assessment of conditions that

affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed as the case may be. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The Company utilizes an external independent loan review firm that reviews and validates the credit risk program on at least an annual basis. Results of these reviews are presented to management and the board of directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

Non-accrual loans

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

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Non-accrual loans, segregated by class, at June 30, 2018 and December 31, 2017, were as follows:

(dollars in thousands)	June 30, 2018	December 31, 2017
Commercial and industrial	\$ 100	\$ 36
Commercial real estate:		
Non-owner occupied	501	649
Owner occupied	923	942
Construction	159	161
Consumer:		
Home equity installment	82	15
Home equity line of credit	31	559
Auto loans and leases	51	5
Residential:		
Real estate	916	1,074
Total	\$ 2,763	\$ 3,441

Troubled Debt Restructuring

A modification of a loan constitutes a TDR when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company considers all TDRs to be impaired loans. The Company typically considers the following concessions when modifying a loan, which may include lowering interest rates below the market rate, temporary interest-only payment periods, term extensions at interest rates lower than the current market rate for new debt with similar risk and/or converting revolving credit lines to term loans. The Company typically does not consider forgiveness of principal when granting a TDR modification. Of the TDRs outstanding as of June 30, 2018 and 2017, when modified, the concessions granted consisted of temporary interest-only payments, extensions of maturity date, or a reduction in the rate of interest to a below-market rate for a contractual period of time. Other than the TDRs that were placed on non-accrual status, the TDRs were performing in accordance with their modified terms.

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

(dollars in thousands)	Loans modified as TDRs for the six months ended:					
	June 30, 2018			June 30, 2017		
	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)

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Commercial real estate - non-owner occupied	-	\$ -	\$ -	1	\$ 119	\$ 3
Commercial real estate - owner occupied	-	-	-	5	918	163
Consumer home equity installment	1	413	350	-	-	-
Residential real estate	1	316	-	-	-	-
Total	2	\$ 729	\$ 350	6	\$ 1,037	\$ 166

Loans modified as TDRs for the three months ended:

(dollars in thousands)

June 30, 2018

June 30, 2017

	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)
Commercial real estate - owner occupied	-	\$ -	\$ -	1	\$ 142	\$ 7

In the above tables, the period end balance is inclusive of all partial pay downs and charge-offs since the modification date. For all loans modified in a TDR, the pre-modification recorded investment was the same as the post-modification recorded investment.

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

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

(dollars in thousands)	June 30, 2018		June 30, 2017	
	Number of contracts	Recorded investment	Number of contracts	Recorded investment
Commercial real estate - owner occupied	-	\$ -	1	\$ 142

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

Loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment.

The allowance for loan losses (allowance) may be increased, adjustments may be made in the allocation of the allowance or partial charge-offs may be taken to further write-down the carrying value of the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral is used to establish the allowance. As of June 30, 2018 and 2017, respectively, the allowance for impaired loans that have been modified in a TDR was \$0.8 million and \$0.9 million, respectively.

Past due loans

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

	Past due				Current	Total loans (3)	Recorded investment past due ≥ 90 days and accruing
	30 - 59 Days past due	60 - 89 Days past due	90 days or more (1)	Total past due			
June 30, 2018							
Commercial and industrial	\$ 247	\$ 242	\$ 100	\$ 589	\$ 125,417	\$ 126,006	\$ -
Commercial real estate:							
Non-owner occupied	115	-	501	616	89,878	90,494	-
Owner occupied	599	48	1,087	1,734	111,369	113,103	164
Construction	-	-	159	159	5,829	5,988	-

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Consumer:							
Home equity installment	600	31	82	713	28,304	29,017	-
Home equity line of credit	365	125	31	521	53,390	53,911	-
Auto loans and leases	283	91	51	425	104,305	104,730 (2)	-
Other	38	21	-	59	5,685	5,744	-
Residential:							
Real estate	-	407	916	1,323	143,541	144,864	-
Construction	-	-	-	-	11,831	11,831	-
Total	\$ 2,247	\$ 965	\$ 2,927	\$ 6,139	\$ 679,549	\$ 685,688	\$ 164

(1) Includes \$2.8 million of non-accrual loans. (2) Net of unearned lease revenue of \$0.9 million. (3) Includes net deferred loan costs of \$2.4 million.

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December 31, 2017	30 - 59	60 - 89	Past due		Current	Total loans (3)	Recorded investment past due ≥ 90 days and accruing
	Days past due	Days past due	90 days or more (1)	Total past due			
Commercial and industrial	\$ 286	\$ -	\$ 36	\$ 322	\$ 113,279	\$ 113,601	\$ -
Commercial real estate:							
Non-owner occupied	51	1,018	649	1,718	91,133	92,851	-
Owner occupied	52	85	942	1,079	108,304	109,383	-
Construction	-	-	161	161	6,067	6,228	-
Consumer:							
Home equity installment	130	30	15	175	27,142	27,317	-
Home equity line of credit	276	-	559	835	52,438	53,273	-
Auto loans and leases	449	85	11	545	82,326	82,871	(2) 6
Other	42	-	-	42	5,562	5,604	-
Residential:							
Real estate	38	351	1,074	1,463	135,438	136,901	-
Construction	-	-	-	-	9,931	9,931	-
Total	\$ 1,324	\$ 1,569	\$ 3,447	\$ 6,340	\$ 631,620	\$ 637,960	\$ 6

(1) Includes \$3.4 million of non-accrual loans. (2) Net of unearned lease revenue of \$0.6 million. (3) Includes net deferred loan costs of \$2.1 million.

Impaired loans

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

At June 30, 2018, impaired loans totaled \$6.7 million consisting of \$2.6 million in accruing TDRs, \$2.8 million in non-accrual loans and \$1.3 million in accruing impaired loans. At December 31, 2017, impaired loans totaled \$6.9 million consisting of \$1.9 million in accruing TDRs, \$3.4 million in non-accrual loans and \$1.6 million in accruing impaired loans. As of June 30, 2018, the non-accrual loans included two TDRs to two unrelated borrowers totaling \$1.1 million compared with three TDRs totaling \$1.6 million to three unrelated borrowers as of December 31, 2017.

