FIDELITY D & D BANCORP INC
Form 10-Q
August 10, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2010

OR

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

For the transition period from ______________to______________________

Commission file number: 333-90273

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION:	IRS EMPLOYER IDENTIFICATION NO:
PENNSYLVANIA	23-3017653

Address of principal executive offices:
BLAKELY & DRINKER ST.
DUNMORE, PENNSYLVANIA 18512

TELEPHONE:
570-342-8281

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

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

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company x

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
¨ YES x NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on July 30, 2010, the latest practicable date, was 2,148,408 shares.

FIDELITY D & D BANCORP, INC.

Form 10-Q June 30, 2010

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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, 2010	December 31, 2009
Assets:		
Cash and due from banks	$ 13,734,046	$ 8,173,199
Interest-bearing deposits with financial institutions	22,994,829	154,755
Total cash and cash equivalents	36,728,875	8,327,954
Available-for-sale securities	75,370,473	75,821,292
Held-to-maturity securities (fair value $636,015 in 2010; $765,195 in 2009)	577,591	708,706
Federal Home Loan Bank Stock	4,781,100	4,781,100
Loans and leases, net (allowance for loan losses of $7,523,250 in 2010; $7,573,603 in 2009)	420,215,504	423,124,054
Loans available-for-sale (fair value $388,709 in 2010; $1,233,345 in 2009)	384,000	1,221,365
Bank premises and equipment, net	14,936,387	15,361,810
Cash surrender value of bank owned life insurance	9,269,973	9,117,156
Accrued interest receivable	2,149,434	2,250,855
Foreclosed assets held-for-sale	1,084,007	887,397
Other assets	13,772,939	14,415,582
Total assets	$ 579,270,283	$ 556,017,271
Liabilities:		
Deposits:		
Interest-bearing	$ 403,090,854	$ 388,103,880
Non-interest-bearing	77,836,050	70,890,578
Total deposits	480,926,904	458,994,458
Accrued interest payable and other liabilities	2,922,545	2,815,159
Short-term borrowings	15,577,694	16,533,107
Long-term debt	32,000,000	32,000,000
Total liabilities	531,427,143	510,342,724
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-
Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 2,148,408 in 2010; and 2,105,860 in 2009)	20,553,888	19,982,677
Retained earnings	35,101,386	34,886,265
Accumulated other comprehensive loss	(7,812,134)	(9,194,395)

Total shareholders' equity	47,843,140	45,674,547
Total liabilities and shareholders' equity	$ 579,270,283	$ 556,017,271

See notes to consolidated financial statements

FIDELITY D & D BANCORP, INC. AND SUBSIDIARY
Consolidated Statements of Income
(Unaudited)

	Three months ended		Six months ended	
	June 30, 2010	June 30, 2009	June 30, 2010	June 30, 2009
Interest income:				
Loans and leases:				
Taxable	$ 6,004,167	$ 6,356,864	$ 12,084,184	$ 12,917,612
Nontaxable	153,855	113,488	300,151	228,262
Interest-bearing deposits with financial institutions	7,890	337	16,318	448
Investment securities:				
U.S. government agency and corporations	478,691	550,457	959,010	1,317,828
States and political subdivisions (non-taxable)	256,083	270,334	509,410	468,909
Other securities	63,060	157,458	128,971	342,508
Federal funds sold	6,447	6,575	13,440	7,359
Total interest income	6,970,193	7,455,513	14,011,484	15,282,926
Interest expense:				
Deposits	1,299,716	2,138,133	2,713,777	4,329,905
Securities sold under repurchase agreements	25,298	8,081	70,190	16,555
Other short-term borrowings and other	2	405	633	26,545
Long-term debt	427,896	568,325	850,669	1,344,532
Total interest expense	1,752,912	2,714,944	3,635,269	5,717,537
Net interest income	5,217,281	4,740,569	10,376,215	9,565,389
Provision for loan losses	300,000	300,000	875,000	725,000
Net interest income after provision for loan losses	4,917,281	4,440,569	9,501,215	8,840,389
Other income:				
Service charges on deposit accounts	671,890	648,228	1,288,914	1,280,648
Fees and other service charges	514,550	472,313	1,018,009	979,489
Gain (loss) on sale or disposal of:				
Loans	129,386	327,785	228,716	818,326
Premises and equipment	-	(4,378)	(16,171)	(6,624)
Foreclosed assets held-for-sale	405	14,891	21,415	25,887
Impairment losses on investment securities:				
Other-than-temporary impairment on investment securities	(828,601)	(570)	(2,265,237)	(326,095)
Non-credit related losses on investment securities not expected to be sold (recognized in other comprehensive income/(loss))	152,729	-	1,510,315	-
Net impairment losses on investment securities recognized in earnings	(675,872)	(570)	(754,922)	(326,095)
Total other income	640,359	1,458,269	1,785,961	2,771,631

Other expenses:				
Salaries and employee benefits	2,232,842	2,422,656	5,001,932	4,992,349
Premises and equipment	846,443	904,893	1,741,262	1,811,315
Advertising	182,471	135,992	307,803	278,393
Other	1,432,399	1,275,293	2,747,607	2,318,719
Total other expenses	4,694,155	4,738,834	9,798,604	9,400,776
Income before income taxes	863,485	1,160,004	1,488,572	2,211,244
Provision for income taxes	144,513	247,851	213,720	474,033
Net income	$ 718,972	$ 912,153	$ 1,274,852	$ 1,737,211
Per share data:				
Net income - basic	$ 0.34	$ 0.44	$ 0.60	$ 0.84
Net income - diluted	$ 0.34	$ 0.44	$ 0.60	$ 0.84
Dividends	$ 0.25	$ 0.25	$ 0.50	$ 0.50

See notes to consolidated financial statements

FIDELITY D & D BANCORP, INC. AND SUBSIDIARY
Consolidated Statements of Changes in Shareholders' Equity
For the six months ended June 30, 2010 and 2009
(Unaudited)

	Capital stock		Treasury stock		Retained	Accumulated other comprehensive	
	Shares	Amount	Shares	Amount	earnings	income (loss)	Total
Balance, December 31, 2008	2,075,182	$ 19,410,306	(12,255)	$ (351,665)	$ 38,126,250	$ (8,224,240)	$ 48,960,651
Cumulative effect of change in accounting principle					350,720	(350,720)	-
Total comprehensive income:							
Net income					1,737,211		1,737,211
Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and net of tax adjustments of $310,796						(603,309)	(603,309)
Change in cash flow hedge intrinsic value						(334,716)	(334,716)
Comprehensive income							799,186
Issuance of common stock through Employee Stock Purchase Plan	1,701	40,569					40,569
Dividends reinvested through Dividend Reinvestment Plan	5,774	112,477	14,755	408,170	(112,329)		408,318
Stock-based compensation expense		4,508					4,508
Purchase of treasury stock			(2,500)	(56,505)			(56,505)
					(1,034,178)		(1,034,178)

Cash dividends declared							
Balance, June 30, 2009	2,082,657	$ 19,567,860	-	$ -	$ 39,067,674	$ (9,512,985)	$ 49,122,549
Balance, December 31, 2009	2,105,860	$ 19,982,677	-	$ -	$ 34,886,265	$ (9,194,395)	$ 45,674,547
Total comprehensive income:							
Net income					1,274,852		1,274,852
Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and net of tax adjustments of $1,225,581						2,379,069	2,379,069
Non-credit related impairment losses on investment securities not expected to be sold, net of tax adjustments of $513,507						(996,808)	(996,808)
Comprehensive income							2,657,113
Issuance of common stock through Employee Stock Purchase Plan	4,754	67,367					67,367
Issuance of common stock through Dividend Reinvestment Plan	37,794	496,359					496,359
Stock-based compensation expense		7,485					7,485
Cash dividends declared					(1,059,731)		(1,059,731)
Balance, June 30, 2010	2,148,408	$ 20,553,888	-	$ -	$ 35,101,386	$ (7,812,134)	$ 47,843,140

See notes to consolidated financial statements

FIDELITY DEPOSIT & DISCOUNT BANCORP, INC. AND SUBSIDIARY
Consolidated Statements of Cash Flows
(Unaudited)

	Six months ended June 30, 2010	2009
Cash flows from operating activities:		
Net income	$ 1,274,852	$ 1,737,211
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	929,446	609,143
Provision for loan losses	875,000	725,000
Deferred income tax (benefit) expense	(432,600)	133,518
Stock-based compensation expense	7,485	4,508
Loss from investment in limited partnership	-	40,200
Proceeds from sale of loans available-for-sale	18,964,669	74,147,662
Originations of loans available-for-sale	(15,970,697)	(64,393,533)
Increase in cash surrender value of life insurance	(152,817)	(154,297)
Net gain on sale of loans	(228,716)	(818,326)
Net gain on sale of foreclosed assets held-for-sale	(21,415)	(25,887)
Loss on disposal of equipment	16,171	6,624
Other-than-temporary impairment on securities	754,922	326,095
Change in:		
Accrued interest receivable	44,988	74,687
Other assets	357,217	(1,339,119)
Accrued interest payable and other liabilities	108,196	629,634
Net cash provided by operating activities	6,526,701	11,703,120
Cash flows from investing activities:		
Held-to-maturity securities:		
Proceeds from maturities, calls and principal pay-downs	131,113	66,727
Available-for-sale securities:		
Proceeds from maturities, calls and principal pay-downs	20,636,090	29,835,486
Purchases	(18,726,036)	(23,752,046)
Net (increase) decrease in loans and leases	(805,707)	4,282,109
Acquisition of bank premises and equipment	(412,873)	(415,925)
Proceeds from sale of foreclosed assets held-for-sale	570,605	408,680
Net cash provided by investing activities	1,393,192	10,425,031
Cash flows from financing activities:		
Net increase in deposits	21,932,446	20,561,432
Net decrease in short-term borrowings	(955,413)	(29,249,361)
Repayments of long-term debt	-	(10,000,000)
Purchase of treasury stock	-	(56,505)
Proceeds from Employee Stock Purchase Plan participants	67,367	40,569
Dividends paid, net of dividends reinvested	(702,600)	(625,860)
Proceeds from Dividend Reinvestment Plan participants	139,228	-

Net cash provided by (used in) financing activities	20,481,028	(19,329,725)
Net increase in cash and cash equivalents	28,400,921	2,798,426
Cash and cash equivalents, beginning	8,327,954	12,771,147
Cash and cash equivalents, ending	$ 36,728,875	$ 15,569,573

See notes to consolidated financial statements

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 in the Commonwealth of Pennsylvania and a wholly-owned subsidiary of Fidelity D & D Bancorp, Inc. (the Company or 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 10-01 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.

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. 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, 2009.

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, 2010 and December 31, 2009 and the related consolidated statements of income for the three- and six-month periods ended June 30, 2010 and 2009 and changes in shareholders’ equity and cash flows for the six months ended June 30, 2010 and 2009 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.

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, 2009, and the notes included therein, included within the Company’s Annual Report filed on Form 10-K.

