

FIDELITY D & D BANCORP INC
Form 10-Q
August 12, 2009
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2009

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.

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STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

PENNSYLVANIA

23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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

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

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

Large accelerated filer

Accelerated filer

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

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 NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. at July 31, 2009, the latest practicable date, was 2,082,657 shares.

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FIDELITY D & D BANCORP, INC.

Form 10-Q June 30, 2009

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Consolidated Balance Sheets

| | June 30, 2009 (unaudited) | December 31, 2008 (audited) |
|--|------------------------------|--------------------------------|
| Assets: | | |
| Cash and due from banks | \$ 10,959,880 | \$ 12,335,905 |
| Federal funds sold | 4,538,000 | |
| Interest-bearing deposits with financial institutions | 71,693 | 435,242 |
| Total cash and cash equivalents | 15,569,573 | 12,771,147 |
| Available-for-sale securities | 76,476,415 | 83,278,132 |
| Held-to-maturity securities | 842,679 | 909,447 |
| Federal Home Loan Bank Stock | 4,781,100 | 4,781,100 |
| Loans and leases, net (allowance for loan losses of \$5,215,736 in 2009; \$4,745,234 in 2008) | 419,928,399 | 436,207,460 |
| Loans available-for-sale (fair value \$2,307,950 in 2009; \$85,312 in 2008) | 2,287,993 | 84,000 |
| Bank premises and equipment, net | 15,544,799 | 16,056,362 |
| Cash surrender value of bank owned life insurance | 8,962,081 | 8,807,784 |
| Other assets | 12,613,873 | 8,929,917 |
| Accrued interest receivable | 2,248,236 | 2,443,141 |
| Foreclosed assets held-for-sale | 1,199,060 | 1,450,507 |
| Total assets | \$ 560,454,208 | \$ 575,718,997 |
| Liabilities: | | |
| Deposits: | | |
| Interest-bearing | \$ 384,370,177 | \$ 361,869,281 |
| Non-interest-bearing | 69,503,187 | 71,442,651 |
| Total deposits | 453,873,364 | 433,311,932 |
| Accrued interest payable and other liabilities | 6,577,952 | 3,316,710 |
| Short-term borrowings | 8,880,343 | 38,129,704 |
| Long-term debt | 42,000,000 | 52,000,000 |
| Total liabilities | 511,331,659 | 526,758,346 |
| 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; 2,082,657 in 2009; and 2,075,182 shares issued and 2,062,927 shares outstanding in 2008) | 19,567,860 | 19,410,306 |

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| | | |
|--|----------------|----------------|
| Treasury stock, at cost (no shares in 2009; 12,255 shares in 2008) | | (351,665) |
| Retained earnings | 39,067,674 | 38,126,250 |
| Accumulated other comprehensive loss | (9,512,985) | (8,224,240) |
| Total shareholders' equity | 49,122,549 | 48,960,651 |
| Total liabilities and shareholders' equity | \$ 560,454,208 | \$ 575,718,997 |

See notes to consolidated financial statements

Table of Contents**FIDELITY D & D BANCORP, INC. AND SUBSIDIARY**

Consolidated Statements of Income

(unaudited)

| | Three months ended | | Six months ended | |
|---|--------------------|------------------|-------------------|-------------------|
| | June 30, 2009 | June 30, 2008 | June 30, 2009 | June 30, 2008 |
| Interest income: | | | | |
| Loans and leases: | | | | |
| Taxable | \$ 6,356,864 | \$ 6,775,180 | \$ 12,917,612 | \$ 13,584,314 |
| Nontaxable | 113,488 | 85,330 | 228,262 | 163,406 |
| Interest-bearing deposits with financial institutions | 337 | 696 | 448 | 1,802 |
| Investment securities: | | | | |
| U.S. government agency and corporations | 550,457 | 1,284,136 | 1,317,828 | 2,537,317 |
| States and political subdivisions (nontaxable) | 270,334 | 155,102 | 468,909 | 299,232 |
| Other securities | 157,458 | 305,658 | 342,508 | 680,694 |
| Federal funds sold | 6,575 | 6,964 | 7,359 | 91,133 |
| Total interest income | 7,455,513 | 8,613,066 | 15,282,926 | 17,357,898 |
| Interest expense: | | | | |
| Deposits | 2,138,133 | 2,831,400 | 4,329,905 | 6,065,136 |
| Securities sold under repurchase agreements | 8,081 | 13,443 | 16,555 | 80,596 |
| Other short-term borrowings and other | 405 | 48,849 | 26,545 | 113,671 |
| Long-term debt | 568,325 | 776,210 | 1,344,532 | 1,608,495 |
| Total interest expense | 2,714,944 | 3,669,902 | 5,717,537 | 7,867,898 |
| Net interest income | 4,740,569 | 4,943,164 | 9,565,389 | 9,490,000 |
| Provision for loan losses | 300,000 | 125,000 | 725,000 | 125,000 |
| Net interest income after provision for loan losses | 4,440,569 | 4,818,164 | 8,840,389 | 9,365,000 |
| Other income: | | | | |
| Service charges on deposit accounts | 648,228 | 737,330 | 1,280,648 | 1,500,599 |
| Fees and other service charges | 472,313 | 461,809 | 979,489 | 892,638 |
| Gain (loss) on sale or disposal of: | | | | |
| Loans | 327,785 | 59,590 | 818,326 | 151,196 |
| Investment securities | | 7,519 | | 8,653 |
| Premises and equipment | (4,378) | (984) | (6,624) | (984) |
| Foreclosed assets held-for-sale | 14,891 | 405 | 25,887 | 9,109 |
| Impairment losses on investment securities: | | | | |
| Other-than-temporary impairment on investment securities | (570) | | (326,095) | |
| Non-credit related losses on investment securities not expected to be sold (recognized in other comprehensive income/(loss)) | | | | |
| Net impairment losses on investment securities recognized in earnings | (570) | | (326,095) | |

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| | | | | |
|--|------------|--------------|--------------|--------------|
| Total other income | 1,458,269 | 1,265,669 | 2,771,631 | 2,561,211 |
| Other expenses: | | | | |
| Salaries and employee benefits | 2,422,656 | 2,472,302 | 4,992,349 | 4,889,848 |
| Premises and equipment | 904,893 | 781,469 | 1,811,315 | 1,572,109 |
| Advertising | 135,992 | 168,348 | 278,393 | 336,704 |
| Other | 1,275,293 | 1,022,421 | 2,318,719 | 2,038,628 |
| Total other expenses | 4,738,834 | 4,444,540 | 9,400,776 | 8,837,289 |
| Income before provision for income taxes | 1,160,004 | 1,639,293 | 2,211,244 | 3,088,922 |
| Provision for income taxes | 247,851 | 435,347 | 474,033 | 796,029 |
| Net income | \$ 912,153 | \$ 1,203,946 | \$ 1,737,211 | \$ 2,292,893 |
| Per share data: | | | | |
| Net income - basic | \$ 0.44 | \$ 0.59 | \$ 0.84 | \$ 1.11 |
| Net income - diluted | \$ 0.44 | \$ 0.59 | \$ 0.84 | \$ 1.11 |
| Dividends | \$ 0.25 | \$ 0.25 | \$ 0.50 | \$ 0.50 |

See notes to consolidated financial statements

Table of Contents**FIDELITY D & D BANCORP, INC. AND SUBSIDIARY**

Consolidated Statements of Changes in Shareholders' Equity

For the six months ended June 30, 2009 and 2008

| | Capital stock | | Treasury stock | | Retained earnings | Accumulated other comprehensive income (loss) | Total |
|--|---------------|---------------|----------------|--------------|-------------------|---|---------------|
| | Shares | Amount | Shares | Amount | | | |
| Balance, December 31, 2007 | 2,072,929 | \$ 19,223,363 | | \$ | \$ 36,564,157 | \$ (596,226) | \$ 55,191,294 |
| Total comprehensive income: | | | | | | | |
| Net income | | | | | 2,292,893 | | 2,292,893 |
| Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects | | | | | | (3,531,356) | (3,531,356) |
| Change in cash flow hedge intrinsic value | | | | | | 97,818 | 97,818 |
| Comprehensive income | | | | | | | (1,140,645) |
| Issuance of common stock through Employee Stock Purchase Plan | 2,253 | 57,891 | | | | | 57,891 |
| Stock-based compensation expense | | 126,738 | | | | | 126,738 |
| Purchase of treasury stock | | | (5,000) | (145,605) | | | (145,605) |
| Cash dividends declared | | | | | (1,037,590) | | (1,037,590) |
| Balance, June 30, 2008 (unaudited) | 2,075,182 | \$ 19,407,992 | (5,000) | \$ (145,605) | \$ 37,819,460 | \$ (4,029,764) | \$ 53,052,083 |
| 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, adoption of FSP FAS 115-2 and 124-2 | | | | | 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 tax effects | | | | | | (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) |
| Cash dividends declared | | | | | (1,034,178) | | (1,034,178) |

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| | | | | | | | | | | |
|---------------------------------------|-----------|----|------------|----|----|------------|----|-------------|----|------------|
| Balance, June 30, 2009 (unaudited) | 2,082,657 | \$ | 19,567,860 | \$ | \$ | 39,067,674 | \$ | (9,512,985) | \$ | 49,122,549 |
|---------------------------------------|-----------|----|------------|----|----|------------|----|-------------|----|------------|

See notes to consolidated financial statements

Table of Contents**FIDELITY DEPOSIT & DISCOUNT BANCORP, INC. AND SUBSIDIARY**

Consolidated Statements of Cash Flows

(unaudited)

| | Six months ended June 30, | |
|--|----------------------------------|---------------------|
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Net income | \$ 1,737,211 | \$ 2,292,893 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation, amortization and accretion | 609,143 | 296,817 |
| Provision for loan losses | 725,000 | 125,000 |
| Deferred income tax expense | 133,518 | 240,736 |
| Stock-based compensation expense | 4,508 | 126,738 |
| Loss from investment in limited partnership | 40,200 | 40,200 |
| Proceeds from sale of loans available-for-sale | 74,147,662 | 37,691,085 |
| Originations of loans available-for-sale | (64,393,533) | (6,626,744) |
| Increase in cash surrender value of life insurance | (154,297) | (156,934) |
| Net gain on sale of loans | (818,326) | (151,196) |
| Net gain on sale of investment securities | | (8,653) |
| Net gain on sale of foreclosed assets held for sale | (25,887) | (9,109) |
| Loss on disposal of equipment | 6,624 | 984 |
| Other-than-temporary impairment on securities | 326,095 | |
| Change in: | | |
| Accrued interest receivable | 74,687 | (174,221) |
| Other assets | (1,339,119) | (1,881,674) |
| Accrued interest payable and other liabilities | 629,634 | 1,170,971 |
| Net cash provided by operating activities | 11,703,120 | 32,976,893 |
| Cash flows from investing activities: | | |
| Held-to-maturity securities: | | |
| Proceeds from maturities, calls and principal pay-downs | 66,727 | 87,104 |
| Available-for-sale securities: | | |
| Proceeds from sales | | 12,889,251 |
| Proceeds from maturities, calls and principal pay-downs | 29,835,486 | 26,121,600 |
| Purchases | (23,752,046) | (50,247,929) |
| Net decrease in FHLB stock | | (1,055,400) |
| Net decrease (increase) in loans and leases | 4,282,109 | (24,092,055) |
| Acquisition of bank premises and equipment | (415,925) | (2,104,991) |
| Proceeds from sale of foreclosed assets held-for-sale | 408,680 | 62,090 |
| Net cash provided by (used in) investing activities | 10,425,031 | (38,340,330) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 20,561,432 | 22,525,504 |
| Net decrease in short-term borrowings | (29,249,361) | (9,982,018) |
| Repayments of long-term debt | (10,000,000) | (423,095) |
| Purchase of treasury stock | (56,505) | (145,605) |
| Proceeds from employee stock purchase plan | 40,569 | 57,891 |
| Dividends paid, net of dividends reinvested | (625,860) | (1,037,590) |

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| | | |
|---|---------------|---------------|
| Net cash (used in) provided by financing activities | (19,329,725) | 10,995,087 |
| Net increase in cash and cash equivalents | 2,798,426 | 5,631,650 |
| Cash and cash equivalents, beginning | 12,771,147 | 10,408,816 |
| Cash and cash equivalents, ending | \$ 15,569,573 | \$ 16,040,466 |

See notes to consolidated financial statements

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FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

The 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 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, 2008.

