FIDELITY D & D BANCORP INC
Form 10-K
March 14, 2019
Table Of Contents

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, 2018

COMMISSION FILE NUMBER 001-38229

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:
Common Stock, without par value

NAME OF EACH EXCHANGE ON WHICH REGISTERED:

The NASDAQ Stock Market LLC

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 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," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Non-accelerated filer	Accelerated filer	Smaller reporting company	Emerging growth company

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

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant was $172.4 million as of June 30, 2018, based on the closing price of $61.99. The number of shares of common stock outstanding as of February 28, 2019, was 3,780,975.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement to be used in connection with the 2019 Annual Meeting of Shareholders are incorporated herein by reference in partial response to Part III.

Table Of Contents

Fidelity D & D Bancorp, Inc.
2018 Annual Report on Form 10-K
Table of Contents

2

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

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

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

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

ITEM 1: BUSINESS

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

The Bank has offered a full range of traditional banking services since it commenced operations in 1903. The Bank has a personal and corporate trust department and also provides alternative financial and insurance products with asset management services. A full list of services provided by the Bank is detailed in the section entitled “Products and Services” contained within the 2018 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. In 2018, the Company had 6.12% of the Scranton-Wilkes-Barre metropolitan statistical area's total deposit market share ranking 7th in total deposits. The Company had 181 full-time equivalent employees on December 31, 2018, 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 2018, the national economy continued to improve with the unemployment rate dropping to 3.9% compared to 4.1% at the end of 2017. The unemployment rate in the Company's local statistical market, Scranton-Wilkes-Barre, fell to 4.8% from 5.0% at the end of 2017. The local economy has been volatile in recent years and generally lags the national market trends. 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
- disclosure
- community reinvestment

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.

Table Of Contents

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

Table Of Contents

Company's financial condition and results of operations.

The FASB has recently issued an accounting standard update that will result in a significant change in how we recognize credit losses and may have a material impact on our financial condition or results of operations.

In June 2016, the Financial Accounting Standards Board ("FASB") issued an accounting standard update ("ASU") entitled "Financial Instruments-Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments," which replaces the current "incurred loss" model for recognizing credit losses with an "expected loss" model referred to as the Current Expected Credit Loss ("CECL") model. Under the CECL model, banks will be required to present certain financial assets carried at amortized cost, such as loans held for investment and held-to-maturity debt securities, at the net amount expected to be collected. The measurement of expected credit losses is to be based on information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This measurement will take place at the time the financial asset is first added to the balance sheet and periodically thereafter. This differs significantly from the "incurred loss" model required under current generally accepted accounting principles ("GAAP"), which delays recognition until it is probable a loss has been incurred.

The new CECL standard will become effective for the Company for the fiscal year beginning January 1, 2020 and for interim periods thereafter. The Company is currently evaluating the impact the CECL model will have on its accounting. There is a risk that the Company may recognize a one-time cumulative-effect adjustment to its allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, consistent with regulatory expectations set forth in interagency guidance issued at the end of 2016. The Company cannot yet determine the magnitude of any such one-time cumulative adjustment or the overall impact of the new standard on its business, financial condition and results of operations. Accordingly, it is possible the new standard may require an increase in the allowance for credit losses for the estimated life of the financial asset, including an allowance for debt securities. The amount of the change in the allowance for credit losses, if any, resulting from the new guidance will be impacted by the portfolio composition and asset quality at the adoption date, as well as economic conditions and forecasts at the time of adoption. Moreover, the CECL model may create more volatility in the level of the allowance for loan losses. If the Company is required to materially increase the level of its allowance for loan losses for any reason, such increase could adversely affect its business, 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 may dilute the ownership interests of current investors and may 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 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.

Table Of Contents

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

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

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

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

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

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

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

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

The Company continually encounters technological change.

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

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

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

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

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

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

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

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.

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.

Table Of Contents

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.

Federal income tax reform could have unforeseen effects on our financial condition and results of operations.

On December 22, 2017, the President of the United States signed into law H.R. 1, originally known as the "Tax Cuts and Jobs Act." The Tax Cuts and Jobs Act includes a number of provisions, including the lowering of the U.S. corporate tax rate from 35 percent to 21 percent, effective January 1, 2018. There are also provisions that may partially offset the benefit of such rate reduction. Financial statement impacts include adjustments for, among other things, the re-measurement of deferred tax assets and liabilities. While there are benefits, there is also substantial uncertainty regarding the details of U.S. Tax Reform. The long-term intended and unintended consequences of Tax Cuts and Jobs Act on our business and on holders of our common shares is uncertain and could be adverse. The Company anticipates that the impact of Tax Cuts and Jobs Act may be material to our business, financial condition and results of operations.

Risks Associated with the Company's Common Stock

The Company's stock price can be volatile.

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

- Actual or anticipated variations in quarterly results of operations.
- Recommendations by securities analysts.
- Operating and stock price performance of other companies that investors deem comparable to the Company.
- News reports relating to trends, concerns and other issues in the financial services industry.
- Perceptions in the marketplace regarding the Company and/or its competitors.
- New technology used, or services offered, by competitors.
- Significant acquisitions or business combinations, strategic partnerships, joint ventures or capital commitments by or involving the Company or its competitors.
- Failure to integrate acquisitions or realize anticipated benefits from acquisitions.
- Changes in government regulations.

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

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

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

The Company's common stock is listed for trading on Nasdaq 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

Table Of Contents

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 "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.

A protracted government shutdown or issues relating to debt and the deficit may adversely affect the Company.

Extended shutdowns of parts of the federal government could negatively impact the financial performance of certain customers and could impact customers' future access to certain loan and guarantee programs. As a result, this could impact the Company's business, financial condition and results of operations.

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

Table Of Contents

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

ITEM 2: PROPERTIES

As of December 31, 2018, the Company operated 11 full-service banking offices, of which six were owned and five were leased. None of the lessors of the properties leased by the Company are affiliated with the Company and all of the properties are located in the Commonwealth of Pennsylvania. The Company is headquartered at its owner-occupied main branch located on the corner of Blakely and Drinker Streets in Dunmore, PA. We believe each of our facilities is suitable and adequate to meet our current operational needs.

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

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

1598 Main St.,					
Peckville, PA	Leased	Peckville Branch	x	x	x
247 Wyoming Ave.,					
Kingston, PA	Owned	Kingston Branch	x	x	x
400 S. Main St.,					
Scranton, PA	Owned	West Scranton Branch(2)	x	x	x
2363 Memorial Hwy.,					
Dallas, PA 18612	Leased	Back Mountain Branch	x	x	

*All of the owned properties are free of encumbrances. At the Green Ridge branch office, Back Mountain 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.

During 2018, the Bank entered into a lease for a new branch in Mountaintop, Pennsylvania and lease payments will commence in August 2019.

As of December 31, 2018, the Bank maintained five 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;
- Back Mountain, 32 Dallas Shopping Ctr., Dallas, PA.

Foreclosed assets held-for-sale includes other real estate owned (ORE). The Company had six ORE properties as of December 31, 2018, which stemmed from six unrelated borrowers. Upon possession, foreclosed properties are recorded on

Table Of Contents

the Company's balance sheet at the lower of cost or fair value. For a further discussion of ORE properties, see "Foreclosed assets held-for-sale", located in the comparison of financial condition section of managements' discussion and analysis.

ITEM 3: LEGAL PROCEEDINGS

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

ITEM 4: MINE SAFETY DISCLOSURES

Not Applicable

PART II

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

The common stock of the Company is listed on Nasdaq and traded on The NASDAQ Global Market 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 Company's common stock began trading on the Nasdaq Global Market on October 6, 2017. 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 1,310 shareholders at December 31, 2018 and 1,324 shareholders as of February 28, 2019. 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.

Table Of Contents

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 SNL U.S. Bank NASDAQ index (the SNL NASDAQ index) for the period of five fiscal years commencing January 1, 2014, and ending December 31, 2018. As of December 31, 2018, the SNL NASDAQ index consisted of 277 banks. A listing of the banks that comprise the SNL NASDAQ index can be found on the Company's website at www.bankatfidelity.com and then on the bottom of the page clicking on, Investor Relations, Fidelity D & D Bancorp Stock, Stock Information, List of all companies in The SNL U.S. Bank NASDAQ index 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, 2013, in each of: the Company's common stock, the NASDAQ Composite and the SNL NASDAQ index. All cumulative total returns are computed assuming the reinvestment of dividends into the applicable securities. The shareholder return shown on the graph and table below is not necessarily indicative of future performance:

	Period Ending					
Index	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18
Fidelity D & D Bancorp, Inc.	100.00	129.39	139.86	151.91	268.14	424.39
NASDAQ Composite Index	100.00	114.75	122.74	133.62	173.22	168.30
SNL U.S. Bank NASDAQ Index	100.00	103.57	111.80	155.02	163.20	137.56

Table Of Contents

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:	2018	2017	2016	2015	2014
Total assets	$ 981,102	$ 863,637	$ 792,944	$ 729,358	$ 676,485
Total investment securities	182,810	157,385	130,037	125,232	97,896
Net loans and leases	707,233	628,767	588,130	546,682	506,327
Loans held-for-sale	5,707	2,181	2,854	1,421	1,161
Total deposits	770,183	730,146	703,459	620,675	586,944
Short-term borrowings	76,366	18,502	4,223	28,204	3,969
FHLB advances	31,704	21,204	-	-	10,000
Total shareholders' equity	93,557	87,383	80,631	76,351	72,219
Operating data for the year ended:					
Total interest income	$ 35,330	$ 31,064	$ 27,495	$ 26,014	$ 24,844
Total interest expense	4,873	3,223	2,358	2,529	2,917
Net interest income	30,457	27,841	25,137	23,485	21,927
Provision for loan losses	1,450	1,450	1,025	1,075	1,060
Net interest income after provision for loan losses	29,007	26,391	24,112	22,410	20,867
Other income	9,200	8,367	8,005	7,533	7,354
Other operating expense	25,072	24,836	21,655	21,022	19,703
Income before income taxes	13,135	9,922	10,462	8,921	8,518
Provision for income taxes	2,129	1,206	2,769	1,818	2,166
Net income	$ 11,006	$ 8,716	$ 7,693	$ 7,103	$ 6,352
Per share data:					
Net income per share, basic	$ 2.93	$ 2.35	$ 2.09	$ 1.94	$ 1.75
Net income per share, diluted	$ 2.90	$ 2.33	$ 2.09	$ 1.94	$ 1.75
Dividends declared	$ 3,708	$ 3,285	$ 3,061	$ 2,844	$ 2,667
Dividends per share	$ 0.98	$ 0.88	$ 0.83	$ 0.77	$ 0.73
Book value per share	$ 24.89	$ 23.40	$ 21.91	$ 20.83	$ 19.83
Weighted-average shares outstanding	3,752,704	3,711,490	3,679,507	3,658,687	3,619,443
Shares outstanding	3,759,426	3,734,478	3,680,707	3,665,107	3,641,650

Ratios:					
Return on average assets	1.20%	1.03%	1.02%	1.00%	0.96%
Return on average equity	12.36%	10.34%	9.64%	9.55%	9.12%
Net interest margin (1) (2)	3.64%	3.70%	3.72%	3.70%	3.75%
Efficiency ratio (1)	62.10%	66.25%	63.20%	65.49%	65.03%
Expense ratio	1.73%	1.95%	1.81%	1.89%	1.87%
Allowance for loan losses to loans	1.36%	1.44%	1.57%	1.71%	1.78%
Dividend payout ratio	33.69%	37.69%	39.79%	40.04%	41.99%
Equity to assets	9.54%	10.12%	10.17%	10.47%	10.68%
Equity to deposits	12.15%	11.97%	11.46%	12.30%	12.30%

(1) Non-GAAP disclosure – For a discussion on these ratios, see "Non-GAAP Financial Measures," located in management's discussion and analysis.

