

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

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2016

COMMISSION FILE NUMBER 333-90273

FIDELITY D & D BANCORP, INC.

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

BLAKELY AND DRINKER STREETS

DUNMORE, PENNSYLVANIA 18512

TELEPHONE NUMBER (570) 342-8281

SECURITIES REGISTERED UNDER SECTION 12(b) OF THE ACT:

None

SECURITIES REGISTERED UNDER SECTION 12(g) OF THE ACT:

Common Stock, without par value

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

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required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

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

Large accelerated filer Non-accelerated filer

Accelerated filer Smaller reporting  
company

(Do not check if a smaller reporting  
company)

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

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

DOCUMENTS INCORPORATED BY REFERENCE

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

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FIDELITY D & D BANCORP, INC.

PART I

Forward-Looking Statements

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

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

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

the risk that our analyses of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful.

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

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

#### ITEM 1: BUSINESS

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

The Bank has offered a full range of traditional banking services since it commenced operations in 1903. The Bank has a personal and corporate trust department and also provides alternative financial and insurance products with asset management services. A full list of services provided by the Bank is detailed in the section entitled “Products and Services” contained

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within the 2016 Annual Report to Shareholders, incorporated by reference. The service area is comprised of the Borough of Dunmore and the surrounding communities within Lackawanna and Luzerne counties in Northeastern Pennsylvania. The Company had 167 full-time equivalent employees on December 31, 2016, which includes exempt officers, exempt, non-exempt and part-time employees.

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

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

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

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

Federal and state banking laws contain numerous provisions that affect various aspects of the business and operations of the Company and the Bank. The Company is subject to, among others, the regulations of the Securities and Exchange Commission (the SEC) and the Federal Reserve Board (the FRB) and the Bank is subject to, among others, the regulations of the Pennsylvania Department of Banking and Securities, the Federal Deposit Insurance Corporation (the FDIC) and the rules promulgated by the Consumer Financial Protection Bureau (the CFPB) but continues to be

examined and supervised by federal banking regulators for consumer compliance purposes. Refer to Part II, Item 7 “Supervision and Regulation” for descriptions of and references to applicable statutes and regulations which are not intended to be complete descriptions of these provisions or their effects on the Company or the Bank. They are summaries only and are qualified in their entirety by reference to such statutes and regulations. Applicable regulations relate to, among other things:

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

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

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



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

ITEM 1A: RISK FACTORS

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

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

Risks Related to the Company's Business

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

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

The Company is subject to lending risk.

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

Commercial, commercial real estate and real estate construction loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because these loans generally have larger balances than residential

real estate loans and consumer loans, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for possible loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Company's financial condition and results of operations.

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

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

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Company's financial condition and results of operations.

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

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

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

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

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

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

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

operations.

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

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

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

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

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

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

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

The Company is subject to extensive government regulation and supervision.

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

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

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

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

From time-to-time, the Company may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new

products and services the Company may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Company's system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Company's business, results of operations and financial condition.

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

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

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

The Company's success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities engaged in by the Company can be intense and the Company may not be able to hire people or to retain

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them. The unexpected loss of services of one or more of the Company's key personnel could have a material adverse impact on the Company's business because of their skills, knowledge of the Company's market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

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

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

The Company continually encounters technological change.

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

#### Risks Associated with the Company's Common Stock

The Company's stock price can be volatile.

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

Actual or anticipated variations in quarterly results of operations.

Recommendations by securities analysts.

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

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

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

New technology used, or services offered, by competitors.

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

Failure to integrate acquisitions or realize anticipated benefits from acquisitions.

Changes in government regulations.

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

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

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

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

Risks Associated with the Company's Industry

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**ITEM 1B: UNRESOLVED STAFF COMMENTS**

None



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## ITEM 2: PROPERTIES

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

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

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

Kingston, PA

400 S. Main St.,

|              |       |                         |   |   |   |
|--------------|-------|-------------------------|---|---|---|
| Scranton, PA | Owned | West Scranton Branch(2) | x | x | x |
|--------------|-------|-------------------------|---|---|---|

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

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

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

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

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

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

### ITEM 3: LEGAL PROCEEDINGS

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



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to the business of the Company and the Bank. In addition, to management's knowledge, no governmental authorities have initiated or contemplated any material legal actions against the Company or the Bank.

## ITEM 4: MINE SAFETY DISCLOSURES

Not Applicable

## PART II

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

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

Salvatore R. DeFrancesco, Jr., Treasurer

Fidelity D & D Bancorp, Inc.

Blakely and Drinker Streets

Dunmore, PA 18512

(570) 342-8281

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

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

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

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

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

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

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

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## Performance graph

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

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

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## ITEM 6: SELECTED FINANCIAL DATA

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

(dollars in thousands except per share data)

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

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

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

Critical accounting policies

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

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

Another material estimate is the calculation of fair values of the Company's investment securities. Fair values of investment securities are determined by pricing provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. As described in Notes 1 and 4 of the consolidated financial statements, incorporated by reference in Part II, Item 8, all of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (loss) (AOCI).

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

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

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

Comparison of Financial Condition as of December 31, 2016

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

#### Executive Summary

Nationally, the unemployment rate declined from 5.0% at December 31, 2015 to 4.7% at December 31, 2016, which is considered the natural unemployment rate by many analysts. However, the unemployment rate in the Scranton-Wilkes-Barre Metropolitan Statistical Area (local) ticked up in December 2016 after hitting its lowest level since 2007 at the end of 2015. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at December 31, 2016 was 5.5%, an increase of 0.8 percentage points from 4.7% at December 31, 2015. The number of unemployed increased 18% which drove up the unemployment rate. The median home values in the region increased 1.2% from a year ago, and according to Zillow, an online database advertising firm providing access to its real estate search engines to various media outlets, values are expected to grow 1.9% during 2017. For 2017, there is considerable uncertainty about the economic effects of the legislative agenda of the Trump administration and the Republican-controlled Congress, coupled with the affects international pressures could have on the U.S. economy. In light of these expectations, we will continue to monitor the economic climate in our region and scrutinize growth prospects with credit quality as a principal consideration.

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

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

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

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

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

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

### Financial Condition

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

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



(dollars in thousands)

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

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

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

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

## Funds Provided:

## Deposits

The Company is a community based commercial depository financial institution, member FDIC, which offers a variety of deposit products with varying ranges of interest rates and terms. Generally, deposits are obtained from consumers, businesses and public entities within the communities that surround the Company's 10 branch offices and all deposits are insured by the FDIC up to the full extent permitted by law. Deposit products consist of transaction accounts including: savings; clubs; interest-bearing checking; money market and non-interest bearing checking (DDA). The Company also offers short- and long-term time deposits or certificates of deposit (CDs). CDs are deposits with stated maturities which can range from seven days to ten years. Cash flow from deposits is influenced by economic conditions, changes in the interest rate environment, pricing and competition. To determine interest rates on its deposit products, the Company considers local competition, spreads to earning-asset yields, liquidity position and rates charged for alternative sources of funding such as short-term borrowings and long-term FHLB advances.

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

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

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

Customers' interest in long-term time deposit products continues to be weak with a sustaining preference for non-maturing transaction deposits. The Company's portfolio of CDs continues to decrease; having declined \$11.4 million, or 11%, from year-end 2015. The Company expects CDs to increase 14% in 2017 mostly as a result of the Company's acquisition of all of the deposits of a bank branch. The Company's relationship strategy resulted in a successful bid for over \$10 million in public CDs to one customer in the third quarter of 2015, but otherwise the low rate environment has basically enticed customers to vacate the CD marketplace. If rates continue to rise, demand for CDs may also increase thereby possibly increasing funding costs. The Company will continue to pursue strategies to grow and retain retail and business customers with an emphasis on deepening and broadening existing and creating new relationships.

The Company uses the Certificate of Deposit Account Registry Service (CDARS) reciprocal program to obtain FDIC insurance protection for customers who have large deposits that at times may exceed the FDIC maximum amount of \$250,000 per person. In the CDARS program, deposits with varying terms and interest rates, originated in the Company's

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own markets, are exchanged for deposits of other financial institutions that are members in the CDARS network. By placing the deposits in other participating institutions, the deposits of our customers are fully insured by the FDIC. In return for deposits placed with network institutions, the Company receives from network institutions deposits that are approximately equal in amount and are comprised of terms similar to those placed for our customers. Deposits the Company receives from other institutions are considered reciprocal deposits by regulatory definitions. As of December 31, 2016 and 2015, CDARS represented \$1.1 million, or less than 1%, and \$3.4 million, or 1%, respectively, of total deposits.

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

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

Including CDARS, approximately 55% of the CDs, with a weighted-average interest rate of 0.67%, are scheduled to mature in 2017 and an additional 16%, with a weighted-average interest rate of 0.94%, are scheduled to mature in 2018. Renewing CDs may re-price to lower or higher market rates depending on the rate on the maturing CD, the pace and direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative, non-term products. As noted, the widespread preference continues for customers with maturing CDs to hold their deposits in readily available transaction accounts. The Company does not expect significant CD growth other than from the branch purchase during 2017, but will develop CD promotional programs when the Company deems that it is economically feasible to do so or when demand exists. As with all promotions, the Company will consider the needs of the customers and simultaneously be mindful of the liquidity levels and the interest rate sensitivity exposure of the Company.

#### Short-term borrowings

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

The components of short-term borrowings are as follows:

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

Repurchase agreements are non-insured interest-bearing liabilities that have a perfected security interest in qualified investments of the Company as required by the FDIC Depositor Protection Act of 2009. Repurchase agreements are offered through a sweep product. A sweep account is designed to ensure that on a daily basis, an attached DDA is adequately funded and excess funds are transferred, or swept, into an interest-bearing overnight repurchase agreement account. Due to the constant inflow and outflow of funds of the sweep product, their balances tend to be somewhat volatile, similar to a DDA. Customer liquidity is the typical cause for variances in repurchase agreements. In addition, short-term borrowings may include overnight balances which the Company may require to fund daily liquidity needs such as deposit and repurchase agreement cash outflow, loan demand and operations. Short-term borrowings decreased \$24.0 million during 2016. Less borrowing was needed because of growth in deposits during 2016. A \$48.7 million temporary deposit at the end of 2016 prevented the Company from having to use overnight borrowings at year-end. Short-term borrowings are expected to increase in 2017 to fund asset growth above deposit balance growth.

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

#### Long-term debt

As of December 31, 2016 and 2015, the Company had no long-term debt. At the end of the second quarter of 2015, the Company paid off its long-term debt, due to its high interest rate relative to other available borrowing sources, and incurred a \$0.6 million prepayment fee. As of December 31, 2016, the Company had the ability to borrow an additional \$194.3 million

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from the FHLB. During the first quarter of 2017, the Company borrowed \$10 million from the FHLB maturing in 2 years to fund investment security purchases.

Funds Deployed:

Investment Securities

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

At the time of purchase, management classifies investment securities into one of three categories: trading, available-for-sale (AFS) or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. All of the securities the Company purchases are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at fair value on the consolidated balance sheets with unrealized gains and losses, net of deferred income taxes, reported separately within shareholders' equity as a component of accumulated other comprehensive income (AOCI). Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity.

As of December 31, 2016, the carrying value of investment securities amounted to \$130.0 million, or 16% of total assets, compared to \$125.2 million, or 17% of total assets, at December 31, 2015. On December 31, 2016, 55% of the carrying value of the investment portfolio was comprised of U.S. Government Sponsored Enterprise residential mortgage-backed securities (MBS – GSE residential or mortgage-backed securities) that amortize and provide monthly cash flow that the Company can use for reinvestment, loan demand, unexpected deposit outflow, facility expansion or operations.

Investment securities were comprised of AFS securities as of December 31, 2016. The AFS securities were recorded with a net unrealized gain of \$2.1 million as of December 31, 2016 compared to a net unrealized gain of \$3.3 million as of December 31, 2015, or a net reduction of \$1.2 million during 2016. The direction and magnitude of the change in value of the Company's investment portfolio is attributable to the direction and magnitude of the change in interest rates along the treasury yield curve. Generally, the values of debt securities move in the opposite direction of the changes in interest rates. As interest rates along the treasury yield curve decline, especially at the intermediate and long end, the values of debt securities tend to rise. Whether or not the value of the Company's investment portfolio will continue to exceed its amortized cost will be largely dependent on the direction and magnitude of interest rate movements and the duration of the debt securities within the Company's investment portfolio. When interest rates rise, the market values of the Company's debt securities portfolio could be subject to market value declines.

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

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

During 2016, the carrying value of total investments increased \$4.8 million, or 4%. The Company attempts to maintain a well-diversified and proportionate investment portfolio that is structured to complement the strategic direction of the Company. Its growth typically supplements the lending activities but also considers the current and forecasted economic

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conditions, the Company's liquidity needs and interest rate risk profile. The Company expects to grow the portfolio and increase its relative size with a preference toward mortgage-backed securities. If rates rise, the strategy will provide a good source of cash flow to reinvest into higher yielding interest-sensitive assets. During the first quarter of 2017, the Company purchased approximately \$20 million of securities, primarily MBS - GSE residential, funded by \$10 million in debt maturing in two years and another \$10 million in borrowings laddered out from six months to one year matching a spread expected to produce a suitable after-tax return.

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

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

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

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

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

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



### Federal Home Loan Bank Stock

Investment in Federal Home Loan Bank (FHLB) stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB of Pittsburgh. Excess stock is repurchased from the Company at par if the amount of borrowings decline to a predetermined level. In addition, the Company earns a return or dividend based on the amount invested. The dividends received from the FHLB totaled \$54 thousand and \$123 thousand for the years ended December 31, 2016 and 2015, respectively. The reason for the decrease was the Company received a \$57 thousand one-time special dividend during the first quarter of 2015. The balance in FHLB stock was \$2.6 million and \$2.1 million as of December 31, 2016 and 2015, respectively. During 2017, the balance of FHLB stock is expected to increase to support anticipated borrowing activities.

### Loans and leases

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

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

### Commercial and industrial and commercial real estate

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

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

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

## Consumer

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

## Residential

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

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

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

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

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

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

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

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

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

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

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

#### Loans held-for-sale

Upon origination, most residential mortgages and certain Small Business Administration (SBA) guaranteed loans may be classified as held-for-sale (HFS). In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In low interest rate environments, the Company would be exposed to prepayment risk and, as rates on adjustable-rate loans decrease, interest income would be negatively affected. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as HFS. Occasionally, residential mortgage and/or other nonmortgage loans may be transferred from the loan portfolio to HFS. The carrying value of loans HFS is based on the lower of cost or estimated fair value. If the fair values of these loans decline below their original cost, the difference is written down and charged to current earnings. Subsequent appreciation in the portfolio is credited to current earnings but only to the extent of previous write-downs.

As of December 31, 2016 and 2015, loans HFS consisted of residential mortgages with carrying amounts of \$2.9 million and \$1.4 million, respectively, which approximated their fair values. During the year ended December 31, 2016, residential mortgage loans with principal balances of \$51.3 million were sold into the secondary market and the Company recognized net gains of \$1.0 million, compared to \$47.3 million and \$1.0 million, respectively during the year ended December 31, 2015. During 2015, the Company also sold five SBA guaranteed loans and recognized net

gains on these sales of \$0.2 million. The Company did not sell any SBA guaranteed loans in 2016.

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

At December 31, 2016 and 2015, the servicing portfolio balance of sold SBA loans was \$4.1 million and \$4.4 million, respectively.

#### Allowance for loan losses

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

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

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

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

Through December 31, 2016, allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk grading of individual commercial loans. Commercial loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed. The credit risk grades may be changed at any time management determines an upgrade or downgrade may be warranted. The credit risk grades for the commercial loan portfolio are taken into account in the reserve methodology and loss factors are applied based upon the credit risk grades. The loss factors applied are based upon the Company's historical experience as well as what management believes to be best practices and within common industry standards. Historical experience reveals there is a direct correlation between the credit risk grades and loan charge-offs. The changes in allocations in the commercial loan portfolio from period-to-period are based upon the credit risk grading system and from periodic reviews of the loan portfolio.

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

Net charge-offs were \$1.2 million as of the year ended December 31, 2016, \$0.7 million as of the year ended December 31, 2015 and \$0.8 million as of December 31, 2014. During the year ended December 31, 2016, no specific loan class significantly underperformed as charge-offs were taken across a variety of consumer, commercial and residential loans. Compared to December 31, 2015, charge-offs increased by \$0.5 million for the twelve months of 2016, of which \$0.4 million was taken in the commercial loan portfolio and was mostly related to three large charge-offs to three commercial loans to unrelated borrowers. The remaining \$0.1 million was taken in the consumer and mortgage portfolios across a number of loans. For a discussion on the provision for loan losses, see the "Provision for loan losses," located in the results of operations section of management's discussion and analysis contained herein.

The allowance for loan losses was \$9.4 million as of December 31, 2016, \$9.5 million as of December 31, 2015 and \$9.2 million as of December 31, 2014. Management believes that the current balance in the allowance for loan losses is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but inherent to the portfolio. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status nor past due 90 days or more. There could be additional instances which become identified in future periods that may require additional charge-offs and/or increases to the allowance due to continued sluggishness in the economy and pressure on property values. In contrast, an abrupt significant increase in the U.S. Prime lending rate could adversely impact the debt service capacity of existing borrowers' ability to repay.



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The following table sets forth the activity in the allowance for loan losses and certain key ratios for the periods indicated:

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

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



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

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

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

## Non-performing assets

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

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

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

\* In the table above, the amount includes non-accrual TDRs of \$1.5 million, \$0.9 million, \$1.0 million and \$1.1 million as of 2016, 2014, 2013 and 2012, respectively. There were no non-accrual TDRs as of December 31, 2015.

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

Non-performing loans, which consists of accruing loans that are over 90 days past due as well as all non-accrual loans, decreased \$2.0 million, or 21%, from \$9.4 million at December 31, 2015 to \$7.4 million at December 31, 2016. This decrease is attributed to the payoff of one large non-accrual loan in the commercial real estate portfolio. At December 31, 2016, the portion of accruing loans that was over 90 days past due totaled \$19 thousand and consisted of 4 auto loans with recourse to four unrelated borrowers, ranging from \$1 thousand to \$9 thousand. At December 31, 2015, the portion of accruing loans that was over 90 days past due totaled \$0.4 million and consisted of eight loans to seven unrelated borrowers ranging from less than \$1 thousand to \$0.2 million. The Company seeks payments from all past due customers through an aggressive customer communication process. A past due loan will be placed on non-accrual at the 90 day point when it is deemed that a customer is non-responsive and uncooperative to collection efforts.

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At December 31, 2016, there were 46 loans to 39 unrelated borrowers ranging from less than \$1 thousand to \$2.3 million in the non-accrual category. At December 31, 2015, there were 51 loans to 46 unrelated borrowers on non-accrual ranging from less than \$1 thousand to \$5.1 million. Non-accrual loans decreased during the twelve month period ending December 31, 2016 for the following reasons: \$7.2 million in new non-accrual loans plus capitalized expenditures on these loans were added; \$5.8 million were paid down or paid off; \$0.6 million were charged off; \$1.0 million were transferred to ORE, and \$1.4 million was moved back to accrual status.

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

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

\*Net of unearned lease revenue of \$0.5 million.

Payments received from non-accrual loans are recognized on a cost recovery method. Payments are first applied to the outstanding principal balance, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of interest income. If the non-accrual loans that were outstanding as of December 31, 2016 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of \$0.1 million.

The Company, on a regular basis, reviews changes to loans to determine if they meet the definition of a TDR. TDRs arise when a borrower experiences financial difficulty and the Company grants a concession that it would not

otherwise grant based on current underwriting standards in order to maximize the Company's recovery. TDRs aggregated \$3.4 million at December 31, 2016, a net increase of \$1.0 million, from \$2.4 million at December 31, 2015, due to the addition of one home equity line of credit (HELOC) for \$0.6 million and a residential real estate loan totaling \$0.9 million, partially offset by the payoff of a C&I loan categorized as a TDR of \$0.5 million. The \$3.4 million in TDRs as of December 31, 2016, consisted of seven commercial loans (6 CRE and 1 C&I), one residential mortgage and one consumer loan (HELOC) to six unrelated borrowers. As of December 31, 2016, two TDRs, the residential mortgage and the HELOC, were on non-accrual.

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

As of and for the year ended  
December 31, 2016

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

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As of and for the year ended December 31, 2015

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

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

## Foreclosed assets held-for-sale

Foreclosed assets held-for-sale aggregated \$1.3 million at December 31, 2016 and \$1.1 million at December 31, 2015. The following table sets forth the activity in the ORE component of foreclosed assets held-for-sale:

| (dollars in thousands)         | 2016     |      | 2015     |     |
|--------------------------------|----------|------|----------|-----|
|                                | Amount   | #    | Amount   | #   |
| Balance at beginning of period | \$ 1,074 | 14   | \$ 1,961 | 12  |
| Additions                      | 1,056    | 11   | 466      | 10  |
| Pay downs                      | (18)     |      | (1)      |     |
| Write downs                    | (80)     |      | (37)     |     |
| Sold                           | (734)    | (12) | (1,315)  | (8) |
| Balance at end of period       | \$ 1,298 | 13   | \$ 1,074 | 14  |

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

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

#### Cash surrender value of bank owned life insurance

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

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### Premises and equipment

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

### Other assets

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

### Results of Operation

#### Earnings Summary

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

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

### Overview

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



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

#### Net interest income and interest sensitive assets / liabilities

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

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

During 2017, the Company expects to operate in a gradually increasing interest rate environment. A rate environment with rising interest rates positions the Company to improve its interest income performance from new and maturing earning assets. Until there is a sustained period of yield curve steepening, with rates rising more sharply at the long end, the interest rate margin may continue to experience compression. However for 2017, the Company anticipates net interest income to improve as growth in interest-earning assets would help mitigate an adverse impact of rate movements. The Federal Open Market Committee (FOMC) adjusted the short-term federal funds rate upward only once in both 2015 and 2016, but it had a minimal effect on rates paid on funding sources. The focus for 2017 is to manage net interest income after years of a sustained low interest rate environment by maintaining a reasonable spread. Interest expense is projected to increase for 2017 from growth in deposits and borrowings and an increase in the rates paid on both. Continued growth in the loan portfolios complemented with investment security growth is expected to boost interest income, and when coupled with a proactive approach to deposit cost setting strategies should help contain the interest rate margin at acceptable levels.