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, 2009 and December 31, 2008 and the related consolidated statements of income for the three- and six-month periods ended June 30, 2009 and 2008 and changes in shareholders' equity and cash flows for the six months ended June 30, 2009 and 2008 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, 2008, 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, 2009 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 and / or collateral values 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 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

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and related services to financial institutions. For the pooled trust preferred securities, management was unable to obtain readily attainable and realistic pricing from market traders due to lack of active market participants and therefore management has determined that the market for these securities continues to be inactive. In order to determine the fair value of the preferred term securities, management relied on the use of an income valuation approach (present value technique) that maximizes the use of relevant 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. A large 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 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. As of June 30, 2009 and December 31, 2008, loans classified as AFS consisted of residential mortgages.

2. New Accounting Pronouncements

On January 1, 2009, the Company adopted Financial Accounting Standards Board (FASB) FASB Staff Position (FSP) No. 142-3, *Determination of the Useful Life of Intangible Assets*, (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. The intent of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows, particularly as used to measure fair value in business combinations. FSP 142-3 is effective for fiscal years beginning after December 15, 2008, and is immaterial as it relates to the Company's consolidated financial statements.

On January 1, 2009, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. SFAS 161 amends and expands the disclosure requirements of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. It requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. The adoption of SFAS No. 161 had no impact on the Company's consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events*. SFAS No. 165 establishes standards under which an entity shall recognize and disclose events that occur after a balance sheet date but before the related financial statements are issued or are available to be issued. SFAS No. 165 is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of SFAS No. 165 had no impact on the Company's consolidated financial statements.

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In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140*. SFAS No. 166 makes several significant amendments to SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, including the removal of the concept of a qualifying special-purpose entity from SFAS No. 140. SFAS No. 166 also clarifies that a transferor must evaluate whether it has maintained effective control of a financial asset by considering its continuing direct or indirect involvement with the transferred financial asset. The provisions of SFAS No. 166 are effective for interim and annual reporting periods that begin after November 15, 2009. The adoption of the provisions of SFAS No. 166 is not expected to have a material impact on the Company's consolidated financial statements.

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*. SFAS No. 167 requires a qualitative rather than a quantitative analysis to determine the primary beneficiary of a variable interest entity (VIE) for consolidation purposes. The primary beneficiary of a VIE is the enterprise that has: (1) the power to direct the activities of the VIE that most significantly impact the VIE's economic performance, and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits of the VIE that could potentially be significant to the VIE. The provisions of SFAS No. 167 are effective for interim and annual reporting periods that begin after November 15, 2009. The adoption of the provisions of SFAS No. 167 is not expected to have an impact on the Company's consolidated financial statements.

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In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (SFAS168). SFAS 168 will become the single source of authoritative nongovernmental U.S. generally accepted accounting principles, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related accounting literature. SFAS 168 reorganizes GAAP pronouncements and displays them using a consistent structure. This will have an impact on the Company's financial statements since all future references to authoritative accounting literature will be references in accordance with SFAS 168.

Additional accounting pronouncements recently adopted are discussed where applicable in the notes to the consolidated financial statements.

3. Investment securities

The amortized cost and fair value of investment securities at June 30, 2009 and December 31, 2008 are summarized as follows (in thousands):

| | June 30, 2009 | | | |
|--|-------------------|---------------------------|----------------------------|------------------|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| <u>Held-to-maturity securities:</u> | | | | |
| Mortgage-backed securities | \$ 843 | \$ 57 | \$ | \$ 900 |
| <u>Available-for-sale securities:</u> | | | | |
| U.S. government agencies and corporations | \$ 32,146 | \$ 17 | \$ 1,531 | \$ 30,632 |
| Obligations of states and political subdivisions | 27,721 | 172 | 535 | 27,358 |
| Corporate bonds: | | | | |
| Pooled trust preferred securities | 21,729 | | 13,466 | 8,263 |
| Mortgage-backed securities | 9,382 | 379 | | 9,761 |
| Total debt securities | 90,978 | 568 | 15,532 | 76,014 |
| Equity securities | 322 | 147 | 7 | 462 |
| Total available-for-sale | \$ 91,300 | \$ 715 | \$ 15,539 | \$ 76,476 |

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| | Amortized cost | December 31, 2008 | | Fair value |
|--|-------------------|---------------------------|----------------------------|---------------|
| | | Gross unrealized gains | Gross unrealized losses | |
| <u>Held-to-maturity securities:</u> | | | | |
| Mortgage-backed securities | \$ 909 | \$ 31 | \$ | \$ 940 |
| <u>Available-for-sale securities:</u> | | | | |
| U.S. government agencies and corporations | \$ 45,824 | \$ 134 | \$ 2,451 | \$ 43,507 |
| Obligations of states and political subdivisions | 18,009 | 97 | 553 | 17,553 |
| Corporate bonds: | | | | |
| Pooled trust preferred securities | 21,415 | | 11,155 | 10,260 |
| Mortgage-backed securities | 11,088 | 442 | | 11,530 |
| Total debt securities | 96,336 | 673 | 14,159 | 82,850 |
| Equity securities | 322 | 122 | 16 | 428 |
| Total available-for-sale | \$ 96,658 | \$ 795 | \$ 14,175 | \$ 83,278 |

The amortized cost and fair value of debt securities at June 30, 2009 and December 31, 2008 by contractual maturity are summarized below (in thousands):

| | June 30, 2009 | | December 31, 2008 | |
|--|-------------------|-----------------|-------------------|-----------------|
| | Amortized cost | Market value | Amortized cost | Market value |
| <u>Held-to-maturity securities:</u> | | | | |
| Mortgage-backed securities | \$ 843 | \$ 900 | \$ 909 | \$ 940 |
| <u>Available-for-sale securities:</u> | | | | |
| Debt securities: | | | | |
| Due in one year or less | \$ | \$ | \$ | \$ |
| Due after one year through five years | | | | |
| Due after five years through ten years | 4,274 | 4,289 | 10,649 | 10,706 |
| Due after ten years | 77,322 | 61,964 | 74,599 | 60,614 |
| Total debt securities | 81,596 | 66,253 | 85,248 | 71,320 |
| Mortgage-backed securities | 9,382 | 9,761 | 11,088 | 11,530 |
| Total available-for-sale debt securities | \$ 90,978 | \$ 76,014 | \$ 96,336 | \$ 82,850 |

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, 2009 and December 31, 2008 (in thousands):

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| | Less than 12 months | | June 30, 2009 More than 12 months | | Total | |
|--|---------------------|-------------------|--------------------------------------|-------------------|------------|-------------------|
| | Fair value | Unrealized losses | Fair value | Unrealized losses | Fair value | Unrealized losses |
| U.S. government agencies and corporations | \$ 18,278 | \$ 214 | \$ 4,337 | \$ 1,317 | \$ 22,615 | \$ 1,531 |
| Obligations of states and political subdivisions | 12,492 | 309 | 6,181 | 226 | 18,673 | 535 |
| Corporate bonds: | | | | | | |
| Pooled trust preferred securities | | | 8,263 | 13,466 | 8,263 | 13,466 |
| Mortgage-backed securities | | | | | | |
| Total debt securities | 30,770 | 523 | 18,781 | 15,009 | 49,551 | 15,532 |
| Equity securities | | | 69 | 7 | 69 | 7 |
| Total securities | \$ 30,770 | \$ 523 | \$ 18,850 | \$ 15,016 | \$ 49,620 | \$ 15,539 |
| Number of securities | 34 | | 26 | | 60 | |

| | Less than 12 months | | December 31, 2008 More than 12 months | | Total | |
|--|---------------------|-------------------|--|-------------------|------------|-------------------|
| | Fair value | Unrealized losses | Fair value | Unrealized losses | Fair value | Unrealized losses |
| U.S. government agencies and corporations | \$ 12,506 | \$ 1,878 | \$ 5,145 | \$ 573 | \$ 17,651 | \$ 2,451 |
| Obligations of states and political subdivisions | 8,154 | 496 | 1,455 | 57 | 9,609 | 553 |
| Corporate bonds: | | | | | | |
| Pooled trust preferred securities | 2,235 | 2,352 | 8,025 | 8,803 | 10,260 | 11,155 |
| Mortgage-backed securities | 17 | | | | 17 | |
| Total debt securities | 22,912 | 4,726 | 14,625 | 9,433 | 37,537 | 14,159 |
| Equity securities | | | 60 | 16 | 60 | 16 |
| Total securities | \$ 22,912 | \$ 4,726 | \$ 14,685 | \$ 9,449 | \$ 37,597 | \$ 14,175 |
| Number of securities | 20 | | 22 | | 42 | |

In the table above, the unrealized losses on mortgage-backed securities were less than \$1,000 in 2008.

Management conducts a formal review of investment securities on a quarterly basis for the presence of other-than-temporary-impairment (OTTI). During the second quarter of 2009, the Company adopted FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, issued by the FASB on April 9, 2009. The Company assesses whether OTTI is present when the fair value of a debt security is less than its amortized cost basis at the balance sheet date. Under these circumstances as required by the new FSP, 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 basis.

The FSP requires that credit-related OTTI is recognized in earnings while non-credit-related OTTI on securities not expected to be sold is recognized in other comprehensive income (OCI). Non-credit-related OTTI is based on other factors effecting market conditions, including illiquidity. Presentation of OTTI is made in the statement of income on a gross basis with an offset for the amount of OTTI recognized in OCI. Non-credit-related OTTI recognized in earnings previous to April 1, 2009 has been reclassified from retained earnings to accumulated OCI as a cumulative effect adjustment.

The Company's OTTI evaluation process also follows the guidance of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, Emerging Issues Task Force (EITF) Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*, and FSP No. EITF 99-20-1, *Amendments to the Impairment and Interest Income Measurement Guidance of EITF Issue No. 99-20*. This guidance 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 in securities portfolios. FSP EITF 99-20-1 was issued on January 12, 2009 and is effective for reporting periods ending after December 15, 2008. This FSP amends EITF 99-20 by eliminating the requirement that a holder's best estimate of cash

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flows is based upon those that a market participant would use. Instead, the FSP 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 SFAS 115.

For all security types discussed below where no OTTI is considered necessary at June 30, 2009, the Company applied the criteria of FSP FAS 115-2 and 124-2. 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. There was no non-credit related OTTI on securities not expected to be sold recognized in OCI during the three months ended June 30, 2009.

U.S. government agencies and corporations

The agency securities consist of medium and long-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA). These securities are fixed rate issues, have varying mid- to long-term maturity dates and have contractual cash flows guaranteed by agencies of the U.S. government. In the latter half of 2008, the U.S. Government provided substantial liquidity to FNMA and FHLMC to bolster their creditworthiness.

Agency guaranteed mortgage-backed securities

The agency mortgage-backed securities are comprised largely of fixed rate residential mortgage-backed securities issued by FNMA or FHLMC. They have mid- to long-term maturity dates and have contractual cash flows guaranteed by agencies of the U.S. Government. In the latter half of 2008, the U.S. government provided substantial liquidity to both FNMA and FHLMC to bolster their creditworthiness.

Obligations of states and political subdivisions

The municipal securities are rated as investment grade by various credit rating agencies and are at fixed rates 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 the above three securities types, the decline in fair value is attributable to changes in interest rates and not credit quality. As such, no OTTI is considered necessary for these securities at June 30, 2009.

Pooled trust preferred securities

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A Pooled Trust Preferred Collateralized Deal Obligation (CDO) is a type of investment security collateralized by trust preferred securities (TPS) issued by banks, insurance companies and 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 a junior security in the capital structure of the issuer.