(2) Net interest margin is calculated using the fully-taxable equivalent (FTE) yield on tax-exempt securities and loans. See the "Non-GAAP Financial Measures" in management's discussion and analysis for the FTE adjustments.

Table Of Contents

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, 2018 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, 2018 and 2017and 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.

Non-GAAP Financial Measures

The following are non-GAAP financial measures which provide useful insight to the reader of the consolidated financial statements but should be supplemental to GAAP used to prepare the Company's financial statements and should not be read in isolation or relied upon as a substitute for GAAP measures. In addition, the Company's non-GAAP measures may not be comparable to non-GAAP measures of other companies. The Company's tax rate used to calculate the fully-taxable equivalent (FTE) adjustment was 21% at December 31, 2018 compared to 34% at December 31, 2017, 2016, 2015 and 2014.

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

(dollars in thousands)	2018	2017	2016	2015	2014
Interest income (GAAP)	$ 35,330	$ 31,064	$ 27,495	$ 26,014	$ 26,014
Adjustment to FTE	718	1,281	1,124	1,084	1,017
Interest income adjusted to FTE (Non-GAAP)	36,048	32,345	28,619	27,098	27,031
Interest expense	4,873	3,223	2,358	2,529	2,529
Net interest income adjusted to FTE (Non-GAAP)	$ 31,175	$ 29,122	$ 26,261	$ 24,569	$ 24,502

Table Of Contents

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

(dollars in thousands)	2018	2017	2016	2015	2014
Efficiency Ratio (non-GAAP)					
Non-interest expenses (GAAP)	$ 25,072	$ 24,836	$ 21,655	$ 21,022	$ 19,703
Net interest income (GAAP)	30,457	27,841	25,137	23,485	21,927
Plus: taxable equivalent adjustment	718	1,281	1,124	1,084	1,017
Non-interest income (GAAP)	9,200	8,367	8,005	7,533	7,354
Net interest income (FTE) plus non-interest income (non-GAAP)	$ 40,375	$ 37,489	$ 34,266	$ 32,102	$ 30,298
Efficiency ratio (non-GAAP)	62.10%	66.25%	63.20%	65.49%	65.03%

Comparison of Financial Condition as of December 31, 2018

and 2017 and Results of Operations for each of the Years then Ended

Executive Summary

Nationally, the unemployment rate declined from 4.1% at December 31, 2017 to 3.9% at December 31, 2018. However, the unemployment rate in the Scranton-Wilkes-Barre Metropolitan Statistical Area (local) remained at a higher level than the national unemployment rate. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at December 31, 2018 was 4.8%, a decrease of 0.2 percentage points from 5.0% at December 31, 2017. This is a positive sign for our local economy as the labor force and the number of employed both increased which decreased the unemployment rate. The median home values in the region increased 9.8% from a year ago, according to Zillow, an online database advertising firm providing access to its real estate search engines to various media outlets, and values are expected to grow 1.3% during 2019. 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 2018, the Company’s assets grew by 14% from deposit growth, borrowings and retained net earnings, which were used to fund growth in the loan and securities portfolios. In 2019, we expect to continue to grow most facets of loans with funding provided primarily by deposit growth. We expect to grow the investment portfolio weighted heavier in mortgage-backed securities as 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. About 24% of the municipal bond portfolio is subject to call during 2019 totaling approximately $12.5 million that management expects to reinvest into high credit quality municipal securities to maintain the portfolio allocation. We also plan to roll over $16.7 million in maturing FHLB advances in 2019 while the focus will be on paying down short-term borrowings.

Non-performing assets represented 0.64% of total assets as of December 31, 2018, down from 0.73% at the prior year end. Non-performing assets to total assets was lower during 2018 mostly due to non-performing assets remaining stable while total assets grew. For 2019, management expects to maintain non-performing assets to total assets at historically low levels despite a volatile economic environment.

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. The Company continues to focus on the trusted financial advisor model by utilizing the team approach of experienced bankers that are fully engaged and dedicated towards maintaining and growing profitable relationships.

We generated $11.0 million in net income in 2018, up $2.3 million, or 26%, from $8.7 million in 2017. In 2018, our larger and better positioned balance sheet contributed to the success of our earnings performance. The 2019 focus is to manage net interest income through a rising rate cycle by mitigating expected interest expense increases after many years of a sustained low interest rate environment to maintain a reasonable spread. Federal Open Market Committee (FOMC) officials began increasing interest rates at the end of 2015 in an attempt to return to a “normal” stance. As we continue through this nine-time 25 basis point rising rate cycle, global economic and financial developments will be closely monitored for signals of future rate hikes, and more so a potential rate pause. From a financial condition and performance perspective, our mission for 2019 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 wealth management and business services and to manage credit risk at tolerable levels thereby maintaining overall asset quality.

Finally, we are building a new branch in Mountaintop, PA, which is scheduled to open during the third quarter of 2019. We are expecting $1.5 million in investment related to the construction of this new branch in 2019. The Company is also

Table Of Contents

expecting construction in process to increase $1.7 million in 2019 due to remodeling of the Main Branch building which is scheduled to begin in the second quarter. The Company is committed to selectively expanding branch banking and wealth management locations in Lackawanna and Luzerne Counties as opportunities arrive going forward.

For the near-term, we expect to continue to operate in a slowly-rising interest rate environment. The Company's balance sheet is positioned to improve its net interest income performance, but the rising cost of funds will continue to compress net interest spread and margin. Although we expect interest rates to continue to rise, we anticipate net interest margin to decline in 2019. The FOMC had been adjusting the short-term federal funds rate up during 2018. Expectations are for short-term rates to continue to climb throughout 2019, potentially pressuring deposit rate pricing. A U.S. Treasury yield curve inversion is becoming more likely in 2019. Growth in deposits to fund loans originated at prudent pricing along with paying down short-term borrowings should mitigate the projected increase in interest expense from higher deposit and borrowing rates and help maintain an acceptable interest rate margin during 2019 and beyond.

Financial Condition

Consolidated assets increased $117.5 million, or 14%, to $981.1 million as of December 31, 2018 from $863.6 million at December 31, 2017. The increase in assets occurred predominantly in the loan and investment portfolios. The asset growth was funded by utilizing growth in deposits of $40.0 million, borrowings of $68.4 million and $7.7 million in retained earnings, net of dividends declared.

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

(dollars in thousands)												
Assets:	2018		%		2017		%		2016		%	
Cash and cash equivalents	$	17,485	1.8	%	$	15,825	1.9	%	$	25,843	3.3	%
Investment securities		182,810	18.6			157,385	18.2			130,037	16.4	
Federal Home Loan Bank stock		6,339	0.6			2,832	0.3			2,606	0.3	
Loans and leases, net		712,940	72.7			630,948	73.1			590,984	74.5	
Bank premises and equipment		18,289	1.9			16,576	1.9			17,164	2.2	
Life insurance cash surrender value		20,615	2.1			20,017	2.3			11,435	1.4	
Other assets		22,624	2.3			20,054	2.3			14,875	1.9	
Total assets	$	981,102	100.0	%	$	863,637	100.0	%	$	792,944	100.0	%
Liabilities:												
Total deposits	$	770,183	78.5	%	$	730,146	84.6	%	$	703,459	88.7	%
Short-term borrowings		76,366	7.8			18,502	2.1			4,223	0.5	
FHLB advances		31,704	3.2			21,204	2.5			-	-	
Other liabilities		9,292	1.0			6,402	0.7			4,631	0.6	
Total liabilities		887,545	90.5			776,254	89.9			712,313	89.8	
Shareholders' equity		93,557	9.5			87,383	10.1			80,631	10.2	
Total liabilities and shareholders' equity	$	981,102	100.0	%	$	863,637	100.0	%	$	792,944	100.0	%

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

(dollars in thousands)	Assets	%	Earning assets*	%	Deposits	%	Short-term borrowings	%	FHLB advances	%
2018	$ 117,465	14	$ 110,399	14	$ 40,037	5	$ 57,864	313	$ 10,500	50
2017	70,693	9	59,991	8	26,687	4	14,279	338	21,204	100
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)

* Earning assets include interest-bearing deposits with financial institutions, gross loans and leases, loans held-for-sale, available-for-sale securities and FHLB stock excluding loans placed on non-accrual status.

Table Of Contents

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 11 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 FHLB advances.

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

(dollars in thousands)	2018 Amount	%	2017 Amount	%
Interest-bearing checking	$ 224,185	29.1 %	$ 202,536	27.7 %
Savings and clubs	118,971	15.4	129,992	17.8
Money market	116,010	15.1	111,921	15.3
Certificates of deposit	116,286	15.1	107,066	14.7
Total interest-bearing	575,452	74.7	551,515	75.5
Non-interest bearing	194,731	25.3	178,631	24.5
Total deposits	$ 770,183	100.0 %	$ 730,146	100.0 %

Total deposits increased $40.0 million, or 5%, from $730.2 million at December 31, 2017 to $770.2 million at December 31, 2018. Interest-bearing and non-interest bearing checking accounts contributed the most to the growth with increases of $21.6 million and $16.1 million, respectively. The increase in interest-bearing checking accounts was due to the transfer of repurchase agreement accounts into checking accounts at the end of 2018 and growth throughout 2018 in business account balances. The Company focused on obtaining a full-banking relationship with existing customers as well as forming new customer relationships. During 2018, the Company received $11.2 million in non-interest bearing deposits from a new business relationship. The remainder of the growth in non-interest bearing checking resulted mostly from growth in business and personal accounts. Additionally, money market accounts grew $4.1 million primarily from personal account activity and CDs also increased $9.2 million during 2018. These increases were partially offset by a $11.0 million decrease in savings and clubs, of which $5.6 million was from one customer. The Company will continue to execute on its relationship development strategy, explore the demographics within its marketplace and develop creative programs for its customers. For 2019, the Company will focus on deposit growth to fund asset growth and pay down short-term borrowings. Growth in deposits from new markets is expected from a full year with the Back Mountain branch plus the Mountaintop branch scheduled to open during the third quarter of 2019. 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 started to pick up in 2018 as interest rates have risen. The Company's portfolio of CDs increased mostly due to CD promotions and customers' desire for higher-yielding deposit alternatives. During 2018, deposit customers began to move some money from savings and money market accounts to CDs. If rates continue to rise, demand for higher rate money market accounts and CDs may continue to grow thereby 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 and Insured Cash Sweep (ICS) reciprocal program to obtain FDIC insurance protection for customers who have large deposits that at times may exceed the FDIC maximum insured amount of $250,000. In the CDARS program, deposits with varying terms and interest rates, originated in the Company's own markets, are exchanged for deposits of other financial institutions that are members in the CDARS network. By placing 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, 2018 and 2017, CDARS and ICS reciprocal deposits represented $4.7 million and $1.1 million, or less than 1%, of total deposits.