The Company's cost of interest-bearing liabilities was 46 basis points for the year ended December 31, 2016 or five basis points lower than the cost for the year ended December 31, 2015. The decline in the rate paid on borrowings was the reason for the reduction. Other than retaining maturing long-term CDs, further reductions in deposit rates from the current historic low levels would have an insignificant cost-savings impact. Interest rates along the treasury yield curve have been volatile with relative stability existing only at the short end. Competition could pressure banks to increase deposit rates. On the asset side, the prime interest rate, the benchmark rate that banks use as a base rate for adjustable rate loans, rose 25 basis points at the end of 2016. If rates continue to rise in 2017, the effect could pressure net interest income if short-term rates rise more rapidly than longer-term interest rates, thereby compressing the interest rate spread. To help mitigate the impact of the imminent change to the economic landscape, the Company has successfully developed and will continue to strengthen its association with existing customers, develop new business relationships, generate new loan volumes, and retain and generate higher levels of average non-interest bearing deposit balances. Strategically deploying no- and low-cost deposits into interest – earning assets is an effective margin-preserving strategy that the Company expects to continue to pursue and expand to help stabilize net interest margin.

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

The table that follows sets forth a comparison of average balances of assets and liabilities and their related net tax equivalent yields and rates for the years indicated. Within the table, interest income was adjusted to a tax-equivalent basis, using the corporate federal tax rate of 34% to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. This treatment allows a uniform comparison among yields on interest-earning assets. Loans

include loans HFS and non-accrual loans but exclude the allowance for loan losses. Net deferred loan cost amortization of \$0.5 million in 2016, \$0.4 million in 2015 and \$0.3 million in 2014, respectively, are included in interest income from loans. Average balances are based on amortized cost and do not reflect net unrealized gains or losses. Net interest margin is calculated by dividing net interest income-FTE by total average interest-earning assets. Cost of funds includes the effect of average non-interest bearing deposits as a funding source:

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

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

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

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

Provision for loan losses

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

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

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

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- changes in risk selection and underwriting standards;
- changes in lending policies, procedures and practices;
- experience, ability and depth of lending management;
- national and local economic trends and conditions; and
- changes in credit concentrations.

For the twelve months ended December 31, 2016 and 2015, the Company recorded a provision for loan losses of \$1.0 million and \$1.1 million, respectively. The provision decreased \$0.1 million despite approximately \$41 million growth in gross loans because \$35.3 million of this growth occurred from high quality auto loans. At the same time, non-performing loans as a percentage of total loans fell 45 basis points to 1.23% at December 31, 2016 from 1.68% at December 31, 2015 indicating improvement in year-over-year asset quality. For a discussion on the allowance for loan losses, see "Allowance for loan losses," located in the comparison of financial condition section of management's discussion and analysis contained herein.

### Other income

For the year ended December 31, 2016, non-interest income amounted to \$8.0 million, a \$0.5 million, or 6%, increase compared to \$7.5 million recorded for the year ended December 31, 2015. A majority of this increase was due to \$0.4 million higher deposit service charges resulting from a new fee structure that was implemented during 2016. Debit card interchange fees and financial services revenue also contributed \$0.2 million and \$0.1 million, respectively, to the increase. Partially offsetting these items was \$0.2 million fewer gains on the sale of loans and \$0.1 million fewer gains on the sales of investment securities. During the first quarter of 2017, the Company will assume the trust accounts of a bank and as a result expects trust fiduciary fees to increase by approximately \$0.4 million for the year.

### Other operating expenses

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

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

### Provision for income taxes



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

Comparison of Financial Condition as of December 31, 2015

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

Executive Summary

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

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During 2015, our assets grew by 8% from deposit growth and retained net earnings, both of which were used to fund growth in the loan and securities portfolios. Short-term borrowings were used to pay-off high cost long-term debt.

Non-performing assets represented 1.76% of total assets as of December 31, 2015, up from 1.18% as of December 31, 2014. Although non-performing assets increased during 2015, it was mostly due to the movement of one large commercial real estate loan to non-accrual status.

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

### Financial Condition

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

### Funds Provided:

#### Deposits

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

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

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

#### Short-term borrowings

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

### Long-term debt

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

### Funds Deployed:

#### Investment Securities

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

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

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

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

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coupon rates as well as intermediate term agency bonds. The proceeds were used to reduce the Company's long-term debt with the balance retained in cash that was reinvested along with available cash holdings during the first half of 2015.

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

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

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

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

#### Federal Home Loan Bank Stock

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

#### Loans and leases

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

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

#### Commercial and industrial and commercial real estate

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

#### Consumer

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

#### Residential

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

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

#### Loans held-for-sale

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

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

Allowance for loan losses

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

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

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

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

The allocation of the allowance for the commercial loan portfolio, which is comprised of commercial real estate and commercial and industrial loans, accounted for approximately 66.6%, or \$6.4 million, of the total allowance for loan

losses at December 31, 2015, which represented a 4.2 percentage point increase from December 31, 2014. The increase in the commercial real estate and commercial and industrial allocation from December 31, 2014 to December 31, 2015 was mostly related to the addition of one large commercial non-owner occupied real estate loan into the non-accrual category.

#### Non-performing assets

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

Non-performing loans, which consists of accruing loans that are over 90 days past due as well as all non-accrual loans, increased \$4.1 million, or 77%, from \$5.3 million at December 31, 2014 to \$9.4 million at December 31, 2015. This increase was related mostly to the preemptive addition of one large commercial non-owner occupied loan to the non-accrual category of non-performing loans. At December 31, 2015, the portion of accruing loans that was over 90 days past due totaled \$0.4 million and consisted of eight loans to seven unrelated borrowers ranging from less than \$1 thousand to \$0.2 million. At December 31, 2014, the portion of accruing loans that was over 90 days past due totaled \$1.1 million and consisted of eleven loans to seven unrelated borrowers ranging from \$2 thousand to \$0.4 million.

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At December 31, 2014, there were 46 loans to 41 unrelated borrowers ranging from less than \$1 thousand to \$0.9 million in the non-accrual category. At December 31, 2015, there were 51 loans to 46 unrelated borrowers on non-accrual ranging from less than \$1 thousand to \$5.1 million. At December 31, 2014, non-accrual loans totaled \$4.2 million compared with \$9.0 million at December 31, 2015, an increase of \$4.8 million. Non-accrual loans increased during the period ending December 31, 2015 for the following reasons: \$7.5 million in new non-accrual loans plus capitalized expenditures on these loans were added; \$0.9 million were paid down or paid off; \$0.6 million were charged off; \$0.5 million were transferred to ORE, \$0.1 million was moved back to accrual status and \$0.6 million were sold in the secondary market.

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

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

### Foreclosed assets held-for-sale

Foreclosed assets held-for-sale aggregated \$1.1 million at December 31, 2015 and \$2.0 million at December 31, 2014. As of December 31, 2015, ORE consisted of fourteen properties from thirteen unrelated borrowers totaling \$1.1 million. Six of these properties (\$0.4 million) were added in 2015; three were added in 2014 (\$0.1 million); two were added in 2013 (\$0.2 million); two were added in 2012 (\$0.3 million); and one was added in 2011 (\$0.1 million). In addition, of the fourteen properties, nine (\$0.8 million) were either listed for sale or awaiting listing, while the remaining properties (five totaling \$0.3 million) are either in litigation, awaiting closing, have disposition plans or are undergoing renovations.

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

### Premises and equipment

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

### Other assets

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

## Results of Operations

### Overview

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



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

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

#### Net interest income and interest sensitive assets / liabilities

Net interest income increased \$1.6 million, or 7%, from \$21.9 million for the year ended December 31, 2014 to \$23.5 million for the year ended December 31, 2015, with higher interest income and lower interest expense combining for the net increase. Total average interest-earning assets increased \$52.1 million and helped offset the negative impact of a fifteen basis point net reduction in their yields resulting in \$1.2 million of growth in interest income. In the loan portfolio, the Company experienced average balance growth of \$39.1 million, which had the effect of producing \$1.1 million of interest income, more than offsetting the \$0.6 million negative impact of a 13 basis point lower yield earned thereon. Though all loan portfolios showed more interest income from growth, the mortgage loan portfolio had the most accretive impact due to the Company's mortgage modification program. This program offered mortgage customers, both secondary-market compliant and held for portfolio, shorter-termed loans with current interest rates for a flat fee. Higher average balances of municipal and mortgage-backed securities produced \$0.1 million in additional interest income from investments despite lower yields. On the liability side, total interest-bearing liabilities grew \$40.3 million on average but a thirteen basis point decline in the average rates paid offset the impact of this growth. The reduction in average rate paid was due to the \$10 million payoff of long-term debt carrying an interest rate of 5.26% during the second quarter of 2015 which reduced interest expense from borrowings by \$0.6 million. This decrease was partially offset by an increase of \$0.2 million in interest expense paid on deposits due to higher average balances. Interest expense from interest-bearing transaction deposits increased \$0.3 million

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mostly due to higher average balances from successful relationship-building efforts, promotions, cross-selling, transfers from unpopular certificates of deposit, or CDs, and contractual and negotiated rates. The increase in interest expense from transaction deposits was partially offset by a \$0.1 million decline in interest expense from CDs due to lower rates paid.

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

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

### Provision for loan losses

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

### Other income

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

### Other operating expenses

For the year ended December 31, 2015, total other operating expenses increased \$1.3 million, or 7%, compared to the year ended December 31, 2014. Salary and employee benefits contributed the most to the increase rising \$0.6 million, or 6%, in 2015 compared to 2014. The basis of the increase included annual merit increases, staff additions, including the hiring of an executive officer during the second quarter of 2015, hiring new management level positions, replacing an existing management position, higher recognized employee incentives and an increase in group insurance from higher claims accruals. Premises and equipment increased during the period by \$0.1 million, or 3%. Additional depreciation expense caused this increase due to assets placed in service for the new branch which opened during the

second quarter of 2015. Advertising and marketing experienced a \$0.2 million, or 16%, increase due to a grand opening and re-opening celebration for 2 branches as well as a cash bonus associated with checking/savings summer and fall campaigns. There was also \$0.1 million more in donations made to educational improvement programs in 2015. Professional services were up \$0.3 million, or 19%, during 2015 compared to 2014 due to the implementing of an enterprise risk management program, an architectural design study completed in 2015 and higher audit expense due to a trust audit and additional compliance review services. Data processing and communications expense increased \$0.2 million during 2015 compared to 2014 because of fees incurred from outsourcing the Company's data processing. The Company also incurred \$0.1 million more long-term debt prepayment fees in 2015 than 2014. The Company paid off \$10.0 million of long-term debt in 2015 compared to a pay down of \$6.0 million during 2014. During 2015, the Company incurred \$81 thousand in losses on the reacquisition of previously sold loans that were not recognized in 2014. Offsetting these items, other real estate owned (ORE) expense decreased \$0.1 million during 2015 compared to the same period in 2014. ORE expense decreased mostly due to a few subsequent write-downs taken on ORE properties during 2014.

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

#### Provision for income taxes

The Company's effective income tax rate approximated 20.4% in 2015 and 25.4% in 2014. The difference between the effective rate and the enacted statutory corporate rate of 34% was due mostly to the effect of tax exempt income in relation to the level of pre-tax income. In 2015, the Company had a higher amount of tax exempt income and a higher amount of pre-

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

## Off-Balance Sheet Arrangements and Contractual Obligations

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

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

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

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

| (dollars in thousands)      | One year<br>or less | Over one<br>year<br>through<br>three<br>years | Over<br>three<br>years<br>through<br>five years | Over<br>five<br>years | Total     |
|-----------------------------|---------------------|---|---|-----------------------|-----------|
| Contractual obligations:    |                     |   |   |                       |           |
| Certificates of deposit (1) | \$ 51,168           | \$ 29,218                                     | \$ 11,191                                       | \$ 1,176              | \$ 92,753 |
| Short-term borrowings       | 4,223               | -   | -   | -                     | 4,223     |
| Operating leases            | 263                 | 642   | 607   | 6,040                 | 7,552     |
| Commitments:                |                     |   |   |                       |           |

|                      |           |           |           |          |            |
|----------------------|-----------|-----------|-----------|----------|------------|
| Letters of credit    | 1,167     | 6,118     | -         | 360      | 7,645      |
| Loan commitments (2) | 22,029    | -         | -         | -        | 22,029     |
| Total                | \$ 78,850 | \$ 35,978 | \$ 11,798 | \$ 7,576 | \$ 134,202 |

(1) Includes certificates in the CDARS program.

(2) Available credit to borrowers in the amount of \$106.5 million is excluded from the above table since, by its nature, the borrowers may not have the need for additional funding, and, therefore, the credit may or may not be disbursed by the Company.

#### Related Party Transactions

Information with respect to related parties is contained in Note 16, “Related Party Transactions”, within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

#### Impact of Accounting Standards and Interpretations

Information with respect to the impact of accounting standards is contained in Note 19, “Recent Accounting Pronouncements”, within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

#### Impact of Inflation and Changing Prices

The consolidated financial statements and notes thereto presented herein have been prepared in accordance with U.S. GAAP, which requires the measurement of the Company’s financial condition and results of operations in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of our operations. Unlike industrial businesses, most all of the Company’s assets and liabilities are monetary in nature. As a result, interest rates have a greater impact on our performance than do the effects of general levels of inflation as interest rates do not necessarily move in the same direction or, to the same extent, as the price of goods and services.

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## Capital Resources

The Company is 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 financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classification are also subject to qualitative judgments by the regulators about components, asset risk-weightings and other factors.

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting ratios represent capital as a percentage of total risk-weighted assets and certain off-balance sheet items. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I common equity to total risk-weighted assets (Tier I Common Equity) of 4.5%, Tier I capital to total risk-weighted assets (Tier I Capital) of 6% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. A capital conservation buffer, comprised of common equity Tier I capital, is also established above the regulatory minimum capital requirements rising up to 2.50% by 2019. The Company's Total Risk Adjusted Capital Ratio was 14.9%, Tier I Common Equity was 13.6%, Tier I Capital Ratio was 13.6% and Leverage Ratio was 10.3% as of December 31, 2016. Additional information with respect to capital requirements is contained in Note 15, "Regulatory Matters", within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

During the year ended December 31, 2016, total shareholders' equity increased \$4.3 million, or 6%, due principally from the \$7.7 million in net income added into retained earnings. Capital was further enhanced by \$0.1 million from investments in the Company's common stock via the Employee Stock Purchase (ESPP) and \$0.3 million from stock-based compensation expense from the ESPP and unvested restricted stock. These items were partially offset by the \$0.8 million, after tax reduction in the net unrealized gain position in the Company's investment portfolio and \$3.1 million of cash dividends declared on the Company's common stock. The Company's dividend payout ratio, defined as the rate at which current earnings are paid to shareholders, was 39.8% for the year ended December 31, 2016. The balance of earnings is retained to further strengthen the Company's capital position. The Company's sources (uses) of capital during the previous five years are indicated below:

|                        | Net      | Cash<br>dividends<br>declared | Earnings<br>retained | DRP<br>and<br>ESPP<br>infusion | Changes<br>in<br>AOCI<br>and<br>other<br>changes | Capital<br>retained |
|------------------------|----------|-------------------------------|----------------------|--------------------------------|--|---------------------|
| (dollars in thousands) | income   | declared                      | retained             | infusion                       | changes  | retained            |
| 2016                   | \$ 7,693 | \$ (3,061)                    | \$ 4,632             | \$ 111                         | \$ (463)   | \$ 4,280            |
| 2015                   | 7,103    | (2,844)                       | 4,259                | 102                            | (229)  | 4,132               |
| 2014                   | 6,352    | (2,667)                       | 3,685                | 763                            | 1,711  | 6,159               |
| 2013                   | 7,122    | (2,602)                       | 4,520                | 1,479                          | 1,115  | 7,114               |
| 2012                   | 4,902    | (2,283)                       | 2,619                | 1,342                          | 1,361  | 5,322               |

As of December 31, 2016, the Company reported a net unrealized gain position of \$1.4 million, net of tax, from the securities AFS portfolio compared to a net unrealized gain of \$2.2 million as of December 31, 2015. The decline during 2016 was from all security types. Management believes that changes in fair value of the Company's securities are due to changes in interest rates and not in the creditworthiness of the issuers. Generally, when U.S. Treasury rates rise, investment securities' pricing declines and fair values of investment securities also decline. While volatility has existed in the yield curve within the past twelve months, a rising rate environment is inevitable and during the period of rising rates, the Company expects pricing in the bond portfolio to decline. There is no assurance that future realized and unrealized losses will not be recognized from the Company's portfolio of investment securities. To help maintain a healthy capital position, the Company can issue stock to participants in the DRP and ESPP plans. The DRP affords the Company the option to acquire shares in open market purchases and/or issue shares directly from the Company to plan participants. During 2016, the Company purchased all of the shares in the open market to fulfill the needs of the DRP. Both the DRP and the ESPP plans have been a consistent source of capital from the Company's loyal employees and shareholders and their participation in these plans will continue to help strengthen the Company's balance sheet. Beginning in 2009, the Company's board of directors had allowed a benefit to its loyal shareholders as a discount on the purchase price for shares issued directly from the Company through the DRP and voluntary cash feature. During the first quarter of 2014, the DRP was amended to discontinue a portion of the discount on the voluntary cash feature as the board of directors had determined that the Company's capital position achieved sufficient levels.

See the section entitled "Supervision and Regulation", below for a discussion on regulatory capital changes and other recent enactments, including a summary of the recently issued federal banking agencies final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

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## Liquidity

Liquidity management ensures that adequate funds will be available to meet customers' needs for borrowings, deposit withdrawals and maturities, facility expansion and normal operating expenses. Sources of liquidity are cash and cash equivalents, asset maturities and pay-downs within one year, loans HFS, investments AFS, growth of core deposits and repurchase agreements, utilization of borrowing capacities from the FHLB, correspondent banks, CDARs, the Discount Window of the Federal Reserve Bank of Philadelphia (FRB) and proceeds from the issuance of capital stock. Though regularly scheduled investment and loan payments are dependable sources of daily liquidity, sales of both loans HFS and investments AFS, deposit activity and investment and loan prepayments are significantly influenced by general economic conditions including the interest rate environment. During low and declining interest rate environments, prepayments from interest-sensitive assets tend to accelerate and provide significant liquidity that can be used to invest in other interest-earning assets but at lower market rates. Conversely, in periods of high or rising interest rates, prepayments from interest-sensitive assets tend to decelerate causing prepayment cash flows from mortgage loans and mortgage-backed securities to decrease. Rising interest rates may also cause deposit inflow but priced at higher market interest rates or could also cause deposit outflow due to higher rates offered by the Company's competition for similar products. The Company closely monitors activity in the capital markets and takes appropriate action to ensure that the liquidity levels are adequate for funding, investing and operating activities.

The Company's contingency funding plan (CFP) sets a framework for handling liquidity issues in the event circumstances arise which the Company deems to be less than normal. The Company established guidelines for identifying, measuring, monitoring and managing the resolution of potentially serious liquidity crises. The CFP outlines required monitoring tools, acceptable alternative funding sources and required actions during various liquidity scenarios. Thus, the Company has implemented a proactive means for the measurement and resolution for handling potentially significant adverse liquidity conditions. At least quarterly, the CFP monitoring tools, current liquidity position and monthly projected liquidity sources and uses are presented and reviewed by the Company's Asset/Liability Committee. As of December 31, 2016, the Company had not experienced any adverse issues that would give rise to its inability to raise liquidity in an emergency situation.

During the year ended December 31, 2016, the Company accumulated \$13.6 million of cash. During the period, the Company's operations provided approximately \$15.9 million mostly from \$26.5 million of net cash inflow from the components of net interest income and \$5.0 million in proceeds of loans HFS over originations; partially offset by net non-interest expense/income related payments of \$12.7 million, \$0.8 million in estimated tax payments and a \$2.1 million increase in the residual value from the Company's automobile leasing activities. Cash inflow from interest-earning assets and growth in deposits were used to replace maturing and cash runoff of investment securities, reduce short-term borrowings and net dividend payments. The Company received a large amount of public deposits over the past two years. The seasonal nature of deposits from municipalities and other public funding sources requires the Company to be prepared for the inherent volatility and the unpredictable timing of cash outflow from this customer base, including maintaining the requirements to pledge investment securities. Accordingly, the use of short-term overnight borrowings could be used to fulfill funding gap needs. The CFP is a tool to help the Company ensure that alternative funding sources are available to meet its liquidity needs.

A \$48.7 million temporary deposit made at the end of 2016 was transferred to a trust escrow account in January 2017 and cash and available FHLB borrowings were used to replace this funding. During the third quarter of 2016, the Company entered into an agreement to acquire all of the deposits, certain loans and fixed assets of a bank branch. The transaction is expected to close during the first quarter of 2017. As a result of this agreement, the Company expects an increase in deposits (excluding the temporary deposit) during the first quarter of 2017 partially offset by seasonal fluctuations of public deposits.



As of December 31, 2016, the Company maintained \$25.8 million in cash and cash equivalents and \$132.9 million of investments AFS and loans HFS. Also as of December 31, 2016, the Company had approximately \$194.3 million available to borrow from the FHLB, \$21.0 million from correspondent banks, \$40.9 million from the FRB and \$38.6 million from the CDARS program. The combined total of \$453.5 million represented 57% of total assets at December 31, 2016. Management believes this level of liquidity to be strong and adequate to support current operations.