There are various tranches or classes issued by the CDO with the most senior tranche having the lowest yield but the most protection from credit losses (versus other tranches that are subordinate). Losses are generally allocated from the lowest tranche with the equity piece 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 were 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. Our review of these securities, in accordance with the previous discussion, determined that an OTTI credit loss be recorded on one of our holdings of these securities.

The following table summarizes the amount of credit-related OTTI recognized in earnings for the periods indicated. There was no OTTI for the first six months of 2008 (in thousands):

| | Three months ended June 30, 2009 | | | Six months ended June 30, 2009 | | |
|------------------------------------|-------------------------------------|------|-------|-----------------------------------|--------|--------|
| | HTM | AFS | Total | HTM | AFS | Total |
| Pooled trust preferred securities: | | | | | | |
| PreTSL VII, Mezzanine | \$ | \$ 1 | \$ 1 | \$ | \$ 326 | \$ 326 |

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

| | Three months ended June 30, 2009 | | | Six months ended June 30, 2009 | | |
|--|-------------------------------------|----------|----------|-----------------------------------|----------|----------|
| | HTM | AFS | Total | HTM | AFS | Total |
| Beginning balance of credit-related OTTI | \$ | \$ (755) | \$ (755) | \$ | \$ (429) | \$ (429) |
| Reduction - cumulative effect of accounting change | | 531 | 531 | | 531 | 531 |
| Additions for credit-related OTTI not previously recognized | | | | | | |
| Additional credit-related OTTI previously recognized when there is no intent to sell before recovery of amortized cost basis | | | | | (326) | (326) |
| Ending balance of credit-related OTTI | \$ | \$ (224) | \$ (224) | \$ | \$ (224) | \$ (224) |

To determine the ending balance of credit-related OTTI, the Company used discounted present value cash flow analysis and compared the results with the bond's face value. The analysis considered the following assumptions: the discount rate of 3.03% which approximated the bond's yield for the three months ended June 30, 2009; 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 to create a very onerous 30% rate of default; the default rate was reduced by the actual deferrals / defaults experienced in all Preferred Term Securities for the full year 2008 and the first quarter of 2009; the remaining 18% estimated default rate was then stratified with higher default rates occurring in the beginning regressing to normal in 2011 with an estimated 15% recovery by way of a two year lag ; and no prepayments with receipt of principal at maturity. The present value of PreTSL VII as modeled resulted in cash flow of \$777,000 as of April 1, 2009, or approximately \$224,000 below the bond's face value of \$1,001,000. Upon adoption of this FSP, in the second quarter of 2009, and as a result of the credit-related OTTI determination as explained, the \$531,000 non-credit related portion of OTTI that existed prior to April 1, 2009, or \$351,000 after tax, was reclassified from retained earnings to OCI as a cumulative effect adjustment.

As of June 30, 2009, the book value of the Company's pooled trust preferred securities amounted to \$21,729,000 with an estimated fair value of \$8,263,000.

All of the Company's holdings are mezzanine tranches. As of June 30, 2009, 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, 2009, management estimates the subordination in the Company's tranches ranging from 0% to 23.5% of the current performing collateral. The following table provides additional information with respect to the Company's pooled trust preferred securities:

| Current number of banks / | Actual deferrals | Actual deferrals and defaults as a % of | Excess | Excess subordination* as a % of current | Effective subordination** as a % of current |
|---------------------------|------------------|---|--------|---|---|
|---------------------------|------------------|---|--------|---|---|

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| Deal | Class | Book value | Fair value | Unrealized loss | Moody s / Fitch ratings | insurance companies | and defaults \$(000) | current collateral | subordination \$(000) | performing collateral | performing collateral |
|---------------|-----------|---------------|--------------|-----------------|-------------------------|---------------------|----------------------|--------------------|-----------------------|-----------------------|-----------------------|
| Pre TSL IV | Mezzanine | \$ 609,971 | \$ 569,834 | \$ (40,137) | Ca / B | 6 / - | 18,000 | 27.1 | 9,677 | 18.9 | 36.1 |
| Pre TSL V | Mezzanine | 275,503 | 259,110 | (16,393) | Ba3 / A | 4 / - | 8,950 | 20.4 | 8,540 | 23.5 | 24.8 |
| Pre TSL VII | Mezzanine | 777,386 | 405,647 | (371,739) | Ca / CC | 20 / - | 113,000 | 46.9 | None | N/A | N/A |
| Pre TSL IX | B-1,B-3 | 3,500,000 | 1,783,600 | (1,716,400) | Ca / CC | 49 / - | 85,980 | 19.1 | None | N/A | 10.2 |
| Pre TSL XI | B-3 | 2,408,743 | 1,601,885 | (806,858) | Ca / CC | 65 / - | 86,750 | 14.4 | None | N/A | 15.7 |
| Pre TSL XV | B-1 | 1,505,400 | 540,300 | (965,100) | Ca / CC | 63 / 9 | 103,700 | 17.3 | None | N/A | 9.6 |
| Pre TSL XVI | C | 2,551,253 | 585,394 | (1,965,859) | Ca / CC | 50 / 8 | 111,910 | 18.5 | None | N/A | 11.6 |
| Pre TSL XVII | C | 992,588 | 279,046 | (713,542) | Ca / CC | 51 / 8 | 84,700 | 16.9 | None | N/A | 14.3 |
| Pre TSL XVIII | C | 994,686 | 134,186 | (860,500) | Ca / CCC | 66 / 14 | 111,938 | 16.5 | None | N/A | 12.0 |
| Pre TSL XIX | C | 2,516,026 | 404,187 | (2,111,839) | Ca / CC | 60 / 14 | 96,000 | 13.7 | None | N/A | 15.7 |
| Pre TSL XXIV | B-1 | 2,206,028 | 503,225 | (1,702,803) | B2 / BB | 80 / 13 | 216,300 | 20.6 | 15,373 | 1.8 | 26.2 |
| Pre TSL XXV | C-1 | 1,009,639 | 139,560 | (870,079) | Ca / C | 64 / 9 | 178,100 | 20.3 | None | N/A | 12.6 |
| Pre TSL XXVII | B | 2,381,886 | 1,056,898 | (1,324,988) | B3 / BB | 42 / 7 | 45,300 | 13.9 | 33,046 | 11.7 | 31.8 |
| | | \$ 21,729,109 | \$ 8,262,872 | \$ (13,466,237) | | | | | | | |

* 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.

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For a further discussion 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, 2009 and December 31, 2008" 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. There were no potentially dilutive shares outstanding at June 30, 2009 and 5 potentially dilutive shares outstanding at June 30, 2008.

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. 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:

| Six months ended June 30, | 2009 | 2008 |
|--|--------------|--------------|
| Net income available to common shareholders | \$ 1,737,211 | \$ 2,292,893 |
| Weighted-average common shares outstanding | 2,070,144 | 2,074,558 |
| Basic EPS | \$ 0.84 | \$ 1.11 |
| <u>Diluted EPS:</u> | | |
| Net income available to common shareholders | \$ 1,737,211 | \$ 2,292,893 |
| Weighted-average common shares outstanding | 2,070,144 | 2,074,558 |
| Potentially dilutive common shares | | 5 |
| Weighted-average common shares and dilutive potential shares | 2,070,144 | 2,074,563 |
| Diluted EPS | \$ 0.84 | \$ 1.11 |

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 Statement of Financial Accounting Standard (SFAS) No. 123R, *Share Based Payment*. SFAS 123R requires that the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements.

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Under the stock option plans, options are granted with an exercise price equal to the market price of the Company's stock on the date of grant. The awards vest based on six months of continuous service from the date of grant and have 10-year contractual terms. Stock-based compensation expense is recognized over the six-month vesting period. Generally, all shares that are granted become fully vested. Stock-based compensation is recorded in the consolidated income statement as a component of salaries and employee benefits.

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, 2009 and 2008. As of June 30, 2009, there were 27,400 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, 2009. During the six months ended June 30, 2008, 2,000 stock options were issued under this plan at a weighted-average grant-date fair value of \$4.85 per share. The Company uses the Black-Scholes Option Pricing Valuation Model to determine the fair value of awarded options on the date of grant. The model considers expected volatility, expected dividends, risk-free interest rate and the expected term. As of June 30, 2009, there were 10,190 unexercised stock options outstanding under this plan.

The following tables illustrate stock-based compensation expense recognized during the three and six months ended June 30, 2009 and 2008 and the unrecognized stock-based compensation expense as of June 30, 2009 and 2008. There was no unrecognized stock-based compensation expense as of December 31, 2008:

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| | Three months ended June 30, | | Six months ended June 30, | |
|--|--------------------------------|-----------|------------------------------|------------|
| | 2009 | 2008 | 2009 | 2008 |
| Stock-based compensation expense: | | | | |
| Director's Plan | \$ | \$ 42,079 | \$ | \$ 90,550 |
| Incentive Plan | | 16,868 | | 33,248 |
| Total stock-based compensation expense | \$ | \$ 58,947 | \$ | \$ 123,798 |

| | As of: | |
|--|---------------|---------------|
| | June 30, 2009 | June 30, 2008 |
| Unrecognized stock-based compensation expense: | | |
| Director's Plan | \$ | \$ |
| Incentive Plan | | 2,314 |
| Unrecognized stock-based compensation expense | \$ | \$ 2,314 |

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 under the plan. The plan was designed to promote broad-based employee ownership of the Company's stock. Under the ESPP, employees may elect to purchase the Company's capital stock at a discounted price based on the fair market value of the Company's capital stock on either the commencement date or termination date. At June 30, 2009, 12,271 shares have been issued under the ESPP. The Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the six months ended June 30, 2009 and 2008, compensation expense related to the ESPP approximated \$5,000 and \$3,000, respectively, and is included as components of salaries and employee benefits in the consolidated statements of income.

6. Derivative instruments

As part of the Company's overall interest rate risk management strategy, the Company has adopted a policy whereby it may periodically use derivative instruments to minimize significant fluctuations in earnings caused by interest rate volatility. This interest rate risk management strategy entails the use of interest rate floors, caps and swaps. During the fourth quarter of 2006, the Company entered into a three-year interest rate floor derivative agreement on \$20,000,000 notional value of its prime-based loan portfolio. The transaction required the payment of a premium by the Company to the seller for the right to receive payments in the event national prime drops below a pre-determined level (strike rate), essentially converting floating rate loans to fixed rate loans when prime drops below the contractual strike rate. When purchased, the Company recorded an asset representing the fair value of the hedge at the time of purchase. The Company has designated this agreement as a cash flow hedge pursuant to SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Accordingly, the change in the fair value of the instrument related to the hedge's intrinsic value, or approximately (\$335,000) and \$98,000 for the six months ended June 30, 2009 and 2008, respectively, is recorded as a component of other comprehensive income (loss) (OCI) in the consolidated statement of changes in shareholders' equity and the portion of the change in fair value related to the time value expiration, or approximately \$2,000 and \$12,000 for the six months ended June 30, 2009 and 2008, respectively, is recorded in the consolidated statements of income as a reduction of interest income. No gain or loss has been recognized in earnings due to hedge ineffectiveness as of June 30, 2009. As of June 30, 2009, the Company does not expect to reclassify any amount from OCI to earnings over the next two quarters and no hedge has been discontinued. Also, as of June 30, 2009 and December 31, 2008, the fair value of the derivative contract approximated \$300,000 and \$636,000, respectively, and is recorded as a component of other assets in the consolidated balance sheet. The following table illustrates the present value, intrinsic value and time value components of the Company's derivative contract and the financial statement impact of the change in the fair value for the periods indicated:

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| | Six months ended or as of June 30, | | |
|-----------------------|--|---|---|
| | Present value Balance sheet Other assets | Intrinsic value Balance sheet OCI | Time value Income statement Interest income |
| 2009 | | | |
| Beginning Balance | \$ 635,839 | \$ 606,492 | |
| Change in fair value | (336,256) | (334,716) | (1,540) |
| Balance June 30, 2009 | \$ 299,583 | \$ 271,776 | |
| 2008 | | | |
| Beginning Balance | \$ 440,593 | \$ 385,741 | |
| Change in fair value | 85,360 | 97,819 | (12,459) |
| Balance June 30, 2008 | \$ 525,953 | \$ 483,560 | |

As a result of the low national prime rate relative to the contract's strike rate, the Company earned \$453,000 and \$212,000 for the six months ended June 30, 2009 and 2008, respectively and \$228,000 and \$135,000 for the three months ended June 30, 2009 and 2008, respectively and is included as a component of interest income from loans in the consolidated income statements. The contract is scheduled to expire in the fourth quarter of 2009.