Table Of Contents

The maturity distribution of certificates of deposit at December 31, 2018 is as follows:

(dollars in thousands)	Three months or less	More than three months to six months	More than six months to twelve months	More than twelve months	Total
CDs of $100,000 or more	$ 11,150	$ 8,989	$ 28,228	$ 18,573	$ 66,940
CDs of less than $100,000	7,386	6,150	12,896	22,914	49,346
Total CDs	$ 18,536	$ 15,139	$ 41,124	$ 41,487	$ 116,286

Approximately 64% of the CDs, with a weighted-average interest rate of 1.42%, are scheduled to mature in 2019 and an additional 26%, with a weighted-average interest rate of 1.89%, are scheduled to mature in 2020. 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. The Company does expect CD growth to continue during 2019, and will develop CD promotional programs when the Company deems that it is economically feasible to do so or when demand exists. The Company currently expects the cost of deposit funds to rise due to the current increasing interest rate environment. As with all promotions, the Company will consider the needs of the customers and simultaneously be mindful of the liquidity levels, borrowing rates 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, advances from the FHLB of Pittsburgh and other correspondent banks for asset growth and liquidity needs.

The components of short-term borrowings are as follows:

	As of December 31,	
(dollars in thousands)	2018	2017
Overnight borrowings	$ 76,366	$ 7,455
Securities sold under repurchase agreements	-	11,047
Total	$ 76,366	$ 18,502

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. At the end of 2018, the Company transferred all repurchase agreement accounts to interest-bearing checking accounts. In addition, short-term borrowings may include overnight balances with FHLB line of credit and/or correspondent bank's federal funds lines which the Company may require to fund daily liquidity needs such as deposit outflow, loan demand and operations. Short-term borrowings increased $57.9 million during 2018 to fund loan growth. The Company expects short-term borrowings to decrease in 2019.

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.

FHLB advances

At December 31, 2018, the Company had $31.7 million in FHLB advances with a weighted average interest rate of 2.15%. During the first quarter of 2018, the Company paid off $2.5 million of FHLB advances and another $2.0 million was paid off during the third quarter of 2018. During September 2018, the Company borrowed $15 million with maturity dates laddered out from 3 to 5 years in order to purchase securities. As of December 31, 2018, the Company had the ability to borrow an additional $124.9 million from the FHLB.

Table Of Contents

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. Debt 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). Beginning on January 1, 2018, equity securities were carried at fair value on the consolidated balance sheets with unrealized gains and losses, net of deferred income taxes, reported separately within the consolidated statements of income as a component of non-interest income. The Company sold all of its remaining equity securities during the first half of 2018. 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, 2018, the carrying value of investment securities amounted to $182.8 million, or 19% of total assets, compared to $157.4 million, or 18% of total assets, at December 31, 2017. On December 31, 2018, 68% 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, 2018 and December 31, 2017. The AFS securities were recorded with a net unrealized loss of $1.4 million and a net unrealized gain of $2.3 million as of December 31, 2018 and 2017. On January 1, 2018, $0.5 million of net unrealized gains on equity securities were reclassified from AOCI to retained earnings. Of the remaining net decline in the unrealized gain position of $3.1 million, $2.1 million was net unrealized losses on mortgages-backed securities and $1.0 million was net unrealized losses on municipal securities. 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 fall below 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, 2018, the Company had $118.9 million in public deposits, or 15% of total deposits. Pennsylvania state law requires the Company to maintain pledged securities on these public deposits. As of December 31, 2018, the balance of pledged securities required for deposit accounts was $82.6 million, or 45% of total securities.

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 year ended December 31, 2018, the Company did not incur other-than-temporary impairment charges from its investment securities portfolio.

Table Of Contents

During 2018, the carrying value of total investments increased $25.4 million, or 16%. 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 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 is expected to provide a good source of cash flow to reinvest into higher yielding interest-sensitive assets. During the third quarter of 2018, the Company purchased approximately $15 million of securities, primarily MBS-GSE residential, funded by FHLB advances with maturity dates laddered out from 3 to 5 years matching a spread expected to produce a suitable after-tax return.

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

	2018		2017	
(dollars in thousands)	Amount	%	Amount	%
MBS - GSE residential	$ 124,318	68.0 %	$ 103,152	65.5 %
State & municipal subdivisions	52,575	28.8	44,306	28.2
Agency - GSE	5,917	3.2	9,099	5.8
Equity securities - financial services	-	-	828	0.5
Total	$ 182,810	100.0 %	$ 157,385	100.0 %

As of December 31, 2018, 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, 2018 are as follows:

	One year or less		More than one year to five years		More than five years to ten years		More than ten years		Total	
(dollars in thousands)	$	%	$	%	$	%	$	%	$	%
MBS - GSE residential	$ -	- %	$ 150	5.85 %	$ 996	4.26 %	$ 123,172	3.38 %	$ 124,318	3.39 %
State & municipal subdivisions	9,339	5.00	3,122	5.24	2,620	5.01	37,494	4.67	52,575	4.78
Agency - GSE	-	-	4,945	2.69	972	2.72	-	-	5,917	2.70
Total debt securities	$ 9,339	5.00 %	$ 8,217	3.69 %	$ 4,588	4.36 %	$ 160,666	3.67 %	$ 182,810	3.76 %

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 21%. 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 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 $194 thousand and $135 thousand for the years ended December 31, 2018 and 2017, respectively. The balance in FHLB stock was $6.3 million and $2.8 million as of December 31, 2018 and 2017, respectively.

Loans and leases

As of December 31, 2018, the Company had gross loans and leases totaling $718.0 million compared to $638.6 million at December 31, 2017 which represented an increase of $79.4 million, or 12%. From a percentage point of view, the auto and leases portfolio recognized the most growth at $28.0 million, or 34%, followed by commercial and industrial growth of $13.3 million, or 12%, and commercial real estate growth of $17.9 million, or 9%.

In 2019, management does not have the same loan growth expectations because the auto portfolio has reached the desired risk management levels. Going forward, the Company will maintain auto loan balances relative to its total risk-based capital level. However, the continued growth of all other loan and lease portfolios is fully anticipated.

We continue to emphasize relationship banking by providing products and services that are needed by our existing clients and new clients we are developing within our marketplace.

In 2018, the Company originated $26.0 million of commercial and industrial loans and $34.1 million of commercial real estate loans compared to $43.8 million and $23.9 million, respectively, net of loan participations in 2017. Also, during 2018, the Company originated $68.0 million of residential real estate loans compared to $63.2 million in 2017. Included in mortgage loans were $21.5 million of residential real estate construction lines in 2018 and $17.2 million in 2017. In 2018, the Company originated $77.1 million of consumer loans compared to $61.1 million in 2017. Of the consumer loan originations, $62.3 million were dealer loans in the auto and leases portfolio in 2018 compared to $50.1 million in 2017. In

Table Of Contents

addition for 2018, the Company had originations of lines of credit in the amounts of $61.0 million for commercial borrowers and $17.9 million in home equity and other consumer lines of credit.

Commercial and industrial and commercial real estate

As of December 31, 2018, the commercial loan portfolio recognized net growth of $31.2 million, or 10%, compared to December 31, 2017. This growth was largely attributed to the commercial real estate category of $17.9 million, or 9%, with the owner occupied category increasing $14.7 million, or 13%.

Consumer

The consumer loan portfolio grew 20%, or $33.4 million, from $169.7 million at December 31, 2017 to $203.1 million at December 31, 2018. The growth was largely supported by a 34%, or $28.0 million, increase in auto loans and leases. A shift to fixed rate products due to a rising rate environment was realized as home equity line of credit balances slid by 1%, or $0.8 million. Offsetting this was fixed rate home equity installment loan growth of 20%, or $5.4 million.

Residential

The residential loan portfolio grew approximately $14.9 million, or 10%, from $146.8 million at December 31, 2017 to $161.7 million at December 31, 2018. Held-for-investment and construction real estate mortgages both demonstrated growth over the course of 2018. Held-for-investment residential loans grew $9.1 million from $136.9 million to $146.0 million and construction loan balances grew $5.8 million from $9.9 million to $15.7 million. Held-for-investment real estate makes up approximately 90% of the total residential portfolio at December 31, 2018.

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

	2018		2017		2016		2015		2014	
(dollars in thousands)	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial and industrial	$ 126,884	17.7 %	$ 113,601	17.8 %	$ 98,477	16.5 %	$ 102,653	18.4 %	$ 80,301	15.6
Commercial real estate:										
Non-owner occupied	95,515	13.3	92,851	14.5	87,220	14.5	95,745	17.2	94,771	18.4
Owner occupied	124,092	17.3	109,383	17.1	113,104	18.9	101,652	18.3	95,780	18.5
Construction	6,761	0.9	6,228	1.0	3,987	0.7	4,481	0.8	5,911	1.1
Consumer:										
	32,729	4.6	27,317	4.3	28,466	4.8	30,935	5.6	32,819	6.4

Home equity installment										
Home equity line of credit	52,517	7.3	53,273	8.3	51,609	8.6	48,060	8.7	42,188	8.2
Auto and leases	111,496	15.5	83,510	13.1	56,841	9.5	29,758	5.3	27,972	5.4
Other	6,314	0.9	5,604	0.9	13,301	2.2	6,208	1.1	6,501	1.3
Residential:										
Real estate	145,951	20.3	136,901	21.5	134,475	22.5	126,992	22.8	119,154	23.1
Construction	15,749	2.2	9,931	1.5	10,496	1.8	10,060	1.8	10,298	2.0
Gross loans	718,008	100.0 %	638,599	100.0 %	597,976	100.0 %	556,544	100.0 %	515,695	100.(
Less:										
Allowance for loan losses	(9,747)		(9,193)		(9,364)		(9,527)		(9,173)	
Unearned lease revenue	(1,028)		(639)		(482)		(335)		(195)	
Net loans	$ 707,233		$ 628,767		$ 588,130		$ 546,682		$ 506,327	
Loans held-for-sale	$ 5,707		$ 2,181		$ 2,854		$ 1,421		$ 1,161	

The following table sets forth the maturity distribution of select components of the loan portfolio at December 31, 2018. 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	$ 56,364	$ 29,188	$ 41,332	$ 126,884
Commercial real estate	78,379	114,287	26,941	219,607
Commercial real estate construction *	6,761	-	-	6,761
Residential real estate construction *	15,749	-	-	15,749
Total	$ 157,253	$ 143,475	$ 68,273	$ 369,001

*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.

Table Of Contents

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, 2018:

(dollars in thousands)	One to five years	More than five years	Total
Fixed interest rate	$ 26,269	$ 39,706	$ 65,975
Variable interest rate	117,206	28,567	145,773
Total	$ 143,475	$ 68,273	$ 211,748

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, 2018, approximately 79% of the gross loan portfolio was secured by real estate compared to 69% at December 31, 2017 and 73% at December 31, 2016. The auto and lease portfolio was 15.5% of the gross loan portfolio at December 31, 2018, increasing from 13.1% at December 31, 2017 and 9.5% at December 31, 2016. We do not anticipate the auto and lease portfolio to grow as a percent of gross loans for 2019.

The Company considers its portfolio segmentation, including the real estate secured portfolio, to be normal and reasonably diversified. The banking industry is affected by general economic conditions including, among other things, the effects of real estate values. The Company ensures that its mortgage lending adheres to standards of secondary market compliance. Furthermore, the Company's credit function strives to mitigate the negative impact of economic conditions by maintaining strict underwriting principles for all loan types.