For a discussion on the Company's significant determinable contractual obligations and significant commitments, see "Off-Balance Sheet Arrangements and Contractual Obligations," above.

#### Management of interest rate risk and market risk analysis

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

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

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market rates to protect net interest income from significant fluctuations. The primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on net interest income along with creating an asset/liability structure that maximizes earnings.

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

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

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

To manage this interest rate sensitivity gap position, an asset/liability model commonly known as cumulative gap analysis is used to monitor the difference in the volume of the Company's interest sensitive assets and liabilities that mature or re-price within given time intervals. A positive gap (asset sensitive) indicates that more assets will re-price during a given period compared to liabilities, while a negative gap (liability sensitive) indicates the opposite effect. The Company employs computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest-sensitive assets and liabilities in order to determine what impact these rate changes will have upon the net interest spread. A temporary deposit of approximately \$49 million at December 31, 2016 was removed from the tables below because it was transferred immediately after year-end and would skew the calculations. At December 31, 2016, the Company maintained a one-year cumulative gap of positive (asset sensitive) \$37.7 million, or 5%, of total assets. The effect of this positive gap position provided a mismatch of assets and liabilities which may expose the Company to interest rate risk during periods of falling interest rates. Conversely, in an increasing interest rate environment, net interest income could be positively impacted because more assets than liabilities will re-price upward during the one-year period.

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

amounts. The ability of many borrowers to service their adjustable-rate debt may decrease in the event of an interest rate increase.

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The following table reflects the re-pricing of the balance sheet or “gap” position at December 31, 2016:

| (dollars in thousands)                            | Three<br>months<br>or less | More than<br>three<br>months to<br>twelve<br>months | More than<br>one year<br>to three<br>years | More than<br>three years | Total      |
|---|----------------------------|---|--|--------------------------|------------|
| Cash and cash equivalents (4)                     | \$ 57                      | \$ -  | \$ -                                       | \$ 12,823                | \$ 12,880  |
| Investment securities (1)(2)                      | 4,020                      | 12,150  | 42,770                                     | 73,703                   | 132,643    |
| Loans and leases(2)                               | 193,298                    | 99,653  | 152,348                                    | 145,685                  | 590,984    |
| Fixed and other assets                            | -                          | 11,435  | -  | 32,040                   | 43,475     |
| Total assets                                      | \$ 197,375                 | \$ 123,238  | \$ 195,118                                 | \$ 264,251               | \$ 779,982 |
| Total cumulative assets                           | \$ 197,375                 | \$ 320,613  | \$ 515,731                                 | \$ 779,982               |            |
| Non-interest-bearing transaction deposits (3) (4) | \$ -                       | \$ 16,192   | \$ 44,450                                  | \$ 101,112               | \$ 161,754 |
| Interest-bearing transaction deposits (3)         | 153,277                    | 21,644  | 150,511                                    | 74,121                   | 399,553    |
| Certificates of deposit                           | 10,871                     | 40,297  | 29,218                                     | 12,367                   | 92,753     |
| Repurchase agreements                             | 4,223                      | -   | -  | -                        | 4,223      |
| Short-term borrowings (4)                         | 36,437                     | -   | -  | -                        | 36,437     |
| Other liabilities                                 | -                          | -   | -  | 4,631                    | 4,631      |
| Total liabilities                                 | \$ 204,808                 | \$ 78,133   | \$ 224,179                                 | \$ 192,231               | \$ 699,351 |
| Total cumulative liabilities                      | \$ 204,808                 | \$ 282,941  | \$ 507,120                                 | \$ 699,351               |            |
| Interest sensitivity gap                          | \$ (7,433)                 | \$ 45,105   | \$ (29,061)                                | \$ 72,020                |            |
| Cumulative gap                                    | \$ (7,433)                 | \$ 37,672   | \$ 8,611                                   | \$ 80,631                |            |
| Cumulative gap to total assets                    | -1.0%                      | 4.8%  | 1.1%                                       | 10.3%                    |            |

(1) Includes FHLB stock and the net unrealized gains/losses on available-for-sale securities.

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

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

(4)

A \$49 million temporary non-interest-bearing deposit made at the end of 2016 and transferred to a trust account on January 5, 2017 was removed from the table because it was an anomaly. The table was adjusted to reflect what the balance sheet position would have been without this deposit. Short-term borrowings would have increased by \$36 million and \$13 million of cash would have been used.

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

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

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

The following table illustrates the simulated impact of an immediate 200 basis points upward or downward movement in interest rates on net interest income, net income and the change in the economic value (portfolio equity). This analysis assumed that the adjusted interest-earning asset and interest-bearing liability levels at December 31, 2016 remained constant. The impact of the rate movements was developed by simulating the effect of the rate change over a twelve-month period from the December 31, 2016 levels:

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|   | % change |         |
|---|----------|---------|
|   | Rates    | Rates   |
|   | +200     | -200    |
| Earnings at risk:                                     |          |         |
| Net interest income                                   | 2.9 %    | (4.0) % |
| Net income  | 7.7      | (9.2)   |
| Economic value at risk:                               |          |         |
| Economic value of equity                              | (2.1)    | (24.4)  |
| Economic value of equity as a percent of total assets | (0.3)    | (3.7)   |

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 December 31, 2016, the Company's risk-based capital ratio was 14.9%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning January 1, 2017, under alternate interest rate scenarios using the income simulation model described above:

| (dollars in thousands)             | Net<br>interest<br>income | \$<br>variance | %<br>variance |
|------------------------------------|---------------------------|----------------|---------------|
| Simulated change in interest rates |                           |                |               |
| +200 basis points                  | \$ 26,751                 | \$ 746         | 2.9 %         |
| +100 basis points                  | 26,324                    | 319            | 1.2           |
| Flat rate                          | 26,005                    | -              | -             |
| -100 basis points                  | 25,414                    | (591)          | (2.3)         |
| -200 basis points                  | 24,976                    | (1,029)        | (4.0)         |

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

liability into the same product for a new like term at current product interest rates. As a result, the mix of interest-earning assets and interest bearing-liabilities is held constant.

#### Supervision and Regulation

The following is a brief summary of the regulatory environment in which the Company and the Bank operate and is not designed to be a complete discussion of all statutes and regulations affecting such operations, including those statutes and regulations specifically mentioned herein. Changes in the laws and regulations applicable to the Company and the Bank can affect the operating environment in substantial and unpredictable ways. We cannot accurately predict whether legislation will ultimately be enacted, and if enacted, the ultimate effect that legislation or implementing regulations would have on our financial condition or results of operations. While banking regulations are material to the operations of the Company and the Bank, it should be noted that supervision, regulation and examination of the Company and the Bank are intended primarily for the protection of depositors, not shareholders.

#### Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act (SOX), also known as the “Public Company Accounting Reform and Investor Protection Act,” was established in 2002 and introduced major changes to the regulation of financial practice. SOX represents a comprehensive revision of laws affecting corporate governance, accounting obligations, and corporate reporting. SOX is applicable to all companies with equity or debt securities that are either registered, or file reports under the Securities Exchange Act of 1934. In particular, SOX establishes: (i) requirements for audit committees, including independence, expertise, and responsibilities; (ii) additional responsibilities regarding financial statements for the Principal Executive Officer and Principal Financial Officer of the reporting company; (iii) standards for auditors and regulation of audits; (iv) increased disclosure and reporting obligations for the reporting company and its directors and executive officers; and (v) increased civil and criminal penalties for violations of the securities laws.

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### Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)

The FDICIA established five different levels of capitalization of financial institutions, with “prompt corrective actions” and significant operational restrictions imposed on institutions that are capital deficient under the categories. The five categories are:

- well capitalized;
  - adequately capitalized;
- undercapitalized;
- significantly undercapitalized, and
- critically undercapitalized.

To be considered well capitalized, an institution must have a total risk-based capital ratio of at least 10%, a Tier 1 risk-based capital ratio of at least 8%, a leverage capital ratio of at least 5%, and must not be subject to any order or directive requiring the institution to improve its capital level. An institution falls within the adequately capitalized category if it has a total risk-based capital ratio of at least 8%, a Tier 1 risk-based capital ratio of at least 6%, and a leverage capital ratio of at least 4%. Institutions with lower capital levels are deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, depending on their actual capital levels. In addition, the appropriate federal regulatory agency may downgrade an institution to the next lower capital category upon a determination that the institution is in an unsafe or unsound condition, or is engaged in an unsafe or unsound practice. Institutions are required under the FDICIA to closely monitor their capital levels and to notify their appropriate regulatory agency of any basis for a change in capital category.

Regulatory oversight of an institution becomes more stringent with each lower capital category, with certain “prompt corrective actions” imposed depending on the level of capital deficiency.

### Recent Legislation and Rulemaking

#### Regulatory Capital Changes

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations began on January 1, 2015, while larger institutions (generally those with assets of \$250 billion or more) began compliance on January 1, 2014. The final rules call for the following capital requirements:

- A minimum ratio of common tier 1 capital to risk-weighted assets of 4.5%.
- A minimum ratio of tier 1 capital to risk-weighted assets of 6%.
  - A minimum ratio of total capital to risk-weighted assets of 8% (no change from current rule).
- A minimum leverage ratio of 4%.

In addition, the final rules established a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation and countercyclical capital buffers for all banking organizations began on January 1, 2016.



Under the proposed rules, accumulated other comprehensive income (AOCI) would have been included in a banking organization's common equity tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The Company made the opt-out election in the first call report or FR Y-9 series report that was filed after the financial institution became subject to the final rule.

The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010 for inclusion in the tier 1 capital of banking organizations with total consolidated assets less than \$15 billion as of December 31, 2009 and banking organizations that were mutual holding companies as of May 19, 2010.

The proposed rules would have modified the risk-weight framework applicable to residential mortgage exposures to require banking organizations to divide residential mortgage exposures into two categories in order to determine the applicable risk weight. In response to commenter concerns about the burden of calculating the risk weights and the potential negative effect on credit availability, the final rules do not adopt the proposed risk weights but retain the current risk weights for mortgage exposures under the general risk-based capital rules.

Consistent with the Dodd-Frank Act, the new rules replace the ratings-based approach to securitization exposures, which is based on external credit ratings, with the simplified supervisory formula approach in order to determine the appropriate risk weights for these exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

Under the new rules, mortgage servicing assets (MSAs) and certain deferred tax assets (DTAs) are subject to stricter

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limitations than those applicable under the current general risk-based capital rule. The new rules also increase the risk weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

As noted above the phase-in period for the Company began on January 1, 2015. The new rules will not have a material impact on the Company's capital, operations, liquidity and earnings.

### JOBS Act

In 2012, the Jumpstart Our Business Startups Act (the "JOBS Act") became law. The JOBS Act is aimed at facilitating capital raising by smaller companies and banks and bank holding companies by implementing the following changes:

- raising the threshold requiring registration under the Securities Exchange Act of 1934 (the "Exchange Act") for banks and bank holdings companies from 500 to 2,000 holders of record;
- raising the threshold for triggering deregistration under the Exchange Act for banks and bank holding companies from 300 to 1,200 holders of record;
- raising the limit for Regulation A offerings from \$5 million to \$50 million per year and exempting some Regulation A offerings from state blue sky laws;
- permitting advertising and general solicitation in Rule 506 and Rule 144A offerings;
- allowing private companies to use "crowdfunding" to raise up to \$1 million in any 12-month period, subject to certain conditions; and
- creating a new category of issuer, called an "Emerging Growth Company," for companies with less than \$1 billion in annual gross revenue, which will benefit from certain changes that reduce the cost and burden of carrying out an equity IPO and complying with public company reporting obligations for up to five years.

While the JOBS Act is not expected to have any immediate application to the Company, management will continue to monitor the implementation rules for potential effects which might benefit the Company.

### Dodd-Frank Wall Street Reform and Consumer Protection Act.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became law. Dodd-Frank is intended to effect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank creates a new Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators new authority to take control of and liquidate financial firms. Dodd-Frank additionally creates a new independent federal regulator to administer federal consumer protection laws. Dodd-Frank is expected to have a significant impact on our business operations as its provisions take effect. Overtime, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense. Among the provisions that are likely to affect us and the community banking industry are the following:

**Holding Company Capital Requirements.** Dodd-Frank requires the Federal Reserve to apply consolidated capital requirements to bank holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, pooled trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by a bank holding company with less than \$15 billion in assets. Dodd-Frank additionally requires that bank regulators issue countercyclical capital requirements so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

Deposit Insurance. Dodd-Frank permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to \$250,000 per depositor, and extended unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. Dodd-Frank also broadens the base for FDIC insurance assessments. Assessments will now be based on the average consolidated total assets less tangible equity capital of a financial institution. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Dodd-Frank also eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

Corporate Governance. Dodd-Frank requires publicly traded companies to give shareholders a non-binding vote on executive compensation at least every three years, a non-binding vote regarding the frequency of the vote on executive compensation at least every six years, and a non-binding vote on “golden parachute” payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders. The SEC has finalized the rules implementing these requirements. Additionally, Dodd-Frank directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of \$1.0 billion, regardless of whether the company is publicly traded. Dodd-Frank also gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

Prohibition Against Charter Conversions of Troubled Institutions. Dodd-Frank prohibits a depository institution from converting from a state to federal charter or vice versa while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate

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federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the conversion application with its current federal regulator which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating thereto.

**Interstate Branching.** Dodd-Frank authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks will be able to enter new markets more freely.

**Limits on Interstate Acquisitions and Mergers.** Dodd-Frank precludes a bank holding company from engaging in an interstate acquisition – the acquisition of a bank outside its home state – unless the bank holding company is both well capitalized and well managed. Furthermore, a bank may not engage in an interstate merger with another bank headquartered in another state unless the surviving institution will be well capitalized and well managed. The previous standard in both cases was adequately capitalized and adequately managed.

**Limits on Interchange Fees.** Dodd-Frank amends the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. The interchange rules became effective on October 1, 2011.

**Consumer Financial Protection Bureau.** Dodd-Frank creates a new, independent federal agency called the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. Dodd-Frank authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, Dodd-Frank will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a "qualified mortgage" as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

In summary, the Dodd-Frank Act provides for sweeping financial regulatory reform and may have the effect of increasing the cost of doing business, limiting or expanding permissible activities and affect the competitive balance between banks and other financial intermediaries. While many of the provisions of the Dodd-Frank Act do not impact the existing business of the Company, the extension of FDIC insurance to all non-interest bearing deposit accounts and the repeal of prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts, will likely increase deposit funding costs paid by the Company in order to retain and grow deposits. In addition, the limitations imposed on the assessment of

interchange fees have reduced the Company's ability to set revenue pricing on debit and credit card transactions. Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company, its customers or the financial industry as a whole. The Company will continue to monitor legislative developments and assess their potential impact on our business.

Department of Defense Military Lending Rule. In 2015, the U.S. Department of Defense issued a final rule which restricts pricing and terms of certain credit extended to active duty military personnel and their families. This rule, which was implemented effective October 3, 2016, caps the interest rate on certain credit extensions to an annual percentage rate of 36% and restricts other fees. The rule requires financial institutions to verify whether customers are military personnel subject to the rule. The impact of this final rule, and any subsequent amendments thereto, on the Company's lending activities and the Company's statements of income or condition has had little or no impact; however, management will continue to monitor the implementation of the rule for any potential side effects on the Company's business.

#### Future Federal and State Legislation and Rulemaking

From time-to-time, various types of federal and state legislation have been proposed that could result in additional regulations and restrictions on the business of the Company and the Bank. We cannot predict whether legislation will be adopted, or if adopted, how the new laws would affect our business. As a consequence, we are susceptible to legislation that may increase the cost of doing business. Management believes that the effect of any current legislative proposals on the liquidity, capital resources and the results of operations of the Company and the Bank will be minimal.

It is possible that there will be regulatory proposals which, if implemented, could have a material effect upon our liquidity, capital resources and results of operations. In addition, the general cost of compliance with numerous federal and state laws

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does have, and in the future may have, a negative impact on our results of operations. As with other banks, the status of the financial services industry can affect the Bank. Consolidations of institutions are expected to continue as the financial services industry seeks greater efficiencies and market share. Bank management believes that such consolidations may enhance the Bank's competitive position as a community bank.

Future Outlook

The Company is highly impacted by local economic factors that could influence the performance and strength of our loan portfolios. Though the national economy is improving, the local operating environment continues to be challenging and is expected to be challenging for the near term time horizon. Though short-term interest rates have been at or near historic lows, we expect them to continue to slowly rise in 2017. A consensus of top analysts predicts a period of consolidation in the Treasury market over the next several months following the sizeable increase in yields registered during the second half of 2016. Above-trend economic growth and additional tightening of the labor market conditions are forecast to help produce the largest annual change in consumer price inflation since 2011. The Federal Reserve is predicted to step up the pace at which it normalizes interest rates. After hiking rates only once in both 2015 and 2016, the Federal Open Market Committee (FOMC) is forecast to enact two to three 25-basis-point increases in 2017 and probably two to three more in 2018. Jobs declined in December 2016 from a year earlier in the Scranton/Wilkes-Barre metropolitan statistical area while jobs in the state rose during the same time period. In 2016, the local foreclosure rate reached its lowest point since before the housing market crash. We believe market conditions are slowly improving but we will continue to monitor the economic climate in our region, scrutinize growth prospects and proactively observe existing credits for early warning signs of risk deterioration.

In addition to the challenging economic environment, regulatory oversight has changed significantly in recent years. As described in more detail in the "supervision and regulation" section above, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The rules revise the quantity and quality of required minimum risk-based and leverage capital requirements and revise the calculation of risk-weighted assets.

Management believes the Company is prepared to face the challenges ahead. We expect that there will be further improvement in asset quality. Our conservative approach to loan underwriting will help improve and keep non-performing asset levels at bay. The Company expects to overcome the relative flattening of the positively sloped yield curve by cautiously growing the balance sheet to enhance financial performance. We intend to grow all lending portfolios in both the business and retail sectors using growth in market-place low costing deposits to stabilize net interest margin and to enhance revenue performance.

**ITEM 7A: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information required by 7A is set forth at Item 7, under "Liquidity" and "Management of interest rate risk and market risk analysis," contained within management's discussion and analysis of financial condition and results of operations and incorporated herein by reference.



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ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders

Fidelity D & D Bancorp, Inc.

We have audited the accompanying consolidated balance sheets of Fidelity D & D Bancorp, Inc. and Subsidiary (the Company) as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Fidelity D & D Bancorp, Inc. and Subsidiary as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ RSM US LLP

Blue Bell, Pennsylvania



March 10, 2017

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Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

Fidelity D & D Bancorp, Inc.:

We have audited the accompanying consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows of Fidelity D & D Bancorp, Inc. and Subsidiary (the "Company") for the year ended December 31, 2014. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of operations and cash flows of Fidelity D & D Bancorp, Inc. and Subsidiary for the year ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America.