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

Unpaid	Recorded investment	Recorded investment	Total
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(dollars in thousands)	principal balance	with allowance	with no allowance	recorded investment	Related allowance
June 30, 2018					
Commercial and industrial	\$ 195	\$ 76	\$ 48	\$ 124	\$ -
Commercial real estate:					
Non-owner occupied	2,341	1,855	311	2,166	419
Owner occupied	2,713	1,493	971	2,464	418
Construction	382	-	159	159	-
Consumer:					
Home equity installment	529	413	82	495	350
Home equity line of credit	70	30	1	31	30
Auto loans and leases	78	-	51	51	-
Other	-	-	-	-	-
Residential:					
Real estate	1,564	55	1,177	1,232	1
Construction	-	-	-	-	-
Total	\$ 7,872	\$ 3,922	\$ 2,800	\$ 6,722	\$ 1,218

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(dollars in thousands)	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance
December 31, 2017					
Commercial and industrial	\$ 281	\$ 225	\$ 24	\$ 249	\$ 196
Commercial real estate:					
Non-owner occupied	2,426	1,975	363	2,338	488
Owner occupied	2,742	1,768	725	2,493	433
Construction	384	-	161	161	-
Consumer:					
Home equity installment	48	-	15	15	-
Home equity line of credit	878	32	527	559	25
Auto	13	-	5	5	-
Other	-	-	-	-	-
Residential:					
Real estate	1,350	131	943	1,074	37
Construction	-	-	-	-	-
Total	\$ 8,122	\$ 4,131	\$ 2,763	\$ 6,894	\$ 1,179

The following table presents the average recorded investments in impaired loans and related amount of interest income recognized during the periods indicated below. The average balances are calculated based on the quarter-end balances of impaired loans. Payments received from non-accruing impaired loans are first applied against the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income. Payments received from accruing impaired loans are applied to principal and interest, as contractually agreed upon.

(dollars in thousands)	For the six months ended June 30, 2018			June 30, 2017		
	Average recorded investment	Interest income recognized	Cash basis interest income recognized	Average recorded investment	Interest income recognized	Cash basis interest income recognized
Commercial and industrial	\$ 207	\$ 1	\$ -	\$ 237	\$ 4	\$ -
Commercial real estate:						
Non-owner occupied	2,376	63	-	3,316	63	-
Owner occupied	2,912	41	-	4,819	71	-
Construction	166	-	-	192	-	-
Consumer:						
Home equity installment	194	5	-	30	-	-
Home equity line of credit	388	8	-	816	-	-
Auto	14	-	-	25	4	-

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Other	6	-	-	5	1	-
Residential:						
Real estate	1,278	31	-	1,282	23	-
Construction	-	-	-	-	-	-
Total	\$ 7,541	\$ 149	\$ -	\$ 10,722	\$ 166	\$ -

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(dollars in thousands)	For the three months ended June 30, 2018			June 30, 2017		
	Average recorded investment	Interest income recognized	Cash basis interest income recognized	Average recorded investment	Interest income recognized	Cash basis interest income recognized
Commercial and industrial	\$ 169	\$ 1	\$ -	\$ 221	\$ 4	\$ -
Commercial real estate:						
Non-owner occupied	2,183	40	-	2,984	28	-
Owner occupied	2,512	23	-	4,829	41	-
Construction	163	-	-	179	-	-
Consumer:						
Home equity installment	462	3	-	8	-	-
Home equity line of credit	31	-	-	801	-	-
Auto	32	-	-	21	4	-
Other	11	-	-	3	-	-
Residential:						
Real estate	1,238	9	-	1,493	15	-
Construction	-	-	-	-	-	-
Total	\$ 6,801	\$ 76	\$ -	\$ 10,539	\$ 92	\$ -

Credit Quality Indicators

Commercial and industrial and commercial real estate

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

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

Pass

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

Special Mention

Loans in this category are graded a six and may be protected but are potentially weak. They constitute a credit risk to the Company, but have not yet reached the point of adverse classification. Some of the following conditions may exist: little or no collateral coverage; lack of current financial information; delinquency problems; highly leveraged; available financial information reflects poor balance sheet ratios and profit and loss statements reflect uncertain trends; and document exceptions. Cash flow may not be sufficient to support total debt service requirements.

Substandard

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

Doubtful

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

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Consumer and residential

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

The following table presents loans including \$2.4 million and \$2.1 million of deferred costs, segregated by class, categorized into the appropriate credit quality indicator category as of June 30, 2018 and December 31, 2017, respectively:

Commercial credit exposure

Credit risk profile by creditworthiness category

(dollars in thousands)	June 30, 2018				
	Pass	Special mention	Substandard	Doubtful	Total
Commercial and industrial	\$ 124,480	\$ 567	\$ 959	\$ -	\$ 126,006
Commercial real estate - non-owner occupied	86,543	620	3,331	-	90,494
Commercial real estate - owner occupied	107,722	752	4,629	-	113,103
Commercial real estate - construction	5,829	-	159	-	5,988
Total commercial	\$ 324,574	\$ 1,939	\$ 9,078	\$ -	\$ 335,591

Consumer & Mortgage lending credit exposure

Credit risk profile based on payment activity

(dollars in thousands)	June 30, 2018		
	Performing	Non-performing	Total
Consumer			
Home equity installment	\$ 28,935	\$ 82	\$ 29,017
Home equity line of credit	53,880	31	53,911
Auto loans and leases (1)	104,679	51	104,730
Other	5,744	-	5,744
Total consumer	\$ 193,238	\$ 164	\$ 193,402
Residential			

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Real estate	\$ 143,948	\$ 916	\$ 144,864
Construction	11,831	-	11,831
Total residential	\$ 155,779	\$ 916	\$ 156,695
Total consumer & residential	\$ 349,017	\$ 1,080	\$ 350,097

(1)Net of unearned lease revenue of \$0.9 million.

Commercial credit exposure

Credit risk profile by creditworthiness category

(dollars in thousands)	December 31, 2017				
	Pass	Special mention	Substandard	Doubtful	Total
Commercial and industrial	\$ 112,398	\$ 509	\$ 694	\$ -	\$ 113,601
Commercial real estate - non-owner occupied	84,892	998	6,961	-	92,851
Commercial real estate - owner occupied	103,426	2,479	3,478	-	109,383
Commercial real estate - construction	6,067	-	161	-	6,228
Total commercial	\$ 306,783	\$ 3,986	\$ 11,294	\$ -	\$ 322,063

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Consumer & Mortgage lending credit exposure

Credit risk profile based on payment activity

(dollars in thousands)	December 31, 2017		
	Performing	Non-performing	Total
Consumer			
Home equity installment	\$ 27,302	\$ 15	\$ 27,317
Home equity line of credit	52,714	559	53,273
Auto loans and leases (2)	82,860	11	82,871
Other	5,604	-	5,604
Total consumer	\$ 168,480	\$ 585	\$ 169,065
Residential			
Real estate	\$ 135,827	\$ 1,074	\$ 136,901
Construction	9,931	-	9,931
Total residential	\$ 145,758	\$ 1,074	\$ 146,832
Total consumer & residential	\$ 314,238	\$ 1,659	\$ 315,897

(2)Net of unearned lease revenue of \$0.6 million.

Allowance for loan losses

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

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

- § identification of specific impaired loans by loan category;
- § identification of specific loans that are not impaired, but have an identified potential for loss;
- § calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- § determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;
- § application of historical loss percentages (trailing twelve-quarter average) to pools to determine the allowance allocation;
- §

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

§ Qualitative factor adjustments include:

- o levels of and trends in delinquencies and non-accrual loans;
- o levels of and trends in charge-offs and recoveries;
- o trends in volume and terms of loans;
- o changes in risk selection and underwriting standards;
- o changes in lending policies and legal and regulatory requirements;
- o experience, ability and depth of lending management;
- o national and local economic trends and conditions; and
- o changes in credit concentrations.