The use of derivative instruments exposes the Company to credit risk in the event of non-performance by the agreement's counterparty to the derivative instrument. In the event of default by the counterparty, the Company would be subject to an economic loss that corresponds to the cost to replace the agreement. The Company controls the credit risk associated with the derivative instrument by engaging counterparties with high credit ratings, establishing counterparty exposure limits and monitoring procedures.

7. Fair value measurements

On April 9, 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, and FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. The Company adopted both of these FSPs in the second quarter of 2009.

FSP FAS 157-4 provides additional guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity. FSP FAS 157-4 also requires additional disclosures on fair value measurements and provides additional guidance on circumstances that may indicate that a transaction is not orderly. This FSP supersedes FAS 157-3 (issued in October 2008), *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* which clarifies the application of FAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

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On January 1, 2008, the Company adopted SFAS 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measurements required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 establishes 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.

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In February 2008 the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 to fiscal years beginning after November 15, 2008 for non-financial assets and non-financial liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis. The adoption of FSP 157-2 did not have an impact on the Company's financial statements.

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. This is done primarily for AFS securities, loans available for sale and derivatives. Fair value is used on a nonrecurring basis to measure certain assets when adjusting carrying 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 (dollars in thousands):

| | Total carrying value at June 30, 2009 | Fair value measurements at June 30, 2009: | | |
|--|---|---|---|---|
| | | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Assets: | | | | |
| Available-for-sale securities: | | | | |
| U.S. government agencies and corporations | \$ 30,632 | \$ | \$ 30,632 | \$ |
| Obligations of states and political subdivisions | 27,358 | | 27,358 | |
| Corporate bonds: | | | | |
| Pooled trust preferred securities | 8,263 | | | 8,263 |
| Mortgage-backed securities | 9,761 | | 9,761 | |
| Equity securities | 462 | 462 | | |
| Total available-for-sale securities: | 76,476 | 462 | 67,751 | 8,263 |
| Loans available-for-sale | 2,288 | | 2,288 | |
| Derivative instrument | 300 | | 300 | |
| Total | \$ 79,064 | \$ 462 | \$ 70,339 | \$ 8,263 |

Equity securities in the available-for-sale securities 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 available-for-sale securities 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. The Company's pooled trust preferred securities include both observable and unobservable inputs to determine fair value as described above and, therefore, are considered Level 3 inputs. 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, 2009 and December 31, 2008* of Part 1, Item 2, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, below.

Loans available-for-sale are measured at fair value from quotes received through secondary market sources, i.e., FNMA or FHLB, who provide pricing for similar assets with similar terms in actively traded markets. The derivative instrument, included in other assets, is measured at fair value from pricing provided by a third party who considers observable interest rates, forward yield curves at commonly quoted intervals and volatility.

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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):

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| | As of and for the six months ended June 30, 2009 | | As of and for the six months ended June 30, 2008 | |
|--|--|---------|--|---------|
| Assets: | | | | |
| Balance at beginning of period | \$ | 10,260 | \$ | 16,335 |
| Realized / unrealized gains (losses): | | | | |
| in earnings | | (326) | | |
| in comprehensive income | | (2,311) | | (3,867) |
| Purchases, sales, issuances and settlements, amortization and accretion, net | | 640 | | 4,398 |
| Balance at end of period | \$ | 8,263 | \$ | 16,866 |

The following table illustrates the financial instruments measured at fair value on a nonrecurring basis segregated by hierarchy fair value levels (dollars in thousands):

| | Total carrying value at June 30, 2009 | Fair value measurements at June 30, 2009 using: | | |
|----------------|---|---|---|---|
| | | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Assets: | | | | |
| Impaired loans | \$ 2,280 | \$ 13 | \$ 1,345 | \$ 922 |

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; observable inputs, employed by certified appraisers for similar assets classified as Level 2 inputs. In cases where valuation techniques included inputs that are unobservable or are based on estimates and assumptions developed by management, with significant adjustments from the best information available under each circumstance, the asset valuation is classified as Level 3 inputs.

FSP FAS 107-1 and APB 28-1 extends the annual fair value disclosure requirements of SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, to interim financial statements.

As required by SFAS 107, the following is a summary of the carrying values and estimated fair values of certain financial instruments (in thousands):

| | June 30, 2009 | | December 31, 2008 | |
|-------------------------------|--------------------|-------------------------|--------------------|-------------------------|
| | Carrying amount | Estimated fair value | Carrying amount | Estimated fair value |
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 15,570 | \$ 15,570 | \$ 12,771 | \$ 12,771 |
| Held-to-maturity securities | 843 | 900 | 910 | 940 |
| Available-for-sale securities | 76,476 | 76,476 | 83,278 | 83,278 |
| FHLB stock | 4,781 | 4,781 | 4,781 | 4,781 |
| Loans and leases | 419,928 | 418,408 | 436,207 | 438,838 |
| Loans available-for-sale | 2,288 | 2,308 | 84 | 85 |
| Accrued interest | 2,248 | 2,248 | 2,443 | 2,443 |

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Financial liabilities:

| | | | | |
|--|---------|---------|---------|---------|
| Deposit liabilities | 453,873 | 455,992 | 433,312 | 436,011 |
| Short-term borrowings | 8,880 | 8,880 | 38,130 | 38,130 |
| Long-term debt | 42,000 | 45,633 | 52,000 | 57,230 |
| Accrued interest | 1,484 | 1,484 | 1,390 | 1,390 |
| On-balance sheet derivative instrument | | | | |
| Cash flow hedge | 300 | 300 | 636 | 636 |

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The following summarized 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: With the exception 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 preferred term 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, 2009 and December 31, 2008 in Part I, Item II, below.

Federal Home Loan Bank stock, 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 the current offering 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.

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Certificates of deposit: The fair values of certificate of deposit accounts are based on discounted cash flows using rates which approximate the rates we offer for deposits of similar maturities.

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

Cash flow hedge: The carrying amount of interest rate contracts are based on pricing provided by a third party who considers observable interest rates, forward yield curves at commonly quoted intervals and volatility.

8. Subsequent Events

Pursuant to the requirements of SFAS 165, subsequent events have been evaluated through August 12, 2009, which is the date the financial statements were available to be issued. Through that date, there were no events requiring disclosure.

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, 2009 compared to December 31, 2008 and the results of operations for the three- and six month periods ended June 30, 2009 and 2008. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2008 Annual Report filed on Form 10-K.

Forward-looking statements

This Interim Report on Form 10-Q contains a number of forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These statements may be identified by the use of the words anticipate, believe, could, estimate, expect, intend, may, outlook, plan, project, should, will, would and similar terms and phrases, including references to assumptions. Forward-looking statements include risks and uncertainties.

Forward-looking statements are based on various assumptions and analyses made by us in light of management's experience and its perception of historical trends, current conditions and expected future developments, as well as other factors management believes are appropriate under the circumstances. These statements are not guarantees of future performance and are subject to risks, uncertainties and other factors (many of which are beyond our control) that could cause actual results to differ materially from future results expressed or implied by such forward-looking statements. These factors include, without limitation, the following:

- the timing and occurrence or non-occurrence of events may be subject to circumstances beyond our control;

- volatilities in the securities market;

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- deteriorating economic conditions;
- effects of deterioration of economic conditions on customers, specifically the effect on loan customers ability to repay their loans;
- there may be increases in competitive pressure among financial institutions or from non-financial institutions;
- changes in the interest rate environment may reduce interest margins;
- changes in deposit flows, loan demand or real estate and investment securities values may adversely affect our business;
- changes in accounting principles, policies or guidelines may cause our financial condition to be perceived differently;
- general economic conditions, either nationally or locally in some or all areas in which we do business, or conditions in the securities markets or the banking industry may be less favorable than we currently anticipate;
- legislative or regulatory changes may adversely affect our business;
- technological changes may be more rapid, difficult or expensive than we anticipate;
- success or consummation of new business initiatives may be more difficult or expensive than we anticipate;
- acts of war or terrorism; and
- natural disaster.

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Management 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 principal revenues are derived from interest, dividends and fees earned on its interest-earning assets, which are comprised of loans, securities and other short-term investments. The Company's principal expenses consist of interest paid on its interest-bearing liabilities, which are comprised of deposits, short- and long-term borrowings and operating and general expenses. The Company's profitability depends primarily on its 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 dependent upon the interest-rate spread (i.e., 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. The 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 and securities AFS, sales of other real estate (ORE) properties and from 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

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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, 2009 and 2008****Overview**

Net income for the second quarter of 2009 was \$912,000 compared to \$1,204,000 recorded in the same quarter of 2008. Diluted earnings per share were \$0.44 and \$0.59 for each of the respective quarters. For the six months ended June 30, 2009, net income was \$1,737,000, or \$0.84 per share compared to \$2,293,000, or \$1.11 per share for the six months ended June 30, 2008. The decrease in net income, in the quarterly comparison, was due to a reduction of net interest income and increases in the provision for loan losses and non-interest expenses, partially offset by an increase in non-interest income. The decline in net income in the first half of 2009 compared to the first half of 2008 was caused by an increase in the provision for loans losses, an increase in non-interest expenses and a non-cash OTTI charge of \$326,000 related to the Company's investment portfolio that did not occur during the first half of 2008. These items were partially offset by higher gains from the sales of mortgage loans in the three- and six- month periods ended June 30, 2009 compared to the same period of 2008. For the six months ended June 30, 2009, net income excluding the OTTI charge would have been \$1,952,000, or \$0.94 per share. The following table reconciles net income as reported to pro forma net operating income for the periods indicated:

| | Three months ended June 30, | | | | Six months ended June 30, | | | |
|---------------------------------|-----------------------------|-----------|--------------|-----------|---------------------------|-----------|--------------|-----------|
| | 2009 | | 2008 | | 2009 | | 2008 | |
| | Amount | Per share | Amount | Per share | Amount | Per share | Amount | Per share |
| Net income, as reported | \$ 912,153 | \$ 0.44 | \$ 1,203,946 | \$ 0.59 | \$ 1,737,211 | \$ 0.84 | \$ 2,292,893 | \$ 1.11 |
| Other-than-temporary impairment | 570 | 0.00 | | | 326,095 | 0.15 | | |
| Tax effect | (194) | (0.00) | | | (110,872) | (0.05) | | |
| Net operating earnings | \$ 912,529 | \$ 0.44 | \$ 1,203,946 | \$ 0.59 | \$ 1,952,434 | \$ 0.94 | \$ 2,292,893 | \$ 1.11 |

Return on average assets (ROA) and return on average shareholders' equity (ROE) were 0.65% and 7.63%, respectively, for the three months ended June 30, 2009 compared to 0.83% and 8.73%, respectively, for the same period in 2008. For the six months ended June 30, 2009, ROA and ROE were 0.62% and 7.33%, respectively, compared to 0.78% and 8.26% for the same period in 2008. The decrease in both ROA and ROE is attributable to lower net income.

Net interest income and interest sensitive assets / liabilities

Net interest income decreased \$202,000, or 4%, to \$4,741,000 for the second quarter of 2009, from \$4,943,000 recorded in the same period of 2008. The decline in net interest income was principally due to a combination of: a 70 basis point decline in yields from earning-assets, mostly in the commercial loan and investment portfolios partially offset by a decrease in rates paid on deposits and lower balances of interest-bearing

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liabilities mostly from a reduction of \$10,000,000 in long-term Federal Home Loan Banks (FHLB) advances and short-term borrowings. The decline in FHLB advances were supplanted by growth in average deposits which were used to help reduce dependence on short-term borrowings.