/s/ Baker Tilly Virchow Krause, LLP

Wilkes-Barre, Pennsylvania

March 17, 2015



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Consolidated Balance Sheets

|   | As of December 31, |            |
|---|--------------------|------------|
|   | 2016               | 2015       |
| (dollars in thousands)  |                    |            |
| Assets:   |                    |            |
| Cash and due from banks   | \$ 12,856          | \$ 12,259  |
| Interest-bearing deposits with financial institutions   | 12,987             | 18         |
| Total cash and cash equivalents   | 25,843             | 12,277     |
| Available-for-sale securities   | 130,037            | 125,232    |
| Federal Home Loan Bank stock  | 2,606              | 2,120      |
| Loans and leases, net (allowance for loan losses of \$9,364 in 2016; \$9,527 in 2015)   | 588,130            | 546,682    |
| Loans held-for-sale (fair value \$2,907 in 2016, \$1,444 in 2015)   | 2,854              | 1,421      |
| Foreclosed assets held-for-sale   | 1,306              | 1,074      |
| Bank premises and equipment, net  | 17,164             | 16,723     |
| Cash surrender value of bank owned life insurance   | 11,435             | 11,082     |
| Accrued interest receivable   | 2,246              | 2,210      |
| Other assets  | 11,323             | 10,537     |
| Total assets  | \$ 792,944         | \$ 729,358 |
| Liabilities:  |                    |            |
| Deposits:   |                    |            |
| Interest-bearing  | \$ 492,306         | \$ 477,901 |
| Non-interest-bearing  | 211,153            | 142,774    |
| Total deposits  | 703,459            | 620,675    |
| Accrued interest payable and other liabilities  | 4,631              | 4,128      |
| Short-term borrowings   | 4,223              | 28,204     |
| Total liabilities   | 712,313            | 653,007    |
| Shareholders' equity:   |                    |            |
| Preferred stock authorized 5,000,000 shares with no par value; none issued  | -                  | -          |
| Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 2,453,805 in 2016; and 2,443,405 in 2015) | 27,155             | 26,700     |
| Retained earnings   | 52,095             | 47,463     |
| Accumulated other comprehensive income  | 1,381              | 2,188      |
| Total shareholders' equity  | 80,631             | 76,351     |
| Total liabilities and shareholders' equity  | \$ 792,944         | \$ 729,358 |

See notes to consolidated financial statements



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Consolidated Statements of Income

| (dollars in thousands except per share data)          | 2016      | 2015      | 2014      |
|---|-----------|-----------|-----------|
| Interest income:                                      |           |           |           |
| Loans and leases:                                     |           |           |           |
| Taxable   | \$ 23,609 | \$ 22,710 | \$ 21,799 |
| Nontaxable  | 753       | 654       | 538       |
| Interest-bearing deposits with financial institutions | 67        | 26        | 26        |
| Investment securities:                                |           |           |           |
| U.S. government agency and corporations               | 1,709     | 1,180     | 1,088     |
| States and political subdivisions (nontaxable)        | 1,282     | 1,301     | 1,280     |
| Other securities                                      | 75        | 143       | 112       |
| Federal funds sold                                    | -         | -         | 1         |
| Total interest income                                 | 27,495    | 26,014    | 24,844    |
| Interest expense:                                     |           |           |           |
| Deposits  | 2,309     | 2,236     | 2,036     |
| Securities sold under repurchase agreements           | 20        | 18        | 21        |
| Other short-term borrowings and other                 | 29        | 20        | 8         |
| Long-term debt  | -         | 255       | 852       |
| Total interest expense                                | 2,358     | 2,529     | 2,917     |
| Net interest income                                   | 25,137    | 23,485    | 21,927    |
| Provision for loan losses                             | 1,025     | 1,075     | 1,060     |
| Net interest income after provision for loan losses   | 24,112    | 22,410    | 20,867    |
| Other income:   |           |           |           |
| Service charges on deposit accounts                   | 2,139     | 1,756     | 1,837     |
| Interchange fees                                      | 1,551     | 1,375     | 1,324     |
| Fees from trust fiduciary activities                  | 721       | 739       | 674       |
| Fees from financial services                          | 586       | 504       | 545       |
| Service charges on loans                              | 859       | 809       | 750       |
| Fees and other revenue                                | 783       | 764       | 682       |
| Earnings on bank-owned life insurance                 | 353       | 342       | 339       |
| Gain (loss) on sale or disposal of:                   |           |           |           |
| Loans   | 1,009     | 1,191     | 645       |
| Investment securities                                 | 9         | 80        | 599       |
| Premises and equipment                                | (5)       | (27)      | (41)      |
| Total other income                                    | 8,005     | 7,533     | 7,354     |
| Other expenses:                                       |           |           |           |
| Salaries and employee benefits                        | 11,594    | 10,476    | 9,877     |
| Premises and equipment                                | 3,543     | 3,590     | 3,501     |
| Advertising and marketing                             | 1,223     | 1,482     | 1,279     |
| Professional services                                 | 1,561     | 1,631     | 1,368     |
| FDIC assessment                                       | 351       | 397       | 358       |
| Loan collection                                       | 194       | 160       | 224       |

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|                                   |          |          |          |
|-----------------------------------|----------|----------|----------|
| Other real estate owned           | 207      | 205      | 344      |
| Office supplies and postage       | 472      | 434      | 461      |
| Automated transaction processing  | 607      | 615      | 627      |
| FHLB prepayment fee               | -        | 570      | 457      |
| Data processing and communication | 981      | 582      | 402      |
| PA shares tax                     | 320      | 148      | 212      |
| Other                             | 602      | 732      | 593      |
| Total other expenses              | 21,655   | 21,022   | 19,703   |
| Income before income taxes        | 10,462   | 8,921    | 8,518    |
| Provision for income taxes        | 2,769    | 1,818    | 2,166    |
| Net income                        | \$ 7,693 | \$ 7,103 | \$ 6,352 |
| Per share data:                   |          |          |          |
| Net income - basic                | \$ 3.14  | \$ 2.91  | \$ 2.63  |
| Net income - diluted              | \$ 3.13  | \$ 2.90  | \$ 2.62  |
| Dividends                         | \$ 1.24  | \$ 1.16  | \$ 1.10  |

See notes to consolidated financial statements

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Consolidated Statements of Comprehensive Income

(dollars in thousands)

Years ended December 31,  
2016      2015      2014

|   |          |          |          |
|---|----------|----------|----------|
| Net income  | \$ 7,693 | \$ 7,103 | \$ 6,352 |
| Other comprehensive (loss) income, before tax:                  |          |          |          |
| Unrealized holding (loss) gain on available-for-sale securities | (1,213)  | (761)    | 2,878    |
| Reclassification adjustment for net gains realized in income    | (9)      | (80)     | (599)    |
| Net unrealized (loss) gain                                      | (1,222)  | (841)    | 2,279    |
| Tax effect  | 415      | 286      | (775)    |
| Unrealized (loss) gain, net of tax                              | (807)    | (555)    | 1,504    |
| Other comprehensive (loss) income, net of tax                   | (807)    | (555)    | 1,504    |
| Total comprehensive income, net of tax                          | \$ 6,886 | \$ 6,548 | \$ 7,856 |

See notes to consolidated financial statements



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Fidelity D & D Bancorp, Inc. and Subsidiary  
 Consolidated Statements of Changes in Shareholders' Equity  
 Years ended December 31, 2016, 2015 and 2014

| (dollars in thousands)  | Capital stock |           | Retained  | Accumulated<br>other<br>comprehensive | Total     |
|---|---------------|-----------|-----------|---------------------------------------|-----------|
|   | Shares        | Amount    | earnings  | income                                |           |
| Balance, December 31, 2013  | 2,391,617     | \$ 25,302 | \$ 39,519 | \$ 1,239                              | \$ 66,060 |
| Net income  |               |           | 6,352     |                                       | 6,352     |
| Other comprehensive income  |               |           |           | 1,504                                 | 1,504     |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 4,373         | 80        |           |                                       | 80        |
| Issuance of common stock through Dividend Reinvestment Plan                                   | 26,527        | 683       |           |                                       | 683       |
| Issuance of common stock from vested restricted share grants through stock compensation plans | 5,250         |           |           |                                       |           |
| Stock-based compensation expense  |               | 207       |           |                                       | 207       |
| Cash dividends declared   |               |           | (2,667)   |                                       | (2,667)   |
| Balance, December 31, 2014  | 2,427,767     | \$ 26,272 | \$ 43,204 | \$ 2,743                              | \$ 72,219 |
| Net income  |               |           | 7,103     |                                       | 7,103     |
| Other comprehensive loss  |               |           |           | (555)                                 | (555)     |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 4,358         | 102       |           |                                       | 102       |
| Issuance of common stock from vested restricted share grants through stock compensation plans | 7,780         |           |           |                                       |           |
| Issuance of common stock through exercise of stock options                                    | 3,500         | 101       |           |                                       | 101       |
| Stock-based compensation expense  |               | 225       |           |                                       | 225       |
| Cash dividends declared   |               |           | (2,844)   |                                       | (2,844)   |
| Balance, December 31, 2015  | 2,443,405     | \$ 26,700 | \$ 47,463 | \$ 2,188                              | \$ 76,351 |
| Net income  |               |           | 7,693     |                                       | 7,693     |
| Other comprehensive loss  |               |           |           | (807)                                 | (807)     |
| Issuance of common stock through Employee Stock Purchase Plan                                 | 3,695         | 111       |           |                                       | 111       |
| Issuance of common stock from vested restricted share grants through stock compensation plans | 6,205         |           |           |                                       |           |
| Issuance of common stock through exercise of stock options                                    | 500           | 14        |           |                                       | 14        |
| Stock-based compensation expense  |               | 330       |           |                                       | 330       |
| Cash dividends declared   |               |           | (3,061)   |                                       | (3,061)   |
| Balance, December 31, 2016  | 2,453,805     | \$ 27,155 | \$ 52,095 | \$ 1,381                              | \$ 80,631 |

See notes to consolidated financial statements



Table Of ContentsFidelity D & D Bancorp, Inc. and Subsidiary  
Consolidated Statements of Cash Flows

| (dollars in thousands)  | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2016                     | 2015     | 2014     |
| Cash flows from operating activities:   |                          |          |          |
| Net income  | \$ 7,693                 | \$ 7,103 | \$ 6,352 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |          |          |
| Depreciation, amortization and accretion  | 3,301                    | 3,566    | 3,137    |
| Provision for loan losses   | 1,025                    | 1,075    | 1,060    |
| Deferred income tax expense   | 1,248                    | 1,645    | 156      |
| Stock-based compensation expense  | 519                      | 225      | 207      |
| Proceeds from sale of loans held-for-sale   | 51,656                   | 48,356   | 35,248   |
| Originations of loans held-for-sale   | (46,670)                 | (46,131) | (35,058) |
| Earnings from bank-owned life insurance   | (353)                    | (342)    | (339)    |
| Net gain from sales of loans  | (1,009)                  | (1,191)  | (645)    |
| Net gain from sales of investment securities                                      | (9)                      | (80)     | (599)    |
| Net loss from sale and write-down of foreclosed assets held-for-sale              | 70                       | 45       | 103      |
| Net loss from disposal of equipment   | 5                        | 27       | 42       |
| Change in:  |                          |          |          |
| Accrued interest receivable   | (36)                     | (124)    | (17)     |
| Other assets  | (1,895)                  | 776      | (1,677)  |
| Accrued interest payable and other liabilities                                    | 314                      | 775      | (72)     |
| Net cash provided by operating activities   | 15,859                   | 15,725   | 7,898    |
| Cash flows from investing activities:   |                          |          |          |
| Held-to-maturity securities:  |                          |          |          |
| Proceeds from sales   | -                        | -        | 187      |
| Proceeds from maturities, calls and principal pay-downs                           | -                        | -        | 3        |
| Available-for-sale securities:  |                          |          |          |
| Proceeds from sales   | 2,884                    | 15,431   | 20,939   |
| Proceeds from maturities, calls and principal pay-downs                           | 20,378                   | 20,233   | 13,611   |
| Purchases   | (30,654)                 | (65,421) | (33,639) |
| (Increase) decrease in FHLB stock   | (486)                    | (814)    | 1,334    |
| Net increase in loans and leases  | (49,579)                 | (43,885) | (40,547) |
| Acquisition of bank premises and equipment  | (1,476)                  | (1,596)  | (2,970)  |
| Proceeds from sale of bank premises and equipment                                 | 1                        | 52       | -        |
| Proceeds from sale of foreclosed assets held-for-sale                             | 771                      | 1,376    | 1,149    |
| Net cash used in investing activities   | (58,161)                 | (74,624) | (39,933) |
| Cash flows from financing activities:   |                          |          |          |
| Net increase in deposits  | 82,784                   | 33,731   | 57,245   |

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|   |           |           |           |
|---|-----------|-----------|-----------|
| Net (decrease) increase in short-term borrowings        | (23,980)  | 24,235    | (4,673)   |
| Repayment of long-term debt                             | -         | (10,000)  | (6,000)   |
| Proceeds from employee stock purchase plan participants | 111       | 102       | 80        |
| Exercise of stock options                               | 14        | 101       | -         |
| Dividends paid, net of dividends reinvested             | (3,061)   | (2,844)   | (2,088)   |
| Proceeds from dividend reinvestment plan participants   | -         | -         | 104       |
| Net cash provided by financing activities               | 55,868    | 45,325    | 44,668    |
| Net increase (decrease) in cash and cash equivalents    | 13,566    | (13,574)  | 12,633    |
| Cash and cash equivalents, beginning                    | 12,277    | 25,851    | 13,218    |
| Cash and cash equivalents, ending                       | \$ 25,843 | \$ 12,277 | \$ 25,851 |

See notes to consolidated financial statements

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FIDELITY D & D BANCORP, INC.

AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1.NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements include the accounts of Fidelity D & D Bancorp, Inc. and its wholly-owned subsidiary, The Fidelity Deposit and Discount Bank (the Bank) (collectively, the Company). All significant inter-company balances and transactions have been eliminated in consolidation.

NATURE OF OPERATIONS

The Company provides a full range of banking, trust and financial services to individuals, small businesses and corporate customers. Its primary market areas are Lackawanna and Luzerne Counties, Pennsylvania. The Company's primary deposit products are demand deposits and interest-bearing time and savings accounts. It offers a full array of loan products to meet the needs of retail and commercial customers. The Company is subject to regulation by the Federal Deposit Insurance Corporation (FDIC) and the Pennsylvania Department of Banking.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, the valuation of investment securities, the determination and the amount of impairment in the securities portfolios and the related realization of the deferred tax assets related to the allowance for loan losses, other-than-temporary impairment on and valuations of investment securities.

In connection with the determination of the allowance for loan losses, management generally obtains independent appraisals for significant properties. While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Company to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near-term. However, the amount of the change that is reasonably possible cannot be estimated.

The Company's investment securities are comprised of a variety of financial instruments. The fair values of the securities are subject to various risks including changes in the interest rate environment and general economic conditions including illiquid conditions in the capital markets. Due to the increased level of these risks and their potential impact on the fair values of the securities, it is possible that the amounts reported in the accompanying

financial statements could materially change in the near-term. Any credit-related impairment is included as a component of non-interest income in the consolidated income statements while non-credit-related impairment is charged to other comprehensive income, net of tax.

#### SIGNIFICANT GROUP CONCENTRATION OF CREDIT RISK

The Company originates commercial, consumer, and mortgage loans to customers primarily located in Lackawanna and Luzerne Counties of Pennsylvania. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic sector in which the Company operates. The loan portfolio does not have any significant concentrations from one industry or customer.

#### HELD-TO-MATURITY SECURITIES

Debt securities, for which the Company has the positive intent and ability to hold to maturity, are reported at cost. Premiums and discounts are amortized or accreted, as a component of interest income over the life of the related security as an adjustment to yield using the interest method. The Company did not have any held-to-maturity securities at December 31, 2016 or 2015.

#### TRADING SECURITIES

Debt and equity securities held principally for resale in the near-term, or trading securities, are recorded at their fair values. Unrealized gains and losses are included in other income. The Company did not have investment securities held for trading purposes during 2016, 2015 or 2014.

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AVAILABLE-FOR-SALE SECURITIES

Available-for-sale (AFS) securities consist of debt and equity securities classified as neither held-to-maturity nor trading and are reported at fair value. Premiums and discounts are amortized or accreted as a component of interest income over the life of the related security as an adjustment to yield using the interest method. Unrealized holding gains and losses, including non-credit-related other-than-temporary impairment (OTTI), on AFS securities are reported as a separate component of shareholders' equity, net of deferred income taxes, until realized. The net unrealized holding gains and losses are a component of accumulated other comprehensive income. Gains and losses from sales of securities AFS are determined using the specific identification method.

FEDERAL HOME LOAN BANK STOCK

The Company, is a member of the Federal Home Loan Bank system, and as such is required to maintain an investment in capital stock of the Federal Home Loan Bank of Pittsburgh (FHLB). The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB. Based on redemption provisions of the FHLB, the stock has no quoted market value and is carried at cost.

LOANS

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at face value, net of unamortized loan fees and costs and the allowance for loan losses. Interest on residential real estate loans is recorded based on principal pay downs on an actual days basis. Commercial loan interest is accrued on the principal balance on an actual days basis. Interest on consumer loans is determined using the simple interest method.

Generally, loans are placed on non-accrual status when principal or interest is past due 90 days or more. When a loan is placed on non-accrual status, all interest previously accrued but not collected is charged against current earnings. Any payments received on non-accrual loans are applied, first to the outstanding loan amounts, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of lost interest.

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the Company grants a concession that it would not otherwise grant based on current underwriting standards. Regardless of the type of concession, when modifying a loan forgiveness of principal is rarely granted.

MORTGAGE BANKING OPERATIONS AND MORTGAGE SERVICING RIGHTS

The Company sells one-to-four family residential mortgage loans on a servicing retained basis. On a loan sold where servicing was retained, the Company determines at the time of sale the value of the retained servicing rights, which represents the present value of the differential between the contractual servicing fee and adequate compensation, defined as the fee a sub-servicer would require to assume the role of servicer, after considering the estimated effects of prepayments. If material, a portion of the gain on the sale of the loan is recognized due to the value of the servicing rights, and a mortgage servicing asset is recorded.

Commitments to sell one-to-four family residential mortgage loans are made primarily during the period between the intent to proceed and the closing of the mortgage loan. The timing of making these sale commitments is dependent upon the timing of the borrower's election to lock-in the mortgage interest rate and fees prior to loan closing. Most of these sales commitments are made on a best-efforts basis whereby the Company is only obligated to sell the mortgage

if the mortgage loan is approved and closed by the Company. Commitments to fund mortgage loans (rate lock commitments) to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as free standing derivatives. Fair values of these derivatives are estimated based on changes in mortgage interest rates from the date the interest rate on the loan is locked. The Company enters into forward commitments for the future delivery of mortgage loans when interest rate locks are entered into, in order to hedge the change in interest rates resulting from its commitments to fund the loans. Changes in the fair values of these derivatives are included in gains or losses on sales of loans. The fair value of these derivative instruments was not significant at December 31, 2016 and 2015.

Servicing assets are reported in other assets and amortized in proportion to and over the period during which estimated servicing income will be received. Servicing loans for others consists of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors, and processing foreclosures. Loan servicing income is recorded when earned and represents servicing fees from investors and certain charges collected from borrowers, such as late payment fees. The Company has fiduciary responsibility for related escrow and custodial funds.

Servicing assets are recognized as separate assets when rights are acquired through the sale of financial assets. For sales of mortgage loans originated by the Company, a portion of the cost of originating the loan is allocated to the servicing retained right based on fair value. Capitalized servicing rights are amortized into interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Remaining servicing rights are charged against income upon payoff of the loan. Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal and are recorded as income when earned.



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LOANS HELD-FOR-SALE

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income. Unrealized gains are recognized but only to the extent of previous write-downs.

AUTOMOBILE LEASING

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

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is established through a provision for loan losses. The allowance represents an amount which, in management's judgment, will be adequate to absorb losses on existing loans that may become uncollectible. Management's judgment in determining the adequacy of the allowance is based on evaluations of the collectability of the loans. These evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, current economic conditions that may affect the borrower's ability to pay, collateral value, overall portfolio quality and review of specific loans for impairment. Management applies two primary components during the loan review process to determine proper allowance levels; a specific loan loss allocation for loans that are deemed impaired; and a general loan loss allocation for those loans not specifically allocated based on historical charge-off history and qualitative factor adjustments for trends or changes in the loan portfolio. Delinquencies, changes in lending policies and local economic conditions are some of the items used for the qualitative factor adjustments. Loans considered uncollectible are charged against the allowance. Recoveries on loans previously charged off are added to the allowance.

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

The risk characteristics of each of the identified portfolio segments are as follows:

Commercial and industrial loans (C&I): C&I loans are primarily based on the identified historic and/or the projected cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of the borrower, however, do fluctuate based on changes in the Company's internal and external environment including management, human and capital resources, economic conditions, competition and regulation. Most C&I loans are secured by business assets being financed such as equipment, accounts receivable, and/or inventory and generally incorporate a secured or unsecured personal guarantee. Unsecured loans may be made on a short-term basis. The ability of the borrower to collect amounts due from its customers may be affected by its customers' economic and financial condition.

Commercial real estate loans: Commercial real estate loans are made to finance the purchase of real estate, refinance existing obligations and/or to provide capital. These commercial real estate loans are generally secured by first lien security interests in the real estate as well as assignment of leases and rents. The real estate may include apartments, hotels, retail stores or plazas and healthcare facilities whether they are owner or non-owner occupied. These loans are typically originated in amounts of no more than 80% of the appraised value of the property.

Consumer loans: The Company offers home equity installment loans and lines of credit. Risks associated with loans secured by residential properties are generally lower than commercial real estate loans and include general economic risks, such as the strength of the job market, employment stability and the strength of the housing market. Since most loans are secured by a primary or secondary residence, the borrower's continued employment is considered the greatest risk to repayment. The Company also offers a variety of loans to individuals for personal and household purposes. These loans are generally considered to have greater risk than mortgages on real estate because they may be unsecured, or if they are secured, the value of the collateral may be difficult to assess and more likely to decrease in value than real estate.

Residential mortgage loans: Residential mortgages are secured by a first lien position of the borrower's residential real estate. These loans have varying loan rates depending on the financial condition of the borrower and the loan to value ratio. Residential mortgages have terms up to thirty years with amortizations varying from 10 to 30 years. The majority of the loans are underwritten according to FNMA and/or FHLB standards.

#### TRANSFER OF FINANCIAL ASSETS

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: the assets have been isolated from the Company—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership; the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets; and the

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Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

### LOAN FEES AND COSTS

Nonrefundable loan origination fees and certain direct loan origination costs are recognized as a component of interest income over the life of the related loans as an adjustment to yield. The unamortized balance of the deferred fees and costs are included as components of the loan balances to which they relate.

### BANK PREMISES AND EQUIPMENT

Land is carried at cost. Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the shorter of the term of the lease or the estimated useful lives of the improved property. Rent expense is recognized on the straight-line method over the term of the lease.

### BANK OWNED LIFE INSURANCE

The Company maintains bank owned life insurance (BOLI) for a chosen group of employees, at the time of purchase, namely its officers where the Company is the owner and sole beneficiary of the policies. The earnings from the BOLI are recognized as a component of other income in the consolidated statements of income. The BOLI is an asset that can be liquidated, if necessary, with tax consequences. However, the Company intends to hold these policies and, accordingly, the Company has not provided for deferred income taxes on the earnings from the increase in the cash surrender value.

### FORECLOSED ASSETS HELD-FOR-SALE

Foreclosed assets held-for-sale are carried at the lower of cost or fair value less cost to sell. Losses from the acquisition of property in full and partial satisfaction of debt are treated as credit losses. Routine holding costs, gains and losses from sales, write-downs for subsequent declines in value and any rental income received are recognized net, as a component of other real estate owned expense in the consolidated statements of income. Gains or losses are recorded when the properties are sold.

### IMPAIRMENT OF LONG-LIVED ASSETS

Long-lived assets, including bank premises and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If impairment is indicated by that review, the asset is written down to its estimated fair value through a charge to non-interest expense.

### STOCK PLANS

The Company has two stock-based compensation plans. The Company accounts for these plans under the recognition and measurement accounting principles, which requires the cost of share-based payment transactions be recognized in the financial statements. The stock-based compensation accounting guidance requires that compensation cost for stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. Compensation cost is recognized on a straight-line basis over the requisite service period. When granting

stock options, the Company uses the Black-Sholes option pricing model to determine their estimated fair value on the date of grant. When granting stock-settled stock appreciation rights (SSARs), the Company uses Black-Scholes-Merton valuation model to determine fair value on the date of grant.