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

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

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

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

As of and for the six months ended June 30, 2018

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,374	\$ 4,060	\$ 2,063	\$ 1,608	\$ 88	\$ 9,193
Charge-offs	(97)	(130)	(202)	(115)	-	(544)
Recoveries	54	33	66	-	-	153
Provision	10	(149)	702	229	(67)	725
Ending balance	\$ 1,341	\$ 3,814	\$ 2,629	\$ 1,722	\$ 21	\$ 9,527
Ending balance: individually evaluated for impairment	\$ -	\$ 837	\$ 380	\$ 1	\$ -	\$ 1,218
Ending balance: collectively evaluated for impairment	\$ 1,341	\$ 2,977	\$ 2,249	\$ 1,721	\$ 21	\$ 8,309
Loans Receivables:						
Ending balance (2)	\$ 126,006	\$ 209,585	\$ 193,402 (1)	\$ 156,695	\$ -	\$ 685,688
Ending balance: individually evaluated for impairment	\$ 124	\$ 4,789	\$ 577	\$ 1,232	\$ -	\$ 6,722
Ending balance: collectively evaluated for impairment	\$ 125,882	\$ 204,796	\$ 192,825	\$ 155,463	\$ -	\$ 678,966

(1) Net of unearned lease revenue of \$0.9 million. (2) Includes \$2.4 million of net deferred loan costs.

As of and for the three months ended June
30, 2018

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(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,236	\$ 3,988	\$ 2,470	\$ 1,662	\$ 52	\$ 9,408
Charge-offs	(82)	(87)	(90)	(110)	-	(369)
Recoveries	-	30	33	-	-	63
Provision	187	(117)	216	170	(31)	425
Ending balance	\$ 1,341	\$ 3,814	\$ 2,629	\$ 1,722	\$ 21	\$ 9,527

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As of and for the year ended
December 31, 2017

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,075	\$ 4,706	\$ 1,834	\$ 1,622	\$ 127	\$ 9,364
Charge-offs	(143)	(635)	(658)	(309)	-	(1,745)
Recoveries	10	47	67	-	-	124
Provision	432	(58)	820	295	(39)	1,450
Ending balance	\$ 1,374	\$ 4,060	\$ 2,063	\$ 1,608	\$ 88	\$ 9,193
Ending balance: individually evaluated for impairment	\$ 196	\$ 921	\$ 25	\$ 37	\$ -	\$ 1,179
Ending balance: collectively evaluated for impairment	\$ 1,178	\$ 3,139	\$ 2,038	\$ 1,571	\$ 88	\$ 8,014
Loans Receivables:						
Ending balance (2)	\$ 113,601	\$ 208,462	\$ 169,065 (1)	\$ 146,832	\$ -	\$ 637,960
Ending balance: individually evaluated for impairment	\$ 249	\$ 4,992	\$ 579	\$ 1,074	\$ -	\$ 6,894
Ending balance: collectively evaluated for impairment	\$ 113,352	\$ 203,470	\$ 168,486	\$ 145,758	\$ -	\$ 631,066

(1) Net of unearned lease revenue of \$0.6 million. (2) Includes \$2.1 million of net deferred loan costs.

As of and for the six months ended June
30, 2017

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,075	\$ 4,706	\$ 1,834	\$ 1,622	\$ 127	\$ 9,364
Charge-offs	(30)	(368)	(160)	(38)	-	(596)
Recoveries	3	41	44	-	-	88
Provision	335	131	221	(73)	(64)	550
Ending balance	\$ 1,383	\$ 4,510	\$ 1,939	\$ 1,511	\$ 63	\$ 9,406

As of and for the three months ended June
30, 2017

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,263	\$ 4,922	\$ 1,731	\$ 1,519	\$ 113	\$ 9,548
Charge-offs	(30)	(301)	(84)	-	-	(415)
Recoveries	1	31	16	-	-	48
Provision	149	(142)	276	(8)	(50)	225
Ending balance	\$ 1,383	\$ 4,510	\$ 1,939	\$ 1,511	\$ 63	\$ 9,406

6. Earnings per share

Basic earnings per share (EPS) is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but also reflects the potential dilution that could occur from the grant of stock-based compensation awards. The Company maintains two active share-based compensation plans that may generate additional potentially dilutive common shares. For granted and unexercised stock options and stock-settled stock appreciation rights (SSARs), dilution would occur if Company-issued stock options or SSARs were exercised and converted into common stock. As of the three and six months ended June 30, 2018, there were 27,894 and 26,674 potentially dilutive shares related to issued and unexercised stock options and SSARs compared to 12,206 and 10,529 for the same 2017 periods, respectively. For restricted stock, dilution would occur from the Company's previously granted but unvested shares. There were 11,137 and 11,006 potentially dilutive shares related to unvested restricted share grants as of the three and six months ended June 30, 2018 compared to 6,148 and 7,243 for the same 2017 periods, respectively.

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options and SSARs and unvested restricted stock. Under the treasury stock method, the assumed proceeds, as defined, received from shares issued in a hypothetical stock option exercise or restricted stock grant, are assumed to be used to purchase treasury stock. Proceeds include: amounts received from the exercise of outstanding stock options and compensation cost for future service that the Company has not yet recognized in earnings. The Company does not consider awards from share-based grants in the computation of basic EPS.

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

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
(dollars in thousands except per share data)				
Basic EPS:				
Net income available to common shareholders	\$ 2,768	\$ 2,183	\$ 5,296	\$ 4,163
Weighted-average common shares outstanding	3,751,728	3,705,534	3,749,389	3,701,078
Basic EPS	\$ 0.74	\$ 0.59	\$ 1.41	\$ 1.12
Diluted EPS:				
Net income available to common shareholders	\$ 2,768	\$ 2,183	\$ 5,296	\$ 4,163
Weighted-average common shares outstanding	3,751,728	3,705,534	3,749,389	3,701,078
Potentially dilutive common shares	39,031	18,354	37,680	17,772
Weighted-average common and potentially dilutive shares outstanding	3,790,759	3,723,888	3,787,069	3,718,850
Diluted EPS	\$ 0.73	\$ 0.59	\$ 1.40	\$ 1.12

7. Stock plans

The Company has two stock-based compensation plans (the stock compensation plans) from which it can grant stock-based compensation awards, and applies the fair value method of accounting for stock-based compensation provided under current accounting guidance. The guidelines require the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. The Company's stock compensation plans were shareholder-approved and permit the grant of share-based compensation awards to its employees and directors. The Company believes that the stock-based compensation plans will advance the development, growth and financial condition of the Company by providing incentives through participation in the appreciation in the value of the Company's common stock. In return, the Company hopes to secure, retain and motivate the employees and directors who are responsible for the operation and the management of the affairs of the Company by aligning the interest of its employees and directors with the interest of its shareholders. In the stock compensation plans, employees and directors are eligible to be awarded stock-based compensation grants which can consist of stock options (qualified and non-qualified), stock appreciation rights (SARs) and restricted stock.