During the second quarter of 2009, the Company's tax-equivalent margin and spread were 3.70% and 3.28%, respectively, compared to 3.71% and 3.18% during the second quarter of 2008. The improvement in spread was caused by a greater reduction in rates paid on interest-bearing liabilities than the lower yields earned on interest-earning assets. Rates paid on interest-bearing liabilities declined 75 basis points compared to a decline in yield of 65 basis points.

For the six months ended June 30, 2009, net interest income improved 1%, or, \$75,000 compared to the six months ended June 30, 2008. The Company's tax-equivalent margin and spread improved to 3.71% and 3.27%, respectively, from 3.54% and 2.97% during the same period of 2008. The improvements were largely from lower balances of interest-bearing liabilities - most notably from lower long-and short-term borrowings. Rates paid on deposits declined 94 basis points compared to lower yields from earning-assets of 58 basis points.

The current interest rate environment has not materially changed since year-end 2008; however, it is much different than a year ago. The interest rate environment was considerably lower during the first half of 2009 compared to 2008, albeit the treasury yield curve is somewhat steeper today. The lower rates have caused assets to price and re-price at significantly

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lower levels thereby pressuring earning-yields downward. Increased prepayment activity in asset portfolios, thereby shortening the duration of interest-earning assets as well as increased activity in loan refinancing all contribute to lower portfolio yields. However, the steepness of the curve has enabled the Company to help mitigate the lower yields earned from its asset portfolios. To manage the interest rate margin to acceptable levels, the Company's Asset Liability Management (ALM) team meets regularly to discuss interest rate risk and when deemed necessary adjusts interest rates on deposits and repurchase agreements and when necessary uses lower costing wholesale funding sources. The actions of the ALM team have helped minimize the effect rate changes have had on interest income so that net interest income is not materially and disproportionately impacted during this lower yield environment. During the first quarter of 2009, the Company sold \$10.8 million of lower yielding mortgage loans and used the proceeds to pay off the aforementioned FHLB advance that was scheduled to mature in the second quarter of 2009. The Company's proactive attention to interest rate risk should continue to help contain the Company's net interest income at acceptable levels.

The following table sets forth a comparison of average balance sheet amounts 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):

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| | June 30, 2009 | | Three months ended: | | June 30, 2008 | | Yield / rate |
|-------------------------------|-----------------|----------|---------------------|-----------------|---------------|--------------|--------------|
| | Average balance | Interest | Yield / rate | Average balance | Interest | Yield / rate | |
| Assets | | | | | | | |
| Interest-earning assets: | | | | | | | |
| Loans and leases | \$ 428,079 | \$ 6,529 | 6.12% | \$ 407,208 | \$ 6,904 | 6.82% | |
| Investments | 94,535 | 1,113 | 4.72 | 141,728 | 1,834 | 5.20 | |
| Federal funds sold | 10,793 | 7 | 0.24 | 1,268 | 7 | 2.21 | |
| Interest-bearing deposits | 1,419 | | 0.10 | 118 | 1 | 2.37 | |
| Total interest-earning assets | 534,826 | 7,649 | 5.74 | 550,322 | 8,746 | 6.39 | |
| Non-interest-earning assets | 28,615 | | | 35,317 | | | |
| Total assets | \$ 563,441 | | | \$ 585,639 | | | |

Liabilities and shareholders equity

| | | | | | | | |
|--|------------|----------|-------|------------|----------|-------|--|
| Interest-bearing liabilities: | | | | | | | |
| Other interest-bearing deposits | \$ 217,249 | \$ 550 | 1.02% | \$ 197,552 | \$ 852 | 1.73% | |
| Certificates of deposit | 172,573 | 1,588 | 3.69 | 180,925 | 1,980 | 4.40 | |
| Borrowed funds | 42,578 | 569 | 5.36 | 70,896 | 825 | 4.68 | |
| Repurchase agreements | 9,837 | 8 | 0.33 | 10,234 | 13 | 0.53 | |
| Total interest-bearing liabilities | 442,237 | 2,715 | 2.46 | 459,607 | 3,670 | 3.21 | |
| Non-interest-bearing deposits | 68,909 | | | 65,591 | | | |
| Other non-interest-bearing liabilities | 4,373 | | | 5,005 | | | |
| Shareholders equity | 47,922 | | | 55,436 | | | |
| Total liabilities and shareholders equity | \$ 563,441 | | | \$ 585,639 | | | |
| Net interest income / interest rate spread | | \$ 4,934 | 3.28% | | \$ 5,076 | 3.18% | |
| Net interest margin | | | 3.70% | | | 3.71% | |

| | June 30, 2009 | | Six months ended: | | June 30, 2008 | | Yield / rate |
|-------------------------------|-----------------|-----------|-------------------|-----------------|---------------|--------------|--------------|
| | Average balance | Interest | Yield / rate | Average balance | Interest | Yield / rate | |
| Assets | | | | | | | |
| Interest-earning assets: | | | | | | | |
| Loans and leases | \$ 433,412 | \$ 13,263 | 6.17% | \$ 409,151 | \$ 13,832 | 6.80% | |
| Investments | 98,488 | 2,372 | 4.86 | 138,110 | 3,690 | 5.37 | |
| Federal funds sold | 6,145 | 7 | 0.24 | 6,721 | 91 | 2.73 | |
| Interest-bearing deposits | 773 | | 0.12 | 135 | 2 | 2.69 | |
| Total interest-earning assets | 538,818 | 15,642 | 5.85 | 554,117 | 17,615 | 6.39 | |
| Non-interest-earning assets | 29,027 | | | 34,743 | | | |
| Total assets | \$ 567,845 | | | \$ 588,860 | | | |

Liabilities and shareholders equity

| | | | | | | | |
|--|------------|----------|-------|------------|----------|-------|--|
| Interest-bearing liabilities: | | | | | | | |
| Other interest-bearing deposits | \$ 212,270 | \$ 1,119 | 1.06% | \$ 194,424 | \$ 1,946 | 2.01% | |
| Certificates of deposit | 172,922 | 3,210 | 3.74 | 185,263 | 4,119 | 4.47 | |
| Borrowed funds | 52,387 | 1,371 | 5.28 | 69,796 | 1,722 | 4.96 | |
| Repurchase agreements | 10,098 | 17 | 0.33 | 12,803 | 81 | 1.27 | |
| Total interest-bearing liabilities | 447,677 | 5,717 | 2.58 | 462,286 | 7,868 | 3.42 | |
| Non-interest-bearing deposits | 68,498 | | | 66,048 | | | |
| Other non-interest-bearing liabilities | 3,873 | | | 4,730 | | | |
| Shareholders equity | 47,797 | | | 55,796 | | | |
| Total liabilities and shareholders equity | \$ 567,845 | | | \$ 588,860 | | | |
| Net interest income / interest rate spread | | \$ 9,925 | 3.27% | | \$ 9,747 | 2.97% | |
| Net interest margin | | | 3.71% | | | 3.54% | |

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In the table above, interest income was adjusted to a tax-equivalent basis to recognize the income from the various tax-exempt assets as if the interest was fully taxable. This treatment allows a uniform comparison among the yields on interest-earning assets. The calculations were computed on a fully tax-equivalent basis using the corporate federal tax rate of 34%. Net interest spread represents the difference between the yield on interest-earning assets and the rate on interest-bearing liabilities. Net interest margin represents the ratio of net interest income to total average interest-earning assets.

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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 Asset Committee meets periodically to review problem loans and leases. The committee is comprised of management, including the chief risk officer, 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 loss was \$300,000 for the second quarter of 2009 and \$725,000 for the six month period ending June 30, 2009, as compared to \$125,000 for the same 2008 quarter and six month periods. A provision for loan loss was required due to internally classified credit downgrades, weakening economic conditions, plus commercial loan growth during the second quarter of 2009.

The allowance for loan losses was \$5,216,000 at June 30, 2009 compared to \$4,189,000 at June 30, 2008. 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, 2009 and December 31, 2008", below.

Other income

In the second quarter of 2009, other (non-interest) income increased \$193,000, or 15%, to \$1,458,000 from \$1,265,000 recorded in second quarter of 2008. The increase was the result of higher volumes of mortgage origination / refinance activity that has been prevalent throughout 2009. Most fixed-rate mortgage loan originations are sold into the secondary market with gains of \$328,000 recognized during the current year quarter compared to \$60,000 recognized during the same 2008 quarter. A decrease in the volume of deposit overdraft transactions has resulted in an \$89,000 decline in service charges on deposit accounts for the three months ended June 30, 2009 compared to the three months ended June 30, 2008.

For the six months ended June 30, 2009, other income improved by \$210,000, or 8%, compared to the six months ended June 30, 2008. In the first half of 2009, the Company sold \$74,148,000 of residential mortgage loans and recognized gains of \$818,000. Included in these sales were \$10,838,000 of loans transferred from the loan and lease portfolio to loans AFS during the first quarter of the current year and simultaneously sold. Partially offsetting this gain was a non-cash OTTI charge of \$326,000 from the investment portfolio. The OTTI charge is related to the Company's investment in a pooled trust preferred security. The carrying value of this security was further written down to its fair market value during the first half of 2009 as management has deemed the additional impairment to be other-than-temporary. There was no similar OTTI charge during the first half of 2008. Service charges from deposit accounts declined \$220,000, or 15%, due to lower volumes of overdraft transactions.

Other operating expenses

For the quarter ended June 30, 2009, other (non-interest) expenses increased \$294,000, or 7%, compared to the quarter ended June 30, 2008. In the second quarter of 2009, the Company's FDIC insurance premium was \$321,000 greater than the premium incurred in the 2008 quarter. The increase was caused by the \$255,000, 5 basis points on total assets less tier I capital, special assessment imposed by the FDIC to all member-insured banks on June 30, 2009. The increase in premises and equipment is from added depreciation expense for the new West Scranton branch expansion project that opened in the third quarter of 2008, property insurance and increased equipment maintenance in information technology.

For the six months ended June 30, 2009, non-interest related expenses increased \$563,000, or 6%, compared to the six months ended June 30, 2008. The previously mentioned FDIC special assessment and increased premiums contributed to \$383,000 of the increase. The 2% increase in salary and benefits was due to a full six month of operations of the Company's

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West Scranton branch that was not operational until the third quarter of 2008, a Company's executive officer was re-employed during the middle of the first quarter of 2008 compared to a full six-month impact in the current year, higher commissions earned on production by our financial services staff, increased health care and partially offset by lower stock-based compensation. The increase in premises and equipment is from depreciation expense for the new West Scranton branch. An increase in the level of ORE, as a result of our efforts to resolve non-performing assets, resulted in a \$126,000 increase in the costs associated with foreclosure and the resultant operating costs of property ownership.

Provision for income taxes

The provision for income taxes for the three- and six- months ended June 30, 2009 was lower compared to the same periods in 2008 primarily from lower pretax income.

Comparison of financial condition at

June 30, 2009 and December 31, 2008

Overview

Consolidated assets declined \$15,265,000, or 3%, during the six months ended June 30, 2009. The decline was caused by a \$39,249,000, or 43%, reduction in total borrowings, partially offset by a \$20,561,000, or 4%, increase in total deposits. The reduction in borrowings was from implementing a de-leveraging strategy, during the first quarter that used the proceeds from the sale of residential mortgage loans to reduce a FHLB advance that was scheduled to mature during the second quarter of 2009. The increase in deposits was used to reduce overnight borrowings and fund commercial loan growth.

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, 2009, the carrying value of investment securities totaled \$77,319,000, or 14% of total assets, compared to \$84,187,000, or 15% of total assets, at December 31, 2008. At June 30, 2009, approximately 14% of the carrying value of the investment portfolio was comprised of mortgage-backed securities that amortize and provide monthly cash flow. Agency, municipal and corporate bonds comprised 40%, 35% and 11%, respectively, of the investment portfolio at June 30, 2009.

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During the six months ended June 30, 2009, total investments decreased \$6,868,000, net of a \$1,444,000 decline in the market value of AFS investments. The investment securities are comprised of HTM and AFS securities with carrying values of \$843,000 and \$76,014,000, respectively. As of June 30, 2009, the AFS debt securities were recorded with a net unrealized loss in the amount of \$14,964,000 and equity securities were recorded with an unrealized net gain of \$140,000.