#### TRUST AND FINANCIAL SERVICE FEES

Trust and financial service fees are recorded on the cash basis, which is not materially different from the accrual basis.

#### ADVERTISING COSTS

Advertising costs are charged to expense as incurred.

#### LEGAL AND PROFESSIONAL EXPENSES

Generally, the Company recognizes legal and professional fees as incurred and are included as a component of professional services expense in the consolidated statements of income. Legal costs incurred that are associated with the collection of outstanding amounts due from delinquent borrowers are included as a component of loan collection expense in the consolidated statements of income. In the event of litigation proceedings brought about by an employee or third party against the Company, expenses for damages will be accrued if the likelihood of the outcome against the Company is probable, the amount can be reasonably estimated and the amount would have a material impact on the financial results of the Company.

#### INCOME TAXES

Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The benefit of a tax position is recognized on the financial statements in the period during which, based on all available evidence, management believes it is more-likely-than-not that the position will be sustained upon examination, including the

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resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50% likely of being realized upon settlement with the applicable taxing authority. For tax positions not meeting the more likely than not threshold, no tax benefit is recorded. Under the more likely than not threshold guidelines, the Company believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. The Company had no material unrecognized tax benefits or accrued interest and penalties for the years ended December 31, 2016, 2015 or 2014, respectively.

### COMPREHENSIVE INCOME (LOSS)

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the shareholders' equity section of the consolidated balance sheets, such items, along with net income, are components of comprehensive income (loss).

### CASH FLOWS

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks and interest-bearing deposits with financial institutions.

For the years ended December 31, 2016, 2015 and 2014, the Company paid interest of \$2.4 million, \$2.5 million and \$2.9 million, respectively. For the years ended December 31, 2016, 2015 and 2014, the Company paid income taxes of \$0.8 million, \$0.4 million and \$1.7 million, respectively. For the years ended December 31, 2016, 2015 and 2014, the Company had a net change in unrealized (losses) gains on available for sale securities of (\$1.2 million), (\$0.8 million) and \$2.3 million, respectively.

Transfers from loans to foreclosed assets held-for-sale amounted to \$1.1 million, \$0.6 million and \$1.2 million in 2016, 2015 and 2014, respectively. Transfers from loans to loans held-for-sale amounted to \$6.0 million, \$2.1 million and \$0.2 million in 2016, 2015 and 2014, respectively. During 2014, transfers from loans to bank premises and equipment amounted to \$1.0 million. There were no transfers from loans to bank premises and equipment in 2016 or 2015. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of premises and equipment.

### RECLASSIFICATION ADJUSTMENTS

Certain reclassifications have been made to the 2014 and 2015 financial statements to conform to the 2016 presentation with no impact on total equity or net income.

### 2.CASH

The Company is required by the Federal Reserve Bank to maintain average reserve balances based on a percentage of deposits. The amounts of those reserve requirements on December 31, 2016 and 2015 were \$1.3 million and \$1.0 million, respectively.

Deposits with any one financial institution are insured up to \$250,000. From time-to-time, the Company may maintain cash and cash equivalents with certain other financial institutions in excess of the insured amount.

## 3. ACCUMULATED OTHER COMPREHENSIVE INCOME

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

As of and for the year ended December 31, 2016

| (dollars in thousands)   | Unrealized gains<br>(losses) on<br>available-for-sale<br>securities | Total    |
|--|---|----------|
| Beginning balance  | \$ 2,188  | \$ 2,188 |
| Other comprehensive loss before reclassifications, net of tax                | (801)   | (801)    |
| Amounts reclassified from accumulated other comprehensive income, net of tax | (6)   | (6)      |
| Net current-period other comprehensive loss                                  | (807)   | (807)    |
| Ending balance   | \$ 1,381  | \$ 1,381 |

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As of and for the year ended December 31, 2015

| (dollars in thousands)   | Unrealized gains<br>(losses) on<br>available-for-sale<br>securities | Total    |
|--|---|----------|
| Beginning balance  | \$ 2,743  | \$ 2,743 |
| Other comprehensive loss before reclassifications, net of tax                | (502)   | (502)    |
| Amounts reclassified from accumulated other comprehensive income, net of tax | (53)  | (53)     |
| Net current-period other comprehensive loss                                  | (555)   | (555)    |
| Ending balance   | \$ 2,188  | \$ 2,188 |

As of and for the year ended December 31, 2014

| (dollars in thousands)   | Unrealized gains<br>(losses) on<br>available-for-sale<br>securities | Total    |
|--|---|----------|
| Beginning balance  | \$ 1,239  | \$ 1,239 |
| Other comprehensive income before reclassifications, net of tax              | 1,899   | 1,899    |
| Amounts reclassified from accumulated other comprehensive income, net of tax | (395)   | (395)    |
| Net current-period other comprehensive income                                | 1,504   | 1,504    |
| Ending balance   | \$ 2,743  | \$ 2,743 |

Details about accumulated other

|   |  |  |
|---|--|--|
| comprehensive income components<br><br>(dollars in thousands) | Amount reclassified<br>from accumulated<br>other comprehensive<br>income | Affected line item in the statement<br><br>where net income is presented |
|---|--|--|

Years ended  
December 31,  
2016 2015 2014

|  |      |       |        |                                       |
|--|------|-------|--------|---------------------------------------|
| Unrealized gains on AFS securities     | \$ 9 | \$ 80 | \$ 599 | Gain on sale of investment securities |
|  | (3)  | (27)  | (204)  | Provision for income taxes            |
| Total reclassifications for the period | \$ 6 | \$ 53 | \$ 395 | Net income                            |

#### 4.INVESTMENT SECURITIES

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

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

Obligations of states and political subdivisions

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



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Amortized cost and fair value of investment securities as of the period indicated are as follows:

| (dollars in thousands)                           | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| December 31, 2016                                |                   |                              |                               |               |
| Available-for-sale securities:                   |                   |                              |                               |               |
| Agency - GSE                                     | \$ 18,362         | \$ 58                        | \$ (144)                      | \$ 18,276     |
| Obligations of states and political subdivisions | 38,648            | 1,803                        | (260)                         | 40,191        |
| MBS - GSE residential                            | 70,639            | 851                          | (553)                         | 70,937        |
| Total debt securities                            | 127,649           | 2,712                        | (957)                         | 129,404       |
| Equity securities - financial services           | 294               | 339                          | -                             | 633           |
| Total available-for-sale securities              | \$ 127,943        | \$ 3,051                     | \$ (957)                      | \$ 130,037    |

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

Some of the Company's debt securities are pledged to secure trust funds, public deposits, repurchase agreements, other short-term borrowings, FHLB advances, Federal Reserve Bank of Philadelphia Discount Window borrowings and certain other deposits as required by law.

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

| (dollars in thousands)                       | Amortized<br>cost | Fair<br>value  |
|--|-------------------|----------------|
| Available-for-sale securities:               |                   |                |
| Debt securities:                             |                   |                |
| Due in one year or less                      | \$ 4,006          | \$ 4,017       |
| Due after one year through five years        | 14,356            | 14,259         |
| Due after five years through ten years       | 1,662             | 1,794          |
| Due after ten years                          | 36,986            | 38,397         |
| <br>Total debt securities                    | <br>57,010        | <br>58,467     |
| <br>MBS - GSE residential                    | <br>70,639        | <br>70,937     |
| <br>Total available-for-sale debt securities | <br>\$ 127,649    | <br>\$ 129,404 |

Actual maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Agency – GSE and municipal securities are included based on their original stated maturity. MBS – GSE residential, which are based on weighted-average lives and subject to monthly principal

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pay-downs, are listed in total. Most of the securities have fixed rates or have predetermined scheduled rate changes and many have call features that allow the issuer to call the security at par before its stated maturity without penalty.

Gross realized gains and losses from sales, determined using specific identification, for the periods indicated were as follows:

|                        | December 31, |        |        |
|------------------------|--------------|--------|--------|
| (dollars in thousands) | 2016         | 2015   | 2014   |
| Gross realized gain    | \$ 16        | \$ 137 | \$ 603 |
| Gross realized loss    | (7)          | (57)   | (4)    |
| Net gain               | \$ 9         | \$ 80  | \$ 599 |

The following table presents the fair value and gross unrealized losses of investments aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of the period indicated:

| (dollars in thousands)                           | Less than 12 months |                   | More than 12 months |                   | Total      |                   |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|  | Fair value          | Unrealized losses | Fair value          | Unrealized losses | Fair value | Unrealized losses |
| December 31, 2016                                |                     |                   |                     |                   |            |                   |
| Agency - GSE                                     | \$ 6,032            | \$ (144)          | \$ -                | \$ -              | \$ 6,032   | \$ (144)          |
| Obligations of states and political subdivisions | 8,690               | (260)             | -                   | -                 | 8,690      | (260)             |
| MBS - GSE residential                            | 41,111              | (553)             | -                   | -                 | 41,111     | (553)             |
| Total  | \$ 55,833           | \$ (957)          | \$ -                | \$ -              | \$ 55,833  | \$ (957)          |
| Number of securities                             | 48                  |                   | -                   |                   | 48         |                   |
| December 31, 2015                                |                     |                   |                     |                   |            |                   |
| Agency - GSE                                     | \$ 8,156            | \$ (24)           | \$ -                | \$ -              | \$ 8,156   | \$ (24)           |
| Obligations of states and political subdivisions | 3,656               | (20)              | 485                 | (4)               | 4,141      | (24)              |
| MBS - GSE residential                            | 36,899              | (299)             | -                   | -                 | 36,899     | (299)             |
| Total  | \$ 48,711           | \$ (343)          | \$ 485              | \$ (4)            | \$ 49,196  | \$ (347)          |
| Number of securities                             | 32                  |                   | 1                   |                   | 33         |                   |

The Company had forty-eight securities in an unrealized loss position at December 31, 2016, including six agency securities, twenty-five mortgage-backed securities and seventeen municipal securities. The severity of these unrealized

losses based on their underlying cost basis was as follows at December 31, 2016: 2.33% for agencies; 1.33% for total MBS-GSE; and 2.91% for municipals. In addition, none of these securities had been in an unrealized loss position in excess of 12 months. The changes in the prices on these securities are the result of interest rate movement and management believes they are temporary in nature.

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

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

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

## 5.LOANS AND LEASES

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

| (dollars in thousands)     | 2016       | 2015       |
|----------------------------|------------|------------|
| Commercial and industrial  | \$ 98,477  | \$ 102,653 |
| Commercial real estate:    |            |            |
| Non-owner occupied         | 93,364     | 95,745     |
| Owner occupied             | 106,960    | 101,652    |
| Construction               | 3,987      | 4,481      |
| Consumer:                  |            |            |
| Home equity installment    | 28,466     | 30,935     |
| Home equity line of credit | 51,609     | 48,060     |
| Auto loans and leases      | 56,841     | 29,758     |
| Other                      | 13,301     | 6,208      |
| Residential:               |            |            |
| Real estate                | 134,475    | 126,992    |
| Construction               | 10,496     | 10,060     |
| Total                      | 597,976    | 556,544    |
| Less:                      |            |            |
| Allowance for loan losses  | (9,364)    | (9,527)    |
| Unearned lease revenue     | (482)      | (335)      |
| Loans and leases, net      | \$ 588,130 | \$ 546,682 |

Net deferred loan costs of \$1.8 million and \$1.5 million have been included in the carrying values of loans at December 31, 2016 and 2015, respectively.

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

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate unpaid principal balance of mortgages serviced amounted to \$285.2 million as of December 31, 2016 and \$269.5 million as of December 31, 2015. Mortgage servicing rights amounted to \$1.3 million and \$1.2 million as of December 31, 2016 and 2015, respectively.

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

#### Non-accrual loans

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

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Non-accrual loans, segregated by class, at December 31, were as follows:

| (dollars in thousands)     | 2016     | 2015     |
|----------------------------|----------|----------|
| Commercial and industrial  | \$ 11    | \$ 30    |
| Commercial real estate:    |          |          |
| Non-owner occupied         | 1,407    | 6,193    |
| Owner occupied             | 3,078    | 988      |
| Construction               | 193      | 226      |
| Consumer:                  |          |          |
| Home equity installment    | 31       | 167      |
| Home equity line of credit | 737      | 512      |
| Auto loans and leases      | 25       | 45       |
| Other                      | 6        | 6        |
| Residential:               |          |          |
| Real estate                | 1,882    | 836      |
| Total                      | \$ 7,370 | \$ 9,003 |

### Troubled Debt Restructuring

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

Loans modified in a TDR may or may not be placed on non-accrual status. As of December 31, 2016, total TDRs amounted to \$3.4 million, consisting of 9 loans (6 CRE loans, 1 C&I loan, 1 HELOC and 1 residential mortgage to 6 unrelated borrowers), of which the HELOC, totaling \$0.6 million, and the residential mortgage, totaling \$0.9 million, were on non-accrual status. The December 31, 2016 balance represented a \$1.0 million increase over the December 31, 2015 balance, which amounted to \$2.4 million (consisting of 7 CRE loans and 2 C&I loans to 5 unrelated borrowers), with none of these loans on non-accrual status. This increase in TDRs was attributed to the addition of the two TDRs (the HELOC and the residential mortgage) on non-accrual, totaling \$1.5 million, partially offset by the

payoff of one C&I loan in the amount of \$0.5 million. Of the TDRs outstanding as of December 31, 2016 and 2015, when modified, the concessions granted consisted of temporary interest-only payments, extensions of maturity date, or a reduction in the rate of interest to a below-market rate for a contractual period of time. Other than the TDRs that were placed on non-accrual status, the TDRs were performing in accordance with their modified terms.

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

| (dollars in thousands)                  | Loans modified as TDRs for the twelve months ended: |  |  |                     |  |  |
|---|---|--|--|---------------------|--|--|
|   | December 31, 2016                                   |  |  | December 31, 2015   |  |  |
|   | Number of contracts                                 | Recorded investment (as of period end) | Increase in allowance (as of period end) | Number of contracts | Recorded investment (as of period end) | Increase in allowance (as of period end) |
| Commercial and industrial               | -   | \$ -                                   | \$ -                                     | 1                   | \$ 500                                 | \$ 331                                   |
| Commercial real estate - owner occupied | -   | -                                      | -  | 4                   | 1,181                                  | 316                                      |
| Consumer home equity line of credit     | 1   | 650                                    | 167                                      | -                   | -                                      | -  |
| Residential real estate                 | 1   | 881                                    | 177                                      | -                   | -                                      | -  |
| Total                                   | 2   | \$ 1,531                               | \$ 344                                   | 5                   | \$ 1,681                               | \$ 647                                   |

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



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

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

| (dollars in thousands)              | Twelve months ended<br>December 31, 2016 |                        |
|-------------------------------------|--|------------------------|
|                                     | Number of<br>contracts                   | Recorded<br>investment |
| Consumer home equity line of credit | 1  | \$ 650                 |

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

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

The allowance for loan losses (allowance) may be increased, adjustments may be made in the allocation of the allowance or partial charge-offs may be taken to further write-down the carrying value of the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral is used to establish the allowance. As of December 31, 2016 and 2015, the allowance for impaired loans that have been modified in a TDR was \$0.7 million and \$0.7 million, respectively.

#### Past due loans

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

| 30 -<br>59 | 60 - 89<br>Days | Past due |       | Total | Total | Recorded<br>investment<br>past<br>due ≥ 90<br>days |
|------------|-----------------|----------|-------|-------|-------|--|
|            |                 | 90 days  | Total |       |       |  |
|            |                 |          |       |       |       |  |

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| December 31, 2016          | Days<br>past<br>due | past due | or<br>more (1) | past due | Current    | loans (3)  | and<br>accruing |
|----------------------------|---------------------|----------|----------------|----------|------------|------------|-----------------|
| Commercial and industrial  | \$ 208              | \$ -     | \$ 11          | \$ 219   | \$ 98,258  | \$ 98,477  | \$ -            |
| Commercial real estate:    |                     |          |                |          |            |            |                 |
| Non-owner occupied         | 180                 | -        | 1,407          | 1,587    | 91,777     | 93,364     | -               |
| Owner occupied             | 13                  | 776      | 3,078          | 3,867    | 103,093    | 106,960    | -               |
| Construction               | -                   | -        | 193            | 193      | 3,794      | 3,987      | -               |
| Consumer:                  |                     |          |                |          |            |            |                 |
| Home equity installment    | 213                 | 25       | 31             | 269      | 28,197     | 28,466     | -               |
| Home equity line of credit | -                   | -        | 737            | 737      | 50,872     | 51,609     | -               |
| Auto loans and leases      | 293                 | 59       | 44             | 396      | 55,963     | 56,359 (2) | 19              |
| Other                      | 37                  | 2        | 6              | 45       | 13,256     | 13,301     | -               |
| Residential:               |                     |          |                |          |            |            |                 |
| Real estate                | 14                  | 421      | 1,882          | 2,317    | 132,158    | 134,475    | -               |
| Construction               | -                   | -        | -              | -        | 10,496     | 10,496     | -               |
| Total                      | \$ 958              | \$ 1,283 | \$ 7,389       | \$ 9,630 | \$ 587,864 | \$ 597,494 | \$ 19           |

(1) Includes \$7.4 million of non-accrual loans. (2) Net of unearned lease revenue of \$0.5 million. (3) Includes net deferred loan costs of \$1.8 million.

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

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

## Impaired loans

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

At December 31, 2016, impaired loans consisted of accruing TDRs of \$1.8 million, \$7.4 million in non-accrual loans and \$2.2 million in accruing loans. At December 31, 2015, impaired loans consisted of accruing TDRs totaling \$2.4 million, \$9.0 million of non-accrual loans and a \$1.2 million accruing loan. As of December 31, 2015, the non-accrual loans did not include any TDRs compared with two TDRs totaling \$1.5 million as of December 31, 2016.

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

| (dollars in thousands)     | Unpaid<br>principal<br>balance | Recorded<br>investment<br>with<br>allowance | Recorded<br>investment<br>with no<br>allowance | Total<br>recorded<br>investment | Related<br>allowance |
|----------------------------|--------------------------------|---|--|---------------------------------|----------------------|
| December 31, 2016          |                                |   |  |                                 |                      |
| Commercial and industrial  | \$ 235                         | \$ 206                                      | \$ 29  | \$ 235                          | \$ 193               |
| Commercial real estate:    |                                |   |  |                                 |                      |
| Non-owner occupied         | 3,346                          | 2,611                                       | 405  | 3,016                           | 993                  |
| Owner occupied             | 5,363                          | 4,351                                       | 876  | 5,227                           | 1,389                |
| Construction               | 416                            | -   | 193  | 193                             | -                    |
| Consumer:                  |                                |   |  |                                 |                      |
| Home equity installment    | 64                             | -   | 31   | 31                              | -                    |
| Home equity line of credit | 778                            | 650   | 87   | 737                             | 167                  |
| Auto loans and leases      | 25                             | 25  | -  | 25                              | 3                    |
| Other                      | 6                              | 6   | -  | 6                               | 1                    |
| Residential:               |                                |   |  |                                 |                      |
| Real estate                | 1,949                          | 1,466                                       | 416  | 1,882                           | 315                  |
| Construction               | -                              | -   | -  | -                               | -                    |
| Total                      | \$ 12,182                      | \$ 9,315                                    | \$ 2,037                                       | \$ 11,352                       | \$ 3,061             |

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

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

| (dollars in thousands)    | December 31, 2016           |                            |                                       | December 31, 2015           |                            |                                       |
|---------------------------|-----------------------------|----------------------------|---------------------------------------|-----------------------------|----------------------------|---------------------------------------|
|                           | Average recorded investment | Interest income recognized | Cash basis interest income recognized | Average recorded investment | Interest income recognized | Cash basis interest income recognized |
| Commercial and industrial | \$ 434                      | \$ 51                      | \$ -                                  | \$ 511                      | \$ 22                      | \$ 1                                  |
| Commercial real estate:   |                             |                            |                                       |                             |                            |                                       |
| Non-owner occupied        | 4,230                       | 176                        | -                                     | 2,755                       | 95                         | -                                     |
| Owner occupied            | 3,088                       | 129                        | -                                     | 2,705                       | 67                         | -                                     |
| Construction              | 209                         | -                          | -                                     | 241                         | -                          | -                                     |
| Consumer:                 |                             |                            |                                       |                             |                            |                                       |

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|                            |          |        |      |          |        |      |
|----------------------------|----------|--------|------|----------|--------|------|
| Home equity installment    | 78       | 3      | -    | 239      | 2      | -    |
| Home equity line of credit | 816      | 28     | -    | 472      | 1      | -    |
| Auto                       | 30       | -      | -    | 25       | 2      | -    |
| Other                      | 6        | -      | -    | 12       | 2      | -    |
| Residential:               |          |        |      |          |        |      |
| Real estate                | 628      | 15     | -    | 629      | 7      | -    |
| Construction               | -        | -      | -    | -        | -      | -    |
| Total                      | \$ 9,519 | \$ 402 | \$ - | \$ 7,589 | \$ 198 | \$ 1 |

The average recorded investment for the year ended December 31, 2014 was \$5.5 million. There was also interest income recognized of \$81 thousand and no cash basis interest income recognized.

### Credit Quality Indicators

#### Commercial and industrial and commercial real estate

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

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

#### Pass

Loans in this category have an acceptable level of risk and are graded in a range of one to five. Secured loans generally have good collateral coverage. Current financial statements reflect acceptable balance sheet ratios, sales and earnings trends.

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Management is considered to be competent, and a reasonable succession plan is evident. Payment experience on the loans has been good with minor or no delinquency experience. Loans with a grade of one are of the highest quality in the range. Those graded five are of marginally acceptable quality.