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 declining interest rate environments, the Company would be exposed to prepayment risk as rates on fixed-rate loans decrease, and customers look to refinance loans. 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, 2018 and 2017, loans HFS consisted of residential mortgages with carrying amounts of $5.7 million and $2.2 million, respectively, which approximated their fair values. During the year ended December 31, 2018, residential mortgage loans with principal balances of $32.1 million were sold into the secondary market and the Company recognized net gains of $0.6 million, compared to $40.7 million and $0.8 million, respectively, during the year ended December 31, 2017. During the year ended December 31, 2018, the Company also sold one SBA guaranteed loan with a principal balance of $0.4 million and recognized a net gain on the sale of $47 thousand, compared to $2.4 million and $100 thousand, respectively, during the year ended December 31, 2017.

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. At December 31, 2018 and 2017, the servicing portfolio balance of sold residential mortgage loans was $304.9 million and $299.3 million, respectively. At December 31, 2018 and 2017, the servicing portfolio balance of sold SBA loans was $5.5 million and $5.6 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.

Table Of Contents

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

- identification of specific impaired loans by loan category;
- calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;
- application of historical loss percentages (trailing twelve-quarter average) to pools to determine the allowance allocation;
- application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio, regulations, and/or current economic conditions.

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 quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount, if applicable, based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered regarding not only loans considered for specific reserves, but also the collectability of loans that may be past due. 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.

Table Of Contents

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

(dollars in thousands)	2018		2017		2016		2015		2014	
Balance at beginning of period	$ 9,193		$ 9,364		$ 9,527		$ 9,173		$ 8,928	
Charge-offs:										
Commercial and industrial	(196)		(143)		(224)		(25)		(309)	
Commercial real estate	(268)		(635)		(592)		(432)		(239)	
Consumer	(391)		(658)		(504)		(437)		(361)	
Residential	(371)		(309)		(60)		(15)		(93)	
Total	(1,226)		(1,745)		(1,380)		(909)		(1,002)	
Recoveries:										
Commercial and industrial	77		10		55		47		32	
Commercial real estate	42		47		37		18		91	
Consumer	211		67		100		95		30	
Residential	-		-		-		28		34	
Total	330		124		192		188		187	
Net charge-offs	(896)		(1,621)		(1,188)		(721)		(815)	
Provision for loan losses	1,450		1,450		1,025		1,075		1,060	
Balance at end of period	$ 9,747		$ 9,193		$ 9,364		$ 9,527		$ 9,173	
Allowance for loan losses to total loans	1.36	%	1.44	%	1.57	%	1.71	%	1.78	%
Net charge-offs to average total loans outstanding	0.13	%	0.26	%	0.21	%	0.13	%	0.16	%
Average total loans	$ 677,726		$ 630,960		$ 568,953		$ 534,903		$ 495,758	
Loans 30 - 89 days past due and accruing	$ 5,891		$ 2,893		$ 2,241		$ 3,707		$ 3,932	
Loans 90 days or more past due and accruing	$ 1		$ 6		$ 19		$ 356		$ 1,060	
Non-accrual loans	$ 4,298		$ 3,441		$ 7,370		$ 9,003		$ 4,215	
Allowance for loan losses to non-accrual loans	2.27	x	2.67	x	1.27	x	1.06	x	2.18	x
Allowance for loan losses to non-performing loans	2.27	x	2.67	x	1.27	x	1.02	x	1.74	x

The allowance for loan losses was $9.7 million at December 31, 2018 compared to $9.2 million at December 31, 2017. Relative to the loan portfolio, the allowance decreased from 1.44% of total loans at December 31, 2017 to 1.36% at December 31, 2018, as loan growth outpaced the higher allowance for loan losses. The actual allowance increased $0.5 million, or 6%, during 2018, while total loans increased $79.0 million, or 12%, over the same time period. The decline in the allowance relative to total loans was considered appropriate by management due to the strength of the Company’s asset quality.

During the first quarter of 2018, management reduced qualitative factors associated with owner occupied commercial real estate and home equity lines of credit due to lower levels of delinquency associated with these loan categories. During the fourth quarter of 2018, management reduced qualitative factors associated with auto loans and leases due to an improving trend in delinquency observed for this loan category. Otherwise, the qualitative factors remained unchanged for 2018.

The allocation of net charge-offs among major categories of loans are as follows for the periods indicated:

(dollars in thousands)	2018	% of Total Net Charge-offs		2017	% of Total Net Charge-offs	
Net charge-offs						
Commercial and industrial	$ (119)	13	%	$ (133)	8	%
Commercial real estate	(226)	25		(588)	36	
Consumer	(180)	20		(591)	37	
Residential	(371)	42		(309)	19	
Total net charge-offs	$ (896)	100	%	$ (1,621)	100	%

Table Of Contents

Net charge-offs against the allowance totaled $0.9 million for the year ended December 31, 2018 compared with $1.6 million for the year ended December 31, 2017, representing a $0.7 million, or 45%, decrease. The decline in net charge-offs was attributed to total charge-offs decreasing $0.5 million for 2018 compared to 2017, and total recoveries increasing $0.2 million over the same period. The $0.7 million decrease in net charge-offs coupled with the $46.8 million increase in average total loans caused net charge-offs to average total loans outstanding to decline from 0.26% at December 31, 2017 to 0.13% at December 31, 2018.

For the year ended December 31, 2018, allowance levels rose by $0.5 million to $9.7 million compared to $9.2 million at December 31, 2017, while total loans increased by $79.0 million to $717.0 million from $638.0 million at December 31, 2017. Management believes that the current balance in the allowance for loan losses is sufficient to meet the identified potential credit quality issues that may arise and other issues 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.

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

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

	2018		2017		2016		2015		2014	
(dollars in thousands)	Allowance	Category % of Loans	Allowance	Category % of Loans	Allowance	Category % of Loans	Allowance	Category % of Loans	Allowance	Category % of Loans
Category										
Commercial real estate	$ 3,901	32 %	$ 4,060	33 %	$ 4,808	35 %	$ 5,014	36 %	$ 4,672	38 %
Commercial and industrial	1,432	18	1,374	18	1,131	16	1,336	18	1,052	16
Consumer	2,548	28	2,063	26	1,788	24	1,533	21	1,519	21
Residential real estate	1,844	22	1,608	23	1,357	25	1,407	25	1,316	25
Unallocated	22	-	88	-	112	-	237	-	614	-
Total	$ 9,747	100 %	$ 9,193	100 %	$ 9,196	100 %	$ 9,527	100 %	$ 9,173	100 %

The allocation of the allowance for the commercial loan portfolio, which is comprised of commercial real estate and commercial & industrial loans, accounted for approximately 55% of the total allowance for loan losses at December 31, 2018, which represents a four percentage point decrease from 59% of the total allowance for loan losses at December 31, 2017. The decrease in the allowance allocated to the commercial loan portfolio was attributed to lower historical loss percentages applied to the commercial real estate portfolio as a result of the reduction in commercial real estate net charge-offs observed for 2018 versus 2017. The allowance also decreased when a previously impaired single commercial real estate loan that had a large specific impairment was reclassified to performing status during the fourth quarter of 2018.

The allocation of the allowance for the consumer loan portfolio, accounted for approximately 26% of the total allowance for loan losses at December 31, 2018, which represents a four percentage point increase from 22% of the total allowance for loan losses at December 30, 2017. This higher allocation to the consumer loan portfolio was mostly related to consumer loan growth, specifically in the Company’s auto portfolio, along with the addition of a consumer installment TDR loan with a large specific impairment in the first quarter of 2018.

The allocation of the allowance for the residential real estate portfolio, accounted for approximately 19% of the total allowance for loan losses at December 31, 2018, which represents a two percentage point increase from 17% of the total allowance for loan losses December 31, 2017. The increase in the allowance allocated to residential real estate was attributed to growth in this category of loans.

The unallocated amount represents the portion of the allowance not specifically identified with a loan or groups of loans. The unallocated reserve was less than 1% of the total allowance for loan losses at December 31, 2018, practically unchanged from 1% of the total allowance for loan losses at December 31, 2017.

Table Of Contents

Non-performing assets

The Company defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, TDRs, other real estate owned (ORE) and repossessed assets. At December 31, 2018, non-performing assets represented 0.64% of total assets compared with 0.73% at December 31, 2017. The improvement in the ratio of non-performing assets to total assets was attributed to total asset growth of $117.5 million, or 14%, during 2018 while non-performing assets remained essentially unchanged at $6.3 million at December 31, 2017 and December 31, 2018.

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

(dollars in thousands)	2018	2017	2016	2015	2014
Loans past due 90 days or more and accruing	$ 1	$ 6	$ 19	$ 356	$ 1,060
Non-accrual loans *	4,298	3,441	7,370	9,003	4,215
Total non-performing loans	4,299	3,447	7,389	9,359	5,275
Troubled debt restructurings	1,830	1,871	1,823	2,423	753
Other real estate owned and repossessed assets	190	973	1,306	1,074	1,972
Total non-performing assets	$ 6,319	$ 6,291	$ 10,518	$ 12,856	$ 8,000
Total loans, including loans held-for-sale	$ 722,687	$ 640,141	$ 600,348	$ 557,630	$ 516,661
Total assets	$ 981,102	$ 863,637	$ 792,944	$ 729,358	$ 676,485
Non-accrual loans to total loans	0.59%	0.54%	1.23%	1.61%	0.82%
Non-performing loans to total loans	0.59%	0.54%	1.23%	1.68%	1.02%
Non-performing assets to total assets	0.64%	0.73%	1.33%	1.76%	1.18%

* In the table above, the amount includes non-accrual TDRs of $1.7 million, $1.6 million, $1.5 million and $0.9 million as of 2018, 2017, 2016 and 2014, 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.

From December 31, 2017 to December 31, 2018, non-performing loans, which consists of accruing loans that were over 90 days past due as well as all non-accrual loans, increased from $3.4 million to $4.3 million, a $0.9 million, or 25%, increase. The rise in non-performing loans was the result of additions of $3.4 million and miscellaneous expenses totaling $0.1 million added to balances of respective non-accrual loans. These increases were partially offset by payments received of $0.9 million, charge-offs of $0.7 million, transfers back to accrual of $0.3 million and transfers to ORE of $0.7 million for all non-accrual loans.

From December 31, 2017 to December 31, 2018, the portion of accruing loans that were over 90 days past due decreased from one loan totaling $6 thousand to three loans totaling $1 thousand. 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.

From December 31, 2017 to December 31, 2018, non-accrual loans increased by $0.9 million, or 25%, from $3.4 million to $4.3 million. At December 31, 2017, there were a total of 39 loans to 32 unrelated borrowers with balances that ranged from less than $1 thousand to $0.6 million. At December 31, 2018, there were a total of 40 loans to 34 unrelated borrowers with balances that ranged from less than $1 thousand to $0.6 million. The increase in non-accrual loans is primarily attributed to two loans to a single borrower, totaling $0.7 million, being placed on non-accrual status during the third quarter of 2018 along with two loans to a single borrower, totaling $0.8 million, being placed on non-accrual status during the fourth quarter of 2018.