Critical accounting policies

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

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at June 30, 2010 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company’s allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. Except for the Company's investment in corporate bonds, consisting of pooled trust preferred securities, fair values of the other investment securities are determined by prices provided by a third-party vendor who is a provider of financial market data, analytics and related services to financial institutions. For the pooled trust preferred securities, management is unable to obtain readily attainable and realistic pricing from market traders due to lack of active market participants and therefore management has determined the market for these securities to be inactive. In order to determine the fair value of the pooled trust preferred securities, management relied on the use of an income valuation approach (present value technique) that maximizes the use of observable inputs and minimizes the use of unobservable inputs, the results of which are more representative of fair value than the market approach valuation technique used for the other investment securities.

Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes from more than one source may be obtained. The majority of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheet, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity through accumulated other comprehensive income (loss).

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

For purposes of reporting cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. For the six months ended June 30, 2010 and 2009, the Company paid interest of $3,674,000 and $5,623,000, respectively. The Company paid income taxes during the first six months of 2010 of $375,000, and $400,000 for the six months ended June 30, 2009. Transfers from loans to foreclosed assets held-for-sale amounted to $747,000 and $132,000 during the first six months of 2010 and 2009, respectively. Transfers from loans to loans available-for-sale amounted to $2,093,000 and $11,140,000 during the first six months of 2010 and 2009, respectively. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of bank premises and equipment.

2. New Accounting Pronouncements

During the first quarter of 2010, the Company adopted the new accounting guidance related to the transfers and servicing of financial assets. The standard eliminates the concept of qualifying special purpose entities, provides guidance as to when a portion of a transferred financial asset should be evaluated for sale accounting, provides additional guidance with regard to accounting for transfers of financial assets and requires additional disclosures. The adoption of the new accounting guidance did not have a material impact on the Company's consolidated financial statements.

During the first quarter of 2010, the Company adopted the amended accounting guidance related to fair value measurements which entails new disclosures and clarifies disclosure requirements about fair value measurement as set forth in previous guidance. The objective is to improve these disclosures and, thus, increase the transparency in financial reporting. Specifically, an entity is required to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; and in the reconciliation for fair value measurements using significant unobservable inputs, a reporting entity should present separately information about purchases, sales, issuances, and settlements. The amended guidance also clarifies the requirements of the following disclosures: for purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; and a reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and non-recurring fair value measurements. The new guidance became effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures will become effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

In July 2010, the FASB issued new guidance on disclosures about the credit quality of financing receivables and the allowance for credit losses. The new disclosure guidance will significantly expand the existing requirements for greater transparency into a company's exposure to credit losses from lending type arrangements. The objectives of the expanded disclosures are to provide information that will enable readers of financial statements to understand the nature of credit risk in a company's financing receivables, how that risk is analyzed in determining the related allowance for credit losses and changes to the allowance during the reporting period. The new guidance applies to all companies. The extensive new disclosures of information as of the end of a reporting period will become effective for both interim and annual reporting periods ending after December 15, 2010 for public companies. Specific items regarding activity that occurred before the issuance of the new guidance, such as the allowance roll forward and modification disclosures will be required for periods beginning after December 15, 2010 for public companies.

3. Investment securities

The amortized cost and fair value of investment securities at June 30, 2010 and December 31, 2009 are summarized as follows (dollars in thousands):

	June 30, 2010			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Held-to-maturity securities:				
MBS - GSE residential	$ 578	$ 58	$ -	$ 636
Available-for-sale securities:				
Agency - GSE	$ 24,273	$ 243	$ 206	$ 24,310
Obligations of states and political subdivisions	22,743	531	114	23,160
Corporate bonds:				
Pooled trust preferred securities	18,109	-	13,189	4,920
MBS - GSE residential	21,759	806	-	22,565
Total debt securities	86,884	1,580	13,509	74,955
Equity securities - financial services	322	104	11	415
Total available-for-sale securities	$ 87,206	$ 1,684	$ 13,520	$ 75,370

	December 31, 2009			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Held-to-maturity securities:				
MBS - GSE residential	$ 709	$ 56	$ -	$ 765
Available-for-sale securities:				
Agency - GSE	$ 34,205	$ 4	$ 1,077	$ 33,132
Obligations of states and political subdivisions	23,013	394	137	23,270
Corporate bonds:				
Pooled trust preferred securities	18,794	-	13,552	5,242
MBS - GSE residential	13,418	401	71	13,748
Total debt securities	89,430	799	14,837	75,392
Equity securities - financial services	322	121	14	429
Total available-for-sale securities	$ 89,752	$ 920	$ 14,851	$ 75,821

The amortized cost and fair value of debt securities at June 30, 2010 by contractual maturity are summarized below (dollars in thousands):

	Amortized cost	Market value
Held-to-maturity securities:		
MBS - GSE residential	$ 578	$ 636
Available-for-sale securities:		
Debt securities:		
Due in one year or less	$ -	$ -
Due after one year through five years	1,000	1,005
Due after five years through ten years	10,153	10,259
Due after ten years	53,972	41,126
Total debt securities	65,125	52,390
MBS - GSE residential	21,759	22,565
Total available-for-sale debt securities	$ 86,884	$ 74,955

Expected 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. Federal agency and municipal securities are included based on their original stated maturity. Mortgage-backed securities, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total.

The following tables present the fair value and gross unrealized losses of investment securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of June 30, 2010 and December 31, 2009 (dollars in thousands):

	June 30, 2010					
	Less than 12 months		More than 12 months		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Agency - GSE	$ -	$ -	$ 5,790	$ 206	$ 5,790	$ 206
Obligations of states and political subdivisions	3,575	102	2,605	12	6,180	114
Corporate bonds:						
Pooled trust preferred securities	-	-	4,920	13,189	4,920	13,189
MBS - GSE residential	-	-	-	-	-	-
Total debt securities	3,575	102	13,315	13,407	16,890	13,509
Equity securities - financial services	49	1	114	10	163	11
Total temporarily impaired securities	$ 3,624	$ 103	$ 13,429	$ 13,417	$ 17,053	$ 13,520
Number of securities	8		18		26	

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	December 31, 2009					
	Less than 12 months		More than 12 months		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Agency - GSE	$ 21,090	$ 291	$ 5,038	$ 786	$ 26,128	$ 1,077
Obligations of states and political subdivisions	3,534	115	2,600	22	6,134	137
Corporate bonds:						
Pooled trust preferred securities	-	-	5,242	13,552	5,242	13,552
MBS - GSE residential	5,055	71	-	-	5,055	71
Total debt securities	29,679	477	12,880	14,360	42,559	14,837
Equity securities - financial services	114	10	46	4	160	14
Total temporarily impaired securities	$ 29,793	$ 487	$ 12,926	$ 14,364	$ 42,719	$ 14,851
Number of securities	23		17		40	

Management conducts a formal review of investment securities on a quarterly basis for the presence of other-than-temporary impairment (OTTI). The accounting guidance related to OTTI requires the Company to assess whether OTTI is present when the fair value of a debt security is less than its amortized cost as of the balance sheet date. Under these 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 effecting market conditions, including illiquidity. The presentation of OTTI is made in the consolidated statements of income on a gross basis with an offset for the amount of non-credit-related OTTI recognized in OCI.

The Company’s OTTI evaluation process also follows the guidance set forth in topics related to debt and equity securities. The guidance set forth in these pronouncements requires 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 maturity, and other factors when evaluating for the existence of OTTI. This guidance also eliminates the requirement that a holder’s best estimate of cash flows is based upon those that a market participant would use. Instead, the guidance requires that OTTI be recognized as a realized loss through earnings when there has been an adverse change in the holder’s expected cash flows such that the full amount (principal and interest) will probably not be received. This requirement is consistent with the impairment model in the guidance for accounting for debt and equity securities.

For all security types discussed below, at June 30, 2010 the Company applied the criteria provided in the recognition and presentation of OTTI guidance. 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 for the Company’s portfolios of Agency – Government Sponsored Enterprise (GSE), Mortgage-backed securities (MBS) – GSE residential and Obligations of states and political subdivisions.

Agency - GSE and MBS - GSE residential
Agency – GSE and MBS – GSE residential securities consist of medium and 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 largely fixed-rate issues, have varying mid- 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, general obligation 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.

In all of the above security types, the decline in fair value is attributable to changes in interest rates and not credit quality. Consequently, no OTTI is considered necessary for these securities at June 30, 2010.

Pooled trust preferred securities

A Pooled Trust Preferred Collateralized Debt Obligation (CDO) is a type of investment security collateralized by trust preferred securities (TPS) issued by banks, insurance companies and real estate investment trusts (REITs). The primary collateral type is a TPS issued by a bank. A TPS is a hybrid security with both debt and equity characteristics such as the ability to voluntarily defer interest payments for up to 20 consecutive quarters. A TPS is considered a junior security in the capital structure of the issuer.

There are various tranches or investment classes issued by the CDO with the most senior tranche having the lowest yield but the most protection from credit losses compared to other tranches that are subordinate. Losses are generally allocated from the lowest tranche with the equity component holding the most risk and then subordinate tranches in reverse order up to the senior tranche. The allocation of losses is defined in the indenture when the CDO was formed.

Unrealized losses in the pooled trust preferred securities (PreTSLs) are caused mainly by the following factors: (1) collateral deterioration due to bank failures and credit concerns across the banking sector; (2) widening of credit spreads and (3) illiquidity in the market. The Company’s review of these securities, in accordance with the previous discussion, determined that in 2010, credit-related OTTI be recorded on three holdings of these securities all of which are in the AFS securities portfolio.

The following table summarizes the amount of credit-related OTTI recognized in earnings for 2010 and the amount of credit- and non-credit-related OTTI recognized in earnings for 2009, by security during the periods indicated (dollars in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Pooled trust preferred securities:				
PreTSL VII, Mezzanine	$ 67	$ 1	$ 86	$ 326
PreTSL XI, B3	-	-	60	-
PreTSL XVI, C	609	-	609	-
Total	$ 676	$ 1	$ 755	$ 326

The following table is a tabular roll-forward of the cumulative amount of credit-related OTTI recognized in earnings (dollars in thousands):

	Inception to June 30, 2010		
	HTM	AFS	Total
Beginning balance of credit-related OTTI	$ -	$ (3,198)	$ (3,198)
Additions for credit-related OTTI not previously recognized	-	(669)	(669)
Additional credit-related OTTI previously recognized when there is no intent to sell before recovery of amortized cost basis	-	(86)	(86)
Ending balance of credit-related OTTI	$ -	$ (3,953)	$ (3,953)

To determine the ending balance of credit-related OTTI, the Company uses discounted present value cash flow analysis and compares the results with the bond's face value. The analysis considered the following assumptions: the discount rate which equated to the discount margin for each tranche (credit spread) at the time of purchase which was then added to the appropriate three-month Libor forward rate obtained from the forward Libor curve; historical average default rates obtained from the FDIC for U.S. Banks and Thrifts for the period spanning 1988 to 1991 increased by a factor of three and rolled forward to project a rate of default of approximately one-third; the default rate was reduced by the actual deferrals / defaults experienced in all preferred term securities from 2008 through 2009; the remaining estimated default rate was then stratified with higher default rates occurring in the beginning of 2010 regressing to normal in 2011, with an estimated 15% recovery by way of a two year lag; and no prepayments of principal.