A comparison of investment securities at June 30, 2009 and December 31, 2008 is as follows (dollars in thousands):

| | June 30, 2009 | | December 31, 2008 | |
|-----------------------------------|---------------|-------|-------------------|-------|
| | Amount | % | Amount | % |
| U.S. government agencies | \$ 30,632 | 39.6 | \$ 43,507 | 51.6 |
| Mortgage-backed securities | 10,604 | 13.7 | 12,439 | 14.8 |
| State & municipal subdivisions | 27,358 | 35.4 | 17,553 | 20.9 |
| Pooled trust preferred securities | 8,263 | 10.7 | 10,260 | 12.2 |
| Equity securities | 462 | 0.6 | 428 | 0.5 |
| Total investments | \$ 77,319 | 100.0 | \$ 84,187 | 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. Inputs provided by the third party are reviewed and corroborated by management. Evaluations of the causes of the unrealized losses are performed to determine whether impairment, if any, is temporary or other-than-temporary. Considerations such as the Company's intent and ability to hold the securities to maturity, recoverability of the invested amounts over the intended holding period, the length of time and the severity in pricing decline below cost, the

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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.

During 2008 and today, uncertainty in the financial markets increased the volatility in fair value estimates for the securities in our investment portfolio. Compared to year-end 2008, the fair values of securities have declined. Management believes these changes were due mainly to interest rate changes and liquidity problems in the financial markets, not deterioration in the creditworthiness of the issuers.

At June 30, 2009 and December 31, 2008, the securities with the most significant reductions in fair value and associated estimated unrealized losses were in the Company's corporate bond portfolio consisting of pooled trust preferred securities issued by banks, thrifts and insurance companies.

Except for the 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 portfolio, management was unable to obtain readily attainable and realistic pricing from market traders due to a lack of active market participants and therefore management has determined that the market for these securities is inactive.

The Company owns 13 tranches of pooled trust preferred securities. The market for these securities at June 30, 2009 is inactive and markets for similar securities were also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which pooled trust preferred securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive as no new pooled trust preferred securities have been issued 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, we determined:

- The few observable transactions and market quotations that were available were not reliable for purposes of determining fair value at June 30, 2009,
- An income valuation approach (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at prior measurement dates, and
- The pooled preferred trust securities are classified within Level 3 of the fair value hierarchy because significant adjustments are required to determine fair value at the measurement date. Our pooled preferred trust securities valuations were prepared by an independent third party. Their approach to determine fair value involved the following:

- Data about the issue structure as defined in the indenture and the underlying collateral were collected,
- The credit quality of the collateral is estimated using average probability of default values for each issuer (adjusted for rating levels and stressed to reflect the current environment),
- 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),
- The loss given default was assumed to be 100%,
- The cash flows were forecast at no prepayments and zero recovery for the underlying collateral and applied to each tranche to determine the resulting distribution among the securities,
- The expected cash flows were discounted at 300 basis points over Libor to calculate the present value of the security,
- The effective discount rates on an overall basis range from 3.28% to 16.73% and are highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the security and the prepayment assumptions, and
- The calculations were modeled in ten thousand scenarios using a Monte Carlo engine to establish a distribution of intrinsic values and the average was used for valuation purposes.

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Based on the technique described, the Company determined that as of June 30, 2009, the fair value of one pooled trust preferred security, PreTSL VII, had declined \$326,000 below its amortized cost basis and since the present value of the security's expected cash flows was insufficient to recover the entire amortized cost basis, the security is deemed to have experienced credit related other-than-temporarily impairment and the full amount was charged to current earnings as a component of other income in the consolidated income statement for the six months ended June 30, 2009. Excluding the impairment, the market value of the Company's investment in pooled trust preferred securities has declined by \$6,040,000 since December 31, 2008. The Company closely monitors the pooled trust preferred securities market and performs collateral sufficiency and cash flow analyses on at least a quarterly basis. Future analyses could yield results that may indicate further impairment has occurred and therefore require additional write-downs and corresponding other-than-temporary charges to current earnings. There were no OTTI charges recorded during the first six months of 2008.

On July 15, 2009, an issuer in several of the pooled trust preferred securities that the Company owns announced its intent to defer future payment of interest on its pooled trust preferred securities. After performing initial analysis of the impact of this deferral on cash flow projections, management believes that it is possible for this event to negatively impact the cash flow projections on two of the pooled trust preferred securities owned by the Company. As of June 30, 2009, the Company's investment in these two securities, PreTSL V and PreTSL VII, amounted to \$276,000 and \$777,000 with corresponding fair values of \$259,000 and \$406,000, respectively. It appears that these securities credit enhanced subordinate collateral will not be sufficient to cover the interest due and therefore it is possible that the Company may be required to charge additional credit related OTTI to current earnings during the third quarter of 2009. Management is in the process of evaluating the impact of this event.

At June 30, 2009, the AFS debt securities portfolio was carried with a net unrealized loss of \$14,964,000 compared to a net unrealized loss of \$13,486,000 at December 31, 2008. Management believes the cause of the unrealized losses is related to changes in interest rates or the limited trading activity due to recent debt market illiquid conditions and is not directly or fully related to credit quality, which is consistent with its past experience. In addition, the Company has no intent to sell the securities and it is more likely than not that the Company will not be required to sell the securities before recovery of its amortized cost basis. As of June 30, 2009, the Company has the ability and intent to hold its investments for a period of time sufficient for the fair value of the securities to recover, which may be at maturity. For a further discussion on the investment securities portfolio, see note 3, Investment securities of the notes to the consolidated financial statements in Part I, Item I, herein.

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 borrowings decline to a predetermined level. Throughout most of 2008, the Company earned a return or dividend on the amount invested. In late December 2008, the FHLB announced that it had suspended the payment of dividends and the repurchase of excess capital stock to preserve its capital level. That decision was based on FHLB's analysis and consideration of certain negative market trends and the impact those trends had on their financial condition. Based on the financial results of the FHLB for the year-ended December 31, 2008 and the first quarter of 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 the 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. The Company will continue to monitor the financial condition of the FHLB quarterly to assess its ability to resume these activities in the future.

Loans available-for-sale (AFS)

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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, 2009 amounted to \$2,288,000 with a corresponding fair value of \$2,308,000, compared to \$84,000 and \$85,000, respectively, at December 31, 2008. During the six months ended June 30, 2009, residential mortgage loans with principal balances of \$73,329,000 were sold into the secondary market with net gains of approximately \$818,000 recognized. Included in the sale was \$10,838,000 of residential loans transferred from the loan and lease portfolio during the first quarter of 2009.

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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 levels. The broad spectrum of products provides diversification that helps manage, to an extent, interest rate and credit concentration risk. Credit risk is further managed through underwriting policies and procedures and loan monitoring practices. Interest rate risk is managed using various asset/liability modeling techniques and analyses. The interest rates on most commercial loans are adjustable with reset intervals of five years or less.

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 generally involve a greater degree of credit risk than consumer lending because they typically 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, 2009 and December 31, 2008, is summarized as follows (dollars in thousands):

| | June 30, 2009 | | December 31, 2008 | | Variance | % |
|---------------------------|---------------|-------|-------------------|-------|-------------|--------|
| | Amount | % | Amount | % | | |
| Real estate: | | | | | | |
| Commercial | \$ 181,990 | 42.8 | \$ 164,772 | 37.4 | \$ 17,218 | 10.4 |
| Residential | 72,059 | 17.0 | 98,510 | 22.3 | (26,451) | (26.9) |
| Construction | 8,568 | 2.0 | 11,427 | 2.6 | (2,859) | (25.0) |
| Commercial and industrial | 79,002 | 18.5 | 80,708 | 18.3 | (1,706) | (2.1) |
| Consumer | 83,122 | 19.6 | 85,091 | 19.3 | (1,969) | (2.3) |
| Direct financing leases | 403 | 0.1 | 444 | 0.1 | (41) | (9.2) |
| Gross loans | 425,144 | 100.0 | 440,952 | 100.0 | \$ (15,808) | (3.6) |
| Allowance for loan losses | (5,216) | | (4,745) | | | |
| Net loans | \$ 419,928 | | \$ 436,207 | | | |

Gross loans decreased from \$440,952,000, as of December 31, 2008 to \$425,144,000 at June 30, 2009. The decline was predominately from the transfer from the loan and lease portfolio, to the AFS portfolio, and simultaneous sale of \$10,838,000 of residential mortgage loans during the first quarter of 2009. The balance of the decline is mostly from net pay-downs during the first half of 2009 as borrowers' sentiment, during this low-rate environment, is to re-finance their existing mortgage and home equity debt into new mortgage loans. Most of the mortgage loans that were originated in the first half of 2009 were sold on a servicing-retained basis. New commercial business and relationship emphasis has resulted in an increase in commercial real estate loans of \$17,218,000, or 10%.

Allowance for loan losses

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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:

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- 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 (five-year average) to pools to determine the allowance allocation; and
- application of qualitative factor adjustment percentages for trends or estimated future changes in the loan portfolio.

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. 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 Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, (SFAS 114). The Special Assets Committee's focus is on ensuring the pertinent facts are considered and the SFAS 114 reserve amounts 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, 2009, were \$254,000, compared to \$761,000 in the first half of 2008. The higher level of charge-offs recorded in the previous year resulted primarily from the resolution of an impaired commercial real estate loan and the partial charge-off of a commercial real estate loan for which specific reserves had been allocated. Commercial real estate loan net charge-offs of \$9,000 were recorded during the six months ending June 30, 2009 versus \$535,000 at June 30, 2008. Commercial and industrial loan net charge-offs were \$116,000 for the six months ending June 30, 2009 compared to net recoveries of \$25,000 in the same period of 2008. Residential real estate loan net charge-offs totaled \$3,000 for the six months ending June 30, 2009 compared to \$32,000 in the like period of 2008. Consumer loan net charge-offs of \$126,000 were recorded during the six months ending June 30, 2009 versus \$218,000 at June 30, 2008. 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. 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.

Management believes that the current balance in the allowance for loan losses of \$5,216,000 is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but are inherent to the portfolio. At June 30, 2009, management was unaware of any potential problem loans that have not been reviewed. 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. However, there could be certain instances which become identified over the upcoming year that may require additional charge-offs and/or increases to the allowance. The ratio of allowance for loan losses to total loans was 1.22% at June 30, 2009 compared to 1.00% at June 30, 2008.

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

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| | As of and for the six months ended June 30, 2009 | As of and for the twelve months ended December 31, 2008 | As of and for the six months ended June 30, 2008 |
|---------------------------------|--|---|--|
| Balance at beginning of period | \$ 4,745,234 | \$ 4,824,401 | \$ 4,824,401 |
| Provision charged to operations | 725,000 | 940,000 | 125,000 |
| Charge-offs: | | | |
| Real estate: | | | |
| Commercial | 24,932 | 565,193 | 553,193 |
| Residential | 3,158 | 44,800 | 31,870 |
| Commercial and industrial | 118,520 | 168,021 | 33,836 |
| Consumer | 133,617 | 350,856 | 236,797 |
| Total | 280,227 | 1,128,870 | 855,696 |
| Recoveries: | | | |
| Real estate: | | | |
| Commercial | 15,808 | 18,020 | 18,020 |
| Residential | | 97 | 50 |
| Commercial and industrial | 2,075 | 61,233 | 58,462 |
| Consumer | 7,846 | 30,353 | 18,334 |
| Total | 25,729 | 109,703 | 94,866 |
| Net charge-offs | 254,498 | 1,019,167 | 760,830 |
| Balance at end of period | \$ 5,215,736 | \$ 4,745,234 | \$ 4,188,571 |
| Total loans, end of period | \$ 427,432,128 | \$ 441,036,694 | \$ 418,650,319 |

| | As of and for the six months ended June 30, 2009 | As of and for the twelve months ended December 31, 2008 | As of and for the six months ended June 30, 2008 |
|--|--|---|--|
| Net charge-offs to: | | | |
| Loans, end of period | 0.06% | 0.23% | 0.18% |
| Allowance for loan losses | 4.88% | 21.48% | 18.16% |
| Provision for loan losses | 0.35x | 1.08x | 6.09x |
| Allowance for loan losses to: | | | |
| Total loans | 1.22% | 1.08% | 1.00% |
| Non-accrual loans | 0.70x | 1.36x | 1.14x |
| Non-performing loans | 0.69x | 1.16x | 1.09x |
| Net charge-offs | 20.49x | 4.66x | 5.51x |
| Loans 30-89 days past due and still accruing | \$ 2,360,786 | \$ 1,858,481 | \$ 2,199,056 |
| Loans 90 days past due and accruing | \$ 180,800 | \$ 604,140 | \$ 177,431 |
| Non-accrual loans | \$ 7,398,505 | \$ 3,493,169 | \$ 3,667,929 |
| Allowance for loan losses to loans 90 days or more past due and accruing | 28.85x | 7.85x | 23.61x |

Non-performing assets

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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) and repossessed assets. As of June 30, 2009, non-performing assets represented 1.57% of total assets compared to 0.79% at June 30, 2008. The increase was driven by the higher level of non-accrual loans and ORE at June 30, 2009.