Table Of Contents

The composition of non-performing loans as of December 31, 2018 is as follows:

(dollars in thousands)	Gross loan balances	Past due 90 days or more and still accruing	Non-accrual loans	Total non-performing loans	% of gross loans
Commercial and industrial	$ 126,858	$ -	$ 156	$ 156	0.12%
Commercial real estate:					
Non-owner occupied	95,541	-	472	472	0.49%
Owner occupied	124,092	-	1,634	1,634	1.32%
Construction	6,761	-	-	-	0.00%
Consumer:					
Home equity installment	32,729	-	463	463	1.41%
Home equity line of credit	52,517	-	34	34	0.06%
Auto loans and leases *	110,468	-	25	25	0.02%
Other	6,314	1	-	1	0.02%
Residential:					
Real estate	145,951	-	1,514	1,514	1.04%
Construction	15,749	-	-	-	-
Loans held-for-sale	5,707	-	-	-	-
Total	$ 722,687	$ 1	$ 4,298	$ 4,299	0.59%

*Net of unearned lease revenue of $1.0 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, 2018 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of $303 thousand.

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, 2018

	Accruing		Non-accruing				
(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer HELOC	Commercial real estate	Residential real estate	Consumer installment	Total
Troubled Debt Restructures:							
Beginning balance	$ 24	$ 1,847	$ 395	$ 542	$ 636	$ -	$ 3,444
Additions	-	-	-	-	365	414	779
Transfers	-	-	(395)	-		-	(395)
Pay downs / payoffs	-	(41)	-	(22)	-	(1)	(64)
Charge offs	-	-	-	-	(237)	-	(237)
Ending balance	$ 24	$ 1,806	$ -	$ 520	$ 764	$ 413	$ 3,527
Number of loans	1	10	-	1	2	1	15

Table Of Contents

As of and for the year ended December 31, 2017

	Accruing		Non-accruing			
(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer HELOC	Commercial real estate	Residential real estate	Total
Troubled Debt Restructures:						
Beginning balance	$ 25	$ 1,798	$ 650	$ -	$ 881	$ 3,354
Additions	-	1,059	-	-	-	1,059
Transfers	-	(969)	-	969	-	-
Pay downs / payoffs	(1)	(41)	-	(227)	(18)	(287)
Charge offs	-	-	(255)	(200)	(227)	(682)
Ending balance	$ 24	$ 1,847	$ 395	$ 542	$ 636	$ 3,444
Number of loans	1	10	1	1	1	14

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.

From December 31, 2017 to December 31, 2018, TDRs increased by $0.1 million from $3.4 million to $3.5 million. At December 31, 2017, there were a total of 14 TDRs to 10 unrelated borrowers with balances that ranged from $24 thousand to $0.6 million. At December 31, 2018, there were a total of 15 TDRs to 11 unrelated borrowers with balances that ranged from $24 thousand to $0.5 million. The increase was driven by the addition of 2 TDRs to a single borrower totaling $0.7 million in the first quarter of 2018. This increase was partially offset by the transfer to ORE of a consumer HELOC TDR with a balance of $0.4 million in the first quarter of 2018 along with a $0.2 million charge off of a residential real estate TDR in the fourth quarter of 2018.

Loans modified in a TDR may or may not be placed on non-accrual status. At December 31, 2017, three TDRs totaling $1.6 million were on non-accrual. At December 31, 2018, four TDRs totaling $1.7 million were on non-accrual. During the first quarter of 2018, one non-accrual consumer HELOC TDR was transferred to ORE. During the third quarter of 2018, two TDRs were placed on non-accrual status.

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

From December 31, 2017 to December 31, 2018, foreclosed assets held-for-sale (ORE) decreased from $1.0 million to $0.2 million, a $0.8 million, or 80%, decrease. The following table sets forth the activity in the ORE component of foreclosed assets held-for-sale:

	2018		2017	
(dollars in thousands)	Amount	#	Amount	#
Balance at beginning of period	$ 973	11	$ 1,298	13
Additions	714	8	272	5
Pay downs	(2)		(18)	
Write downs	(123)		(100)	
Sold	(1,372)	(13)	(479)	(7)
Balance at end of period	$ 190	6	$ 973	11

As of December 31, 2018, ORE consisted of six properties from six unrelated borrowers totaling $190 thousand. Three of these properties ($100 thousand) were added in 2018; two of these properties ($48 thousand) were added in 2017; and one was added in 2014 ($42 thousand). Of the six properties, one totaling $15 thousand had a signed sales agreement while the five remaining properties totaling $175 thousand were listed for sale.

As of December 31, 2018 and 2017, the Company had no other repossessed assets held-for-sale.

Table Of Contents

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. In March 2017, the Company invested $8.0 million in additional BOLI as a source of funding for additional life insurance benefits that provides for payments upon death for officers and employee benefit expenses related to the Company's non-qualified SERP implemented for certain executive officers. 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.

Premises and equipment

Net of depreciation, premises and equipment increased $1.7 million during 2018. Additions of $3.3 million were partially offset by $1.3 million of depreciation expense and $0.3 million transferred to other assets held-for-sale in 2018. The additions were primarily due to the construction of the Back Mountain branch. For 2019, we expect premises and equipment to increase, projected to grow by $1.8 million, net of depreciation, by the end of the year primarily due to the building of a new Mountaintop branch scheduled for completion during the third quarter.

Other assets

During 2018, the $2.5 million, or 16%, increase in other assets was due mostly to $1.7 million in higher residual values associated with recording new automobile leases, net of lease disposals; a $0.6 million increase in the prepaid dealer reserve; $0.5 million higher prepaid expenses; $0.3 million more in construction in process and $0.2 million added to other assets held-for-sale. These increases were partially offset by a $0.9 million higher net deferred tax liability. For 2019, other assets are projected to increase $4.1 million due to classifying operating leases as right-of-use assets in accordance with the new lease accounting standard and approximately $1.7 million for construction-in-process from remodeling the Main branch office with completion anticipated in early 2020.

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

Net interest income, net interest rate margin, net interest rate spread and the efficiency ratio are presented in the MD&A on a fully-taxable equivalent (FTE) basis. The Company believes this presentation to be the preferred industry measurement of net interest income as it provides a relevant comparison between taxable and non-taxable amounts.

Overview

For the year ended December 31, 2018, the Company generated net income of $11.0 million, or $2.90 per diluted share, compared to $8.7 million, or $2.33 per diluted share, for the year ended December 31, 2017. The $2.3 million, or 26%, increase in net income stemmed from $2.6 million more net interest income and $0.8 million in additional non-interest income which more than offset a $0.2 million rise in non-interest expenses and $0.9 million higher provision for income taxes.

For the year ended December 31, 2018, return on average assets (ROA) and return on average shareholders’ equity (ROE) were 1.20% and 12.36%, respectively, compared to 1.03% and 10.34% for the same period in 2017. The increase in ROA and ROE was the result of net income growth during 2018.

31

Table Of Contents

Net interest income and interest sensitive assets / liabilities

Net interest income increased $2.6 million, or 9%, from $27.8 million for the year ended December 31, 2017 to $30.4 million for the year ended December 31, 2018, due to interest income increasing more rapidly than interest expense. Total average interest-earning assets increased $70.5 million and the yields earned on these assets rose nine basis points resulting in $3.7 million of growth in FTE interest income. In the loan portfolio, the Company experienced average balance growth of $46.8 million combined with higher yields earned in the commercial and residential portfolios, which had the effect of producing $3.0 million of FTE interest income. Although all loan portfolios showed more interest income, the consumer loan portfolio increased due to average balance growth while the commercial and residential loan portfolios experienced increases due to both average volume growth and higher yields. In the investment portfolio, an increase in the average balances and yields of mortgage-backed securities was the biggest driver of interest income growth. The average balance of total securities grew $20.9 million producing $0.6 million in additional FTE interest income. On the liability side, total interest-bearing liabilities grew $39.9 million on average with a 23 basis point increase in rates paid on these interest-bearing liabilities. Growth in average interest-bearing deposits of $28.6 million, mostly interest-bearing checking accounts, and the 16 basis point higher rates paid on these deposits caused an increase of $1.1 million in interest expense. In addition, the Company had $11.2 million more average borrowings on which they paid higher rates in 2018 compared to 2017 which resulted in $0.6 million more interest expense.

The FTE net interest rate spread and margin decreased by fourteen and six basis points, respectively, for the year ended December 31, 2018 compared to the year ended December 31, 2017. The Company's lower tax rate in 2018 caused FTE interest income from nontaxable interest-earning assets to decline. The negative impact of this lower FTE adjustment had the effect of reducing net interest rate spread by eight basis points and margin by seven basis points. The rates paid on interest-bearing liabilities rose faster than the yields earned on interest-earning assets causing a further decline in FTE net interest rate spread of 6 basis points. If not for the reduction in yields from the lower FTE adjustment, FTE net interest margin would have increased by one basis point due to the $27.7 million increase in average non-interest bearing deposits. The overall cost of funds, which includes the impact of non-interest bearing deposits, increased sixteen basis points for the year ended December 31, 2018 compared to the same period in 2017. The primary reason for the increase was higher rates paid on larger average borrowings which were used to fund asset growth along with an increase in average interest-bearing deposits and the rates paid thereon.

For 2019, the Company expects to operate in a slowly changing interest rate environment. A rate environment with rising interest rates positions the Company to improve its interest income performance from new and maturing earning assets. Until there is a sustained period of yield curve steepening, with rates rising more sharply at the long end, the interest rate margin may experience compression. However for 2019, the Company anticipates net interest income to improve as growth in interest-earning assets would help mitigate an adverse impact of rate movements on cost of funds. The Federal Open Market Committee (FOMC) has been gradually increasing the short-term federal funds rate since the end of 2015, and it has started to effect the rates paid on funding sources. On the asset side, the prime interest rate, the benchmark rate that banks use as a base rate for adjustable rate loans, rose 100 basis points in 2018. The focus for 2019 is to manage net interest income after years of a sustained low interest rate environment through a rising rate environment by maintaining a reasonable spread. Interest expense is projected to continue to grow in 2019 from growth in deposits and borrowings and an increase in rates paid on both. Continued growth in the loan portfolios complemented with investment security growth is expected to boost interest income, and when coupled with a proactive relationship approach to deposit cost setting strategies should help contain the interest rate margin at acceptable levels.

The Company’s cost of interest-bearing liabilities was 78 basis points for the year ended December 31, 2018, or 23 basis points higher than the cost for the year ended December 31, 2017. The increase in average borrowings and average interest-bearing deposits combined with higher rates paid on both contributed to the higher cost of interest-bearing liabilities. During 2017 and 2018, rates paid on interest-bearing deposits started to inch up from historic low levels. Interest rates along the treasury yield curve have been volatile with shorter-term rates rising faster than long-term rates producing a flatter yield curve during 2018. Competition among banks has already begun to pressure banks to increase deposit rates. If rates continue to rise, the effect could pressure net interest income if short-term rates rise more rapidly than longer-term interest rates, thereby compressing the interest rate spread. To help mitigate the impact of the imminent change to the economic landscape, the Company has successfully developed and will continue to strengthen its association with existing customers, develop new business relationships, generate new loan volumes, and retain and generate higher levels of average non-interest bearing deposit balances. Strategically deploying no- and low-cost deposits into interest earning-assets is an effective margin-preserving strategy that the Company expects to continue to pursue and expand to help stabilize net interest margin.