Two of the Company's initial mezzanine holdings (PreTSLs IV and V) are now senior tranches and the remaining holdings are mezzanine tranches. As of June 30, 2010, none of the pooled trust preferred securities were investment grade. At the time of initial issue, the subordination in the Company's tranches ranged in size from approximately 8.0% to 25.2% of the total principal amount of the respective securities and no more than 5% of any pooled trust preferred security consisted of a security issued by any one bank and 4% for insurance companies. As of June 30, 2010, management estimates the subordination in the Company's tranches ranging from 0% to 19.1% of the current performing collateral. During the first six months of 2010, PreTSL IX with a book value of $2.8 million and corresponding fair value of $1.2 million was placed on non-accrual status.

The following table is the composition of the Company's non-accrual PreTSL securities as of the period indicated (dollars in thousands):

Deal	Class	June 30, 2010 Book value	June 30, 2010 Fair value	December 31, 2009 Book value	December 31, 2009 Fair value
PreTSL VII	Mezzanine	$ 340	$ 163	$ 432	$ 219
PreTSL IX	B-1,B-3	2,804	1,207	-	-
PreTSL XV	B-1	1,359	265	1,359	297
PreTSL XVI	C	681	51	1,290	65
PreTSL XXV	C-1	507	20	507	2
		$ 5,691	$ 1,706	$ 3,588	$ 583

The securities included in the above table, have experienced impairment of principal, and interest was "paid-in-kind". On a quarterly basis, each of the other issues will be evaluated for the presence of these two conditions and placed on non-accrual status if necessary.

The following table provides additional information with respect to the Company's pooled trust preferred securities as of June 30, 2010:

Deal	Class	Book value	Fair value	Unrealized loss	Moody's / Fitch ratings	Current number of banks / insurance companies	Actual deferrals and defaults $(000)	Actual deferrals and defaults as a % of current collateral	Excess subordination $(000)	Excess subordination* as a % of current performing collateral	Effective subordination** as a % of current performing collateral
PreTSL IV	Mezzanine	$ 609,971	$ 450,280	$ (159,691)	Ca / CCC	6 / -	18,000	27.1	9,846	19.1	34.0
PreTSL V	Mezzanine	275,162	188,771	(86,391)	Ba3 / C	4 / -	18,950	43.1	None	N/A	N/A
PreTSL VII	Mezzanine	339,758	162,639	(177,119)	Ca / C	19 / -	160,000	70.5	None	N/A	N/A
PreTSL IX	B-1,B-3	2,804,129	1,206,389	(1,597,740)	Ca / C	49 / -	131,510	29.2	None	N/A	N/A
PreTSL XI	B-3	2,339,462	912,500	(1,426,962)	Ca / C	65 / -	142,780	23.7	None	N/A	5.0
PreTSL XV	B-1	1,359,562	265,285	(1,094,277)	Ca / C	63 / 9	159,050	26.6	None	N/A	N/A
PreTSL XVI	C	680,552	51,182	(629,370)	Ca / C	49 / 7	212,890	37.0	None	N/A	N/A
PreTSL XVII	C	1,009,600	41,354	(968,246)	Ca / C	51 / 6	113,720	24.0	None	N/A	3.4
PreTSL XVIII	C	1,012,049	108,997	(903,052)	Ca / C	66 / 14	150,140	22.2	None	N/A	5.5
PreTSL XIX	C	2,555,406	280,042	(2,275,364)	Ca / C	60 / 14	162,400	23.2	None	N/A	4.5
PreTSL XXIV	B-1	2,228,209	379,065	(1,849,144)	Caa3 / CC	80 / 13	349,800	33.3	None	N/A	11.5
PreTSL XXV	C-1	506,673	20,442	(486,231)	C / C	64 / 9	271,600	31.0	None	N/A	0.2
PreTSL XXVII	B	2,388,930	853,095	(1,535,835)	Caa3 / B	42 / 7	90,800	27.8	None	N/A	19.9
		$ 18,109,463	$ 4,920,041	$ (13,189,422)							

* Excess subordination represents the excess (if any) of the amount of performing collateral over the given class of bonds.
**Effective subordination represents the estimated percentage of the performing collateral that would need to defer or default at the next payment in order to trigger a loss of principal or interest. This differs from excess subordination in that it considers the effect of excess interest earned on the performing collateral.

For a further discussion on the fair value determination of the Company’s investment in pooled trust preferred securities, see “Investment securities” under the caption “Comparison of financial condition at June 30, 2010 and December 31, 2009” of Part 1, Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”; below.

4. Earnings per share

Basic earnings per share (EPS) is computed by dividing income available to common shareholders by the weighted-average number of common stock outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but reflects the potential dilution that could occur if stock options to issue additional common stock were exercised, which would then result in additional stock outstanding to share in or dilute the earnings of the Company. The Company maintains two share-based compensation plans that may generate additional potential dilutive common shares. Generally, dilution would occur if Company-issued stock options were exercised and converted into common stock.

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. Under the treasury stock method, the assumed proceeds received from shares issued, in a hypothetical stock option exercise, are assumed to be used to purchase treasury stock. There were no potentially dilutive shares outstanding in either period because the average share price of the Company's common stock during the six months ended June 30, 2010 and 2009 was below the strike prices of all options granted. For a further discussion on the Company's stock option plans, see note 5, "Stock plans," below.

The following table illustrates the data used in computing basic EPS and a reconciliation to derive at the components of diluted EPS for the periods indicated:

		2010		2009
Six months ended June 30,				
Net income available to common shareholders	$	1,274,852	$	1,737,211
Weighted-average common shares outstanding		2,123,364		2,070,144
Basic EPS	$	0.60	$	0.84
Diluted EPS:				
Net income available to common shareholders	$	1,274,852	$	1,737,211
Weighted-average common shares outstanding		2,123,364		2,070,144
Potentially dilutive common shares		-		-
Weighted-average common shares and dilutive potential shares		2,123,364		2,070,144
Diluted EPS	$	0.60	$	0.84

5. Stock plans

The Company has two stock-based compensation plans (the stock option plans) and applies the fair value method of accounting for stock-based compensation provided under the 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 stock option plans were shareholder-approved and permit the grant of share-based compensation awards to its directors, key officers and certain other employees. The Company believes that the stock option plans better align the interest of its directors, key officers and employees with the interest of its shareholders. The Company further believes that the granting of share-based awards is necessary to retain the knowledge base, continuity and expertise of its directors, key officers and employees. In the stock option plans, directors, key officers and certain other employees are eligible to be awarded stock options to purchase the Company's common stock at the fair market value on the date of grant.

The Company established the 2000 Independent Directors Stock Option Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. No stock options were awarded during the six months ended June 30, 2010 and 2009. As of June 30, 2010, there were 21,050 unexercised stock options outstanding under this plan.

The Company also established the 2000 Stock Incentive Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. There were no options awarded during the six months ended June 30, 2010 and 2009. As of June 30, 2010, there were 6,810 unexercised stock options outstanding under this plan.

Since no awards were vested in either of the stock option plans during the six months ended June 30, 2010 and 2009, there was no stock-based compensation expense recognized related to either of the stock option plans.

In addition to the two stock option plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance. The plan 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, 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 date or termination date. As of June 30, 2010, 17,025 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and as such, is required to comply with the provisions of authoritative accounting guidance. The Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the six months ended June 30, 2010 and 2009, compensation expense related to the ESPP approximated $7,000 and $5,000, respectively, and is included as a component of salaries and employee benefits in the consolidated statements of income.

6. Fair value measurements

The accounting guidelines established a framework for measuring fair value and enhancing disclosures 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 inputs based on our 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.

The following table illustrates the financial instruments measured at fair value on a recurring basis segregated by hierarchy fair value levels as of June 30, 2010 and December 31, 2009 (dollars in thousands):

		Fair value measurements at June 30, 2010:		
Assets:	Total carrying value at June 30, 2010	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Available-for-sale securities:				
Agency - GSE	$ 24,310	$ -	$ 24,310	$ -
Obligations of states and political subdivisions	23,160	-	23,160	-
Corporate bonds:				
Pooled trust preferred securities	4,920	-	-	4,920
MBS - GSE residential	22,565	-	22,565	-
Equity securities - financial services	415	415	-	-
Total available-for-sale securities	$ 75,370	$ 415	$ 70,035	$ 4,920

		Fair value measurements at December 31, 2009:		
Assets:	Total carrying value at December 31, 2009	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Available-for-sale securities:				
Agency - GSE	$ 33,132	$ -	$ 33,132	$ -
Obligations of states and political subdivisions	23,270	-	23,270	-
Corporate bonds:				
Pooled trust preferred securities	5,242	-	-	5,242

MBS - GSE residential	13,748	-	13,748	-
Equity securities - financial services	429	429	-	-
Total available-for-sale securities	$ 75,821	$ 429	$ 70,150	$ 5,242

Equity securities in the AFS portfolio are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Other than the Company's investment in corporate bonds, consisting of pooled trust preferred securities, all other debt securities in the AFS portfolio are measured at fair value using prices 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 six months ended June 30, 2010, there were no transfers to and from Level 1 and Level 2 fair value measurements for financial assets measured on a recurring basis.

The Company’s pooled trust preferred securities include both observable and unobservable inputs to determine fair value and, therefore, are classified as Level 3 inputs. For a discussion on the fair value determination of the Company’s investment in pooled trust preferred securities, see “Investment securities” under the caption “Comparison of Financial Condition at June 30, 2010 and December 31, 2009” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” below.

The following table illustrates the changes in Level 3 financial instruments, consisting of the Company’s investment in pooled trust preferred securities, measured at fair value on a recurring basis for the periods indicated (dollars in thousands):

	As of and for the six months ended June 30, 2010	As of and for the six months ended June 30, 2009
Assets:		
Balance at beginning of period	$ 5,242	$ 10,260
Realized / unrealized (losses) gains:		
in earnings	(755)	(326)
in comprehensive income (loss)	363	(2,311)
Purchases, sales, issuances and settlements, amortization and accretion, net	70	640
Balance at end of period	$ 4,920	$ 8,263

The following table illustrates the financial instruments measured at fair value on a non-recurring basis segregated by hierarchy fair value levels as of June 30, 2010 and December 31, 2009 (dollars in thousands):

		Fair value measurements at June 30, 2010 using:		
	Total carrying value at June 30, 2010	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Impaired loans	$ 2,741	$ -	$ 2,360	$ 381

		Fair value measurements at December 31, 2009 using:		
	Total carrying value at December 31, 2009	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Impaired loans	$ 4,842	$ 15	$ 4,447	$ 380

Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secures the impaired loan include: quoted market prices for identical assets classified as Level 1 inputs; for Level 2, observable inputs, employed by certified appraisers for similar assets are utilized if the loan is collateral dependent and then discounted based upon the type and/or age of the appraisal, the costs to sell and maintain the underlying collateral. If the loan is not considered to be collateral dependent, any impairment may be determined based upon the present value of the reported cash flows discounted at the loan’s effective interest rate. In cases where valuation techniques included inputs that are unobservable, the valuations are based on commonly used and generally accepted industry liquidation advance rates or estimates and assumptions developed by management, with significant adjustments applied to the best information available under each circumstance. These asset valuations are classified as Level 3 inputs. A net reduction or transfer out of the impaired loans with Level 2 inputs occurred during the six month period ended June 30, 2010 based upon payments received. There were no significant transfers during the quarter in the Level 1 and Level 3 impaired loans.