### Special Mention

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

### Substandard

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

### Doubtful

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

### Consumer and residential

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

The following table presents loans including \$1.8 million and \$1.5 million of deferred costs, segregated by class, categorized into the appropriate credit quality indicator category as of December 31, 2016 and 2015, respectively:

### Commercial credit exposure

### Credit risk profile by creditworthiness category

| (dollars in thousands)                      | December 31, 2016 |                    |             |          |            |
|---|-------------------|--------------------|-------------|----------|------------|
|   | Pass              | Special<br>mention | Substandard | Doubtful | Total      |
| Commercial and industrial                   | \$ 97,308         | \$ 479             | \$ 690      | \$ -     | \$ 98,477  |
| Commercial real estate - non-owner occupied | 83,962            | 1,811              | 7,591       | -        | 93,364     |
| Commercial real estate - owner occupied     | 99,981            | 1,075              | 5,904       | -        | 106,960    |
| Commercial real estate - construction       | 3,794             | -                  | 193         | -        | 3,987      |
| Total commercial                            | \$ 285,045        | \$ 3,365           | \$ 14,378   | \$ -     | \$ 302,788 |

Consumer & Mortgage lending credit exposure

Credit risk profile based on payment activity

| (dollars in thousands)       | December 31, 2016 |                |            |
|------------------------------|-------------------|----------------|------------|
|                              | Performing        | Non-performing | Total      |
| Consumer                     |                   |                |            |
| Home equity installment      | \$ 28,435         | \$ 31          | \$ 28,466  |
| Home equity line of credit   | 50,872            | 737            | 51,609     |
| Auto loans and leases (1)    | 56,315            | 44             | 56,359     |
| Other                        | 13,295            | 6              | 13,301     |
| Total consumer               | \$ 148,917        | \$ 818         | \$ 149,735 |
| Residential                  |                   |                |            |
| Real estate                  | \$ 132,593        | \$ 1,882       | 134,475    |
| Construction                 | 10,496            | -              | 10,496     |
| Total residential            | \$ 143,089        | \$ 1,882       | \$ 144,971 |
| Total consumer & residential | \$ 292,006        | \$ 2,700       | \$ 294,706 |

(1)Net of unearned lease revenue of \$0.5 million.



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## Commercial credit exposure

## Credit risk profile by creditworthiness category

| (dollars in thousands)                      | December 31, 2015 |                    |             |          |            |
|---|-------------------|--------------------|-------------|----------|------------|
|   | Pass              | Special<br>mention | Substandard | Doubtful | Total      |
| Commercial and industrial                   | \$ 101,342        | \$ 189             | \$ 1,122    | \$ -     | \$ 102,653 |
| Commercial real estate - non-owner occupied | 82,152            | 1,480              | 12,113      | -        | 95,745     |
| Commercial real estate - owner occupied     | 96,401            | 657                | 4,594       | -        | 101,652    |
| Commercial real estate - construction       | 4,255             | -                  | 226         | -        | 4,481      |
| Total commercial                            | \$ 284,150        | \$ 2,326           | \$ 18,055   | \$ -     | \$ 304,531 |

## Consumer &amp; Mortgage lending credit exposure

## Credit risk profile based on payment activity

| (dollars in thousands)       | December 31, 2015 |                |            |
|------------------------------|-------------------|----------------|------------|
|                              | Performing        | Non-performing | Total      |
| Consumer                     |                   |                |            |
| Home equity installment      | \$ 30,768         | \$ 167         | \$ 30,935  |
| Home equity line of credit   | 47,548            | 512            | 48,060     |
| Auto loans and leases (2)    | 29,347            | 76             | 29,423     |
| Other                        | 6,172             | 36             | 6,208      |
| Total consumer               | \$ 113,835        | \$ 791         | \$ 114,626 |
| Residential                  |                   |                |            |
| Real estate                  | \$ 126,156        | \$ 836         | \$ 126,992 |
| Construction                 | 10,060            | -              | 10,060     |
| Total residential            | \$ 136,216        | \$ 836         | \$ 137,052 |
| Total consumer & residential | \$ 250,051        | \$ 1,627       | \$ 251,678 |

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

## Allowance for loan losses

Management continually evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance on a quarterly basis. The allowance reflects management's best estimate of the amount

of credit losses in the loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

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

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

Allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk

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

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

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

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

As of and for the year ended December 31, 2016

| (dollars in thousands)                                   | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer | Residential<br>real estate | Unallocated | Total    |
|--|-------------------------------|---------------------------|----------|----------------------------|-------------|----------|
| Allowance for Loan Losses:                               |                               |                           |          |                            |             |          |
| Beginning balance  | \$ 1,336                      | \$ 5,014                  | \$ 1,533 | \$ 1,407                   | \$ 237      | \$ 9,527 |
| Charge-offs  | (224)                         | (592)                     | (504)    | (60)                       | -           | (1,380)  |
| Recoveries   | 55                            | 37                        | 100      | -                          | -           | 192      |
| Provision  | (92)                          | 247                       | 705      | 275                        | (110)       | 1,025    |
| Ending balance   | \$ 1,075                      | \$ 4,706                  | \$ 1,834 | \$ 1,622                   | \$ 127      | \$ 9,364 |
| Ending balance: individually<br>evaluated for impairment | \$ 193                        | \$ 2,382                  | \$ 171   | \$ 315                     | \$ -        | \$ 3,061 |
|  | \$ 882                        | \$ 2,324                  | \$ 1,663 | \$ 1,307                   | \$ 127      | \$ 6,303 |

Ending balance: collectively  
evaluated for impairment

Loans Receivables:

|                    |           |            |                |            |      |            |
|--------------------|-----------|------------|----------------|------------|------|------------|
| Ending balance (2) | \$ 98,477 | \$ 204,311 | \$ 149,735 (1) | \$ 144,971 | \$ - | \$ 597,494 |
|--------------------|-----------|------------|----------------|------------|------|------------|

Ending balance: individually  
evaluated for impairment

|  |        |          |        |          |      |           |
|--|--------|----------|--------|----------|------|-----------|
|  | \$ 235 | \$ 8,436 | \$ 799 | \$ 1,882 | \$ - | \$ 11,352 |
|--|--------|----------|--------|----------|------|-----------|

Ending balance: collectively  
evaluated for impairment

|  |           |            |            |            |      |            |
|--|-----------|------------|------------|------------|------|------------|
|  | \$ 98,242 | \$ 195,875 | \$ 148,936 | \$ 143,089 | \$ - | \$ 586,142 |
|--|-----------|------------|------------|------------|------|------------|

(1) Net of unearned lease revenue of \$0.5 million. (2) Includes \$1.8 million of net deferred loan costs.

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As of and for the year ended  
December 31, 2015

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

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

As of and for the year ended December  
31, 2014

| (dollars in thousands)     | Commercial<br>&<br>industrial | Commercial<br>real estate | Consumer | Residential<br>real estate | Unallocated | Total    |
|----------------------------|-------------------------------|---------------------------|----------|----------------------------|-------------|----------|
| Allowance for Loan Losses: |                               |                           |          |                            |             |          |
| Beginning balance          | \$ 944                        | \$ 4,253                  | \$ 1,482 | \$ 1,613                   | \$ 636      | \$ 8,928 |
| Charge-offs                | (309)                         | (239)                     | (361)    | (93)                       | -           | (1,002)  |
| Recoveries                 | 32                            | 91                        | 30       | 34                         | -           | 187      |
| Provision                  | 385                           | 567                       | 368      | (238)                      | (22)        | 1,060    |
| Ending balance             | \$ 1,052                      | \$ 4,672                  | \$ 1,519 | \$ 1,316                   | \$ 614      | \$ 9,173 |

## 6.BANK PREMISES AND EQUIPMENT

Components of bank premises and equipment are summarized as follows:

| (dollars in thousands)                         | As of December 31, |           |
|--|--------------------|-----------|
|  | 2016               | 2015      |
| Land   | \$ 2,865           | \$ 2,865  |
| Bank premises                                  | 13,703             | 13,023    |
| Furniture, fixtures and equipment              | 10,257             | 9,659     |
| Leasehold improvements                         | 5,996              | 5,985     |
| Total  | 32,821             | 31,532    |
| Less accumulated depreciation and amortization | (15,657)           | (14,809)  |
| Bank premises and equipment, net               | \$ 17,164          | \$ 16,723 |

Depreciation expense, which includes amortization of leasehold improvements, was \$1.4 million, \$1.3 million and \$1.2 million for the years ended December 31, 2016, 2015 and 2014. The estimated useful life was 40 years for bank premises, 3 to 7 years for furniture and fixtures and for leasehold improvements was the term of the lease.

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In 2016, the Company leased its Green Ridge, Pittston, Peckville, Clarks Summit and Eynon branches under the terms of operating leases. During the third quarter of 2016, the Company entered into a lease agreement for a new branch in Dallas and lease payments will begin when the branch opens for business, which is expected to occur during the fourth quarter of 2017. Rental expense was \$0.3 million, \$0.3 million and \$0.2 million in 2016, 2015 and 2014. The future minimum lease payments for the Company's branch network as of December 31, 2016 are as follows:

| (dollars in thousands) | Amount   |
|------------------------|----------|
| 2017                   | \$ 263   |
| 2018                   | 320      |
| 2019                   | 322      |
| 2020                   | 317      |
| 2021                   | 290      |
| 2022 and thereafter    | 6,040    |
| Total                  | \$ 7,552 |

During 2015, the Company relocated its West Pittston branch to a newly constructed building in Pittston. The Eynon branch closed during the first quarter of 2016, but the Company expects to make lease payments until the end of the lease term in 2020.

During the 2014 first quarter, the Company received through foreclosure the deed that secured the collateral for a non-owner occupied commercial real estate loan that was on non-accrual status. The loan, in the amount \$1.0 million, was transferred from loans to foreclosed assets held-for-sale and then to bank premises. Currently the building has a tenant under a lease agreement expiring in 2018, but the Company expects to use the property for future facility expansion.

**7.DEPOSITS**

The scheduled maturities of certificates of deposit including certificates reciprocated in the Certificate of Deposit Account Registry Service (CDARS) program as of December 31, 2016 were as follows:

| (dollars in thousands) | Amount    | Percent |
|------------------------|-----------|---------|
| 2017                   | \$ 51,168 | 55.1 %  |
| 2018                   | 15,210    | 16.4    |
| 2019                   | 14,008    | 15.1    |
| 2020                   | 8,995     | 9.7     |
| 2021                   | 2,196     | 2.4     |
| 2022 and thereafter    | 1,176     | 1.3     |
| Total                  | \$ 92,753 | 100.0 % |

Including \$1.1 million and \$3.4 million of CDARS deposits, certificates of deposit of \$100,000 or more aggregated \$47.4 million and \$54.2 million as of December 31, 2016 and 2015, respectively. Including CDARS, certificates of deposit of \$250,000 or more aggregated \$25.7 million and \$31.7 million at December 31, 2016 and 2015, respectively.

As of December 31, 2016, investment securities with a combined fair value of \$129.4 million and letters of credit with a notional value of \$30.3 million were available to be pledged as qualifying collateral to secure public deposits and trust funds. The Company required \$145.3 million of the qualifying collateral to secure such deposits as of December 31, 2016 and the balance of \$14.4 million was available for other pledging needs.

#### 8.SHORT-TERM BORROWINGS

The components of short-term borrowings are summarized as follows:

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



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The maximum and average amounts of short-term borrowings outstanding and related interest rates as of the periods indicated are as follows:

| (dollars in thousands) | Maximum<br>outstanding<br>at any<br>month end | Average<br>outstanding | Weighted-<br>average<br>rate during<br>the year | Rate at<br>year-end |
|------------------------|---|------------------------|---|---------------------|
| December 31, 2016      |   |                        |   |                     |
| Overnight borrowings   | \$ 17,862                                     | \$ 2,805               | 0.65 %  | - %                 |
| Repurchase agreements  | 18,765  | 10,239                 | 0.19  | 0.13                |
| Total                  | \$ 36,627                                     | \$ 13,044              |   |                     |
| December 31, 2015      |   |                        |   |                     |
| Overnight borrowings   | \$ 27,236                                     | \$ 4,823               | 0.39 %  | 0.48 %              |
| Repurchase agreements  | 20,684  | 10,268                 | 0.17  | 0.15                |
| Total                  | \$ 47,920                                     | \$ 15,091              |   |                     |
| December 31, 2014      |   |                        |   |                     |
| Overnight borrowings   | \$ 13,694                                     | \$ 2,628               | 0.31 %  | - %                 |
| Repurchase agreements  | 22,972  | 11,349                 | 0.18  | 0.15                |
| Total                  | \$ 36,666                                     | \$ 13,977              |   |                     |

Overnight borrowings may include Fed funds purchased from correspondent banks, open repurchase agreements with the FHLB and borrowings at the Discount Window from the Federal Reserve Bank of Philadelphia (FRB). Securities sold under agreements to repurchase, or repurchase agreements, are non-insured interest-bearing liabilities that have a perfected security interest in qualified investment securities of the Company. Repurchase agreements are reflected at the amount of cash received in connection with the transaction. The carrying value of the underlying qualified investment securities was approximately \$10.1 million and \$14.2 million at December 31, 2016 and 2015, respectively. The Company may be required to provide additional collateral based on the balance of the repurchase agreement and the fair value of the underlying securities.

At December 31, 2016, the Company had approximately \$194.3 million available to borrow from the FHLB, \$21.0 million from correspondent banks and approximately \$40.9 million that it could borrow at the FRB.

## 9.LONG-TERM DEBT

The Company had no long-term debt at December 31, 2016 and 2015. Prior to the pay-off of long-term debt during the second quarter of 2015, the borrowing consisted of a single advance from the FHLB that was scheduled to mature in 2016. The debt was a convertible-select instrument that carried a 5.26% fixed rate of interest. Significant prepayment fees were attached to the borrowing as a deterrent from paying off the high-cost advance. The Company incurred prepayment fees of \$0.6 million and \$0.5 million as of December 31, 2015 and 2014, respectively.

## 10.STOCK PLANS

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

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

In each of the 2012 stock incentive plans, the Company has reserved 500,000 shares of its no-par common stock for future issuance. The Company recognizes share-based compensation expense over the requisite service or vesting period. During

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2015, the Company created a Long-Term Incentive Plan (LTIP) that awards restricted stock and stock-settled stock appreciation rights (SSARs) to senior officers based on the attainment of performance goals. The service requirement is the participant's continued employment throughout the LTIP with a three-year vesting period. The restricted stock has a two-year post vesting holding period requirement. The SSAR awards have a ten year term from the date of each grant. The Company granted restricted stock and SSARs in February 2016 based on 2015 performance.

The following table summarizes the weighted-average fair value and vesting of restricted stock grants awarded during 2016, 2015 and 2014 under the 2012 stock incentive plans:

|               | 2016           |  | 2015           |  | 2014           |  |
|---------------|----------------|--|----------------|--|----------------|--|
|               | Shares granted | Weighted-average grant date fair value | Shares granted | Weighted-average grant date fair value | Shares granted | Weighted-average grant date fair value |
| Director plan | 5,600          | (1) \$ 32.40                           | 3,200          | (1) \$ 32.25                           | 2,000          | (1) \$ 27.00                           |
| Omnibus plan  | 3,155          | (3) 29.22                              | 3,300          | (2) 32.25                              | 2,120          | (2) 27.00                              |
| Omnibus plan  | 50             | (1) 31.50                              | 50             | (1) 32.50                              |                |  |
| Omnibus plan  | -              | -                                      | 1,400          | (2) 34.25                              |                |  |
| Total         | 8,805          | \$ 31.26                               | 7,950          | \$ 32.60                               | 4,120          | \$ 27.00                               |

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

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

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

|   | 2012 Stock incentive plans |         |         | Weighted- average grant date fair value |
|---|----------------------------|---------|---------|---|
|   | Director                   | Omnibus | Total   |   |
| Non-vested balance at December 31, 2013 | 8,000                      | 5,000   | 13,000  | \$ 21.20                                |
| Granted                                 | 2,000                      | 2,120   | 4,120   | 27.00                                   |
| Vested                                  | (4,000)                    | (1,250) | (5,250) | 21.20                                   |
| Non-vested balance at December 31, 2014 | 6,000                      | 5,870   | 11,870  | \$ 23.21                                |
| Granted                                 | 3,200                      | 4,750   | 7,950   | 32.60                                   |
| Vested                                  | (6,000)                    | (1,780) | (7,780) | 23.90                                   |

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|   |         |         |         |          |
|---|---------|---------|---------|----------|
| Non-vested balance at December 31, 2015 | 3,200   | 8,840   | 12,040  | \$ 29.50 |
| Granted                                 | 5,600   | 3,205   | 8,805   | 31.26    |
| Vested                                  | (3,200) | (3,005) | (6,205) | 29.69    |
| Non-vested balance at December 31, 2016 | 5,600   | 9,040   | 14,640  | \$ 30.47 |

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

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

|                               | Awards | Weighted-average grant date fair value | Weighted-average remaining contractual term (years) |
|-------------------------------|--------|--|---|
| Outstanding December 31, 2015 | -      | -                                      | -   |
| Granted                       | 19,341 | \$ 5.21                                | 10.0  |
| Exercised                     | -      | -                                      |   |
| Forfeited                     | -      | -                                      |   |
| Outstanding December 31, 2016 | 19,341 | \$ 5.21                                | 9.1   |

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

Share-based compensation expense is included as a component of salaries and employee benefits in the consolidated statements of income. The following tables illustrate stock-based compensation expense recognized on non-vested equity awards during the years ended December 31, 2016, 2015 and 2014 and the unrecognized stock-based compensation expense as of December 31, 2016:

| (dollars in thousands)                 | Years ended December 31, |        |        |
|--|--------------------------|--------|--------|
|  | 2016                     | 2015   | 2014   |
| Stock-based compensation expense:      |                          |        |        |
| Director stock incentive plan          | \$ 174                   | \$ 107 | \$ 134 |
| Omnibus stock incentive plan           | 141                      | 74     | 40     |
| Employee stock purchase plan           | 15                       | 44     | 33     |
| Total stock-based compensation expense | \$ 330                   | \$ 225 | \$ 207 |

In addition, during 2016 the Company accrued \$0.2 million in stock-based compensation expense for restricted stock and SSARs to be awarded under the Omnibus Plan. The Company did not accrue stock-based compensation expense during 2015 or 2014.

| (dollars in thousands)                         | As of December 31, 2016 |
|--|-------------------------|
| Unrecognized stock-based compensation expense: |                         |

|   |        |
|---|--------|
| Director plan                                       | \$ 15  |
| Omnibus plan  | 235    |
| Total unrecognized stock-based compensation expense | \$ 250 |

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

Transactions under the Company's stock option plans as of and changes during the periods indicated are presented in the following table:

|  | Options | Weighted-average exercise price | Weighted-average remaining contractual term (years) |
|--|---------|---------------------------------|---|
| Outstanding and exercisable, December 31, 2013 | 19,500  | \$ 28.69                        | 4.0   |
| Granted  | -       | -                               |   |
| Exercised                                      | -       | -                               |   |
| Forfeited                                      | (500)   | 28.90                           |   |
| Outstanding and exercisable, December 31, 2014 | 19,000  | 28.69                           | 3.0   |
| Granted  | -       | -                               |   |
| Exercised                                      | (3,500) | 28.90                           |   |
| Forfeited                                      | -       | -                               |   |
| Outstanding and exercisable, December 31, 2015 | 15,500  | 28.64                           | 2.0   |
| Granted  | -       | -                               |   |
| Exercised                                      | (500)   | 27.75                           |   |
| Forfeited                                      | -       | -                               |   |
| Outstanding and exercisable, December 31, 2016 | 15,000  | \$ 28.67                        | 1.0   |

In the above table, the weighted-average exercise price includes options with exercise prices ranging from \$26.05 to \$28.90.

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During 2016, there were 500 stock options exercised at a price of \$27.75 per share. The intrinsic value of these stock options was \$2,585. The tax deduction realized from the exercise of these options was \$808. As of December 31, 2016, 2015 and 2014, the intrinsic value for outstanding stock options with market prices that exceeded their strike price amounted to \$111,425, \$90,800 and \$81,900, respectively. The Company has not issued stock options since 2008.

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

The Company also established the dividend reinvestment plan (the DRP) for its shareholders. The DRP is designed to avail the Company's stock at no transactional cost to its shareholders. Cash dividends paid to shareholders who are enrolled in the DRP plus voluntary cash deposits received can be used to purchase shares; directly from the Company, from shares that become available in the open market or in negotiated transactions with third parties. The Company has reserved 500,000 shares of its un-issued capital stock for issuance under the DRP. Beginning in 2009, shares purchased directly from the Company via dividends paid through the DRP were purchased at 90% of the fair market value as of the purchase date, as defined in the plan. Shares purchased from the open market were purchased at 100% of the fair market value on the purchase date, as defined in the plan. During the first quarter of 2014, the board of directors amended the DRP to eliminate the 10% purchase price discount to fair market on shares purchased directly from the Company with optional cash payments. As of December 31, 2016, there were 405,888 shares available for future issuance.

## 11. INCOME TAXES

Pursuant to the accounting guidelines related to income taxes, the Company has evaluated its material tax positions as of December 31, 2016 and 2015. Under the "more-likely-than-not" threshold guidelines, the Company believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. In periods subsequent to December 31, 2016, determinations of potentially adverse material tax positions will be evaluated to determine whether an uncertain tax position may have previously existed or has been originated. In the event an adverse tax position is determined to exist, penalty and interest will be accrued, in accordance with the Internal Revenue Service (IRS) guidelines, and will be recorded as a component of other expenses in the Company's consolidated statements of income.