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

The table that follows sets forth a comparison of average balances of assets and liabilities and their related net tax equivalent yields and rates for the years indicated. Within the table, interest income was FTE adjusted, using the corporate federal tax

Table Of Contents

rate of 21% for 2018 and 34% for both 2017 and 2016, to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. See "Non-GAAP Financial Measures" within this management's discussion and analysis for the FTE adjustments. This treatment allows a uniform comparison among yields on interest-earning assets. Loans include loans held-for-sale (HFS) and non-accrual loans but exclude the allowance for loan losses. HELOC are included in the residential real estate category since they are secured by real estate. Net deferred loan cost amortization of $0.7 million in 2018, $0.5 million in 2017 and $0.5 million in 2016, 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:

(dollars in thousands)	2018			2017			2016		
Assets	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Interest-earning assets									
Interest-bearing deposits	$ 6,134	$ 104	1.70 %	$ 3,960	$ 48	1.22 %	$ 12,489	$ 67	0.53 %
Restricted regulatory securities	3,740	194	5.17	3,105	135	4.34	1,391	54	3.89
Investments:									
Agency - GSE	6,140	147	2.39	17,313	248	1.43	18,279	237	1.29
MBS - GSE residential	118,197	3,167	2.68	89,909	2,267	2.52	69,437	1,472	2.12
State and municipal (nontaxable)	45,420	2,055	4.53	41,528	2,278	5.49	35,776	2,010	5.62
Other	189	13	6.85	295	30	10.12	295	29	9.85
Total investments	169,946	5,382	3.17	149,045	4,823	3.24	123,787	3,748	3.03
Loans and leases:									
C&I and CRE (taxable)	299,789	14,675	4.89	294,652	13,675	4.64	275,214	12,235	4.45
C&I and CRE (nontaxable)	32,224	1,213	3.76	30,894	1,304	4.22	26,244	1,141	4.35
Consumer	135,723	5,413	3.99	104,700	4,321	4.13	74,482	3,828	5.14
Residential real estate	209,990	9,067	4.32	200,714	8,039	4.01	193,013	7,546	3.91
Total loans and leases	677,726	30,368	4.48	630,960	27,339	4.33	568,953	24,750	4.35

Total interest-earning assets	857,546	36,048	4.20	%	787,070	32,345	4.11	%	706,620	28,619	4.05	%
Non-interest earning assets	60,396				57,277				49,226			
Total assets	$ 917,942				$ 844,347				$ 755,846			
Liabilities and shareholders' equity												
Interest-bearing liabilities												
Deposits:												
Interest-bearing checking	$ 210,277	$ 1,182	0.56	%	$ 188,833	$ 764	0.40	%	$ 157,324	$ 483	0.31	%
Savings and clubs	131,050	221	0.17		126,877	176	0.14		119,695	151	0.13	
MMDA	112,158	1,000	0.89		117,852	802	0.68		130,017	818	0.63	
Certificates of deposit	111,278	1,408	1.27		102,561	1,008	0.98		98,043	857	0.87	
Total interest-bearing deposits	564,763	3,811	0.67		536,123	2,750	0.51		505,079	2,309	0.46	
Repurchase agreements	9,666	16	0.16		10,274	21	0.20		10,239	20	0.19	
Overnight borrowings	27,892	667	2.39		18,399	205	1.11		2,805	29	1.02	
FHLB advances	22,109	379	1.71		19,778	247	1.25		-	-	-	
Total interest-bearing liabilities	624,430	4,873	0.78	%	584,574	3,223	0.55	%	518,123	2,358	0.46	%
Non-interest bearing deposits	196,790				169,075				152,826			
Non-interest bearing liabilities	7,697				6,379				5,120			
Total liabilities	828,917				760,028				676,069			
Shareholders' equity	89,025				84,319				79,777			
Total liabilities and shareholders' equity	$ 917,942				$ 844,347				$ 755,846			
Net interest income - FTE		$ 31,175				$ 29,122				$ 26,261		
Net interest spread			3.42	%			3.56	%			3.59	%
Net interest margin			3.64	%			3.70	%			3.72	%

Cost of funds	0.59 %	0.43 %	0.35 %

Table Of Contents

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

	Years ended December 31,					
(dollars in thousands)	2018 compared to 2017			2017 compared to 2016		
	Increase (decrease) due to					
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Interest-bearing deposits	$ 33	$ 23	$ 56	$ (66)	$ 47	$ (19)
Restricted regulatory securities	30	29	59	74	7	81
Investments:						
Agency - GSE	(213)	112	(101)	(13)	24	11
MBS - GSE residential	750	150	900	484	311	795
State and municipal	137	8	145	200	(33)	167
Other	(7)	(4)	(11)	-	1	1
Total investments	667	266	933	671	303	974
Loans and leases:						
Residential real estate	387	642	1,029	306	187	493
C&I and CRE	288	809	1,097	1,067	480	1,547
Consumer	1,245	(153)	1,092	1,348	(855)	493
Total loans and leases	1,920	1,298	3,218	2,721	(188)	2,533
Total interest income	2,650	1,616	4,266	3,400	169	3,569
Interest expense:						
Deposits:						
Interest-bearing checking	91	326	417	111	170	281
Savings and clubs	6	40	46	12	13	25
Money market	(40)	238	198	(79)	63	(16)
Certificates of deposit	90	310	400	40	111	151
Total deposits	147	914	1,061	84	357	441
Repurchase agreements	(1)	(4)	(5)	-	1	1
Overnight borrowings	143	319	462	173	3	176
FHLB advances	32	100	132	247	-	247
Total interest expense	321	1,329	1,650	504	361	865
Net interest income	$ 2,329	$ 287	$ 2,616	$ 2,896	$ (192)	$ 2,704

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;
- changes in risk selection and underwriting standards;

Table Of Contents

•changes in lending policies and legal and regulatory requirements;

•experience, ability and depth of lending management;

•national and local economic trends and conditions; and

•changes in credit concentrations.

For the year ended December 31, 2018 and 2017, the Company recorded a provision for loan losses of $1.5 million. The provision for loan losses derives from the reserve required from the allowance for loan losses calculation. In response to the level of loan growth observed during 2018, the Company continued provisioning in order to maintain an allowance level that management deemed adequate. Management maintained a $1.5 million provision during 2018, despite a larger loan portfolio compared with 2017, because of strengthening 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, 2018, non-interest income amounted to $9.2 million, a $0.8 million, or 10%, increase compared to $8.4 million recorded for the year ended December 31, 2017. Interchange fees grew $0.3 million due to a higher volume of debit card transactions and an increase in merchant credit card income in 2018. Trust fees were $0.3 million higher due to more assets under management which added $0.2 million and a full year of fees earned from the assumption of the accounts of another bank during 2017 which added $0.1 million. Fees from financial services increased $0.2 million. Gains on the sale of securities were $0.2 million higher in 2018 due a $0.1 million loss on the sale of securities in 2017 and gains recognized on the sale of equity securities in 2018. Losses on the write-down, sale or disposal of premises and equipment were $0.1 million lower due to a $0.2 million loss on the abandonment of leasehold improvements in 2017. Partially offsetting these items was $0.2 million fewer gains on the sale of loans and $0.1 million less service charges on loans.

Other operating expenses

For the year ended December 31, 2018, total other operating expenses totaled $25.0 million, an increase of $0.2 million, or 1%, compared to $24.8 million for the year ended December 31, 2017. Salary and employee benefits contributed the most to the increase rising $0.6 million, or 5%, in 2018 compared to 2017. The basis of the increase includes $0.6 million increased salaries with six more full-time equivalent employees, $0.2 million in stock-based compensation and $0.1 million in expenses from the post-retirement benefit plan implemented in 2017. These increases in salaries and employee benefits were partially offset by $0.2 million less in employee bonuses from a one-time bonus paid in 2017 and $0.1 million lower group insurance costs. Data processing and communications expense increased $0.2 million during 2018 compared to 2017 because of additional costs for data center services. Partially offsetting these increases in expenses was a decrease in professional services of $0.3 million primarily from a NASDAQ entry fee and stock split expenses paid in 2017. Advertising and marketing also decreased $0.2 million resulting from a $0.5 million one-time donation to a charitable foundation in 2017 that was partially offset by $0.2 million higher advertising costs and $0.1 million more in tax credit donations. Loan collection expenses also declined $0.1 million. During the fourth quarter of 2017, the Company utilized tax strategies in response to the passage of the Tax Act that led to a $0.5 million donation, $0.2 million in certain employee bonuses and $0.1 million of early lease termination expenses.

The ratios of non-interest expense less non-interest income to average assets, known as the expense ratio, at December 31, 2018 and 2017 were 1.73% and 1.95%, respectively. The expense ratio decreased because of one-time expenses recorded during the year ended December 31, 2017 as part of tax strategies. The efficiency ratio also decreased from 66.25% at December 31, 2017 to 62.10% at December 31, 2018 due to these expenses in 2017. For more information on the calculation of the efficiency ratio, see “Non-GAAP Financial Measures” located within this management’s discussion and analysis.

Provision for income taxes

The Company’s effective income tax rate approximated 16.2% in 2018 and 12.2% in 2017. The difference between the effective rate and the enacted statutory corporate rate of 21% is due mostly to the effect of tax exempt income in relation to the level of pre-tax income. On December 22, 2017, the Tax Act was signed into law and as a result the Company’s federal corporate tax rate was reduced from 34% to 21% effective January 1, 2018. The Company was required to re-measure its deferred tax assets and liabilities for the change in tax rate and recorded a $1.1 million adjustment that reduced the provision for income taxes at the end of 2017. The provision for income taxes increased $0.9 million, or 77%, from $1.2 million at December 31, 2017 to $2.1 million at December 31, 2018. If not for the tax rate change adjustment in 2017, the provision would have decreased because the higher income before taxes in 2018 was taxed at a lower tax rate.

Comparison of Financial Condition as of December 31, 2017

and 2016 and Results of Operations for each of the Years then Ended

Executive Summary

Nationally, the unemployment rate declined from 4.7% at December 31, 2016 to 4.1% at December 31, 2017. However, the unemployment rate in the Scranton-Wilkes-Barre Metropolitan Statistical Area (local) lagged behind the national unemployment rate. According to the U.S. Bureau of Labor Statistics, the local unemployment rate at December 31, 2017 was 5.0%, a decrease of 0.4 percentage points from 5.4% at December 31, 2016. The unemployment rate dropped during 2017 mostly due to a decrease in the size of the local labor force.

During 2017, the Company's assets grew by 9% from deposit growth, borrowings and retained net earnings, which were used to fund growth in the loan and securities portfolios. Non-performing assets represented 0.73% of total assets as of December 31, 2017, down from 1.33% at the prior year end. Non-performing assets were lower during 2017 mostly due to less non-accrual loans and other foreclosed assets.

On December 22, 2017, the Tax Act was signed into law. The Tax Act lowered the Company's federal income tax rate to 21%, effective January 1, 2018, from the previous rate of 34%. Net income in 2017 included a reduction in income tax expense related to an adjustment to lower the carrying value of the net deferred tax liability by $1.1 million to reflect the change in tax rate.

We generated $8.7 million in net income in 2017, up $1.0 million from $7.7 million in 2016. In 2017, our larger and better positioned balance sheet contributed to the success of our earnings performance. As described above, the Company recognized a $1.1 million credit to the provision for income taxes at the end of 2017. Also as a result of the Tax Act, the Company decided to make a donation to a charitable foundation, paid one-time bonuses to employees, sold securities at a loss and paid off the lease of a former branch early amounting to $0.7 million, net of taxes, during the fourth quarter of 2017 which mitigated the impact of this credit.