A summary of the carrying amounts and estimated fair values of certain financial instruments follows as of the periods indicated (dollars in thousands):

	June 30, 2010 Carrying amount	June 30, 2010 Estimated fair value	December 31, 2009 Carrying amount	December 31, 2009 Estimated fair value
Financial assets:				
Cash and cash equivalents	$ 36,729	$ 36,729	$ 8,328	$ 8,328
Held-to-maturity securities	578	636	709	765
Available-for-sale securities	75,370	75,370	75,821	75,821
FHLB stock	4,781	4,781	4,781	4,781
Loans and leases	420,216	416,717	423,124	420,908
Loans available-for-sale	384	389	1,221	1,233
Accrued interest	2,149	2,149	2,251	2,251
Financial liabilities:				
Deposit liabilities	480,927	479,690	458,994	453,264
Short-term borrowings	15,578	15,578	16,533	16,533
Long-term debt	32,000	35,444	32,000	35,017
Accrued interest	625	625	665	665

The following summarizes the methodology used to determine estimated fair values in the above table:

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 and carry interest rates that approximate market.

- Cash and cash equivalents
- Non-interest bearing deposit accounts
- Savings, NOW and money market accounts
- Short-term borrowings
- Accrued interest

Securities: Except for corporate bonds consisting of preferred term securities, fair values on the other investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. The fair values of pooled trust preferred securities is determined based on a present value technique (income valuation) as described under the caption “Investment securities” of the comparison of financial condition at June 30, 2010 and December 31, 2009, below.

FHLB stock, or restricted regulatory equity, is carried at cost, which approximates fair value.

Loans and leases: The fair value of all loans is estimated by the net present value of the future expected cash flows discounted at current market rates.

Loans available-for-sale: For loans available-for-sale, the fair value is estimated using rates currently offered for similar loans and are obtained from the FNMA or the FHLB.

Certificates of deposit: The fair values of certificate of deposit accounts are based on discounted cash flows using rates which approximate market rates of deposits with similar maturities.

Long-term debt: The fair value is estimated using market rates currently offered for similar borrowings.

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, 2010 compared to December 31, 2009 and a comparison of the results of operations for the three- and six-months ended June 30, 2010 and 2009. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2009 Annual Report filed on Form 10-K.

Forward-looking statements

Certain of the matters discussed in this Interim 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 deterioration 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;
§ governmental monetary and fiscal policies, as well as legislative and regulatory changes, in particular the effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act;
§ the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;
§ the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks;
§ the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet;
§ technological changes;
§ acquisitions and integration of acquired businesses;
§ the failure of assumptions underlying the establishment of reserves for loan and lease losses and estimations of values of collateral and various financial assets and liabilities;
§ volatilities in the securities markets;
§ deteriorating economic conditions;
§ acts of war or terrorism; and
§ disruption of credit and equity markets.

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

Readers should review the risk factors described in 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.

General

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

Company’s interest rate spread (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 our marketplace.

The Company’s profitability is also affected by the level of its non-interest income and expenses, provision for loan losses and provision for income taxes. Non-interest income consists of service charges on the Bank’s loan and deposit products, trust and asset management service fees, increases in the cash surrender value of the bank owned life insurance (BOLI), net gains or losses from sales of loans, securities and foreclosed properties held-for-sale and from credit-related other-than-temporary impairment (OTTI) charges on investment securities. Non-interest expense consists of compensation and related employee benefit expenses, occupancy, equipment, data processing, advertising, marketing, professional fees, insurance and other operating overhead.

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

Comparison of the results of operations
Three and six months ended June 30, 2010 and 2009

Overview

Net income for the second quarter of 2010 was $719,000, or $0.34 per diluted share, compared to $912,000, or $0.44, recorded in the same quarter of 2009. For the six months ended June 30, 2010, net income was $1,275,000, or $0.60 per diluted share, compared to $1,737,000, or $0.84 recorded for the six months ended June 30, 2009. The decrease in net income in the quarter and year-to-date comparisons was due to: a decline in non-interest income, largely from higher non-cash, other-than-temporary impairment (OTTI) charges related to the Company’s investment portfolio and lower levels of gains from the sales of mortgage loans; and in the year-to-date comparison, higher operating overhead and an increase in the provision for loan losses. These items were partially offset by higher net interest income and in the quarter-to-quarter comparison, lower salary and employee benefits.

Return on average assets (ROA) and return on average shareholders’ equity (ROE) were 0.49% and 6.10%, respectively, for the three months ended June 30, 2010 compared to 0.65% and 7.63%, respectively, for the three months ended June 30, 2009. For the six months ended June 30, 2010, ROA and ROE were 0.44% and 5.48%, respectively, compared to 0.62% and 7.33% for the same period in 2009. The decreases in both ROA and ROE are attributable to lower net income.

Net interest income and interest sensitive assets / liabilities

Net interest income increased $477,000, or 10%, to $5,217,000 in the second quarter of 2010, from $4,740,000 recorded in the same quarter of 2009. The improvement was principally from lower interest expense of $962,000 due to a 93 basis point reduction in rates paid on interest-bearing liabilities, where a 92 basis point reduction in deposit rates more than offset the effect of a $17,300,000 increase in average balances. Conversely, though average interest-earning assets increased $19,800,000, interest income was negatively impacted by a 55 basis point decline in yields earned resulting in a net decline in interest income of $485,000 in the second quarter of 2010 compared to the second quarter of 2009.

During the second quarter of 2010, the Company’s tax-equivalent margin and spread were 3.92% and 3.66%, compared to 3.70% and 3.28%, respectively, during the second quarter of 2009. The improvement in spread was caused by a greater reduction in rates paid on interest-bearing liabilities than the reduction in yields earned on interest-earning assets. The improvement in margin was from higher net interest income.

For the six months ended June 30, 2010, net interest income improved 8%, or $811,000, compared to the six months ended June 30, 2009. Similar to the second quarter comparison, the improvement was principally from lower interest expense of $2,082,000 due to a 99 basis point reduction in rates paid on interest-bearing liabilities including a 92 basis point reduction in rates paid on deposits. The decrease in interest income of $1,271,000 was from lower yields on earning assets.

The Company’s tax-equivalent margin and spread improved to 3.91% and 3.64%, respectively, in the first half of 2010 from 3.71% and 3.27% during the same period of 2009. The improvements stem from deposit rates declining more rapidly than yields from earning from assets and higher net interest income.

The prolonged low interest rate environment continued into the first half of 2010. As the Company continues to operate in this environment, earning assets will continue to price and re-price to lower levels thereby causing downward pressure on yields. 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 on deposits and repurchase agreements in order to maintain acceptable interest rate margins. However, the Company’s deposit offering rates are at historical lows and whether the Company can retain and grow its deposit base will largely depend on customers’ sentiment to maintain low-earning deposits. Nonetheless, the Company’s ALM team will continue to address interest rate issues in this difficult financial environment and is poised to create and offer products that are fair for its customers and equitable for the Company.

The table that follows sets forth a comparison of average balances and their corresponding fully tax-equivalent (FTE) interest income and expense and annualized tax-equivalent yield and cost for the periods indicated (dollars in thousands):

	Three months ended:					
	June 30, 2010			June 30, 2009		
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Assets						
Interest-earning assets:						
Loans and leases	$ 432,214	$ 6,237	5.79%	$ 428,079	$ 6,529	6.12%
Investments	99,663	925	3.72	94,535	1,113	4.72
Federal funds sold	10,210	6	0.25	10,793	7	0.24
Interest-bearing deposits	12,482	8	0.25	1,419	-	0.10
Total interest-earning assets	554,569	7,176	5.19	534,826	7,649	5.74
Non-interest-earning assets	30,880			28,615		
Total assets	$ 585,449			$ 563,441		
Liabilities and shareholders' equity						
Interest-bearing liabilities:						
Other interest-bearing deposits	$ 263,717	$ 473	0.72%	$ 217,249	$ 550	1.02%
Certificates of deposit	143,416	827	2.31	172,573	1,588	3.69
Borrowed funds	42,014	428	4.09	42,578	569	5.36
Repurchase agreements	11,309	25	0.90	9,837	8	0.33
Total interest-bearing liabilities	460,456	1,753	1.53	442,237	2,715	2.46
Non-interest-bearing deposits	74,101			68,909		
Other non-interest-bearing liabilities	3,618			4,373		
Shareholders' equity	47,274			47,922		
Total liabilities and shareholders' equity	$ 585,449			$ 563,441		
Net interest income / interest rate spread		$ 5,423	3.66%		$ 4,934	3.28%
Net interest margin			3.92%			3.70%

	Six months ended:					
	June 30, 2010			June 30, 2009		
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Assets						
Interest-earning assets:						
Loans and leases	$ 434,693	$ 12,540	5.82%	$ 433,412	$ 13,263	6.17%
Investments	96,316	1,848	3.87	98,488	2,372	4.86
Federal funds sold	11,540	13	0.23	6,145	7	0.24
Interest-bearing deposits	12,942	16	0.25	773	-	0.12
Total interest-earning assets	555,491	14,417	5.23	538,818	15,642	5.85

Non-interest-earning assets		31,406					29,027			
Total assets	$	586,897				$	567,845			
Liabilities and shareholders' equity										
Interest-bearing liabilities:										
Other interest-bearing deposits	$	260,481	$	979	0.76%	$	212,270	$	1,119	1.06%
Certificates of deposit		144,892		1,735	2.41		172,922		3,210	3.74
Borrowed funds		42,028		851	4.08		52,387		1,371	5.28
Repurchase agreements		14,642		70	0.97		10,098		17	0.33
Total interest-bearing liabilities		462,043		3,635	1.59		447,677		5,717	2.58
Non-interest-bearing deposits		74,452					68,498			
Other non-interest-bearing liabilities		3,499					3,873			
Shareholders' equity		46,903					47,797			
Total liabilities and shareholders' equity	$	586,897				$	567,845			
Net interest income / interest rate spread			$	10,782	3.64%			$	9,925	3.27%
Net interest margin					3.91%					3.71%

In the preceding table, interest income was adjusted to a tax-equivalent basis, using the corporate federal tax rate of 34%, to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. This treatment allows a uniform comparison between yields on interest-earning assets. Loans include loans AFS and non-accrual loans but exclude the allowance for loan losses. Securities include non-accrual securities. Average balances are based on amortized cost and do not reflect net unrealized gains or losses. Net interest margin is calculated by dividing net interest income by total average interest-earning assets.