At the 2012 annual shareholders' meeting, the Company's shareholders approved and the Company adopted the 2012 Omnibus Stock Incentive Plan and the 2012 Director Stock Incentive Plan (collectively, the 2012 stock incentive

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

In each of the 2012 stock incentive plans, the Company has reserved 750,000 shares of its no-par common stock for future issuance. The Company recognizes share-based compensation expense over the requisite service or vesting period. During 2015, the Company created a Long-Term Incentive Plan (LTIP) that awards restricted stock and stock-settled stock appreciation rights (SSARs) to senior officers based on the attainment of performance goals. The service requirement is the participant's continued employment throughout the LTIP with a three-year vesting period. The restricted stock has a two-year post vesting holding period requirement. The SSAR awards have a ten year term from the date of each grant. The Company granted restricted stock and SSARs in February 2016 based on 2015 performance, in February 2017 based on 2016 performance and in February 2018 based on 2017 performance and 2015-2017 3-year cumulative performance.

The following table summarizes the weighted-average fair value and vesting of restricted stock grants awarded during the periods ended June 30, 2018 and 2017 under the 2012 stock incentive plans:

	June 30, 2018			June 30, 2017		
	Shares	Weighted- average grant date fair value		Shares	Weighted- average grant date fair value	
	granted			granted		
Director plan	8,400	(3) \$ 49.50		8,400	(2) \$ 26.17	
Omnibus plan	10,800	(3) 45.83		4,749	(3) 23.93	
Omnibus plan	50	(1) 49.50		75	(1) 26.17	
Total	19,250	\$ 47.44		13,224	\$ 25.36	

(1) Vest after 1 year (2) Vest after 2 years – 50% each year (3) Vest after 3 years – 33% each year

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The fair value of the 10,800 shares granted on February 6, 2018 was calculated using the grant date stock price with a discount valuation. The Chaffe model was used to calculate the discount. Since the shares vest over three years and then have a further two-year holding period, the historical volatility of the five years prior to the issue date was used to estimate volatility. The five year treasury yield was used as the interest rate. The Company does pay a dividend, but since the shareholder will receive the dividends during vesting and the post-vest restriction period, no dividend yield was used in the calculation as not to inflate the discount. The grant date stock price was \$49.50 and the discount of 7.423% was calculated using an interest rate of 2.504% and a 5 year historical volatility of 17.617%.

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

	2012 Stock incentive plans			Weighted- average grant date fair value
	Director	Omnibus	Total	
Non-vested balance at December 31, 2017	8,400	12,304	20,704	\$ 23.59
Granted	8,400	10,850	19,250	47.44
Vested	(4,200)	(5,794)	(9,994)	23.69
Non-vested balance at June 30, 2018	12,600	17,360	29,960	\$ 38.99

The Company granted 38,941 SSARs under the Omnibus Plan on February 6, 2018. The Company estimated the fair value of SSARs using the Black-Scholes-Merton valuation model on the grant date. The Company used the following assumptions: the risk-free interest rate is the rate equivalent to the expected term of the option interpolated from the U.S. Treasury Yield Curve on the valuation date and historical volatility is calculated by taking the standard deviation of historical returns using weekly and monthly data. The fair value of these SSARs was \$13.73 per share, based on a risk-free interest rate of 2.771%, a dividend yield of 1.762% and a volatility of 23.906% using an expected term of ten years.

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

	Awards	Weighted-average grant date fair value	Weighted-average remaining contractual term (years)
Outstanding December 31, 2017	53,360	\$ 4.20	8.5
Granted	38,941	13.73	10.0
Exercised	-	-	

Forfeited	-	-	
Outstanding June 30, 2018	92,301	\$ 8.22	8.7

Of the SSARs outstanding at June 30, 2018, 27,453 vested and were exercisable. SSARs vest over a three year period – 33% per year.

Share-based compensation expense is included as a component of salaries and employee benefits in the consolidated statements of income. The following tables illustrate stock-based compensation expense recognized on non-vested equity awards during the three and six months ended June 30, 2018 and 2017 and the unrecognized stock-based compensation expense as of June 30, 2018:

(dollars in thousands)	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Stock-based compensation expense:				
Director stock incentive plan	\$ 62	\$ 27	\$ 113	\$ 61
Omnibus stock incentive plan	132	50	236	95
Employee stock purchase plan	-	-	143	23
Total stock-based compensation expense	\$ 194	\$ 77	\$ 492	\$ 179

In addition, during the three and six months ended June 30, 2018, the Company reversed accruals of (\$35 thousand) and (\$60 thousand) in stock-based compensation expense for restricted stock and SSARs awarded under the Omnibus Plan. The Company accrued \$54 thousand and \$109 thousand in stock-based compensation expense during the three and six months ended June 30, 2017.

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(dollars in thousands)	As of June 30, 2018
Unrecognized stock-based compensation expense:	
Director plan	\$ 422
Omnibus plan	1,076
Total unrecognized stock-based compensation expense	\$ 1,498

The unrecognized stock-based compensation expense as of June 30, 2018 will be recognized ratably over the periods ended January 2021 and January 2021 for the Director Plan and the Omnibus Plan, respectively.

Transactions under the Company's stock option plan for the six months ended June 30, 2018 are presented in the following table:

	Options	Weighted-average exercise price	Weighted-average remaining contractual term (years)
Outstanding and exercisable, December 31, 2017	750	\$ 18.50	0.2
Granted	-	-	
Exercised	(750)	18.50	
Forfeited	-	-	
Outstanding and exercisable, June 30, 2018	-	\$ -	-

During the first quarter of 2018, there were 750 stock options exercised at a price of \$18.50 per share. The intrinsic value of these stock options was \$2,585. The tax deduction realized from the exercise of these options was \$22,875 resulting in a tax benefit of \$4,804. During the first quarter of 2017, there were 779 stock options exercised at a price of \$19.27 per share. The intrinsic value of these stock options was \$2,891 and the tax deduction realized from the exercise of these options was \$5,761 resulting in a tax benefit of \$1,959. The Company has not issued stock options since 2008.

In addition to the 2012 stock incentive plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 165,000 shares of its un-issued capital stock for issuance under the plan. The ESPP was designed to promote broad-based employee ownership of the Company's stock and to motivate employees to improve job performance and enhance the financial results of the Company. Under the ESPP, participation is voluntary whereby employees use automatic payroll withholdings to purchase the Company's capital stock at a discounted price based on the fair market value of the capital stock as measured on either the commencement or termination dates, as defined. As of June 30, 2018, 76,484 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and is required to comply with the provisions of current accounting guidance. The Company

recognizes compensation expense on its ESPP on the date the shares are purchased and it is included as a component of salaries and employee benefits in the consolidated statements of income.