In the review of loans for both delinquency and collateral sufficiency, management concluded that there were a number of

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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 majority of the non-performing assets for the period are attributed to non-accruing commercial real estate loans, non-accruing residential real estate loans and ORE. Most of the loans are collateralized, thereby mitigating the Company's potential for loss. At June 30, 2009 non-performing loans were \$7,579,000 compared to \$4,097,000 at December 31, 2008. During the first quarter of this year, the Company was notified by a customer of a significant adverse business event causing management to place the customer's \$3,300,000 loan relationship on non-accrual status. Management does not expect this will have a material impact on income going forward. Action plans for the resolution of each of the Company's non-performing loans have been developed and are periodically updated as needed. There were no restructured loans or repossessed assets at June 30, 2009 or at December 31, 2008. ORE at June 30, 2009 was \$1,199,000 and consisted of four properties of which two had an agreement to sell. At June 30, 2009, the non-accrual loans aggregated \$7,399,000 as compared to \$3,493,000 at December 31, 2008. Additions to the non-accrual component of the non-performing assets totaling \$5,009,000 were made during the first six months of the year. These were partially offset by reductions or payoffs of \$681,000, charge-offs of \$213,000, \$132,000 of transfers to ORE and \$77,000 of loans that returned to performing status. Loans past due 90 days or more and accruing declined to \$181,000 at June 30, 2009, from \$604,000, at December 31, 2008. Non-performing loans to net loans were 1.80% at June 30, 2009, and 0.94% at December 31, 2008. The percentage of non-performing assets to total assets was 1.57% at June 30, 2009, an increase from 0.96% at December 31, 2008, primarily due to the aforementioned increase in the non-accrual loans component.

The 30-89 day past due loans at June 30, 2009 were \$2,361,000 and \$1,858,000 at December 31, 2008.

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

| | June 30, 2009 | December 31, 2008 | June 30, 2008 |
|---|----------------|-------------------|----------------|
| Loans past due 90 days or more and accruing | \$ 180,800 | \$ 604,140 | \$ 177,431 |
| Non-accrual loans | 7,398,505 | 3,493,169 | 3,667,929 |
| Total non-performing loans | 7,579,305 | 4,097,309 | 3,845,360 |
| Other real estate owned | 1,199,060 | 1,450,507 | 897,036 |
| Total non-performing assets | \$ 8,778,365 | \$ 5,547,816 | \$ 4,742,396 |
| Net loans including AFS | \$ 422,216,392 | \$ 436,291,460 | \$ 414,461,748 |
| Total assets | \$ 560,454,208 | \$ 575,718,997 | \$ 598,563,896 |
| Non-accrual loans to net loans | 1.75% | 0.80% | 0.88% |
| Non-performing assets to net loans, foreclosed real estate and repossessed assets | 2.07% | 1.27% | 1.14% |
| Non-performing assets to total assets | 1.57% | 0.96% | 0.79% |
| Non-performing loans to net loans | 1.80% | 0.94% | 0.93% |

Foreclosed assets held-for-sale

Foreclosed assets held-for-sale, consisting of ORE, was \$1,199,000 at June 30, 2009 comprised of four properties, two of which were under an agreement to be sold. The remaining two properties are listed for sale with a realtor.

Other assets

Pending receivable of securities purchases of \$2,632,000 was the primary cause of other assets to increase \$3,684,000, or 41%, during the first half of 2009. The purchases, which included agency and municipal obligations, settled in July 2009. Further contributing to the increase in other assets, the Company's deferred tax asset increased \$358,000 on further declines in the investment portfolio and mortgage servicing rights increased \$436,000 due to high volume of mortgage real estate sales that the Company normally sells into the secondary market on a serving-retained basis.

Deposits

The Bank is a community-based commercial financial institution, member FDIC, which offers a variety of deposit accounts with varying ranges of interest rates and terms. Deposit products include savings accounts, 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 ranging from seven days to ten years. The flow of deposits is

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significantly influenced by general economic conditions, changes in prevailing interest rates, pricing and competition. Most of the Company's deposits are obtained from the communities surrounding its 12 branch offices and are insured by the FDIC up to the full extent permitted by law. The Bank attempts to attract and retain deposit customers via sales and marketing efforts, new products, quality service, competitive rates and maintaining long-standing customer relationships. To determine deposit product interest rates, the Company considers local competition, market yields and the rates charged for alternative sources of funding such as borrowings. Though we continue to experience intense competition for deposits, our rate-setting strategy includes consideration of liquidity needs, balance sheet structure and cost effective strategies that are mindful of the current interest rate environment.

Compared to December 31, 2008 total deposits grew \$20,561,000, or 5%, during the six month period ending June 30, 2009. The growth in total deposits was due to increases in money market, NOW and savings accounts of \$17,115,000, or 18%, \$6,919,000, or 14%, and \$3,159,000, or 8%, respectively, partially offset by lower DDA and CD balances. The opening of the West Scranton branch during the third quarter of 2008 and bank-wide money market promotions that the Company attempts to customize to personal and non-personal needs of our customers contributed to growth in deposits during the first half of 2009. On July 20, 2009, the Company closed its Wyoming Avenue, Scranton branch and consolidated with the Financial Center branch located on North Washington Avenue, Scranton. The consolidation is not expected to have a material effect on the Company's deposits.

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

| | June 30, 2009 | | December 31, 2008 | |
|-------------------------|----------------|-------|-------------------|-------|
| | Amount | % | Amount | % |
| Money market | \$ 113,852,919 | 25.1 | \$ 96,738,006 | 22.3 |
| NOW | 57,042,434 | 12.5 | 50,123,744 | 11.6 |
| Savings and club | 44,485,585 | 9.8 | 41,326,616 | 9.5 |
| Certificates of deposit | 162,400,639 | 35.8 | 173,680,915 | 40.1 |
| CDARS | 6,588,600 | 1.5 | | |
| Total interest-bearing | 384,370,177 | 84.7 | 361,869,281 | 83.5 |
| Non-interest-bearing | 69,503,187 | 15.3 | 71,442,651 | 16.5 |
| Total deposits | \$ 453,873,364 | 100.0 | \$ 433,311,932 | 100.0 |

Certificates of deposit of \$100,000 or more aggregated \$62,800,000 and \$74,250,000 at June 30, 2009 and December 31, 2008, respectively. Certificates of deposit of \$250,000 or more aggregated \$22,334,000 and \$35,108,000 at June 30, 2009 and December 31, 2008.

During the first quarter of 2009, the Company began to use the Certificate of Deposit Account Registry Service (CDARS) in order to obtain FDIC insurance protection for customers who have large deposits that at times exceed the FDIC maximum amount of \$250,000. In the CDARS program, deposits are sold at varying terms and interest rates, are originated in our own market place and are placed with 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 we place with network institutions, we can receive from network institutions deposits that are approximately equal in amount of what was placed for our customers. Deposits that we receive, or reciprocal deposits, from other institutions are considered brokered deposits. As of June 30, 2009, CDARS represented \$6,589,000, or 2%, of total deposits.

Approximately 51% of total CDs are scheduled to mature in 2009. Renewing CDs may re-price to 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. To help reduce the financial impact of the unpredictable and highly volatile interest rate environment, management will

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deploy prudent strategies that will diversify the deposit mix across the entire spectrum of products offered. Although we continue to experience intense competition for deposits, we have not adjusted rates above market levels as we consider cost effective strategies as well as relationship retention and development when setting interest rates on deposit accounts.

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 security interest in qualified investment securities of the Bank and 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

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excess DDA funds are transferred, or swept, into an overnight interest-bearing repurchase agreement account. The balance in customer repurchase agreement accounts can fluctuate daily because the daily sweep product is dependent on the level of available funds in depositor accounts. In addition, short-term borrowings may include overnight balances which the Bank may require to fund daily liquidity needs. Overnight balances and repurchase agreements are components of short-term borrowings and FHLB advances are components of long-term debt on the consolidated balance sheets.

The following table represents the components of borrowings as of June 30, 2009 and December 31, 2008 (dollars in thousands):

| | June 30, 2009 | | December 31, 2008 | | |
|----------------------------|---------------|--------|-------------------|--------|-------|
| | Amount | % | Amount | % | |
| Overnight borrowings | \$ | | \$ | 25,668 | 28.5 |
| Repurchase agreements | | 7,895 | | 11,412 | 12.6 |
| Demand note, U.S. Treasury | | 985 | | 1,050 | 1.2 |
| FHLB advances | | 42,000 | | 52,000 | 57.7 |
| Total borrowings | \$ | 50,880 | \$ | 90,130 | 100.0 |

Borrowings have decreased \$39,250,000, or 44%, during the six months ended June 30, 2009. Overnight borrowings and FHLB advances have declined as a result of the Company's balance sheet de-leveraging and deposit generation. The reduction in repurchase agreements was caused by a combination of pricing and the volatile nature of the sweep product.

Accrued interest payable and other liabilities

The \$3,261,000 increase in accrued expenses and other liabilities stems from the securities purchase commitments that settled in July 2009.

Item 3. Quantitative and Qualitative Disclosure About Market RiskManagement 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.

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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

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computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest-sensitive assets and liabilities in order to determine what impact these rate changes will have upon the net interest spread. At June 30, 2009 the Bank maintained a one-year cumulative gap of positive \$16.5 million, or 2.95%, 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, 2009 (dollars in thousands):

| | Interest sensitivity gap at June 30, 2009 | | | | | Total |
|---|---|---------------------------|-----------------------|---------------------|----|---------|
| | Three months or less | Three to twelve months | One to three years | Over three years | | |
| Cash and cash equivalents | \$ 4,634 | \$ | \$ | \$ 10,936 | \$ | 15,570 |
| Investment securities (1)(2) | 24,499 | 4,509 | 15,373 | 37,720 | | 82,101 |
| Loans (2) | 119,890 | 64,396 | 99,761 | 138,169 | | 422,216 |
| Fixed and other assets | | 8,962 | | 31,605 | | 40,567 |
| Total assets | \$ 149,023 | \$ 77,867 | \$ 115,134 | \$ 218,430 | \$ | 560,454 |
| Total cumulative assets | \$ 149,023 | \$ 226,890 | \$ 342,024 | \$ 560,454 | | |
| Non-interest bearing transaction | | | | | | |
| deposits (3) | \$ | \$ 6,950 | \$ 19,113 | \$ 43,440 | \$ | 69,503 |
| Interest-bearing transaction deposits (3) | 62,771 | | 58,018 | 94,592 | | 215,381 |
| Time deposits | 55,402 | 76,365 | 29,190 | 8,032 | | 168,989 |
| Repurchase agreements | 7,895 | | | | | 7,895 |
| Short-term borrowings | 986 | | | (1) | | 985 |
| Long-term debt | | | 21,000 | 21,000 | | 42,000 |
| Other liabilities | | | | 6,578 | | 6,578 |
| Total liabilities | \$ 127,054 | \$ 83,315 | \$ 127,321 | \$ 173,641 | \$ | 511,331 |
| Total cumulative liabilities | \$ 127,054 | \$ 210,369 | \$ 337,690 | \$ 511,331 | | |
| Interest sensitivity gap | \$ 21,969 | \$ (5,448) | \$ (12,187) | \$ 44,789 | | |
| Cumulative gap | \$ 21,969 | \$ 16,521 | \$ 4,334 | \$ 49,123 | | |
| Cumulative gap to total assets | 3.92% | 2.95% | 0.77% | 8.76% | | |