Provision for loan losses

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

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

- specific loans that could have loss potential;
- levels of and trends in delinquencies and non-accrual loans;
- levels of and trends in charge-offs and recoveries;
- trends in volume and terms of loans;
- changes in risk selection and underwriting standards;
- changes in lending policies, procedures and practices;
- experience, ability and depth of lending management;
- national and local economic trends and conditions; and
- changes in credit concentrations.

The provision for loan losses was $300,000 for the three months ending June 30, 2010 and also $300,000 for the three month period ending June 30, 2009. Total provisions for the six months ended June 30, 2010 were $875,000 and $725,000 for the same six months of 2009. The $300,000 provision for the current quarter was recorded to provide for increased allocations for residential mortgages and consumer loans resulting from locally weakened economic conditions and to reserve for a decline in real estate values. For a further discussion on non-performing loans, see "Non-performing assets" under the caption "Comparison of financial condition at June 30, 2010 and December 31, 2009", below.

The allowance for loan losses was $7,523,000 at June 30, 2010 compared to $7,574,000 at December 31, 2009. For a further discussion on the allowance for loan losses, see "Allowance for loan losses" under the caption "Comparison of financial condition at June 30, 2010 and December 31, 2009" below.

Other income

In the second quarter of 2010, other (non-interest) income decreased $818,000, or 56%, to $640,000 from $1,458,000 recorded in second quarter of 2009. The decline was primarily from non-cash OTTI charges of $676,000 recorded in the current year quarter. The OTTI is related to credit impairment in the Company's investments in pooled trust preferred securities that is discussed more fully in Note 3, "Investment securities". Contributing further to the decline in non-interest income in the current year quarter was a $198,000, or 61%, decline in gains from mortgage banking services. These declines stem from the expected slow-down in mortgage refinance and origination activity and therefore lower volumes of sales of fixed-rate mortgage loans into the secondary market. The historical low interest rate environment caused a surge and peak in mortgage origination activity in 2009 and currently the Company does not expect that level of activity to recur.

For the six months ended June 30, 2010, other income declined $986,000, or 36%, compared to the six months ended June 30, 2009. In the current year, the Company recognized $229,000 in gains from mortgage banking services compared to $818,000 recognized during the first half of 2009. The 2009 gain included sales of $10,838,000 of loans transferred from the loan and lease portfolio to loans AFS and simultaneously sold. Further negatively impacting the non-interest income during the first half of 2010 was an increase of $429,000 in OTTI credit charges related to the pooled trust preferred securities, noted above.

Other operating expenses

For the quarter ended June 30, 2010, other (non-interest) expenses declined $45,000, or 1%, compared to the quarter ended June 30, 2009. Salary and employee benefits decreased $190,000, or 8%, due to employee downsizing in conjunction with the planned reorganization of the Company during the latter half of 2009 and first quarter of 2010. The number of full-time equivalent (FTE) employees was 163 at June 30, 2010 compared to 196 at June 30, 2009. The $58,000, or 6%, savings in premises and equipment is from lower property insurance. The $46,000 increase in advertising expenses was due to costs for the development of a new Company website and an integrated marketing campaign that includes the usage of multi-media advertising. The other category of other operating expense increased by $157,000, or 12%, from higher credit collection expense recognized in our efforts to resolve problematic loans and the effect of less deferral of mortgage origination costs on lower volume of mortgage originations during the current year second quarter compared to the second quarter of 2009. In addition, the Company established a contingent liability of $64,000 associated with potential off-balance sheet loan commitments. These items were partially offset by savings from less sold loan charges due to lower loan sales volume, less ORE expense, travel related costs, PA shares tax and greater efficiencies in branch operations.

For the six months ended June 30, 2010, non-interest related expenses increased $398,000, or 4%, compared to the six months ended June 30, 2009. Salary and employee benefits increased $10,000 but included approximately $400,000 of severance and voluntary termination payout from the aforementioned planned, structured reorganization of the Company. This event was offset by lower expenses related to employee group insurance, commission, bonus, overtime and costs related to Company contributions to the employee retirement plan. Savings in property insurance and facility maintenance resulted in a decrease of $70,000, or 4%, in premises and equipment costs. Advertising expenses increased $29,000, or 11%, due to the website re-construction project, usage of multi-media advertising and sundry promotional campaigns. The other category of non-interest expenses increased by $429,000, or 18% in the current year's first half, compared to the first half of 2009. The increase stems from higher legal and professional services including consulting for company-wide training, higher collection expense, less deferral of mortgage origination costs and the establishment of the loss contingency reserve for off-balance sheet loan commitments. Partially offsetting these items were lower: ORE costs, travel related expenses and sold loan charges on lower origination and sales volume.

Provision for income taxes

The Company's effective tax rates for the six months ended June 30, 2010 and 2009 were 14.4% and 21.4%, respectively, and for the quarters ended June 30, 2010 and 2009 were 16.7% and 21.4%, respectively. The decrease in the effective tax rates in the 2010 periods compared to the same periods in 2009 reflects a combination of lower pre-tax income and an increase in non-taxable items (permanent differences), net that had the effect of lowering taxable income.

Comparison of financial condition at June 30, 2010 and December 31, 2009

Overview

Consolidated assets increased to $579,270,000 or 4%, as of June 30, 2010 from $556,017,000 at December 31, 2009. The increase was primarily from $21,932,000 growth in deposits and a $2,169,000 increase in shareholders' equity.

Investment securities

At the time of purchase, management classifies investment securities into one of three categories: trading, AFS or held-to- maturity (HTM). To date, management has not purchased any securities for trading purposes. Most of the securities purchased are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at fair value in the consolidated balance sheet with an adjustment to shareholders' equity, net of tax, presented under the caption "Accumulated other comprehensive income (loss)." Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity.

As of June 30, 2010, the carrying value of investment securities amounted to $75,948,000, or 13% of total assets, compared to $76,530,000, or 14% of total assets, at December 31, 2009. At June 30, 2010, approximately 30% of the carrying value of the investment portfolio was comprised of mortgage-backed securities that amortize and provide monthly cash flow.

Investment securities are comprised of HTM and AFS securities with carrying values of $578,000 and $75,370,000, respectively. As of June 30, 2010, the AFS debt securities were recorded with a net unrealized loss in the amount of $11,929,000 and equity securities were recorded with an unrealized net gain of $93,000. During the six months ended

June 30, 2010, carrying value of total investments declined modestly; approximately $600,000. However, the decline is net of $2,100,000 in net market value appreciation in the AFS portfolio.

A comparison of investment securities at June 30, 2010 and December 31, 2009 is as follows (dollars in thousands):

	June 30, 2010		December 31, 2009	
	Amount	%	Amount	%
Agency - GSE	$ 24,310	32.0	$ 33,132	43.3
MBS - GSE residential	23,143	30.5	14,457	18.9
State & municipal subdivisions	23,160	30.5	23,270	30.4
Pooled trust preferred securities	4,920	6.5	5,242	6.8
Equity securities - financial services	415	0.5	429	0.6
Total investments	$ 75,948	100.0	$ 76,530	100.0

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

Under these 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 uncertainty in the financial markets continues to foster volatility in fair value estimates for the securities in the Company's investment portfolio. Fair values of the Company's investment securities have improved since year-end 2009, but remain well below their amortized cost - $11.8 million, or 14% as of June 30, 2010 and $13.9 million, or 16% as of December 31, 2009. Management believes fair values and their changes are due mainly to a combination of the interest rate environment, instability in the capital markets, limited trading activity and illiquid conditions in the financial markets, not deterioration in the creditworthiness of the issuers. Nearly all of the securities in the portfolio 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. The most significant component of the $11.8 million net unrealized loss in the AFS securities portfolio, as of June 30, 2010, was $13.2 million from the Company's investments in corporate bonds consisting of collateralized debt obligation (CDO) securities that are backed by pooled trust preferred securities issued by banks, thrifts and insurance companies.

Management is unable to obtain readily attainable and realistic pricing from market traders for the pooled trust preferred securities portfolio because there continues to be a lack of active market participants who deal in these securities.

As of June 30, 2010, the Company owned 13 tranches of pooled trust preferred securities (PreTSLs). Management has determined the market for these securities and other issues of PreTSLs at June 30, 2010 is inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which PreTSLs trade, then by a significant decrease in the volume of trades relative to historical levels and the lack of a new-issue market since 2007. There are currently very few market participants who are willing and/or able to transact for these securities. Given the conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, management has made the following observations and has determined:

- The few observable transactions and market quotations that were available were not reliable for purposes of determining fair value at June 30, 2010,

- An income valuation approach (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs are equally or more representative of fair value than the market approach valuation technique, and

- The PreTSL securities are classified within “Level 3” in the fair value hierarchy (as defined in current accounting guidance and explained in Note 6, “Fair Value Measurements” of the consolidated financial statements) because significant adjustments are required to determine fair value at the measurement date. The valuations of the Company’s PreTSLs were prepared by an independent third party and corroborated by management. The approach to determine fair value involved the following:

- o Data about the issue structure as defined in the indenture and the underlying collateral were collected,
- o The credit quality of the collateral is estimated using issuer-specific probability of default values,
- o The default probabilities also considered the potential for 50% correlation among issuers within the same industry (e.g. banks with other banks) and 30% correlation between industries (e.g. banks vs. insurance),
- o The loss given default, or amount of cash lost to the investor when a debt asset defaults, was assumed to be 100% (no recovery). This replicates the historically high default loss levels on trust preferred instruments,
- o The cash flows were forecast for the underlying collateral and applied to each tranche to determine the resulting distribution among the securities. This ascertains which investors are paid and which investors incur losses. Thus, these cash flow projections capture the credit risk,
- o The expected cash flows utilize no prepayments and were discounted utilizing three-month LIBOR as the risk-free rate for the base case and then added a 300bp liquidity premium as the discount rate to calculate the present value of the security,
- o The effective discount rates on an overall basis range from 8.9% to 343.9% and are highly dependent upon the credit quality of the collateral, the relative position of the tranche within the capital structure of the security and the prepayment assumptions, and
- o The calculations were modeled in several thousand scenarios using a Monte Carlo engine to establish a distribution of intrinsic values and the average was used for valuation purposes.

Based on the technique described, the Company determined that as of June 30, 2010, the fair value of three PreTSL securities: VII, XI and XVI had declined $2,988,000 in total below their amortized cost basis and since the present value of the security’s expected cash flows were insufficient to recover the entire amortized cost basis, the securities are deemed to have experienced credit related other-than-temporary impairment in the amount of $755,000 which was charged to current earnings as a component of other income in the consolidated statement of income for the six months ended June 30, 2010. This compares to $326,000 of impairment charges recorded for the first half of 2009. The Company closely monitors the pooled trust preferred securities market and performs collateral sufficiency and cash flow analyses on a quarterly basis. Future analyses could yield results that may indicate further impairment has occurred and would therefore require additional write-downs and corresponding other-than-temporary impairment charges to current earnings.