As of December 31, 2016, there were no unrecognized tax benefits that, if recognized, would significantly affect the Company's effective tax rate. Also, there were no penalties and interest recognized in the consolidated statements of income in 2016, 2015 and 2014 as a result of management's evaluation of whether an uncertain tax position may exist nor does the Company foresee a change in its material tax positions that would give rise to the non-recognition of an existing tax benefit during the forthcoming twelve months. Tax returns filed with the IRS are subject to review by law under a three-year statute of limitations. The Company has not received notification from the IRS regarding adverse tax issues from tax returns filed for tax years 2016, 2015 or 2014.





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The following temporary differences gave rise to the net deferred tax liability, a component of other assets in the consolidated balance sheets, as of the periods indicated:

| (dollars in thousands)                                | As of December 31, |            |
|---|--------------------|------------|
|   | 2016               | 2015       |
| Deferred tax assets:                                  |                    |            |
| Allowance for loan losses                             | \$ 3,184           | \$ 3,239   |
| Deferred interest from non-accrual assets             | 425                | 376        |
| Other   | 336                | 281        |
| Total   | 3,945              | 3,896      |
| Deferred tax liabilities:                             |                    |            |
| Net unrealized gains on available-for-sale securities | (711)              | (1,127)    |
| Loan fees and costs                                   | (1,525)            | (1,434)    |
| Automobile leasing                                    | (3,263)            | (2,019)    |
| Depreciation  | (368)              | (357)      |
| Mortgage loan servicing rights                        | (430)              | (410)      |
| Other   | -                  | (69)       |
| Total   | (6,297)            | (5,416)    |
| Deferred tax liability, net                           | \$ (2,352)         | \$ (1,520) |

The components of the total provision for income taxes for the years indicated are as follows:

| (dollars in thousands)           | Years ended December 31, |          |          |
|----------------------------------|--------------------------|----------|----------|
|                                  | 2016                     | 2015     | 2014     |
| Current                          | \$ 1,521                 | \$ 173   | \$ 2,010 |
| Deferred                         | 1,248                    | 1,645    | 156      |
| Total provision for income taxes | \$ 2,769                 | \$ 1,818 | \$ 2,166 |

The reconciliation between the expected statutory income tax and the actual provision for income taxes is as follows:

Years ended December 31,

| (dollars in thousands)                      | 2016     | 2015     | 2014     |
|---|----------|----------|----------|
| Expected provision at the statutory rate    | \$ 3,557 | \$ 3,033 | \$ 2,896 |
| Tax-exempt income                           | (742)    | (715)    | (671)    |
| Bank owned life insurance                   | (120)    | (116)    | (115)    |
| Nondeductible interest expense              | 14       | 14       | 16       |
| Nondeductible other expenses and other, net | 60       | 41       | 40       |
| Tax credits                                 | -        | (439)    | -        |
| Actual provision for income taxes           | \$ 2,769 | \$ 1,818 | \$ 2,166 |

## 12. RETIREMENT PLAN

The Company has a defined contribution profit sharing 401(k) plan covering substantially all of its employees. The plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Contributions to the plan approximated \$0.4 million, \$0.4 million and \$0.3 million in 2016, 2015 and 2014.

## 13. FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

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

December 31, 2016

| (dollars in thousands)             | Carrying<br>amount | Estimated<br>fair value | Quoted<br>prices<br>in active<br>markets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|------------------------------------|--------------------|-------------------------|---|---|---|
| Financial assets:                  |                    |                         |   |   |   |
| Cash and cash equivalents          | \$ 25,843          | \$ 25,843               | \$ 25,843   | \$ -  | \$ -  |
| Available-for-sale securities      | 130,037            | 130,037                 | 633   | 129,404   | -   |
| FHLB stock                         | 2,606              | 2,606                   | -   | 2,606   | -   |
| Loans and leases, net              | 588,130            | 590,688                 | -   | -   | 590,688   |
| Loans held-for-sale                | 2,854              | 2,907                   | -   | 2,907   | -   |
| Accrued interest receivable        | 2,246              | 2,246                   | -   | 2,246   | -   |
| Financial liabilities:             |                    |                         |   |   |   |
| Deposits with no stated maturities | 610,706            | 610,706                 | -   | 610,706   | -   |
| Time deposits                      | 92,753             | 91,969                  | -   | 91,969  | -   |
| Short-term borrowings              | 4,223              | 4,223                   | -   | 4,223   | -   |
| Accrued interest payable           | 181                | 181                     | -   | 181   | -   |

December 31, 2015

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

Financial assets:

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

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

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

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

Loans and leases: The fair value of loans is estimated by the net present value of the future expected cash flows discounted at current offering rates for similar loans. Current offering rates consider, among other things, credit risk. The carrying value

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that fair value is compared to is net of the allowance for loan losses and since there is significant judgment included in evaluating credit quality, loans are classified within Level 3 of the fair value hierarchy.

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

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

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

|  | Total<br>carrying<br>value<br>December<br>31, 2016 | Quoted<br>prices<br>in active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|--|--|--|---|---|
| (dollars in thousands)                           |  |  |   |   |
| Available-for-sale securities:                   |  |  |   |   |
| Agency - GSE                                     | \$ 18,276  | \$ -   | \$ 18,276   | \$ -  |
| Obligations of states and political subdivisions | 40,191   | -  | 40,191  | -   |
| MBS - GSE residential                            | 70,937   | -  | 70,937  | -   |
| Equity securities - financial services           | 633  | 633  | -   | -   |
| Total available-for-sale securities              | \$ 130,037   | \$ 633   | \$ 129,404  | \$ -  |

|  | Total<br>carrying<br>value<br>December<br>31, 2015 | Quoted<br>prices<br>in active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|--|--|--|---|---|
| (dollars in thousands)                           |  |  |   |   |
| Available-for-sale securities:                   |  |  |   |   |
| Agency - GSE                                     | \$ 18,386  | \$ -   | \$ 18,386   | \$ -  |
| Obligations of states and political subdivisions | 36,885   | -  | 36,885  | -   |

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|  |            |        |            |      |
|--|------------|--------|------------|------|
| MBS - GSE residential                  | 69,415     | -      | 69,415     | -    |
| Equity securities - financial services | 546        | 546    | -          | -    |
| Total available-for-sale securities    | \$ 125,232 | \$ 546 | \$ 124,686 | \$ - |

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

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

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

|                         | Total<br>carrying<br>value<br>at<br>December<br>31, 2016 | Quoted<br>prices in<br>active<br>markets<br>(Level<br>1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|-------------------------|--|--|---|---|
| (dollars in thousands)  |  |  |   |   |
| Impaired loans          | \$ 6,254   | \$ -   | \$ -  | \$ 6,254  |
| Other real estate owned | 872  | -  | -   | 872   |
| Total                   | \$ 7,126   | \$ -   | \$ -  | \$ 7,126  |

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

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

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

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

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

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

At December 31, 2016 and 2015, the range of liquidation expenses and other valuation adjustments applied to impaired loans ranged from -22.72% to -57.49% and from -4.92% to -50.00% respectively. The weighted-average of liquidation expenses and other valuation adjustments applied to impaired loans amounted to -32.47% and -27.84% as of December 31, 2016 and 2015, respectively. Due to the multitude of assumptions, many of which are subjective in nature, and the varying inputs and techniques used to determine fair value, the Company recognizes that valuations could differ across a wide spectrum of techniques employed. Accordingly, fair value estimates for impaired loans are classified as Level 3.

For ORE, fair value is generally determined through independent appraisals of the underlying properties which generally include various Level 3 inputs which are not identifiable. Appraisals form the basis for determining the net realizable value from these properties. Net realizable value is the result of the appraised value less certain costs or discounts associated with liquidation which occurs in the normal course of business. Management's assumptions may include consideration of the location and occupancy of the property, along with current economic conditions. Subsequently, as these properties are actively marketed, the estimated fair values may be periodically adjusted through incremental subsequent write-downs. These write-downs usually reflect decreases in estimated values resulting from sales price observations as well as changing economic and market conditions. At December 31, 2016 and 2015, the discounts applied to the appraised values of ORE ranged from -21.74% to -99.00% and -15.90% to -99.00%, respectively. As of December 31, 2016 and 2015, the weighted-average of discount to the appraisal values of ORE amounted to -32.38% and -37.64%, respectively.

As of December 31, 2016, the Company had one automobile with a balance of \$8 thousand in other repossessed assets. There were no adjustments to the carrying value of this automobile. As of December 31, 2015, there were no other repossessed assets.

#### Financial Instruments with Off-Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of the Company's involvement in particular classes of financial instruments. Because of the nature of these instruments, the fair values of these off-balance sheet items are not material.



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The notional amount of the Company's financial instruments with off-balance sheet risk was as follows:

| (dollars in thousands)                   | December 31, |            |
|--|--------------|------------|
|  | 2016         | 2015       |
| Off-balance sheet financial instruments: |              |            |
| Commitments to extend credit             | \$ 128,543   | \$ 109,628 |
| Standby letters of credit                | 7,645        | 8,178      |

## Commitments to Extend Credit and Standby Letters of Credit

The Company's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees. Since commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Company evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if considered necessary by the Company on extension of credit, is based on management's credit assessment of the customer.

Financial standby letters of credit are conditional commitments issued by the Company to guarantee performance of a customer to a third party. Those guarantees are issued primarily to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The Company's performance under the guarantee is required upon presentation by the beneficiary of the financial standby letter of credit. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company was not required to recognize any liability in connection with the issuance of these financial standby letters of credit.

The following table summarizes outstanding financial letters of credit as of December 31, 2016:

| (dollars in thousands) | Less than one year | More than              | Over five | Total    |
|------------------------|--------------------|------------------------|-----------|----------|
|                        |                    | one year to five years |           |          |
| Secured by:            |                    |                        |           |          |
| Collateral             | \$ 305             | \$ 6,080               | \$ 360    | \$ 6,745 |
| Bank lines of credit   | 576                | -                      | -         | 576      |
|                        | 881                | 6,080                  | 360       | 7,321    |
| Unsecured              | 287                | 37                     | -         | 324      |
| Total                  | \$ 1,168           | \$ 6,117               | \$ 360    | \$ 7,645 |

The Company has not incurred losses on its commitments in 2016, 2015 or 2014.

#### 14.EARNINGS PER SHARE

Basic earnings per share (EPS) is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but also reflects the potential dilution that could occur from the grant of stock-based compensation awards. The Company maintains two active share-based compensation plans that may generate additional potentially dilutive common shares. For granted and unexercised stock options and stock-settled stock appreciation rights (SSARs), dilution would occur if Company-issued stock options or SSARs were exercised and converted into common stock. As of the years ended December 31, 2016, 2015 and 2014, there were 2,156, 2,265 and 115 potentially dilutive shares related to issued and unexercised stock options. There were no potentially dilutive shares related to issued and unexercised SSARs. For restricted stock, dilution would occur from the Company's previously granted but unvested shares. There were 4,740, 4,975 and 5,425 potentially dilutive shares related to unvested restricted share grants as of the years ended December 31, 2016, 2015 and 2014, respectively.

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

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

|   | Years ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2016                     | 2015      | 2014      |
| (dollars in thousands except per share data)                        |                          |           |           |
| Basic EPS:  |                          |           |           |
| Net income available to common shareholders                         | \$ 7,693                 | \$ 7,103  | \$ 6,352  |
| Weighted-average common shares outstanding                          | 2,453,005                | 2,439,124 | 2,412,962 |
| Basic EPS   | \$ 3.14                  | \$ 2.91   | \$ 2.63   |
| Diluted EPS:  |                          |           |           |
| Net income available to common shareholders                         | \$ 7,693                 | \$ 7,103  | \$ 6,352  |
| Weighted-average common shares outstanding                          | 2,453,005                | 2,439,124 | 2,412,962 |
| Potentially dilutive common shares                                  | 6,896                    | 7,240     | 5,540     |
| Weighted-average common and potentially dilutive shares outstanding | 2,459,901                | 2,446,364 | 2,418,502 |
| Diluted EPS   | \$ 3.13                  | \$ 2.90   | \$ 2.62   |

## 15.REGULATORY MATTERS

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

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

In July 2013, the federal bank regulatory agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. Under the final rules, which became effective for the Company on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements increased for both the quantity and quality of capital held by the Company. The rules require all banks and bank holding companies to maintain a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum

ratio of Tier 1 capital to risk-weighted assets (Tier I capital) from 4.0% to 6.0%, require a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Based Capital) of 8.0%, and require a minimum Tier I capital to average total assets (Leverage Ratio) of 4.0%. A new capital conservation buffer, comprised of common equity Tier I capital, is also established above the regulatory minimum capital requirements. The rule increases the minimum Tier 1 capital to risk-based assets requirement with a capital conservation buffer to 8.5% by 2019 and increases the minimum total capital requirement with a capital conservation buffer to 10.5% by 2019 and assigns higher risk-weightings to certain assets: certain past due and commercial real estate loans and some equity exposures.

The following table reflects the actual and required capital and the related capital ratios as of the periods indicated. No amounts were deducted from capital for interest-rate risk in either 2016 or 2015.

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| (dollars in thousands)<br>As of December 31, 2016: | Actual<br>Amount | Ratio   | For capital<br>adequacy purposes |            | To be well<br>capitalized<br>under prompt<br>corrective<br>action provisions |       |
|--|------------------|---------|----------------------------------|------------|--|-------|
|  |                  |         | Amount                           | Ratio      | Amount   | Ratio |
| Total capital (to risk-weighted assets)            |                  |         |                                  |            |  |       |
| Consolidated                                       | \$ 86,702        | 14.9% ≥ | \$ 46,550 ≥                      | 8.6% (1)   | N/A  | N/A   |
| Bank   | \$ 86,332        | 14.8% ≥ | \$ 46,538 ≥                      | 8.6% (1) ≥ | \$ 58,172 ≥  | 10.0% |
| Tier 1 common equity (to risk-weighted assets)     |                  |         |                                  |            |  |       |
| Consolidated                                       | \$ 79,250        | 13.6% ≥ | \$ 26,184 ≥                      | 5.1% (1)   | N/A  | N/A   |
| Bank   | \$ 79,033        | 13.6% ≥ | \$ 26,178 ≥                      | 5.1% (1) ≥ | \$ 37,812 ≥  | 6.5%  |
| Tier I capital (to risk-weighted assets)           |                  |         |                                  |            |  |       |
| Consolidated                                       | \$ 79,250        | 13.6% ≥ | \$ 34,912 ≥                      | 6.6% (1)   | N/A  | N/A   |
| Bank   | \$ 79,033        | 13.6% ≥ | \$ 34,903 ≥                      | 6.6% (1) ≥ | \$ 46,538 ≥  | 8.0%  |
| Tier I capital (to average assets)                 |                  |         |                                  |            |  |       |
| Consolidated                                       | \$ 79,250        | 10.3% ≥ | \$ 30,717 ≥                      | 4.0%       | N/A  | N/A   |
| Bank   | \$ 79,033        | 10.3% ≥ | \$ 30,650 ≥                      | 4.0%       | ≥ \$ 38,313 ≥  | 5.0%  |

(1) Includes 0.625% capital conservation buffer.

As of December 31, 2015:

|  |           |         |             |      |               |       |
|--|-----------|---------|-------------|------|---------------|-------|
| Total capital (to risk-weighted assets)        |           |         |             |      |               |       |
| Consolidated                                   | \$ 81,074 | 15.0% ≥ | \$ 43,278 ≥ | 8.0% | N/A           | N/A   |
| Bank   | \$ 80,547 | 14.9% ≥ | \$ 43,306 ≥ | 8.0% | ≥ \$ 54,132 ≥ | 10.0% |
| Tier 1 common equity (to risk-weighted assets) |           |         |             |      |               |       |
| Consolidated                                   | \$ 74,163 | 13.7% ≥ | \$ 24,344 ≥ | 4.5% | N/A           | N/A   |
| Bank   | \$ 73,744 | 13.6% ≥ | \$ 24,360 ≥ | 4.5% | ≥ \$ 35,186 ≥ | 6.5%  |
| Tier I capital (to risk-weighted assets)       |           |         |             |      |               |       |
| Consolidated                                   | \$ 74,163 | 13.7% ≥ | \$ 32,459 ≥ | 6.0% | N/A           | N/A   |
| Bank   | \$ 73,744 | 13.6% ≥ | \$ 32,479 ≥ | 6.0% | ≥ \$ 43,306 ≥ | 8.0%  |
| Tier I capital (to average assets)             |           |         |             |      |               |       |

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|              |           |         |           |        |             |       |
|--------------|-----------|---------|-----------|--------|-------------|-------|
| Consolidated | \$ 74,163 | 10.2% ≥ | \$ 29,149 | ≥ 4.0% | N/A         | N/A   |
| Bank         | \$ 73,744 | 10.1% ≥ | \$ 29,090 | ≥ 4.0% | ≥ \$ 36,362 | ≥5.0% |

The Bank can pay dividends to the Company equal to the Bank's retained earnings which approximated \$70.2 million at December 31, 2016. However, such dividends are limited due to the capital requirements discussed above.

16.RELATED PARTY TRANSACTIONS

During the ordinary course of business, loans are made to executive officers, directors, greater than 5% shareholders and associates of such persons. These transactions are executed on substantially the same terms and at the rates prevailing at the time for comparable transactions with others. These loans do not involve more than the normal risk of collectability or present other unfavorable features. A summary of loan activity with officers, directors, associates of such persons and shareholders who own more than 5% of the Company's outstanding shares is as follows:

|                        | Years ended December 31, |          |          |
|------------------------|--------------------------|----------|----------|
| (dollars in thousands) | 2016                     | 2015     | 2014     |
| Balance, beginning     | \$ 6,983                 | \$ 4,924 | \$ 4,739 |
| Additions              | 2,629                    | 5,672    | 2,213    |
| Collections            | (1,763)                  | (3,613)  | (2,028)  |
| Balance, ending        | \$ 7,849                 | \$ 6,983 | \$ 4,924 |

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As of December 31, 2016, 2015 and 2014, deposits from executive officers, directors and associates of such persons approximated \$12.9 million, \$12.9 million and \$13.7 million, respectively.

## 17. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The following is a summary of quarterly results of operations for the years indicated:

|  | 2016             |                   |                  |                   |           |
|--|------------------|-------------------|------------------|-------------------|-----------|
| (dollars in thousands except per share data) | First<br>quarter | Second<br>quarter | Third<br>quarter | Fourth<br>quarter | Total     |
| Interest income                              | \$ 6,736         | \$ 6,715          | \$ 7,006         | \$ 7,038          | \$ 27,495 |
| Interest expense                             | (598)            | (574)             | (585)            | (601)             | (2,358)   |
| Net interest income                          | 6,138            | 6,141             | 6,421            | 6,437             | 25,137    |
| Provision for loan losses                    | (150)            | (275)             | (225)            | (375)             | (1,025)   |
| Gain on sale of investment securities        | -                | 9                 | -                | -                 | 9         |
| Other income                                 | 1,687            | 2,091             | 2,024            | 2,194             | 7,996     |
| Other expenses                               | (5,388)          | (5,369)           | (5,409)          | (5,489)           | (21,655)  |
| Income before taxes                          | 2,287            | 2,597             | 2,811            | 2,767             | 10,462    |
| Provision for income taxes                   | (586)            | (669)             | (776)            | (738)             | (2,769)   |
| Net income                                   | \$ 1,701         | \$ 1,928          | \$ 2,035         | \$ 2,029          | \$ 7,693  |
| Net income per share - basic                 | \$ 0.69          | \$ 0.79           | \$ 0.83          | \$ 0.83           | \$ 3.14   |
| Net income per share - diluted               | \$ 0.69          | \$ 0.79           | \$ 0.82          | \$ 0.83           | \$ 3.13   |

|  | 2015             |                   |                  |                   |           |
|--|------------------|-------------------|------------------|-------------------|-----------|
| (dollars in thousands except per share data) | First<br>quarter | Second<br>quarter | Third<br>quarter | Fourth<br>quarter | Total     |
| Interest income                              | \$ 6,304         | \$ 6,438          | \$ 6,612         | \$ 6,660          | \$ 26,014 |
| Interest expense                             | (697)            | (647)             | (580)            | (605)             | (2,529)   |
| Net interest income                          | 5,607            | 5,791             | 6,032            | 6,055             | 23,485    |
| Provision for loan losses                    | (150)            | (150)             | (200)            | (575)             | (1,075)   |
| Gain on sale of investment securities        | 2                | 16                | 8                | 54                | 80        |
| Other income                                 | 1,748            | 1,817             | 2,015            | 1,873             | 7,453     |
| Other expenses                               | (5,087)          | (5,744)           | (5,239)          | (4,952)           | (21,022)  |
| Income before taxes                          | 2,120            | 1,730             | 2,616            | 2,455             | 8,921     |
| (Provision) credit for income taxes          | (547)            | 50                | (687)            | (634)             | (1,818)   |
| Net income                                   | \$ 1,573         | \$ 1,780          | \$ 1,929         | \$ 1,821          | \$ 7,103  |
| Net income per share - basic                 | \$ 0.65          | \$ 0.73           | \$ 0.79          | \$ 0.74           | \$ 2.91   |
| Net income per share - diluted               | \$ 0.64          | \$ 0.73           | \$ 0.79          | \$ 0.74           | \$ 2.90   |

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|  | 2014             |                   |                  |                   |           |
|--|------------------|-------------------|------------------|-------------------|-----------|
| (dollars in thousands except per share data) | First<br>quarter | Second<br>quarter | Third<br>quarter | Fourth<br>quarter | Total     |
| Interest income                              | \$ 6,002         | \$ 6,145          | \$ 6,295         | \$ 6,402          | \$ 24,844 |
| Interest expense                             | (707)            | (721)             | (730)            | (759)             | (2,917)   |
| Net interest income                          | 5,295            | 5,424             | 5,565            | 5,643             | 21,927    |
| Provision for loan losses                    | (300)            | (300)             | (210)            | (250)             | (1,060)   |
| Gain on sale of investment securities        | 207              | 94                | -                | 298               | 599       |
| Other income                                 | 1,531            | 1,727             | 1,748            | 1,749             | 6,755     |
| Other expenses                               | (4,785)          | (4,761)           | (4,910)          | (5,247)           | (19,703)  |
| Income before taxes                          | 1,948            | 2,184             | 2,193            | 2,193             | 8,518     |
| Provision for income taxes                   | (492)            | (557)             | (562)            | (555)             | (2,166)   |
| Net income                                   | \$ 1,456         | \$ 1,627          | \$ 1,631         | \$ 1,638          | \$ 6,352  |
| Net income per share - basic                 | \$ 0.61          | \$ 0.67           | \$ 0.68          | \$ 0.67           | \$ 2.63   |
| Net income per share - diluted               | \$ 0.61          | \$ 0.67           | \$ 0.67          | \$ 0.67           | \$ 2.62   |



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## 18.CONTINGENCIES

The nature of the Company's business generates litigation involving matters arising in the ordinary course of business. However, in the opinion of management of the Company after consulting with the Company's 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 shareholders' equity or results of operations. No legal proceedings are pending other than ordinary routine litigation incident to the business of the Company and the Bank. In addition, to management's knowledge, no government authorities have initiated or contemplated any material legal actions against the Company or the Bank.