8. Fair value measurements

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

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

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

Level 3 - inputs are unobservable and are based on the Company's own assumptions to measure assets and liabilities at fair value. Level 3 pricing for securities may also include unobservable inputs based upon broker-traded transactions.

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

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

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

June 30, 2018

(dollars in thousands)	Carrying amount	Estimated fair value	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Financial assets:					
Cash and cash equivalents	\$ 17,972	\$ 17,972	\$ 17,972	\$ -	\$ -
Available-for-sale debt securities	164,403	164,403	-	164,403	-
FHLB stock	3,490	3,490	-	3,490	-
Loans and leases, net	676,161	667,199	-	-	667,199
Loans held-for-sale	1,305	1,328	-	1,328	-
Accrued interest receivable	3,130	3,130	-	3,130	-
Financial liabilities:					
Deposits with no stated maturities	667,573	667,573	-	667,573	-
Time deposits	110,685	109,028	-	109,028	-
Short-term borrowings	29,553	29,553	-	29,553	-
FHLB advances	18,704	18,583	-	18,583	-
Accrued interest payable	404	404	-	404	-

December 31, 2017

(dollars in thousands)	Carrying amount	Estimated fair value	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Financial assets:					
Cash and cash equivalents	\$ 15,825	\$ 15,825	\$ 15,825	\$ -	\$ -
Available-for-sale securities	157,385	157,385	828	156,557	-
FHLB stock	2,832	2,832	-	2,832	-
Loans and leases, net	628,767	625,052	-	-	625,052
Loans held-for-sale	2,181	2,221	-	2,221	-
Accrued interest receivable	2,786	2,786	-	2,786	-

Financial liabilities:

Deposits with no stated maturities	623,080	623,080	-	623,080	-
Time deposits	107,066	105,758	-	105,758	-
Short-term borrowings	18,502	18,502	-	18,502	-
FHLB advances	21,204	21,066	-	21,066	-
Accrued interest payable	346	346	-	346	-

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

- Cash and cash equivalents;
- Non-interest bearing deposit accounts;
- Savings, interest-bearing checking and money market accounts and
- Short-term borrowings.

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

Loans and leases: The fair value of accruing loans is estimated by calculating the net present value of the future expected cash flows discounted using the exit price notion. The discount rate is based upon current offering rates, with an additional discount for expected

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potential charge-offs. Additionally, an environmental general credit risk adjustment is subtracted from the net present value to arrive at the total estimated fair value of the accruing loan portfolio.

The carrying value that fair value is compared to is net of the allowance for loan losses and since there is significant judgment included in evaluating credit quality, loans are classified within Level 3 of the fair value hierarchy. The net carrying value of loans acquired through the Wayne Bank branch acquisition approximates the fair value of the loans.

Non-accrual loans: Loans which the Company has measured as non-accruing are generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties. These loans are classified within Level 3 of the fair value hierarchy. The fair value consists of loan balances less the valuation allowance.

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

Certificates of deposit: The fair value of certificates of deposit is based on discounted cash flows using rates which approximate market rates for deposits of similar maturities. The fair value of certificates of deposit acquired through the Wayne Bank branch acquisition represents the estimated fair value of these deposits.

FHLB advances: Fair value is estimated using the rates currently offered for similar borrowings.

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

(dollars in thousands)	Total carrying value June 30, 2018	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Available-for-sale securities:				
Agency - GSE	\$ 5,877	\$ -	\$ 5,877	\$ -
Obligations of states and political subdivisions	46,361	-	46,361	-
MBS - GSE residential	112,165	-	112,165	-
Total available-for-sale debt securities	\$ 164,403	\$ -	\$ 164,403	\$ -

	Total carrying value December 31, 2017	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
(dollars in thousands)				
Available-for-sale securities:				
Agency - GSE	\$ 9,099	\$ -	\$ 9,099	\$ -
Obligations of states and political subdivisions	44,306	-	44,306	-
MBS - GSE residential	103,152	-	103,152	-
Equity securities - financial services	828	828	-	-
Total available-for-sale securities	\$ 157,385	\$ 828	\$ 156,557	\$ -

Equity securities are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Debt securities in the AFS portfolio are measured at fair value using market quotations provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Assets classified as Level 2 use valuation techniques that are common to bond valuations. That is, in active markets whereby bonds of similar characteristics frequently trade, quotes for similar assets are obtained. For the periods ending June 30, 2018 and December 31, 2017, there were no transfers to or from Level 1 and Level 2 fair value measurements for financial assets measured on a recurring basis.

There were no changes in Level 3 financial instruments measured at fair value on a recurring basis as of and for the periods ending June 30, 2018 and December 31, 2017, respectively.

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

	Total	Quoted	Significant	Significant
	carrying	prices in	other	other
	value	active	observable	unobservable
	at June	markets	inputs	inputs
(dollars in thousands)	30, 2018	(Level	(Level 2)	(Level 3)
		1)		
Impaired loans	\$ 2,704	\$ -	\$ -	\$ 2,704
Other real estate owned	532	-	-	532
Total	\$ 3,236	\$ -	\$ -	\$ 3,236

	Total	Quoted	Significant	Significant
	carrying	prices in	other	other
	value	active	observable	unobservable
	at	markets	inputs	inputs
(dollars in thousands)	December	(Level	(Level 2)	(Level 3)
	31, 2017	1)		
Impaired loans	\$ 2,952	\$ -	\$ -	\$ 2,952
Other real estate owned	814	-	-	814
Total	\$ 3,766	\$ -	\$ -	\$ 3,766

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

The following describes valuation methodologies used for financial instruments measured at fair value on a non-recurring basis. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves, a component of the allowance for loan losses, and as such are carried at the lower of net recorded investment or the estimated fair value. Estimates of fair value of the collateral are determined based on a variety of information, including available valuations from certified appraisers for similar assets, present value of

discounted cash flows and inputs that are estimated based on commonly used and generally accepted industry liquidation advance rates and estimates and assumptions developed by management.

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

At June 30, 2018 and December 31, 2017, the range of liquidation expenses and other valuation adjustments applied to impaired loans ranged from -17.30% to -49.89% and from -15.95% to -51.55% respectively. The weighted-average of liquidation expenses and other valuation adjustments applied to impaired loans amounted to -27.05% as of June 30, 2018 and -23.03% as of December 31, 2017, respectively. Due to the multitude of assumptions, many of which are subjective in nature, and the varying inputs and techniques used to determine fair value, the Company recognizes that valuations could differ across a wide spectrum of techniques employed. Accordingly, fair value estimates for impaired loans are classified as Level 3.