Federal Home Loan Bank Stock

Investment in FHLB stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB. Excess stock is typically repurchased from the Company at par if the level of borrowings declines to a predetermined level. In addition, the Company normally earns a return or dividend on the amount invested. In order to preserve its capital level, in December 2008 the FHLB announced that it had suspended the payment of dividends and excess capital stock repurchasing and as of June 30, 2010, that position has not changed. That decision was based on the FHLB’s analysis and consideration of certain negative market trends and the impact those trends will have on their financial condition. Based on the financial results of the FHLB for the six months ended June 30, 2010 and for the year-ended December 31, 2009, management believes that the suspension of both the dividend payments and excess capital stock repurchase is temporary in nature. Management further believes that the FHLB will continue to be a primary source of wholesale liquidity for both short- and long-term funding and has concluded that its investment in FHLB stock is not other-than-temporarily impaired. There can be no assurance, however, that future negative changes to the financial condition of the FHLB may not require the Company to recognize an impairment charge with respect to such holdings. The Company will continue to monitor the financial condition of the FHLB and assess its future ability to resume normal dividend payments and stock redemption activities.

Loans available-for-sale (AFS)

Generally, upon origination, certain residential mortgages are classified as AFS. In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In a declining interest rate environment, the Company would be exposed to prepayment risk and, as rates decrease, interest income could be negatively affected. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as AFS. The carrying value of loans AFS is at the lower of cost or estimated fair value. If the fair values of these loans fall below their original cost, the difference is written down and charged to current earnings. Subsequent appreciation in the portfolio is credited to current earnings but only to the extent of previous write-downs.

Loans AFS at June 30, 2010 amounted to $384,000 with a corresponding fair value of approximately $389,000, compared to $1,221,000 and $1,233,000, respectively, at December 31, 2009. During the six months ended June 30, 2010, residential mortgage loans with principal balances of $18,902,000 were sold into the secondary market with net gains of approximately $229,000 recognized, compared to $73,329,000 and $818,000, respectively, during the six months ended June 30, 2009. Included in the 2009 sales was $10,838,000 of residential mortgage loans transferred from the loan and lease portfolio during the first quarter of 2009. The Company expects loan originations and the related sales to diminish in 2010 as the refinance activity in 2009, caused by low interest rates, has ebbed with originations returning to normal volumes.

Loans and leases

The Company originates commercial and industrial (commercial) and commercial real estate (CRE) loans, residential mortgages, consumer, home equity and construction loans. The relative volume of originations is dependent upon customer demand, current interest rates and the perception and duration of future interest rate levels. As part of the overall strategy to serve the business community in which it operates, the Company is focused on developing and implementing products and services to the broad spectrum of businesses that operate in our marketplace. The Company's goals center on building relationships by providing credit and non-credit products and services, continuing to diversify its loan portfolio and utilizing participations to reduce risk in larger credit transactions. Especially in the current economic climate, the Company, in providing credit to existing and new customers, has implemented policies and procedures to reduce the associated risk. The risks associated with interest rates are being managed by utilizing floating versus long-term fixed rates and exploring programs where we can match our cost of funds.

The majority of the Company's loan portfolio is collateralized, at least in part, by real estate in Lackawanna and Luzerne Counties of Pennsylvania. Commercial lending activities involve a greater degree of credit risk than consumer lending because typically they have larger balances and are more affected by adverse conditions in the economy. Because payments on commercial loans depend upon the successful operation and management of the properties and the businesses which operate from within them, repayment of such loans may be affected by factors outside the borrower's control. Such factors may include adverse conditions in the real estate market, the economy, the industry or changes in government regulations. As such, commercial loans require more ongoing evaluation and monitoring which occurs with the Bank's credit administration and outsourced loan review functions.

The composition of the loan portfolio at June 30, 2010 and December 31, 2009, is summarized as follows (dollars in thousands):

	June 30, 2010		December 31, 2009	
	Amount	%	Amount	%
Real estate:				
Commercial	$ 174,437	40.8	$ 186,727	43.3
Residential	68,586	16.0	71,001	16.5
Construction	11,017	2.6	10,125	2.4
Commercial and industrial	87,332	20.4	76,788	17.8
Consumer	86,036	20.1	85,690	19.9
Direct financing leases	331	0.1	367	0.1
Gross loans	427,739	100.0	430,698	100.0
Allowance for loan losses	(7,523)		(7,574)	
Net loans	$ 420,216		$ 423,124	

The $3.0 million net decline in gross loans during the first half of 2010 was predominantly from the payoff of some sizeable commercial real estate (CRE) credits that the Company aggressively sought for settlement. The growth in commercial and industrial (C&I) is attributable to a short-term, match funded loan with a municipal customer. This loan matures during the fourth quarter of 2010.

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

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

- identification of specific impaired loans by loan category;
- calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- determination of homogenous pools by loan category and eliminating the impaired loans;
- application of historical loss percentages (three-year average) to pools to determine the allowance allocation; and
- application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio, and /or current economic conditions.

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

Each quarter, management performs an assessment of the allowance and the provision for loan losses. The Company's Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based on current accounting guidelines. The Special Assets Committee's focus is on ensuring the pertinent facts are considered and the reserve amounts pursuant to the accounting principles are reasonable. The assessment process includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company's Credit Administration function have assigned a criticized or classified risk rating.

Total charge-offs net of recoveries for the six months ending June 30, 2010, were $925,000, compared to $254,000 in the first six months of 2009. The higher level of charge-offs recorded in the current year primarily resulted from the write-down of impaired commercial real estate loans to current fair value as well as the charge-off of both consumer and commercial and industrial loans. Commercial real estate loan net charge-offs of $454,000 were recorded during the six month period ending June 30, 2010 versus $9,000 at June 30, 2009. Residential real estate loan net charge-offs totaled $63,000 for the six month period ending June 30, 2010, and were $3,000 in the like period of 2009. Commercial and industrial loan net charge-offs were $262,000 for the six months ending June 30, 2010 compared to net charge-offs of $116,000 in the same period of 2009. Consumer loan net charge-offs of $146,000 were recorded during the six months ending June 30, 2010 versus $126,000 at the June 30, 2009 like period end. For a discussion on the provision for loan losses, see the "Provision for loan losses," located in the results of operations section of management's discussion and analysis contained herein.

The allowance for loan losses was $7,523,000 at June 30, 2010 and $7,574,000 at December 31, 2009. Management believes that the current balance in the allowance for loan losses of $7,523,000 is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but inherent to the portfolio as of this time. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status or past due 90 days or more. Given continuing pressure on property values and the generally uncertain economic backdrop, there could be additional instances which become identified in future periods that may require additional charge-offs and/or increases to the allowance. The ratio of allowance for loan losses to total loans was 1.76% at June 30, 2010 compared to 1.22% at June 30, 2009.

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

	As of and for the six months ended June 30, 2010	As of and for the twelve months ended December 31, 2009	As of and for the six months ended June 30, 2009
Balance at beginning of period	$ 7,573,603	$ 4,745,234	$ 4,745,234
Provision charged to operations	875,000	5,050,000	725,000
Charge-offs:			
Real estate:			
Commercial	455,755	843,527	24,932
Residential	63,214	9,158	3,158
Commercial and industrial	265,154	983,490	118,520
Consumer	169,776	432,951	133,617
Total	953,899	2,269,126	280,227
Recoveries:			
Real estate:			
Commercial	1,449	2,075	15,808
Residential	-	-	-
Commercial and industrial	2,949	34,735	2,075
Consumer	24,148	10,685	7,846
Total	28,546	47,495	25,729
Net charge-offs	925,353	2,221,631	254,498
Balance at end of period	$ 7,523,250	$ 7,573,603	$ 5,215,736
Total loans, end of period	$ 428,122,754	$ 431,919,023	$ 427,432,128

	As of and for the six months ended June 30, 2010	As of and for the twelve months ended December 31, 2009	As of and for the six months ended June 30, 2009
Net charge-offs to (annualized):			
Average loans	0.43%	0.51%	0.12%
Allowance for loan losses	24.60%	29.33%	9.76%
Provision for loan losses	1.06x	0.44x	0.35x
Allowance for loan losses to:			
Total loans	1.76%	1.75%	1.22%
Non-accrual loans	0.84x	0.61x	0.70x
Non-performing loans	0.81x	0.59x	0.69x
Net charge-offs (annualized)	4.07x	3.41x	10.25x
Loans 30-89 days past due and still accruing	$ 3,295,675	$ 5,173,394	$ 2,360,786
Loans 90 days past due and accruing	$ 319,828	$ 554,806	$ 180,800

Non-accrual loans	$ 8,918,932	$ 12,329,338	$ 7,398,505
Allowance for loan losses to loans 90 days or more past due and accruing	23.52x	13.65x	28.85x

Non-performing assets

The Company defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, restructured loans, other real estate owned (ORE), non-accrual securities and repossessed assets. As of June 30, 2010, non-performing assets represented 2.21% of total assets compared to 2.58% at December 31, 2009. The decline at June 30, 2010 was driven by reductions in both the loans past due more than 90 days as well as the reduced non-accrual levels.

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

The majority of the non-performing assets for the period were comprised of non-accruing commercial business loans, non-accruing real estate loans, non-accrual securities and ORE. Most of the loans are collateralized, thereby mitigating the Company’s potential for loss. During the first six months of 2010, $1,706,000 of corporate bonds consisting of pooled trust preferred securities were on non-accrual status. There were no non-accrual securities prior to 2009. For a further discussion on the Company’s securities portfolio, see Note 3, “Investments Securities”, within the notes to the consolidated financial statements and the section entitled “Investments”, contained within this management discussion and analysis section.

Non-performing loans were reduced from $12,884,000 on December 31, 2009 to $9,239,000 on June 30, 2010. At December 31, 2009, the over 90 day past due portion was comprised of nine loans ranging from $1,000 to $294,000, and the non-accrual loan portion numbered 58 loans ranging from $2,600 to $2,800,000. At June 30, 2010, there were nine loans ranging from $3,000 to $107,000 in the over 90 days past due category, and 64 loans ranging from $1,600 to $754,000 in the non-accrual category. The reduction of $3,645,000 in non-performing loans from December 31, 2009 to June 30, 2010 resulted mainly from non-accrual commercial loan repayments and the transfer of $747,000 from non-accrual to ORE. Restructured loans were $791,000 at June 30, 2010. There were no restructured loans at December 31, 2009. ORE at June 30, 2010 was $1,084,000 and consisted of three properties. At June 30, 2010, the non-accrual loans aggregated $8,919,000 as compared to $12,329,000 at December 31, 2009. The net reduction in the level of non-accrual loans at June 30, 2010 occurred as follows: Additions to the non-accrual loan component of the non-performing assets totaling $4,850,000 were made during the first six months of the year. These were partially offset by reductions or payoffs of $6,597,000, charge-offs of $685,000, transfers to ORE of $747,000 and $231,000 of loans that returned to performing status. Loans past due 90 days or more and accruing were $320,000 at June 30, 2010 and $555,000, at December 31, 2009. Non-accrual securities were $1,706,000 at June 30, 2010 and $583,000 at December 31, 2009.