Financial Condition

Consolidated assets increased $70.7 million, or 9%, to $863.6 million as of December 31, 2017 from $792.9 million at December 31, 2016. The increase in assets occurred predominantly in the loan and investment portfolios and, to a lesser extent, the purchase of additional bank owned life insurance during 2017. The asset growth was funded by utilizing available cash balances along with growth in deposits of $26.7 million, borrowings of $35.5 million and $5.1 million in retained earnings, net of dividends declared.

Funds Provided:

Deposits

Total deposits increased $26.7 million, or 4%, from $703.5 million at December 31, 2016 to $730.2 million at December 31, 2017. Interest-bearing checking accounts contributed the most to the growth with an increase of $41.0 million. The growth in interest-bearing checking accounts came from a combination of new and existing personal, business and public accounts. CDs contributed $14.3 million to deposit growth due to CDs acquired in a branch acquisition and $5.0 million in CDs to one public customer during 2017. Additionally, savings and clubs increased by $9.5 million. These increases were partially offset by a $32.5 million reduction in non-interest bearing deposits and a $5.6 million decrease in money market accounts. The decrease in non-interest bearing deposits was due to a $48.7 million temporary deposit received at the end of 2016 and transferred to a trust escrow account in January of 2017. Excluding this temporary deposit, the Company experienced growth in non-interest bearing deposits of $16.2 million. During the first quarter of 2017, the Company completed the acquisition of Wayne Bank's West Scranton branch which increased deposits by $13.9 million.

Customers' interest in long-term time deposit products continued to be weak with a sustaining preference for non-maturing transaction deposits. The Company's portfolio of CDs increased mostly due to $11.5 million in CDs acquired from the West Scranton branch of Wayne Bank during the first quarter of 2017.

As of December 31, 2017 and 2016, CDARS represented $1.1 million, or less than 1%, of total deposits.

Short-term borrowings

Short-term borrowings increased $14.3 million during 2017. If not for a $48.7 million temporary deposit at the end of 2016, the Company would have had to use overnight borrowings at December 31, 2016.

FHLB advances

As of December 31, 2017, the Company had $21.2 million in FHLB advances. During the first quarter of 2017, the Company borrowed $17 million from the FHLB to purchase securities. The borrowings were laddered out with maturities ranging from July 2017 to January 2019 and interest rates ranging from 0.64% to 1.34%. During the second quarter of 2017, the Company borrowed another $6.7 million from the FHLB to fund loan growth and replace seasonal deposits. The borrowing matures in May 2019 and has an interest rate of 1.43%. During the third quarter of 2017, $2.0 million that was borrowed in January 2017 matured and was rolled into a new $2.0 million advance from the FHLB that matures July 2018 and has an interest rate of 1.52%. During the fourth quarter of 2017, $2.5 million that was borrowed in January matured. As of December 31, 2016, the Company did not require any FHLB advances.

Funds Deployed:

Investment Securities

As of December 31, 2017, the carrying value of investment securities amounted to $157.4 million, or 18% of total assets,

Table Of Contents

compared to $130.0 million, or 16% of total assets, at December 31, 2016.

Investment securities were comprised of AFS securities as of December 31, 2017. The AFS securities were recorded with a net unrealized gain of $2.3 million and $2.1 million as of December 31, 2017 and December 31, 2016, or a net improvement of $0.2 million during 2017.

As of December 31, 2017, the Company had $124.2 million in public deposits, or 17% of total deposits. Pennsylvania state law requires the Company to maintain pledged securities on these public deposits. As of December 31, 2017, the balance of pledged securities required for deposit and repurchase agreement accounts was $132.4 million.

During the year ended December 31, 2017, the Company did not incur other-than-temporary impairment charges from its investment securities portfolio.

During 2017, the carrying value of total investments increased $27.3 million, or 21%.

During the first quarter of 2017, the Company purchased approximately $20 million of securities, primarily MBS - GSE residential, funded mostly by $10 million in debt maturing in two years and another $7 million in borrowings laddered out from six months to one year matching a spread expected to produce a suitable after-tax return.

As of December 31, 2017, 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, 2017 were as follows:

	One year or less		More than one year to five years		More than five years to ten years		More than ten years		Total	
(dollars in thousands)	$	%	$	%	$	%	$	%	$	%
MBS - GSE residential	$ -	- %	$ 2,472	3.46 %	$ 3,520	3.92 %	$ 97,160	3.28 %	$ 103,152	3.30 %
State & municipal subdivisions	-	-	921	6.44	2,611	5.24	40,774	5.03	44,306	5.07
Agency - GSE	4,997	1.39	4,102	1.67	-	-	-	-	9,099	1.52
Total debt securities	$ 4,997	1.39 %	$ 7,495	2.80 %	$ 6,131	4.48 %	$ 137,934	3.78 %	$ 156,557	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

The dividends received from the FHLB totaled $135 thousand and $54 thousand for the years ended December 31, 2017 and 2016, respectively. The balance in FHLB stock was $2.8 million and $2.6 million as of December 31, 2017 and 2016, respectively.

Loans and leases

As of December 31, 2017, the Company had gross loans and leases totaling $638.6 million compared to $598.0 million at December 31, 2016. The growth of $40.6 million, or 7%, was largely attributed to the Company's continued efforts to grow the commercial and industrial portfolio through opportunities with local government entities including counties, townships, boroughs, cities, school districts and municipalities and authorities. Additionally, the indirect auto and lease portfolio recognized substantial planned growth during 2017 due to new relationships with automobile dealerships in Northeastern Pennsylvania.

In 2017, the Company originated $43.8 million of commercial and industrial loans and $23.9 million of commercial real estate loans compared to $25.2 million and $19.4 million, respectively, net of loan participations in 2016. Also, during 2017, the Company originated $63.2 million of residential real estate loans compared to $68.8 million in 2016. Included in mortgage loans were $17.2 million of residential real estate construction lines in 2017 and $12.7 million in 2016. In 2017, the Company originated $61.1 million of consumer loans compared to $52.1 million in 2016. Of the consumer loan originations, $50.1 million were dealer loans in the auto and leases portfolio in 2017 compared to $42.6 million in 2016. In addition for 2017, the Company had originations of lines of credit in the amounts of $36.9 million for commercial borrowers and $16.9 million in home equity and other consumer lines of credit.

Commercial and industrial and commercial real estate

The commercial and industrial (C&I) portfolio and commercial real estate (CRE) portfolio had growth of $15.1 million, or 15%, and $4.2 million, or 2%, respectively, at December 31, 2017 compared to December 31, 2016. The major contributors to the growth in the C&I portfolio were local government entities. These opportunities continue through developing influential relationships utilized through the Company's strategy. The Company also expanded commercial real estate secured lending. Mitigating the CRE growth, the Company foreclosed on one large owner occupied CRE collateral during 2017, which was subsequently sold. In addition, the increase in CRE construction loans was due to loans added during the third quarter of 2017 to one customer for several construction projects.

Table Of Contents

Consumer

The consumer loan portfolio grew nearly 13%, or $19.5 million, from $150.2 million on December 31, 2016 to $169.7 million at December 31, 2017. This planned growth was largely driven by a 47% increase, or a lift of $26.7 million, in auto loans and leases. Additional growth was realized from $1.7 million in home equity line of credit usage from new and existing clients. These increases more than offset a $7.7 million reduction in other consumer loans from $13.3 million at December 31, 2016 to $5.6 million at December 31, 2017. Other consumer loans settled back to more normalized levels at the end of 2017 as the December 31, 2016 balance was overstated by a temporary overdraft.

Residential

The residential loan portfolio grew approximately $1.8 million, or 1%, from $145.0 million at December 31, 2016 to $146.8 million at December 31, 2017. Construction loans were recorded at $9.9 million after a nominal reduction of $0.6 million while the held-for-investment real estate mortgages grew $2.4 million to $136.9 million from $134.5 million. Held-for-investment real estate made up approximately 93% of the total residential portfolio.

As of December 31, 2017, approximately 69% of the gross loan portfolio was secured by real estate, reflecting a 3 year decreasing trend from 73% at December 31, 2016 and 76% at December 31, 2015. The auto and leases portfolio was 13.1% of the gross loan portfolio at December 31, 2017, increasing from 9.5% at December 31, 2016 and 5.3% at December 31, 2015.

Loans held-for-sale

As of December 31, 2017 and 2016, loans HFS consisted of residential mortgages with carrying amounts of $2.2 million and $2.9 million, respectively, which approximated their fair values. During the year ended December 31, 2017, residential mortgage loans with principal balances of $40.7 million were sold into the secondary market and the Company recognized net gains of $0.8 million, compared to $51.3 million and $1.0 million, respectively during the year ended December 31, 2016. During 2017, the Company also sold one SBA guaranteed loan with a principal balance of $2.4 million and recognized a net gain on the sale of $0.1 million. The Company did not sell any SBA guaranteed loans in 2016.

At December 31, 2017 and 2016, the servicing portfolio balance of sold residential mortgage loans was $299.3 million and $285.2 million, respectively. At December 31, 2017 and 2016, the servicing portfolio balance of sold SBA loans was $5.6 million and $4.1 million, respectively.

Allowance for loan losses

The allowance for loan losses was $9.2 million at December 31, 2017 and $9.4 million at December 31, 2016. Relative to the loan portfolio, which grew $40.6 million in 2017, the allowance decreased from 1.57% of total loans at December 31, 2016 to 1.44% at December 31, 2017.

During the year ended December 31, 2017, management increased qualitative factor loss estimates due to certain macroeconomic and business factors. One factor identified the inverse effect of rising interest rates on commercial real estate values. Another involved relatively higher delinquency rates on urban residential properties (3.1% regionally vs. 1.6% nationally) within the Company’s operating area on properties that were relatively more likely to have negative equity (29.1% regionally vs. 10.4% nationally). An additional factor concerned the increased exposure in the auto and leases segment of the loan portfolio, which went from 9.5% of the gross loan portfolio in 2016 to

13.1% of the gross loan portfolio in 2017. Lastly, management identified potentially increased legal and regulatory requirements as the result of the Company's growing asset size.

For the twelve month period ended December 31, 2017, allowance levels fell by $0.2 million to $9.2 million, while gross loans increased by $40.6 million to $638.6 million compared to December 31, 2016. The inverse movement between allowance levels and gross loans was justified by improving asset quality. Improving asset quality was noted in a reduction of non-performing loans as a percentage of total loans, which fell to 0.54% versus 1.23% and greater coverage of allowance to non-accrual loans, which improved to 2.67x at December 31, 2017 versus 1.27x at December 31, 2016, respectively.

Net charge-offs against the allowance totaled $1.6 million for the year ended December 31, 2017 compared with $1.2 million for the year ended December 31, 2016. For the year ended December 31, 2017, commercial loan net charge-offs were $0.7 million, or, 45%, of net charge-offs. This was primarily due to two commercial real estate secured borrowers who experienced charge-offs of $0.5 million throughout the year. Consumer net charge-offs totaled $0.6 million, or 36%, of net charge-offs. One home equity line of credit borrower accounted for $0.3 million of these consumer net charge-offs. Residential charge-offs were $0.3 million, or roughly 19%, of net charge-offs, with one borrower accounting for $0.2 million during the fourth quarter of 2017.