(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 mortgage-backed securities, 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

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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, 2009 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, 2009 levels:

| | Rates +200 | Rates -200 |
|--|------------|------------|
| Earnings at risk: | | |
| Percent change in: | | |
| Net interest income | 0.7% | 4.5% |
| Net income | 3.7 | 17.0 |
| Economic value at risk: | | |
| Percent change in: | | |
| Economic value of equity | (31.6) | 0.2 |
| Economic value of equity as a percent of book assets | (2.7) | 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%. At June 30, 2009, the Company's risk-based capital ratio was 11.7%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning July 1, 2009 under alternate interest rate scenarios using the income simulation model described above (dollars in thousands):

| Change in interest rates | Net interest income | \$ variance | % variance |
|--------------------------|---------------------|-------------|------------|
|--------------------------|---------------------|-------------|------------|

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| | | | | | |
|-------------------|----|--------|----|------|-------|
| +200 basis points | \$ | 19,793 | \$ | 141 | 0.7% |
| +100 basis points | | 19,574 | | (78) | (0.4) |
| Flat rate | | 19,652 | | | |
| -100 basis points | | 20,189 | | 537 | 2.7 |
| -200 basis points | | 20,540 | | 888 | 4.5 |

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. Mortgage-backed 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 provided by management. As a result, the mix of interest-earning assets and interest bearing-liabilities is held constant.

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Derivative Financial Instruments. As part of the Bank's overall interest rate risk strategy, the Company has adopted a policy whereby the Company may periodically use derivative instruments to minimize significant fluctuations in earnings caused by interest rate volatility. This interest rate risk management strategy entails the use of interest rate floors, caps and swaps. In October 2006, the Bank entered into an interest rate floor derivative agreement on \$20,000,000 notional value of its prime-based loan portfolio. The purpose of the hedge is to help protect the Bank's interest income in the event interest rates decline below a pre-determined contractual interest rate. The strategy is reflected in the scenarios for earnings and economic value at risk and the net interest income in the two immediately preceding tables. For a further discussion on the Bank's derivative contract, see note 4, Derivative instruments, contained within the notes to consolidated financial statements in Part I, Item 1.

Liquidity

Liquidity management ensures that adequate funds will be available to meet loan and investment commitments, deposit withdrawals and maturities and normal operating requirements of the Bank. Current sources of liquidity are cash and cash equivalents, asset maturities, calls and principal repayments, loans and investments AFS, growth of core deposits, growth of repurchase agreements, increases in other borrowed funds from correspondent banks and issuance of capital stock. Although regularly scheduled investment and loan payments are dependable sources 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 level of interest rates. During declining interest rate environments, 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, prepayment from interest-sensitive assets tend to decelerate causing cash flow from mortgage loans and mortgage-backed securities portfolio to decrease. Deposit inflow may 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, 2009, the Company generated approximately \$2.8 million of cash. During this period, the Company's operations provided approximately \$11.7 million primarily from the sales of mortgages AFS net of originations and the investing activities provided approximately \$10.4 million from pay-downs of loans and bonds and from the sale of foreclosed properties held-for-sale. Partially offsetting these cash generators was a use of \$19.3 million in financing activities, mostly from the pay-down of total borrowings net of deposit growth. As of June 30, 2009, the Company maintained \$15.6 million of cash and cash equivalents, \$76.5 million of investments AFS and \$2.3 million of loans AFS. In addition, as of June 30, 2009 the Company had approximately \$168.0 million available to borrow from the FHLB and \$30.0 million available from other correspondent banks. This combined total of \$292.4 million represented 52% of total assets at June 30, 2009. Management believes this level of liquidity to be strong and adequate to support current operations.

Management identified over \$20 million in large municipal and corporate deposits that may depart over the next six months and if so, will be replaced with borrowings.

In October 2008, the FDIC announced the Temporary Liquidity Guarantee Program (TLGP) to strengthen confidence and encourage liquidity in the banking system. Among other things, this new program provides full deposit insurance coverage for non-interest bearing deposit transaction accounts in FDIC-insured institutions regardless of the dollar amount. To protect its depositors, the Company is participating in the TLGP. Under the TLGP, all depositors who hold funds in non-interest bearing accounts, or interest-bearing accounts with an interest rate of 0.50% or less, including the Lawyers Trust Accounts, will have a temporary unlimited guarantee from the FDIC until December 31, 2009. TLGP may be extended into 2010 with a higher premium as much as 50 basis points. Management has not assessed if the Company will elect the extension and take on the much higher costs. The coverage of the TLGP is in addition to and separate from coverage available under the FDIC's general deposit insurance rules, which insures accounts up to \$250,000 until the end of 2013 unless extended.

Capital

During the six months ended June 30, 2009, shareholders' equity increased modestly, or \$162,000, due principally from net income generated during the period and issuance of common stock via the Company's Employee Stock Purchase and Dividend Reinvestment Plans partially offset by increased unrealized net losses in the securities AFS portfolio, the declaration of cash dividends and a decline in the intrinsic value of the Company's cash flow hedge.

As of June 30, 2009, the Company reported a net unrealized loss of \$9,785,000, net of tax, from the securities AFS portfolio compared to a net unrealized loss of \$8,831,000 as of December 31, 2008. The increase in the unrealized loss during the first half of 2009 was caused by the prolonged economic downturn which has created uncertainty and in certain circumstances illiquidity in the financial and capital markets and has had a sizable negative impact on the fair value estimates for securities in banks' investment portfolios. Management believes 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. For a further discussion on the fair value determination of the Company's investment portfolio, see "Investment securities" under the

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caption Comparison of financial condition at June 30, 2009 and December 31, 2008 of Part 1, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations; and notes 3 and 5, Investment securities and Fair value measurement in the notes to the consolidated financial statements, incorporated by reference in Part I, Item 1.

During the second quarter of 2008, the Company's Board of Directors announced its intent to initiate a capital stock repurchase program covering up to 50,000 shares of its outstanding capital stock. The repurchased shares would become treasury stock and could be available for issuance under the Company's various stock-based compensation, employee stock purchase and dividend reinvestment (DRP) plans and for general corporate purposes. The repurchases may be made from time-to-time in open-market transactions, subject to availability, pursuant to safe harbor rule 10b-18 under the Securities Exchange Act of 1934. Management has temporarily suspended repurchase plan activity as a prudent means, in light of the current economic pressures on banking, to preserve and grow the Company's capital base. Since the program's inception, the Company has reacquired (at \$27.83 per share) and reissued (at \$21.11 per share) 17,500 shares to participants in the Company's DRP.

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, required an increase in the risk-weighting of securities that were recently rated below investment grade, thus significantly inflating the total risk-weighted assets. Compared to December 31, 2008, the total capital and Tier I capital ratios were reduced by the increase in risk-weighted assets. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I 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, 2009, the Company and the Bank met all capital adequacy requirements to which it was subject.

The following table depicts the capital amounts and ratios of the Company and the Bank as of June 30, 2009:

| | Actual Amount | Ratio | For capital adequacy purposes | | | To be well capitalized under prompt corrective action provisions | |
|---------------------------|------------------|-------|----------------------------------|-------|---------------|--|--|
| | | | Amount | Ratio | Amount | Ratio | |
| Total capital | | | | | | | |
| (to risk-weighted assets) | | | | | | | |
| Consolidated | \$ 63,822,538 | 11.7% | \$ 43,735,644 | 8.0% | N/A | N/A | |
| Bank | \$ 63,408,547 | 11.6% | \$ 43,725,036 | 8.0% | \$ 54,656,295 | 10.0% | |
| Tier I capital | | | | | | | |
| (to risk-weighted assets) | | | | | | | |
| Consolidated | \$ 58,543,758 | 10.7% | \$ 21,867,822 | 4.0% | N/A | N/A | |
| Bank | \$ 58,192,706 | 10.7% | \$ 21,862,518 | 4.0% | \$ 32,793,777 | 6.0% | |
| Tier I capital | | | | | | | |

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(to average assets)

| | | | | | | | | | | |
|--------------|----|------------|-------|---|----|------------|---|------|-----|----------------------|
| Consolidated | \$ | 58,543,758 | 10.4% | ≥ | \$ | 22,504,276 | ≥ | 4.0% | N/A | N/A |
| Bank | \$ | 58,192,706 | 10.4% | ≥ | \$ | 22,488,506 | ≥ | 4.0% | ≥ | \$ 28,110,633 ≥ 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 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 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

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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, 2009.

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 Form 10-K filed with the Securities and Exchange Commission on March 12, 2009.

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

None

Item 3. Default Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

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At the annual meeting of shareholders held on May 5, 2009, the judges of election made the report concerning the results of balloting. Holders of 1,642,856 shares of common stock, representing 79% of the total number of shares outstanding, were represented in person or by proxy at the 2009 annual meeting of shareholders. The following votes were cast:

Election of Class A Directors to serve for a three-year term:

| | For | Withhold authority | Abstain |
|---------------------|-----------|--------------------|---------|
| John T. Cognetti | 1,632,218 | 10,638 | |
| Michael J. McDonald | 1,632,523 | 10,333 | |

In addition to the above elected Class A Directors, at the conclusion of its annual meeting, the Company's Board of Directors consisted of: Steven C. Ackmann, Brian J. Cali and Patrick J. Dempsey as Class C Directors whose term expires in 2010; and Samuel C. Cali, Mary E. McDonald and David L. Tressler, Sr. as Class B directors whose term expires in 2011. Mr. Samuel C. Cali passed away on May 21, 2009.

Ratification of independent certified public accountants:

| | For | Against | Abstain |
|-----------------------|-----------|---------|---------|
| Parente Randolph, LLC | 1,631,841 | 10,212 | 803 |

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.

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***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 and by Registration Statement No. 333-152806 on Form S-3 filed on August 6, 2008.

***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 Complete Settlement Agreement and General Release between Michael F. Marranca, Registrant and The Fidelity Deposit and Discount Bank, dated July 30, 2004.** Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on August 10, 2004.

***10.10 Amendment to the Complete Settlement Agreement and General Release between Michael F. Marranca, Registrant and The Fidelity Deposit and Discount Bank, dated November 4, 2005.** Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on November 9, 2005.

***10.11 Change of Control Agreements with Salvatore R. DeFrancesco, Registrant and The Fidelity Deposit and Discount Bank, dated**

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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.

***10.12 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.

***10.13 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.

***10.14 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.

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.**

* Management contract or compensatory plan or arrangement.

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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 12, 2009

/s/ Steven C. Ackmann
Steven C. Ackmann,
President and Chief Executive Officer

Date: August 12, 2009

/s/ Salvatore R. DeFrancesco, Jr.
Salvatore R. DeFrancesco, Jr.,
Treasurer and Chief Financial Officer

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EXHIBIT INDEX

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|---|-------------|
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| 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 and by Registration Statement No. 333-152806 on Form S-3 filed on August 6, 2008. | * |
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| 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 Complete Settlement Agreement and General Release between Michael F. Marranca, Registrant and The Fidelity Deposit and Discount Bank, dated July 30, 2004. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on August 10, 2004. | * |
| 10.10 Amendment to the Complete Settlement Agreement and General Release between Michael F. Marranca, Registrant and The Fidelity Deposit and Discount Bank, dated November 4, 2005. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on November 9, 2005. | * |
| 10.11 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. | * |
| 10.12 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 | * |

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Current Report on Form 8-K filed with the SEC on July 13, 2007.

10.13 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. *

10.14 Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount

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| <i>Bank and Daniel J. Santaniello, dated February 28, 2008.</i> Incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 3, 2008. | * |
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