Non-performing loans to total loans were 2.16% at June 30, 2010, down from 2.98% at December 31, 2009. The percentage of non-performing assets to total assets was 2.21% at June 30, 2010, also down from 2.58% at December 31, 2009, primarily driven by the aforementioned decline in the non-accrual loans component.

The 30-89 day past due loans at June 30, 2010 were $3,296,000 and $5,173,000 at December 31, 2009. The reduced level occurred as a result of the transfer of some loans to non-accrual, payments collected on others and the conversion / transfer of a loan to ORE status.

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

	June 30, 2010	December 31, 2009	June 30, 2009
Loans past due 90 days or more and accruing	$ 319,828	$ 554,806	$ 180,800
Non-accrual loans	8,918,931	12,329,338	7,398,505
Total non-performing loans	9,238,759	12,884,144	7,579,305
Restructured loans	791,168	-	-
Other real estate owned	1,084,007	887,397	1,199,060
Non-accrual securities	1,705,937	583,390	-
Total non-performing assets	$ 12,819,871	$ 14,354,931	$ 8,778,365
Total loans including AFS	$ 428,122,754	$ 431,919,023	$ 427,432,128
Total assets	$ 579,270,283	$ 556,017,271	$ 560,454,208
Non-accrual loans to total loans	2.08%	2.85%	1.73%
Non-performing loans to total loans	2.16%	2.98%	1.77%
Non-performing assets to total assets	2.21%	2.58%	1.57%

The composition of gross loans and non-performing loans as of June 30, 2010 (dollars in thousands):

	Gross loan balances	Past due 90 days or more and still accruing	Non-accrual loans	Total non-performing loans	% of gross loans
Real estate:					
Commercial	$ 174,437	$ 3	$ 3,629	$ 3,632	2.08%
Residential (1-4 family)	68,970	278	4,114	4,392	6.37%
Construction	11,017	-	-	-	-
Commercial and industrial	87,332	33	520	553	0.63%
Consumer	86,036	6	656	662	0.77%
Direct financing leases	331	-	-	-	-
Total	$ 428,123	$ 320	$ 8,919	$ 9,239	2.16%

Bank premises and equipment, net

A leased branch building that contains leasehold improvements with a net book value of approximately $618,000, as of June 30, 2010 was in the process of foreclosure by the Company, the lien holder, and was originally scheduled for sheriff's sale in June 2010. The sale was delayed to July and the Company was the successful bidder. The Company has not taken title the property and expects to assign the bid to a third party for a financial commitment. The Company further expects to continue to operate the branch, uninterrupted, under a lease agreement with terms consistent with the prior lease. The Company does not expect the event to have a material impact on its results of operation or financial condition.

Foreclosed assets held-for-sale

Foreclosed assets held-for-sale, consisting of ORE, was $1,084,000 at June 30, 2010 comprised of three properties which are listed for sale with local realtors. The $197,000 rise in ORE from December 31, 2009 occurred from the sale of one commercial property with a book balance of $550,000 and the transfer into ORE of a commercial property for its fair value of $747,000.

Other assets

Other assets at June 30, 2010 declined $643,000, or 4%, from December 31, 2010. A lower deferred tax asset from appreciation in fair values, from December 31, 2009, in the securities portfolio and the period recognition and associated reduction of the prepaid FDIC insurance premium were the primary causes of the decrease.

Deposits

The Bank is a community-based commercial financial institution, member FDIC, which offers a variety of deposit products with varying ranges of interest rates and terms. Deposit products include savings, clubs, interest-bearing checking (NOW), money market, non-interest-bearing checking (DDAs) and certificates of deposit accounts. Certificates of deposit accounts, or CDs, are deposits with stated maturities which can range from seven days to ten years. The flow of deposits is significantly influenced by general economic conditions, changes in prevailing interest rates, pricing and competition. To determine deposit product interest rates, the Company considers local competition, spreads to earning-asset yields, liquidity position and rates charged for alternative sources of funding such as borrowings which include repurchase agreements. Though the Company tends to experience intense competition for deposits, the interest rate setting strategy also includes consideration of the Company's balance sheet structure and cost effective strategies that are mindful of the current economic landscape.

Compared to December 31, 2009 total deposits grew $21,900,000, or 5%, during the first half of 2010. The growth in total deposits was due to increases in DDA, NOW and savings accounts of $6,946,000, or 10%, $11,991,000, or 19% and $20,400,000, or 24%, respectively, partially offset by lower CD balances. Generally, deposits are obtained from consumers and businesses within the communities that surround the Company's 11 branch offices and all deposits are insured by the FDIC up to the full extent permitted by law. In an effort to grow and retain core deposits, the Company introduces innovative options to its variety of deposit products. The multi-tiered interest rate savings account developed in 2009 continues to grow while NOW account balances have prospered from the seasonal influx of local municipal tax deposits and growth in the non-personal, business sector. The Company will continue to provide superb customer service and bring innovative ideas to the market in order to continue to grow and retain deposits.

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

	June 30, 2010		December 31, 2009	
	Amount	%	Amount	%
Money market	$ 78,184	16.3	$ 91,488	19.9
NOW	74,022	15.4	62,031	13.5
Savings and club	106,735	22.2	86,335	18.8
Certificates of deposit	132,352	27.5	139,502	30.5
CDARS	11,798	2.4	8,748	1.9
Total interest-bearing	403,091	83.8	388,104	84.6
Non-interest-bearing	77,836	16.2	70,890	15.4
Total deposits	$ 480,927	100.0	$ 458,994	100.0

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

Excluding CDARS, certificates of deposit accounts of $100,000 or more amounted to $51,089,000 and $54,941,000 at June 30, 2010 and December 31, 2009, respectively. Certificates of deposit of $250,000 or more amounted to $18,327,000 and $20,641,000 as of June 30, 2010 and December 31, 2009.

Including CDARS, approximately 25% of the CDs are scheduled to mature in 2010. Renewing CDs may re-price to lower or higher market rates depending on the direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative products. In this current low interest rate environment, customers with maturing CDs prefer to hold their deposits in readily available transaction products such as savings accounts.

In July 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which, in part, permanently raises the current standard maximum deposit insurance amount to $250,000. The standard maximum insurance amount of $100,000 had been temporarily raised to $250,000 until December 31, 2013. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category.

Borrowings

Borrowings are used as a complement to deposit generation as an alternative funding source whereby the Bank will borrow under customer repurchase agreements in the local market, advances from the Federal Home Loan Bank of Pittsburgh (FHLB) and other correspondent banks for asset growth and liquidity needs.

Repurchase agreements are non-insured interest-bearing liabilities that have a perfected security interest in qualified investments of the Company. The FDIC Depositor Protection Act of 2009 requires banks to provide a perfected security interest to the purchasers of uninsured repurchase agreements. Repurchase agreements are offered through a sweep product. A sweep account is designed to ensure that on a daily basis, an attached DDA is adequately funded and excess funds are transferred, or swept, into an interest-bearing overnight repurchase agreement account. Due to the constant flow of funds in to and out of the sweep product, their balances tend to be somewhat volatile mimicking the likes of a DDA deposit account. Customer liquidity is the typical cause for variances in repurchase agreements, which for the first six months of 2010 declined $1,945,000 from December 31, 2009.

The components of borrowings as of June 30, 2010 and December 31, 2009 are as follows (dollars in thousands):

	June 30, 2010		December 31, 2009	
	Amount	%	Amount	%
Overnight borrowings	$ -	-	$ 8,573	17.7
Repurchase agreements	5,802	12.2	7,747	16.0
Demand note, U.S. Treasury	276	0.5	213	0.4
FHLB advances:				
Short-term	9,500	20.0	-	-
Long-term	32,000	67.3	32,000	65.9
Total borrowings	$ 47,578	100.0	$ 48,533	100.0

Total borrowings have decreased $955,000 or 2%, during the six months ended June 30, 2010. Growth in deposits has reduced the Company's frequency for overnight funding needs. The short-term FHLB advance was to accommodate a short-term, match funded commercial loan with a municipal customer.

Recent Developments

Dodd-Frank Wall Street Reform and Consumer Protection Act. On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act will result in sweeping financial regulatory reform aimed at strengthening the nation's financial services sector.

The Act's provisions that have received the most public attention generally have been those applying to larger institutions or institutions that engage in practices in which we do not engage. These provisions include growth restrictions, credit exposure limits, higher prudential standards, prohibitions on proprietary trading, and prohibitions on sponsoring and investing in hedge funds and private equity funds.

However, the Act contains numerous other provisions that likely will directly impact us and our banking subsidiary. These include increased fees payable by banks to regulatory agencies, new capital guidelines for banks and bank holding companies, permanently increasing the FDIC insurance coverage from $100,000 to $250,000 per depositor, new liquidation procedures for banks, new regulations affecting consumer financial products, new corporate governance disclosures and requirements and the increased cost of supervision and compliance more generally. Many aspects of the law are subject to rulemaking by various government agencies and will take effect over several years. This time table, combined with the Act's significant deference to future rulemaking by various regulatory agencies, makes it difficult for us to anticipate the Act's overall financial, competitive and regulatory impact on us, our customers, and the financial industry more generally.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Management of interest rate risk and market risk analysis

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

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

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

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

To manage this interest rate sensitivity gap position, an asset/liability model commonly known as cumulative gap analysis is used to monitor the difference in the volume of the Company's interest-sensitive assets and liabilities that mature or re-price within given time intervals. A positive gap (asset sensitive) indicates that more assets will mature or re-price during a given period compared to liabilities, while a negative gap (liability sensitive) has the opposite effect. The Company employs computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest-sensitive assets and liabilities in order to determine what impact these rate changes will have upon the net interest spread. As of June 30, 2010, the Bank maintained a one-year cumulative gap of positive $45.6 million, or 7.87%, of total assets. The effect of this positive gap position provided a mismatch of assets and liabilities which may expose the Bank to interest rate risk during periods of falling interest rates. Conversely, in an increasing interest rate environment, net interest income could be positively impacted because more assets than liabilities would re-price upward during the one-year period.