For ORE, fair value is generally determined through independent appraisals of the underlying properties which generally include various Level 3 inputs which are not identifiable. Appraisals form the basis for determining the net realizable value from these properties. Net realizable value is the result of the appraised value less certain costs or discounts associated with liquidation which occurs in the normal course of business. Management's assumptions may include consideration of the location and occupancy of the property, along with current economic conditions. Subsequently, as these properties are actively marketed, the estimated fair values may be periodically adjusted through incremental subsequent write-downs. These write-downs usually reflect decreases in estimated values resulting from sales price observations as well as changing economic and market conditions. At June 30, 2018 and December 31, 2017, the discounts applied to the appraised values of ORE ranged from -25.71% to -68.96% and from -17.95% to -99.00%, respectively. As of June 30, 2018 and December 31, 2017, the weighted-average of discount to the appraisal values of ORE amounted to -38.09% and -35.30% respectively.

9. Acquisition

On March 17, 2017, the Company completed the acquisition of the West Scranton branch of Wayne Bank, the wholly owned banking subsidiary of Norwood Financial Corp., pursuant to the terms of the Branch Purchase and Deposit Assumption Agreement dated September 29, 2016. The Company purchased all of the deposit liabilities associated with the branch, certain loans, and the branch real estate, and immediately closed the branch and consolidated the acquired deposits and loans into its nearby West Scranton branch

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office. The Company expects this transaction to expand its customer base in West Scranton.

The transaction has been accounted for using the acquisition method of accounting. The acquired assets and assumed liabilities were recorded at book value which also represented estimated fair value at the date of acquisition. Management made significant estimates and exercised significant judgement in estimating fair value, but the fair value adjustments were deemed immaterial to the financial statements.

The Company recognized \$41 thousand of acquisition-related costs during 2017. These costs were expensed as incurred and are presented in non-interest expenses on the consolidated statements of income. Costs incurred in 2017 consist principally of legal fees and other professional fees.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition:

(dollars in thousands)	March 17, 2017
Cash and cash equivalents	\$ 11,817
Loans	1,574
Bank premises and equipment	264
Goodwill	209
Accrued interest receivable and other assets	4
Total assets acquired	\$ 13,868
Deposits	\$ 13,809
Accrued interest payable and other liabilities	59
Total liabilities assumed	\$ 13,868

The Company acquired \$1.6 million in residential and consumer loans. None of the loans that were acquired had evidence of credit quality deterioration.

The Company recorded goodwill associated with the acquisition of the West Scranton branch of Wayne bank totaling \$0.2 million. Goodwill is not amortized, but is periodically evaluated for impairment. The Company did not recognize any impairment during 2017. For income tax purposes, goodwill will be deducted over a 15 year period.

10. Employee Benefits

Bank-Owned Life Insurance (BOLI)

The Company has purchased single premium BOLI policies on certain officers. The policies are recorded at their cash surrender values. Increases in cash surrender values are included in non-interest income in the consolidated statements of income. In March 2017, the Company purchased an additional \$8.0 million of BOLI. The policies' cash surrender value totaled \$20.3 million and \$19.7 million, respectively, as of June 30, 2018 and 2017 and is reflected as an asset on the consolidated balance sheets. As of June 30, 2018 and 2017, the Company has recorded income of \$298 thousand and \$264 thousand, respectively.

Officer Life Insurance

In 2017, the Bank entered into separate split dollar life insurance arrangements (Split Dollar Agreements) with eleven officers. This plan provides each officer a specified death benefit should the officer die while in the Bank's employ. The Bank paid the insurance premiums in March 2017 and the arrangements were effective in March 2017. The Bank owns the policies and all cash values thereunder. Upon death of the covered employee, the agreed-upon amount of death proceeds from the policies will be paid directly to the insured's beneficiary. As of June 30, 2018, the policies had total death benefits of \$20.5 million of which \$4.0 million would have been paid to the officer's beneficiaries and the remaining \$16.5 million would have been paid to the Bank. In addition, three executive officers have the opportunity to retain a split dollar benefit equal to two times their highest base salary after separation from service if the vesting requirements are met. As of June 30, 2018, the Company accrued expenses of \$47 thousand for the split dollar benefit.

Supplemental Executive Retirement plan (SERP)

On March 29, 2017, the Bank entered into separate supplemental executive retirement agreements (individually the "SERP Agreement") with five officers, pursuant to which the Bank will credit an amount to a SERP account established on each participant's behalf while they are actively employed by the Bank for each calendar month from March 1, 2017 until retirement. As of June 30, 2018, the Company accrued expenses of \$624 thousand in connection with the SERP.

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

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of June 30, 2018 compared to December 31, 2017 and a comparison of the results of operations for the three and six months ended June 30, 2018 and 2017. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2017 Annual Report filed on Form 10-K.

Forward-looking statements

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

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

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

- § acts of war or terrorism;
- § disruption of credit and equity markets; and
- § the risk that our analyses of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful.

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

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

Executive Summary

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

As a leading Northeastern Pennsylvania community bank, our goals are to enhance shareholder value while continuing to build a full-service community bank. We focus on growing our core business of retail and business lending and deposit gathering while

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maintaining strong asset quality and controlling operating expenses. We continue to implement strategies to diversify earning assets and to increase low cost core deposits. These strategies include a greater level of commercial lending and the ancillary business products and services supporting our commercial customers' needs as well as residential lending strategies and an array of consumer products. We focus on developing a full banking relationship with existing, as well as new, small- and middle-sized business prospects. In addition, we explore opportunities to selectively expand our franchise footprint, consisting presently of our 10-branch network. Currently, the Company is constructing a new branch in Back Mountain, PA in order to expand our presence in Luzerne County, which is expected to open in the fourth quarter of 2018. We incurred \$0.7 million in investment costs related to the construction of this new branch during the first half of 2018 and expect another \$1.5 million during the second half of 2018. In addition, the Company has received regulatory approval to add a branch location in Mountain Top, PA. We currently expect that this branch will open during the first half of 2019.

On August 15, 2017, the Company declared a three-for-two stock split to shareholders effected in the form of a 50% stock dividend. All share and per share information included in the accompanying management's discussion and analysis has been retroactively adjusted to reflect this stock split.

We are impacted by both national and regional economic factors, with commercial, commercial real estate and residential mortgage loans concentrated in Northeastern Pennsylvania, primarily in Lackawanna and Luzerne counties. Although the U.S. economy has shown signs of improvement, the general operating environment and our local market area continue to remain challenging and local competition is strong. For the near-term, we expect to continue to operate in a rising interest rate environment. A rising rate environment positions the Company to improve its net interest income performance. The Federal Open Market Committee (FOMC) adjusted the short-term federal funds rate up 50 basis points so far during 2018. Expectations are for short-term rates to continue to rise this year, potentially pressuring deposit rate pricing. The U.S. Treasury yield curve is expected to flatten even further in 2018. The national unemployment rate for June 2018 was 4.0%, down one percentage point from December 2017. Growth in all loan sectors at prudent pricing should mitigate the projected increase in interest expense from higher deposit and borrowing rates and help maintain an acceptable interest rate margin during 2018 and beyond. The unemployment rate in Scranton - Wilkes-Barre Metropolitan Statistical Area (local) decreased during the first half of 2018, but continued to lag behind the unemployment rates of the state and nation. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at June 30, 2018 was 4.9%, a decrease of 0.1 percentage points from 5.0% at December 31, 2017 and a decrease from 5.6% at June 30, 2017. The local unemployment rate slightly decreased during the first half of 2018 due to an increase in jobs as more people entered the labor force. Seasonal fluctuations in unemployment are expected. The median home values in the region have gone up 8.1% over the past year, 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 fall 2.5% within the next year. In light of these expectations, we will continue to monitor the economic climate in our region and scrutinize growth prospects with credit quality as a principal consideration.