## 19.RECENT ACCOUNTING PRONOUNCEMENTS

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2016-13, Financial Instruments – Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments. The amendments in this update require financial assets measured at amortized cost basis to be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. Previously, when credit losses were measured under GAAP, an entity only considered past events and current conditions when measuring the incurred loss. The amendments in this update broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgement in determining the relevant information and estimation methods that are appropriate under the circumstances. The amendments in this update also require that credit losses on available-for-sale debt securities be presented as an allowance for credit losses rather than a writedown. The amendments in this update are effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2019 for public companies. Early adoption is permitted beginning after December 15, 2018, including interim periods within those fiscal years. An entity will apply the amendments in this update through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption (modified-retrospective approach). Upon adoption, the change in this accounting guidance could result in an increase in the Company's allowance for loan losses and require the Company to record loan losses more rapidly. The Company is currently evaluating the impact of ASU 2016-13 on its consolidated financial statements.

In June 2014, the FASB issued ASU 2014-12, Compensation – Stock Compensation (Topic 718) Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period, an amendment to the stock compensation accounting guidance to clarify that a performance target that affects vesting of a share-based payment and that could be achieved after the requisite service period be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. This amendment is effective for annual reporting periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. Entities may apply the amendments in this update either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. The Company adopted this accounting standard update during the first quarter of 2016 and does not expect this amendment to have a material impact on its consolidated financial statements.

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

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP: identify the contract(s) with a customer; identify the performance obligations in the contract; determine the transaction price; allocate the transaction price to the performance obligations in the contract; recognize revenue when (or as) the entity satisfies a performance obligation. The standard is effective for annual periods beginning after December 15, 2017, and interim periods therein, using either of the following transition methods: a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption

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(which includes additional footnote disclosures). The Company is evaluating the impact of the adoption of ASU 2014-09 on its consolidated financial statements and has not yet determined the method by which it will adopt the standard effective in the first quarter of 2018.

Subsequently, the FASB issued additional guidance to clarify certain implementation issues. Specifically, the FASB issued Principal versus Agent Considerations, Identifying Performance Obligations and Licensing, Narrow-Scope Improvements and Practical Expedients and Technical Corrections and Improvements in March, April, May and December 2016, respectively. These amendments do not change the core principle in Revenue from Contracts with Customers (Topic 606) and the effective date and transition requirements are consistent with those in Topic 606.

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

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

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

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

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

## 20.PARENT COMPANY ONLY

The following is the condensed financial information for Fidelity D & D Bancorp, Inc. on a parent company only basis as of and for the years indicated:

| Condensed Balance Sheets<br>(dollars in thousands) | As of December 31, |           |
|--|--------------------|-----------|
|  | 2016               | 2015      |
| Assets:  |                    |           |
| Cash   | \$ 141             | \$ 190    |
| Investment in subsidiary                           | 80,192             | 75,767    |
| Securities available-for-sale                      | 631                | 545       |
| Other assets                                       | 35                 | 64        |
| Total  | \$ 80,999          | \$ 76,566 |
| Liabilities and shareholders' equity:              |                    |           |
| Liabilities  | \$ 368             | \$ 215    |
| Capital stock and retained earnings                | 79,250             | 74,163    |
| Accumulated other comprehensive income             | 1,381              | 2,188     |
| Total  | \$ 80,999          | \$ 76,566 |

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| Condensed Income Statements<br>(dollars in thousands) | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2016                     | 2015     | 2014     |
| Income:   |                          |          |          |
| Equity in undistributed earnings of subsidiary        | \$ 5,289                 | \$ 4,659 | \$ 4,458 |
| Dividends from subsidiary                             | 2,960                    | 2,844    | 2,242    |
| Other income  | 21                       | 20       | 22       |
| Total income  | 8,270                    | 7,523    | 6,722    |
| Operating expenses                                    | 864                      | 610      | 539      |
| Income before taxes                                   | 7,406                    | 6,913    | 6,183    |
| Credit for income taxes                               | 287                      | 190      | 169      |
| Net income  | \$ 7,693                 | \$ 7,103 | \$ 6,352 |

| Statements of Comprehensive Income<br>(dollars in thousands) | Years ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2016                     | 2015     | 2014     |
| Bancorp net loss   | \$ (556)                 | \$ (400) | \$ (348) |
| Equity in net income of subsidiary                           | 8,249                    | 7,503    | 6,700    |
| Net income   | 7,693                    | 7,103    | 6,352    |

|  |          |          |          |
|--|----------|----------|----------|
| Other comprehensive (loss) income, before tax:                     |          |          |          |
| Unrealized holding gains (losses) on available-for-sale securities | 86       | (49)     | 71       |
| Reclassification adjustment for gains realized in income           | -        | -        | -        |
| Net unrealized gains (losses)                                      | 86       | (49)     | 71       |
| Tax effect   | (29)     | 17       | (24)     |
| Unrealized gain (loss), net of tax                                 | 57       | (32)     | 47       |
| Equity in other comprehensive (loss) income of subsidiary          | (864)    | (523)    | 1,457    |
| Other comprehensive (loss) income, net of tax                      | (807)    | (555)    | 1,504    |
| Total comprehensive income, net of tax                             | \$ 6,886 | \$ 6,548 | \$ 7,856 |

| Condensed Statements of Cash Flows<br>(dollars in thousands) | Years ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2016                     | 2015     | 2014     |
| Cash flows from operating activities:                        |                          |          |          |
| Net income   | \$ 7,693                 | \$ 7,103 | \$ 6,352 |

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Adjustments to reconcile net income to net cash used in operations:

|  |         |         |         |
|--|---------|---------|---------|
| Equity in earnings of subsidiary             | (8,249) | (7,503) | (6,700) |
| Stock-based compensation expense             | 519     | 225     | 207     |
| Changes in other assets and liabilities, net | (36)    | (2)     | (35)    |
| Net cash used in operating activities        | (73)    | (177)   | (176)   |

Cash flows provided by investing activities:

|   |       |       |       |
|---|-------|-------|-------|
| Dividends received from subsidiary        | 2,960 | 2,844 | 2,242 |
| Net cash provided by investing activities | 2,960 | 2,844 | 2,242 |

Cash flows used in financing activities:

|  |         |         |         |
|--|---------|---------|---------|
| Dividends paid, net of dividend reinvestment       | (3,061) | (2,844) | (2,088) |
| Cash contributions from dividend reinvestment plan | -       | -       | 104     |
| Exercise of stock options                          | 14      | 101     | -       |
| Withholdings to purchase capital stock             | 111     | 102     | 80      |
| Net cash used in financing activities              | (2,936) | (2,641) | (1,904) |
| Net change in cash                                 | (49)    | 26      | 162     |

|                 |     |     |   |
|-----------------|-----|-----|---|
| Cash, beginning | 190 | 164 | 2 |
|-----------------|-----|-----|---|

|              |        |        |        |
|--------------|--------|--------|--------|
| Cash, ending | \$ 141 | \$ 190 | \$ 164 |
|--------------|--------|--------|--------|

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ITEM 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

On April 21, 2015, the Audit Committee of Fidelity D&D Bancorp Inc. (the “Company”) through a formal proposal process, engaged RSM US LLP (“RSM”), formerly McGladrey LLP (“McGladrey”), to serve as its independent registered public accounting firm for the year ended December 31, 2015. On April 21, 2015, the Audit Committee dismissed Baker Tilly Virchow Krause LLP (“Baker Tilly”) as the Company’s independent registered public accounting firm.

Prior to engaging RSM, the Company did not consult with RSM regarding the application of accounting principles to a specific completed or contemplated transaction or regarding the type of audit opinions that might be rendered by RSM on the Company’s financial statements, and RSM did not provide any written or oral advice that was an important factor considered by the Company in reaching a decision as to any such accounting, auditing or financial reporting issue.

The report of independent registered public accounting firm of Baker Tilly regarding the Company’s financial statements for the fiscal year ended December 31, 2014 did not contain any adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.

During the year ended December 31, 2014, and during the interim period from the end of the most recently completed fiscal year through April 21, 2015, the date of termination, there were no disagreements with Baker Tilly on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedures, which disagreements, if not resolved to the satisfaction of Baker Tilly would have caused it to make reference to such disagreement in its reports.

The Company provided Baker Tilly with a copy of the above disclosures prior to filing a Current Report on Form 8-K with the Securities and Exchange Commission and requested that Baker Tilly furnish the Company with a letter addressed to the Securities and Exchange Commission stating whether it agrees with above statements and, if it does not agree, the respects in which it does not agree. A copy of the letter, dated April 22, 2015, is filed as Exhibit 16 (which is incorporated by reference herein) to the Current Report on Form 8-K.

ITEM 9A: CONTROLS AND PROCEDURES

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

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, provides smaller companies and debt-only issuers with a permanent exemption from the Sarbanes-Oxley internal control audit requirements. Without

this exemption, these companies would have been required to comply with the internal control audit requirements for fiscal years ended on or after June 15, 2010. The permanent exemption applies to entities that are commonly referred to as non-accelerated filers and smaller reporting companies, such as the Company. Generally speaking, a non-accelerated filer and a smaller reporting company have public float, or market capitalization of less than \$75.0 million. The permanent exemption applies only to the Sarbanes-Oxley internal control audit requirements. Non-accelerated filers and smaller reporting companies are still required to disclose management's assessment of the effectiveness of internal control over financial reporting.

#### Management's Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed under the supervision of the Company's President and Chief Executive Officer and the Chief Financial Officer, and implemented in conjunction with management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's consolidated financial statements for external purposes in accordance with generally accepted accounting principles.

There are inherent limitations in the effectiveness of any internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2016. This assessment was based on criteria for effective internal control over financial reporting described in "Internal Control – Integrated Framework," (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).



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Based on this assessment, management determined that, as of December 31, 2016, the Company maintained effective internal control over financial reporting.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the SEC that permit the Company to provide only management's report in this annual report.

ITEM 9B: OTHER INFORMATION

None

PART III

ITEM 10: DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required in this item is incorporated by reference herein to the information presented in the Company's definitive Proxy Statement for its 2017 Annual Meeting of Shareholders to be filed with the SEC.

Section 16(a) Beneficial Ownership Reporting Compliance

The information required in this item is incorporated by reference herein to the information presented in the Company's definitive Proxy Statement for its 2017 Annual Meeting of Shareholders to be filed with the SEC.

Code of Ethics

Pursuant to Item 406 of Regulation S-K, the Company adopted a written code of ethics that applies to our directors, officers and employees, including our chief executive officer and chief financial officer, which is available on our website at <http://www.bankatfidelity.com> through the Investor Relations link and then under the headings "Other Information", "Governance Documents." In addition, copies of our code of ethics will be provided to shareholders upon written request to Fidelity D & D Bancorp, Inc., Blakely and Drinker Streets, Dunmore, PA 18512 at no charge.

ITEM 11: EXECUTIVE COMPENSATION

The information required in this item is incorporated by reference herein to the information presented in the Company's definitive Proxy Statement for its 2017 annual meeting of shareholders to be filed with the SEC.

ITEM 12: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required in this item is incorporated by reference herein to the information presented in the Company's definitive Proxy Statement for its 2017 annual meeting of shareholders to be filed with the SEC.

Securities authorized for issuance under equity compensation plans

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The following table summarizes the Company's equity compensation plans as of December 31, 2016 that have been approved and not approved by Fidelity D&D Bancorp, Inc. shareholders:

|   | (a)   | (b)   | (c)   |
|---|---|---|---|
| Plan Category   | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
| Equity compensation plans approved by security holders:           |   |   |   |
| 2000 Independent Director Stock Option Plan                       | 11,500  | \$ 28.90  | -   |
| 2000 Stock Incentive Plan   | 3,500   | \$ 27.92  | -   |
| 2002 Employee Stock Purchase Plan                                 | 4,085   | \$ 30.82  | 66,456  |
| 2012 Omnibus Stock Incentive Plan                                 | 9,040   | \$ 29.28  | 484,791   |
| 2012 Director Stock Incentive Plan                                | 5,600   | \$ 32.40  | 481,200   |
| Equity compensation plans not approved by security holders - none | -   | -   | -   |
| Total   | 33,725  | \$ 29.71  | 1,032,447   |

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ITEM 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required in this item is set forth in Footnote No. 16 “Related Party Transactions”, of Part II, Item 8 “Financial Statements and Supplementary Data”, and the information required by Item 407(a) of Regulation S-K is incorporated by reference herein to the information presented in the Company’s definitive Proxy Statement for its 2016 annual meeting of shareholders to be filed with the SEC.

ITEM 14: PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated by reference herein, to the information presented in the Company’s definitive Proxy Statement for its 2017 annual meeting of shareholders to be filed with the SEC.

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PART IV

ITEM 15: EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) (1) Financial Statements - The following financial statements are included by reference in Part II, Item 8 hereof:

Report of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets  
Consolidated Statements of Income  
Consolidated Statements of Comprehensive Income  
Consolidated Statements of Changes in Shareholders' Equity  
Consolidated Statements of Cash Flows  
Notes to Consolidated Financial Statements

(2) Financial Statement Schedules

Financial Statement Schedules are omitted because the required information is either not applicable, the data is not significant or the required information is shown in the respective financial statements or in the notes thereto or elsewhere herein.

(3) Exhibits

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

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

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

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

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

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

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

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

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

\*10.7 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated March 23, 2011. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

\*10.8 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Timothy P. O'Brien, dated March 23, 2011. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

\*10.9 2012 Omnibus Stock Incentive Plan. Incorporated by reference to Appendix A to Registrant's Definitive Proxy Statement filed with the SEC on March 30, 2012.

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

\*10.11 Change in Control and Severance Agreement between the Registrant, The Fidelity Deposit and Discount Bank and Eugene J. Walsh, dated June 26, 2015. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on June 29, 2015.

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\*10.12 Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Salvatore R. DeFrancesco, Jr. dated as of March 17, 2016. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 18, 2016.

11 Statement regarding computation of earnings per share. Included herein in Note 14 "Earnings per Share", contained within the notes to consolidated financial statements, and incorporated herein by reference.

12 Statement regarding computation of ratios. Included herein in Item 6, "Selected Financial Data."

13 Annual Report to Shareholders. Incorporated by reference to the 2016 Annual Report to Shareholders filed with the SEC on Form ARS.

21 Subsidiaries of the Registrant, filed herewith.

23.1 Consent of RSM US LLP, filed herewith.

23.2 Consent of Baker Tilly Virchow Krause LLP, filed herewith.

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

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

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

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

101 Interactive data files: The following, from Fidelity D&D Bancorp, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2016, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of December 31, 2016 and 2015; Consolidated Statements of Income for the years ended December 31, 2016, 2015 and 2014; Consolidated Statements of Comprehensive Income for the years ended December 31, 2016, 2015 and 2014; Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2016, 2015 and 2014; Consolidated Statements of Cash Flows for the years ended December 31, 2016, 2015 and 2014 and the Notes to the Consolidated Financial Statements.

(b)The exhibits required to be filed by this Item are listed under Item 15(a) 3, above.

(c)Not applicable.

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\* Management contract or compensatory plan or arrangement.

ITEM 16: FORM 10-K SUMMARY

None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and 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.  
(Registrant)

Date: March 10, 2017 By: /s/ Daniel J. Santaniello  
Daniel J. Santaniello,  
President and Chief  
Executive Officer

Date: March 10, 2017 By: /s/ Salvatore R.  
DeFrancesco, Jr.  
Salvatore R. DeFrancesco,  
Jr.,  
Treasurer and Chief  
Financial Officer

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following person on behalf of the registrant and in the capacities and on the dates indicated.

DATE

By: /s/ Daniel J. Santaniello March 10, 2017  
Daniel J. Santaniello, President and  
Chief  
Executive Officer

By: /s/ Salvatore R. DeFrancesco, Jr. March 10, 2017  
Salvatore R. DeFrancesco, Jr.,  
Treasurer



and Chief Financial Officer

By: /s/ Patrick J. Dempsey                      March 10, 2017  
Patrick J. Dempsey, Chairman of  
the  
Board of Directors and Director

By: /s/ John T. Cognetti                      March 10, 2017  
John T. Cognetti, Secretary and  
Director

By: /s/ David L. Tressler                      March 10, 2017  
David L. Tressler, Director

By: /s/ Michael J. McDonald                      March 10, 2017  
Michael J. McDonald, Vice  
Chairman  
of the Board of Directors and  
Director

By:    March 10, 2017  
Mary E. McDonald, Assistant  
Secretary and Director

By: /s/ Brian J. Cali                              March 10, 2017  
Brian J. Cali, Director

By: /s/ Kristin Dempsey O'Donnell                      March 10, 2017  
Kristin Dempsey O'Donnell,  
Director

By: /s/ Richard Lettieri                              March 10, 2017  
Richard Lettieri, Director

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| 3(i) Amended and Restated Articles of Incorporation of Registrant. Incorporated by reference to Annex B of the Proxy Statement/Prospectus included in Registrant’s Amendment 4 to its Registration Statement No. 333-90273 on Form S-4, filed with the SEC on April 6, 2000.                                      | *    |
| 3(ii) Amended and Restated Bylaws of Registrant. Incorporated by reference to Exhibit 3(ii) to Registrant’s Form 8-K filed with the SEC on November 21, 2007.   | *    |
| 10.1 Registrant’s Dividend Reinvestment and Stock Repurchase Plan. Incorporated by reference to Exhibit 4.1 to Registrant’s Registration Statement No. 333-183216 on Form S-3 filed with the SEC on August 10, 2012 as amended on February 3, 2014.   | *    |
| 10.2 Registrant’s 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 4.3 to Registrant’s Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.   | *    |
| 10.3 Amendment, dated October 2, 2007, to the Registrant’s 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 10.2 to Registrant’s Form 8-K filed with the SEC on October 4, 2007.  | *    |
| 10.4 Registrant’s 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 4.4 to Registrant’s Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.  | *    |
| 10.5 Amendment, dated October 2, 2007, to the Registrant’s 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 10.1 to Registrant’s Form 8-K filed with the SEC on October 4, 2007.   | *    |
| 10.6 Registrant’s 2002 Employee Stock Purchase Plan. Incorporated by reference to Appendix A to Registrant’s Definitive Proxy Statement filed with the SEC on March 28, 2002.   |      |
| 10.7 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated March 23, 2011. Incorporated by reference to Exhibit 99.1 to Registrant’s Current Report on Form 8-K filed with the SEC on March 29, 2011. | *    |
| 10.8 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Timothy P. O’Brien, dated March 23, 2011. Incorporated by reference to Exhibit 99.2 to Registrant’s Current Report on Form 8-K filed with the SEC on March 29, 2011.    | *    |
| 10.9 2012 Omnibus Stock Incentive Plan. Incorporated by reference to Appendix A to Registrant’s Definitive Proxy Statement filed with the SEC on March 30, 2012.  | *    |
| 10.10 2012 Director Stock Incentive Plan. Incorporated by reference to Appendix B to Registrant’s Definitive Proxy Statement filed with the SEC on March 30, 2012.  | *    |

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

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

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| 11 Statement regarding computation of earnings per share. Included herein Note 14, “Earnings per Share”, contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.   | 81 |
| 12 Statement regarding computation of ratios. Included herein in Item 6, “Selected Financial Data”.   | 16 |
| 13 Annual Report to Shareholders. Incorporated by reference to the 2016 Annual Report to Shareholders filed with* the SEC on Form ARS.  |    |
| 21 Subsidiaries of the Registrant, filed herewith.  |    |
| 23.1 Consent of RSM US LLP, filed herewith.   |    |
| 23.2 Consent of Baker Tilly Virchow Krause LLP, filed herewith.   |    |
| 31.1 Rule 13a-14(a) Certification of Principal Executive Officer, filed herewith.   |    |
| 31.2 Rule 13a-14(a) Certification of Principal Financial Officer, filed herewith.   |    |
| 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.   |    |
| 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.   |    |
| 101 Interactive data files: The following, from Fidelity D&D Bancorp, Inc.’s. Annual Report on Form 10-K for the year ended December 31, 2016, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of December 31, 2016 and 2015; Consolidated Statements of Income for the years ended December 31, 2016, 2015 and 2014; Consolidated Statements of Comprehensive Income for the years ended December 31, 2016, 2015 and 2014; Consolidated Statements of Changes in Shareholders’ Equity for the years ended December 31, 2016, 2015 and 2014; Consolidated Statements of Cash Flows for the years ended December 31, 2016, 2015 and 2014 and the Notes to the Consolidated Financial Statements. |    |

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\*Incorporated by Reference