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

The following table illustrates the Company's interest sensitivity gap position at June 30, 2010 (dollars in thousands):

	Three months or less	Three to twelve months	One to three years	Over three years	Total
Cash and cash equivalents	$ 79	$ -	$ -	$ 36,650	$ 36,729
Investment securities (1)(2)	11,521	19,089	18,643	26,695	75,948
Loans (2)	129,785	68,368	114,075	108,372	420,600
Fixed and other assets	-	9,270	-	36,723	45,993
Total assets	$ 141,385	$ 96,727	$ 132,718	$ 208,440	$ 579,270
Total cumulative assets	$ 141,385	$ 238,112	$ 370,830	$ 579,270	
Non-interest bearing transaction deposits (3)	$ -	$ 7,784	$ 21,405	$ 48,647	$ 77,836
Interest-bearing transaction deposits (3)	80,358	-	67,536	111,047	258,941
Time deposits	16,473	61,320	52,165	14,192	144,150
Repurchase agreements	5,802	-	-	-	5,802
Short-term borrowings	276	9,500	-	-	9,776
Long-term debt	-	11,000	-	21,000	32,000
Other liabilities	-	-	-	2,922	2,922
Total liabilities	$ 102,909	$ 89,604	$ 141,106	$ 197,808	$ 531,427
Total cumulative liabilities	$ 102,909	$ 192,513	$ 333,619	$ 531,427	
Interest sensitivity gap	$ 38,476	$ 7,123	$ (8,388)	$ 10,632	
Cumulative gap	$ 38,476	$ 45,599	$ 37,211	$ 47,843	
Cumulative gap to total assets	6.64%	7.87%	6.42%	8.26%	

(1) Includes FHLB stock and the net unrealized gains/losses on securities AFS.

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

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

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

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

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

The following table illustrates the simulated impact of 200 basis points upward or downward movement in interest rates on net interest income, net income and the change in the economic value (portfolio equity). This analysis assumes that interest-earning asset and interest-bearing liability levels at June 30, 2010 remain constant. The impact of the rate movements was developed by simulating the effect of rates changing over a twelve-month period from the June 30, 2010 levels:

Earnings at risk:	Rates +200	Rates -200
Percent change in:		
Net interest income	1.8%	1.5%
Net income	7.1	4.4
Economic value at risk:		
Percent change in:		
Economic value of equity	(30.7)	(0.3)
Economic value of equity as a percent of book assets	(2.2)	(0.0)

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may normally change beyond the Company's policy guideline for a short period of time as long as the risk-based capital ratio (after adjusting for the excess equity exposure) is greater than 10%. As of June 30, 2010, the Company’s risk-based capital ratio was 12.0%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning July 1, 2010, under alternate interest rate scenarios using the income simulation model described above (dollars in thousands):

Change in interest rates	Net interest income	$ variance	% variance
+200 basis points	$ 20,859	$ 367	1.8%
+100 basis points	20,501	9	0.0
Flat rate	20,492	-	-
-100 basis points	20,817	325	1.6
-200 basis points	20,803	311	1.5

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

Liquidity

Liquidity management ensures that adequate funds will be available to meet customers’ needs for borrowings, deposit withdrawals and maturities and normal operating expenses of the Company. Current sources of liquidity are cash and cash equivalents, asset maturities and pay-downs within one year, loans and investments AFS, growth of core deposits, growth of repurchase agreements, increases of other borrowed funds from correspondent banks and issuance of capital stock. Although regularly scheduled investment and loan payments are a dependable source of daily funds, the sales of both loans and investments AFS, deposit activity and investment and loan prepayments are significantly influenced by general economic conditions and the interest rate environment. During a declining interest rate environment, prepayments from interest-sensitive assets tend to accelerate and provide significant liquidity which can be used to invest in other interest-earning assets but at lower market rates. Conversely, in a period of rising interest rates, prepayments from interest-sensitive assets tend to decelerate causing cash flow from mortgage loans and the MBS–GSE residential securities portfolio to decrease. Rising interest rates may also cause deposit inflow to accelerate and be invested at higher market interest rates. The Company closely monitors activity in the capital markets and takes appropriate action to ensure that the liquidity levels are adequate for funding, investing and operating activities.

For the six months ended June 30, 2010, the Company generated approximately $28.4 million of cash. During the first half of 2010, the Company's financing activities provided $20.5 million, primarily from $21.9 million of deposit growth. During the same period, the Company's operations provided approximately $6.5 million primarily from the sales of mortgages AFS net of originations and from increased net income. $21.0 million of the proceeds from financing, operations and security pay-offs were used to fund growth in the loan portfolio, purchase new securities and facility improvements.

As of June 30, 2010, the Company maintained $36.7 million in cash and cash equivalents and $75.8 million of investments and loans AFS and also had approximately $128.7 million available to borrow from the FHLB, $21.0 million available from other correspondent banks, $23.8 million from the Discount Window of the Federal Reserve Bank and $29.7 million with CDARS. This combined total of $315.7 million represented 54% of total assets at June 30, 2010. Management believes this level of liquidity to be strong and adequate to support current operations.

During April 2010, the FHLB informed the Company of a 50% collateral maintenance requirement on outstanding obligations and restrictions on utilization above 35% of the amount available to borrow. The Company is formulating strategies to improve its position and have the requirements lifted. The requirements only impose more stringent collateral delivery requirements and utilization subject to prior credit committee decision-making and does not minimize or reduce the amount the Company may borrow. Management does not consider this action to significantly effect the liquidity position of the Company.

Capital

During the six months ended June 30, 2010, total shareholders' equity increased $2,169,000, or 5%. The increase was generated by: first half net income of $1,275,000; $67,000 in proceeds from employees enrolled in the Company’s Employee Stock Purchase Plan; a $1,382,000 (net of $997,000 in non-credit-related OTTI) after tax improvement in the market value of the AFS securities portfolio; partially offset by $563,000 of dividends paid to shareholders, net of dividends reinvested and optional cash payments received from participants in the Company’s Dividend Reinvestment Plan.

As of June 30, 2010, the Company reported a net unrealized loss of $7,812,000, net of tax, from the securities AFS compared to a net unrealized loss of $9,194,000 as of December 31, 2009. While the unrealized loss position has improved, the prolonged economic downturn continues to assert uncertainty and in certain circumstances illiquidity in the financial and capital markets and has had a sizable negative impact on the fair value estimates on the securities in banks’ investment portfolios. Management maintains these changes are due mainly to liquidity problems in the financial markets and to a lesser extent the deterioration in the creditworthiness of the issuers.

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

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and certain off-balance sheet items. The appropriate risk-weighting, pursuant to regulatory guidelines, requires an increase in the risk-weighting of securities that are rated below investment grade, thus significantly inflating the total risk-weighted assets. The regulatory guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I capital to total risk-weighted assets (Tier I Capital) of 4% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. As of June 30, 2010, the Company and the Bank met all capital adequacy requirements to which it was subject.

The Company continues to closely monitor and evaluate alternatives to enhance its capital ratios as the regulatory and economic environments change. The following table depicts the capital amounts and ratios of the Company and the Bank as of June 30, 2010:

	Actual		For capital adequacy purposes		To be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)						
Consolidated	$ 62,117,449	12.0%	≥$ 41,542,460	≥ 8.0%	N/A	N/A
Bank	$ 61,734,704	11.9%	≥$ 41,537,582	≥ 8.0%	≥$ 51,921,978	≥ 10.0%
Tier I capital (to risk-weighted assets)						
Consolidated	$ 55,571,145	10.7%	≥$ 20,771,230	≥ 4.0%	N/A	N/A
Bank	$ 55,231,641	10.6%	≥$ 20,768,791	≥ 4.0%	≥$ 31,153,187	≥ 6.0%
Tier I capital (to average assets)						
Consolidated	$ 55,571,145	9.5%	≥$ 23,408,532	≥ 4.0%	N/A	N/A
Bank	$ 55,231,641	9.5%	≥$ 23,386,064	≥ 4.0%	≥$ 29,232,579	≥ 5.0%

Item 4T. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out by the Company’s management, with the participation of its Interim President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company’s disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934. Based on such evaluation, the Interim President and Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports the Company files or furnishes under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and regulations, and are operating in an effective manner. The Company made no significant changes in its internal controls over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, these controls during the last fiscal quarter ended June 30, 2010.

In July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, which in part, provides smaller companies and debt-only issuers with a permanent exemption from the Sarbanes-Oxley internal control audit requirements. Without this exemption, these companies would have been required to comply with the internal control audit requirements for fiscal years ended on or after June 15, 2010. The permanent exemption applies to entities that are commonly referred to as non-accelerated filers and smaller reporting companies, such as the Company. Generally speaking, a non-accelerated filer and a smaller reporting company have public float, or market capitalization of less than $75.0 million. The permanent exemption applies only to the Sarbanes-Oxley internal control audit requirements. Non-accelerated filers and smaller reporting companies are still required to disclose management's assessment of the effectiveness of internal control over financial reporting.

PART II - Other Information

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

Management of the Company does not believe there have been any material changes in risk factors that were disclosed in the 2009 Form 10-K filed with the Securities and Exchange Commission on March 8, 2010.

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

None

Item 3. Default Upon Senior Securities

None

Item 4. (Removed and Reserved)

None

Item 5. Other Information

None

Item 6. Exhibits

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

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

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

*10.1 1998 Independent Directors Stock Option Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.1 to Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.

*10.2 1998 Stock Incentive Plan of The Fidelity Deposit and Discount Bank, as assumed by Registrant. Incorporated by reference to Exhibit 10.2 of Registrant's Registration Statement No. 333-90273 on Form S-4, filed with the SEC on November 3, 1999.

*10.3 Registrant's 2000 Dividend Reinvestment Plan. Incorporated by reference to Exhibit 4 to Registrant's Registration Statement No. 333-45668 on Form S-1, filed with the SEC on September 12, 2000 and as amended by Pre-Effective Amendment No. 1 on October 11, 2000, by Post-Effective Amendment No. 1 on May 30, 2001, by Post-Effective Amendment No. 2 on July 7, 2005, by Registration Statement No. 333-152806 on Form S-3 filed on August 6, 2008 and by Post-Effective Amendment No. 1 on January 25, 2010.

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

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

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

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

*10.8 Registrant's 2002 Employee Stock Purchase Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-113339 on Form S-8 filed with the SEC on March 5, 2004.

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

*10.10 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Steven C. Ackmann, dated July 11, 2007. Incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed with the SEC on July 13, 2007.

*10.11 Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Timothy P. O'Brien, dated January 3, 2008. Incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed with the SEC on January 10, 2008.

*10.12 Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated February 28, 2008. Incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 3, 2008.

*10.13 Release Agreement between Steven C. Ackmann, Registrant and The Fidelity Deposit and Discount Bank, dated August 31, 2009. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on September 8, 2009.

*10.14 Consulting Agreement between Steven C. Ackmann, former President and Chief Executive Officer of the Registrant and The Fidelity Deposit and Discount Bank, and The Fidelity Deposit and Discount Bank, dated September 1, 2009. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on September 8, 2009.

11 Statement regarding computation of earnings per share. Included herein in Note No. 4, "Earnings per share," contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.

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

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

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

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

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* Management contract or compensatory plan or arrangement.

Signatures

FIDELITY D & D BANCORP, INC.

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

	FIDELITY D & D BANCORP, INC.
Date: August 10, 2010	/s/ Patrick J. Dempsey Patrick J. Dempsey, Interim President and Chief Executive Officer
Date: August 10, 2010	/s/ Salvatore R. DeFrancesco, Jr. Salvatore R. DeFrancesco, Jr., Treasurer and Chief Financial Officer

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