Our efforts and focus continue on building relationships concentrating on loans, deposits, wealth management, business services and retail opportunities with clients and prospects with the goal to exceed expectations by providing a valued service.

In addition to the challenging economic environment in which we compete, the regulation and oversight of our business has changed significantly in recent years. As described more fully in Part I, Item 1A, "Risk Factors," and in the "Supervisory and Regulation" section of management's discussion and analysis of financial condition and results of operations in our 2017 Annual Report filed on Form 10-K, certain aspects of the Dodd-Frank Wall Street Reform Act (Dodd-Frank Act) continue to have a significant impact on us. In addition, final rules to implement Basel III regulatory capital reform, approved by the federal bank regulatory agencies in 2013, subject many banks including the Company, to capital requirements which will be phased in. The initial provisions effective for us began on January 1,

2015. The rules also revise the minimum risk-based and leverage capital ratio requirements applicable to the Company and revise the calculation of risk-weighted assets to enhance their risk sensitivity. We will continue to prepare for the impacts that the Dodd-Frank Act and the Basel III capital standards, and related rulemaking will have on our business, financial condition and results of operations.

Non-GAAP Financial Measures

The following are non-GAAP financial measures which management believes provide useful insight to the reader of the consolidated financial statements but should be supplemental to GAAP used to prepare the Company's financial statements and should not be read in isolation or relied upon as a substitute for GAAP measures. In addition, the Company's non-GAAP measures may not be comparable to non-GAAP measures of other companies. The Company's tax rate used to calculate the fully-taxable equivalent (FTE) adjustment was 21% at June 30, 2018 compared to 34% at June 30, 2017.

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The following table reconciles the non-GAAP financial measures of FTE net interest income:

(dollars in thousands)	Three months ended		Six months ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Interest income (GAAP)	\$ 8,535	\$ 7,854	\$ 16,678	\$ 15,220
Adjustment to FTE	175	324	340	633
Interest income adjusted to FTE (Non-GAAP)	8,710	8,178	17,018	15,853
Interest expense	1,012	787	1,896	1,475
Net interest income adjusted to FTE (Non-GAAP)	\$ 7,698	\$ 7,391	\$ 15,122	\$ 14,378

The efficiency ratio is non-interest expenses as a percentage of FTE net interest income plus non-interest income. The following table reconciles the non-GAAP financial measures of the efficiency ratio to GAAP:

(dollars in thousands)	Three months ended		Six months ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Efficiency Ratio (non-GAAP)				
Non-interest expenses (GAAP)	\$ 6,162	\$ 6,051	\$ 12,370	\$ 11,848
Net interest income (GAAP)	7,523	7,067	14,782	13,745
Plus: taxable equivalent adjustment	175	324	340	633
Non-interest income (GAAP)	2,371	2,131	4,654	4,236
Net interest income (FTE) plus non-interest income (non-GAAP)	\$ 10,069	\$ 9,522	\$ 19,776	\$ 18,614
Efficiency ratio (non-GAAP)	61.20%	63.55%	62.55%	63.65%

General

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

liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. Interest rate spread is significantly impacted by: changes in interest rates and market yield curves and their related impact on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in the marketplace.

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

Comparison of the results of operations

Three and six months ended June 30, 2018 and 2017

Overview

For the second quarter of 2018, the Company generated net income of \$2.8 million, or \$0.73 per diluted share, compared to \$2.2 million, or \$0.59 per diluted share, for the second quarter of 2017. The \$0.6 million, or 27%, increase in net income stemmed from \$0.5 million more net interest income, \$0.2 million in additional non-interest income and \$0.2 million less provision for income taxes which more than offset \$0.2 million more provision for loan losses and a \$0.1 million rise in non-interest expenses. In the year-to-date comparison, net income grew \$1.1 million, or 27%, to \$5.3 million, or \$1.40 per diluted share, for the first half of 2018 from \$4.2 million, or \$1.12 per diluted share, for the first half of 2017. As in the quarterly comparison, higher net interest income and non-interest income combined with a lower provision for income taxes were partially offset by higher non-interest expenses and provision for loan losses.

Return on average assets (ROA) was 1.24% and 1.04% for the second quarters of 2018 and 2017, respectively, and 1.20% and 1.01% for the six months ended June 30, 2018 and 2017, respectively. During the same time periods, return on average

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shareholders' equity (ROE) was 12.60% and 10.49%, respectively, and 12.18% and 10.18%, respectively. The increase in ROA and ROE was the result of the higher pace of net income growth during 2018 as assets and equity continue to increase.

Net interest income and interest sensitive assets / liabilities

For the second quarter of 2018, net interest income increased \$0.5 million, or 6%, to \$7.5 million from \$7.0 million for the second quarter of 2017 due to interest income increasing faster than interest expense. The \$0.7 million growth in interest income was produced by adding \$48.7 million in average interest-earning assets combined with a higher yield earned on those assets. The loan portfolio contributed \$0.5 million to this interest income growth due to \$27.0 million more average loans earning a higher yield. A larger average balance of higher yielding mortgage-backed securities produced \$0.2 million more interest income from investments. On the liability side, \$29.9 million in additional average interest-bearing deposits with a 15 basis point increase in rates paid on these deposits resulted in \$0.2 million more interest expense for the second quarter of 2018 compared to the 2017 like period.

Net interest income increased \$1.0 million, or 8%, from \$13.8 million for the six months ended June 30, 2017 to \$14.8 million for the six months ended June 30, 2018, due to higher interest income which more than offset the additional interest expense. Total average interest-earning assets increased \$52.4 million along with an increase in the yields earned thereon resulting in \$1.5 million of growth in interest income. In the loan portfolio, the Company experienced average balance growth of \$27.8 million combined with higher yields in the commercial and residential portfolios, which had the effect of producing \$1.0 million more interest income. Although all loan portfolios showed more interest income, the consumer loan portfolio increased due to average balance growth while the commercial and residential loan portfolios experienced growth mostly due to higher yields. In the investment portfolio, an increase in the average balances of mortgage-backed securities was the biggest driver of interest income growth of \$0.4 million. On the liability side, total interest-bearing liabilities grew \$24.2 million on average with a 12 basis point increase in rates paid on these interest-bearing liabilities. Growth in average interest-bearing deposits of \$42.9 million was partially offset by a decline of \$18.7 million in average borrowings which had a minimal effect on interest expense. The increase in interest expense of \$0.4 million was primarily caused by the 13 basis point increase in rates paid on interest-bearing deposits.

The FTE net interest rate spread decreased by thirteen and nine basis points, respectively, for the three and six months ended June 30, 2018 compared to the same 2017 periods. Over the same periods, the FTE net interest margin decreased by seven and six basis points, respectively. The Company's lower tax rate in 2018 caused FTE interest income from nontaxable interest-earning assets to decline. The negative impact of this lower FTE adjustment had the effect of reducing net interest rate spread by eight and seven basis points and margin by eight and eight basis points, respectively. The rates paid on interest-bearing liabilities rose faster than the yields earned on interest-earning assets causing a further decline in net interest rate spread. The overall cost of funds, which includes the impact of non-interest bearing deposits, increased nine and eight basis points for the three and six months ended June 30, 2018 compared to the same period in 2017. The primary reason for the increase was higher average interest-bearing deposits and the rates paid thereon.

For the second half of 2018, the Company expects to operate in an 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 experience compression. However for 2018, the Company anticipates net interest income to improve as growth in interest-earning assets would help mitigate an adverse impact of rate movements on cost of funds. The FOMC has been gradually increasing the short-term federal funds rate since the end of 2015, and it has started to effect the rates paid on funding sources. 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 in March 2018 and another

25 basis points in June 2018. The focus for the remainder of 2018 is to manage net interest income after years of a sustained low interest rate environment through a rising rate environment by maintaining a reasonable spread. Interest expense is projected to continue to grow in 2018 from growth in deposits and borrowings and an increase in rates paid on both. Continued growth in the loan portfolios complemented with investment security growth is currently expected to boost interest income, and when coupled with a proactive relationship 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 67 and 63 basis points for the three and six months ended June 30, 2018, respectively, and 53 and 51 basis points for the three and six months ended June 30, 2017, respectively. During both periods, an increase in average interest-bearing deposits and their rates primarily caused the higher cost of interest-bearing liabilities. During 2017 and 2018, rates paid on interest-bearing deposits started to increase from historic low levels. Interest rates along the treasury yield curve have been volatile with shorter-term rates rising faster than long-term rates producing a flatter yield curve during 2018. Competition among banks has already begun to pressure banks to increase deposit rates. If rates continue to rise, 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.

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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 FTE adjusted, using the corporate federal tax rate of 21% at June 30, 2018 and 34% at June 30, 2017 to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. See "Non-GAAP Financial Measures" within this management's discussion and analysis for the FTE adjustments. This treatment allows a uniform comparison among yields on interest-earning assets. Loans include loans held-for-sale (HFS) and non-accrual loans but exclude the allowance for loan losses. Net deferred loan cost amortization of \$163 thousand and \$132 thousand during the second quarters of 2018 and 2017, respectively, and \$303 thousand and \$240 thousand for the six months ended June 30, 2018 and 2017, 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)	Three months ended			June 30, 2017		
	June 30, 2018		Yield /	June 30, 2017		Yield /
Assets	Average balance	Interest	rate	Average balance	Interest	rate
Interest-earning assets						
Interest-bearing deposits	\$ 9,217	\$ 42	1.84 %	\$ 2,095	\$ 4	0.88 %
Restricted regulatory securities	2,826	38	5.40	3,438	37	4.33
Investments:						
Agency - GSE	5,344	36	2.67	18,185	64	1.42
MBS - GSE residential	116,427	767	2.64	91,721	594	2.60
State and municipal (nontaxable)	45,247	512	4.53	42,120	577	5.49
Other	463	6	5.29	294	8	10.06
Total investments	167,481	1,321	3.16	152,320	1,243	3.27
Loans and leases:						
C&I and CRE (taxable)	289,638	3,514	4.87	295,892	3,506	4.75
C&I and CRE (nontaxable)	30,863	280	3.64	32,794	329	4.02
Consumer	128,770	1,282	3.99	101,261	1,051	4.16
Residential real estate	208,239	2,233	4.30	200,572	2,009	4.02
Total loans and leases	657,510	7,309	4.46	630,519	6,895	4.39
Total interest-earning assets	837,034	8,710	4.17 %	788,372	8,179	4.16 %
Non-interest earning assets	59,312			57,535		
Total assets	\$ 896,346			\$ 845,907		
Liabilities and shareholders' equity						
Interest-bearing liabilities						
Deposits:						
Interest-bearing checking	\$ 209,431	\$ 288	0.55 %	\$ 188,950	\$ 176	0.37 %
Savings and clubs	136,633	62	0.18	127,701	41	0.13
MMDA	110,238	216	0.79	117,113	183	0.62
Certificates of deposit	109,258	320	1.17	101,933	243	0.96
Total interest-bearing deposits	565,560	886	0.63	535,697	643	0.48
Repurchase agreements	8,188	3	0.14	9,333	5	0.21
Overnight borrowings	11,062	57	2.07	28,077	80	1.15
FHLB advances	18,704	66	1.41	19,873	59	1.19
Total interest-bearing liabilities	603,514	1,012	0.67 %	592,980	787	0.53 %
Non-interest bearing deposits	197,355			163,869		
Non-interest bearing liabilities	7,330			5,603		
Total liabilities	808,199			762,452		
Shareholders' equity	88,147			83,455		
Total liabilities and shareholders' equity	\$ 896,346			\$ 845,907		
Net interest income - FTE		\$ 7,698			\$ 7,392	

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Net interest spread	3.50 %	3.63 %
Net interest margin	3.69 %	3.76 %
Cost of funds	0.51 %	0.42 %

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(dollars in thousands)	Six months ended			June 30, 2017		
	June 30, 2018		Yield / rate	June 30, 2017		Yield / rate
Assets	Average balance	Interest		Average balance	Interest	
Interest-earning assets						
Interest-bearing deposits	\$ 10,283	\$ 84	1.65 %	\$ 2,083	\$ 10	1.01 %
Restricted regulatory securities	2,645	78	5.94	3,328	56	3.41
Investments:						
Agency - GSE	6,350	70	2.21	18,237	128	1.41
MBS - GSE residential	114,757	1,508	2.65	88,648	1,149	2.61
State and municipal (nontaxable)	43,941	989	4.54	41,151	1,122	5.50
Other	381	12	6.60	295	15	10.12
Total investments	165,429	2,579	3.14	148,331	2,414	3.28
Loans and leases:						
C&I and CRE (taxable)	290,103	6,925	4.81	293,955	6,720	4.61
C&I and CRE (nontaxable)	30,584	549	3.62	30,923	648	4.22
Consumer	123,079	2,430	3.98	97,669	2,052	4.24
Residential real estate	205,612	4,373	4.29	199,053	3,954	4.01
Total loans and leases	649,378	14,277	4.43	621,600	13,374	4.34
Total interest-earning assets	827,735	17,018	4.15 %	775,342	15,854	4.12 %
Non-interest earning assets	60,383			54,741		
Total assets	\$					