The allocation of the allowance for the commercial loan portfolio, which is comprised of commercial real estate and commercial & industrial loans, accounted for approximately 59% of the total allowance for loan losses at December 31, 2017, which represents a 3 percentage point decrease from December 31, 2016. The decrease in the commercial real estate and commercial & industrial allocation from December 31, 2016 to December 31, 2017 was mostly related to the payoff of two large commercial real estate loans from a single borrower, which had a substantial specifically reserved impairment. The allocation of the allowance for the consumer category of loans, accounted for approximately 22% of the total allowance for

Table Of Contents

loan losses at December 31, 2017, which represents a 2 percentage point increase from December 31, 2016. This higher allocation was mostly related to increases in the qualitative factor assigned for this segment due to the rising rate environment, the Company's increased auto exposure, and concerns about the urban residential housing market. The allocation of the allowance for the residential real estate category of loans, accounted for approximately 17% of the total allowance for loan losses at December 31, 2017, which remains unchanged from December 31, 2016. The stable allocation was the result of a $0.8 million reduction in non-accrual residential real estate loans from December 31, 2016 to December 31, 2017, which was offset by the increased qualitative factor for this segment associated with risks related to the urban residential housing market. The unallocated amount represents the portion of the allowance not specifically identified with a loan or groups of loans. The unallocated was approximately 1% of the total allowance for loan losses at December 31, 2017, which remains unchanged from December 31, 2016. 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

At December 31, 2017, non-performing assets represented 0.73% of total assets compared with 1.33% as of December 31, 2016. The improvement resulted from a combination of $70.7 million in total asset growth and a $4.2 million net reduction in total non-performing assets year-over-year.

From December 31, 2016 to December 31, 2017, non-performing loans, which consists of accruing loans that were over 90 days past due as well as all non-accrual loans, decreased from $7.4 million to $3.4 million, a $4.0 million, or a 53% decrease. The decrease in non-performing loans was the result of payments received of $3.5 million, charge-offs of $1.2 million, transfers back to accrual of $1.0 million and transfers to ORE of $0.2 million. These reductions were partially offset by additions and miscellaneous expenses totaling $2.0 million. The payments received were mostly related to the payoff of two commercial real estate secured loans for a single borrower during the third quarter.

From December 31, 2016 to December 31, 2017, the portion of accruing loans that were over 90 days past due decreased from $19 thousand to $6 thousand. Accruing loans over 90 days past due at December 31, 2016 consisted of four loans to four unrelated borrowers ranging from $1 thousand to $9 thousand. Accruing loans over 90 days past due at December 31, 2017 consisted of one loan.

From December 31, 2016 to December 31, 2017, non-accruing loans of all types decreased by $4.0 million, or 53%, from $7.4 million to $3.4 million. At December 31, 2016, there were a total of 46 loans to 39 unrelated borrowers with balances that ranged from less than $1 thousand to $2.3 million. At December 31, 2017, there were a total of 39 loans to 32 unrelated borrowers with balances that ranged from less than $1 thousand to $0.6 million. The decrease in non-accruing loans is primarily attributable to the payoff of two significant non-accrual owner occupied commercial real estate secured loans to one borrower with balances totaling $3.0 million. During the third quarter of 2017, the Company foreclosed on the collateral for these loans and sold the foreclosed assets.

If the non-accrual loans that were outstanding as of December 31, 2017 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of $0.2 million.

From December 31, 2016 to December 31, 2017, the balance of TDRs was relatively unchanged from nine loans to six unrelated borrowers totaling $3.4 million to fourteen loans to ten unrelated borrowers totaling $3.4 million. The addition of six commercial real estate secured loans to four unrelated borrowers totaling $1.0 million was offset by $0.3 million in payments and $0.7 million in charge-offs during 2017.

At December 31, 2016, two TDRs totaling $1.5 million were on non-accrual. At December 31, 2017, three TDRs totaling $1.6 million were on non-accrual. During 2017, two CRE loans to one borrower were transferred to non-accrual status and subsequently one of these loans was charged off.

Foreclosed assets held-for-sale

From December 31, 2016 to December 31, 2017, foreclosed assets held-for-sale (ORE) decreased from $1.3 million to $1.0 million, a $0.3 million, or 25%, decrease. As of December 31, 2017, ORE consisted of eleven properties from eleven unrelated borrowers totaling $1.0 million. Four of these properties ($0.2 million) were added in 2017; two were added in 2016 ($0.5 million); one was added in 2015 ($0.1 million); two were added in 2014 ($42 thousand); one was added in 2012 ($100); and one was added in 2011 ($0.2 million). Of the eleven properties, seven totaling $0.8 million were listed for sale, while the four remaining properties totaling $0.2 million were either in negotiations for sale, in process for disposition, or had a signed sales agreement.

As of December 31, 2017, the Company had no other repossessed asset held-for-sale. There was one repossessed asset held-for-sale at December 31, 2016, with a balance of $8 thousand.

Premises and equipment

Net of depreciation, premises and equipment decreased $0.6 million during 2017. The Company recorded $1.3 million in depreciation expense plus $0.2 million in losses on the disposal of premises and equipment which was partially offset by $0.9 million in additions to fixed assets.

Other assets

The $4.8 million increase in other assets was due mostly to $2.0 million in higher residual values associated with recording new automobile leases, net of lease disposals and $1.4 million lower net deferred tax liability. Other items that contributed to the increase were $0.5 million higher prepaid expenses, $0.3 million more in construction in process and $0.5 million higher prepaid dealer reserve.

Results of Operations

Overview

For the year ended December 31, 2017, the Company generated net income of $8.7 million, or $2.33 per diluted share, compared to $7.7 million, or $2.09 per diluted share, for the year ended December 31, 2016. The $1.0 million, or 13%, increase in net income stemmed from $2.7 million more net interest income, $1.6 million less provision for income taxes and $0.4 million in additional non-interest income which more than offset a $3.2 million rise in non-interest expenses and $0.4 million higher loan loss provision.

For the year ended December 31, 2017, return on average assets (ROA) and return on average shareholders' equity (ROE) were 1.03% and 10.34%, respectively, compared to 1.02% and 9.64% for the same period in 2016. The increase in ROA and ROE was the result of net income growth during 2017.

Net interest income and interest sensitive assets / liabilities

Net interest income increased $2.7 million, or 11%, from $25.1 million for the year ended December 31, 2016 to $27.8 million for the year ended December 31, 2017, due to interest income increasing more rapidly than interest expense. Total average interest-earning assets increased $80.5 million and the yields earned on these assets rose six basis points resulting in $3.7 million of growth in FTE interest income. In the loan portfolio, the Company experienced average balance growth of $62.0 million, which had the effect of producing $2.7 million of interest income, more than offsetting the $0.2 million negative impact of a two basis point lower yield earned thereon. Although all loan portfolios showed more interest income from growth, the commercial loan portfolio made the biggest impact. In the investment portfolio, an increase in the average balances and yields of mortgage-backed securities was the biggest driver of interest income growth. The average balance growth of total securities of $25.3 million combined with a 21 basis point increase in their yields produced $1.1 million in additional FTE interest income. On the liability side, total interest-bearing liabilities grew $66.5 million on average with a nine basis point increase in rates paid on these interest-bearing liabilities. Growth in average interest-bearing deposits of $31.0 million, mostly interest-bearing checking accounts, and the higher rates paid on these deposits caused an increase of $0.4 million in interest expense. In addition, the Company had $35.4 million more average borrowings in 2017 compared to 2016 which resulted in $0.4 million more interest expense.

The FTE net interest rate spread and margin decreased by three and two basis points, respectively, for the year ended December 31, 2017 compared to the year ended December 31, 2016. The decrease in the spread was due to the rates paid on interest-bearing liabilities increasing faster than the yields earned on interest-earning assets. Net interest margin declined because average interest-earning assets grew faster than net interest income. The overall cost of funds, which includes the impact of non-interest bearing deposits, increased eight basis points for the year ended December 31, 2017 compared to the same period in 2016. The primary reason for the increase was higher average borrowings which were used to fund asset growth along with an increase in average interest-bearing deposits and the rates paid thereon.

The Company's cost of interest-bearing liabilities was 55 basis points for the year ended December 31, 2017, or nine basis points higher than the cost for the year ended December 31, 2016. The higher average borrowings combined with an increase in average interest-bearing deposits and their rates contributed to the higher cost of interest-bearing liabilities.

Provision for loan losses

For the year ended December 31, 2017 and 2016, the Company recorded a provision for loan losses of $1.5 million and $1.0 million, respectively, a $0.5 million increase. This increase was due primarily to net growth in the loan portfolio, particularly in the auto segment of the portfolio, but also to fund the expected allowance requirements implied from certain macroeconomic and other business factors.

Other income

For the year ended December 31, 2017, non-interest income amounted to $8.4 million, a $0.4 million, or 5%, increase compared to $8.0 million recorded for the year ended December 31, 2016. The biggest contributor to this increase was $0.3 million higher trust fees due to the assumption of the trust accounts of another bank during 2017 which added $0.2 million and organic market growth which added another $0.1 million. The Company also experienced an increase of $0.2 million in earnings on bank-owned life insurance (BOLI) due to the purchase of $8.0 million of additional BOLI during the first quarter of 2017. Debit card interchange fees contributed $0.2 million to the increase due to a higher volume of debit card transactions and an increase in merchant credit card income. Service charges on deposit accounts increased by $0.1 million from higher customer overdraft charges and other revenue increased $0.1 million from higher lease acquisition fees. Partially offsetting these items was $0.2 million higher losses on the disposal of equipment, $0.2 million in additional losses on the sale of investment securities, $0.1 million fewer gains on the sale of loans and $0.1 million less service charges on loans.

Table Of Contents

During the fourth quarter of 2017, the Company utilized tax strategies in response to the passage of the Tax Act that resulted in a $0.1 million loss on the sale of securities and $0.2 million loss on the abandonment of leasehold improvements due to the early payoff of a former lease.

Other operating expenses

For the year ended December 31, 2017, total other operating expenses totaled $24.8 million an increase of $3.2 million, or 15%, compared to $21.6 million for the year ended December 31, 2016. Salary and employee benefits contributed the most to the increase rising $1.5 million, or 13%, in 2017 compared to 2016. The basis of the increase includes $0.6 million increased salaries with eight more full-time equivalent employees, $0.4 million in additional incentive compensation and $0.4 million in expenses from the post-retirement benefit plan implemented in 2017. Advertising and marketing increased $0.6 million resulting from a $0.5 million donation to a charitable foundation and $0.1 million in additional educational improvement donations. Professional services expenses were $0.3 million higher due to more professional services incurred, primarily from a NASDAQ entry fee and stock split expenses. Premises and equipment expense was $0.3 million higher due to the early payoff of a leased property. Data processing and communications expense increased $0.3 million during 2017 compared to 2016 because of additional costs for data center services, a new integrated dealer lending computer system and higher telecommunications expense from more circuits. Automated transaction processing increased $0.1 million due to higher transaction volumes. Partially offsetting these increases in expenses was a $0.1 million decrease in FDIC assessment. During the fourth quarter of 2017, the Company utilized tax strategies in response to the passage of the Tax Act that led to a $0.5 million donation, $0.2 million in certain employee bonuses and $0.1 million of early lease termination expenses.

The ratios of non-interest expense less non-interest income to average assets, known as the expense ratio, at December 31, 2017 and 2016 were 1.95% and 1.81%, respectively. The expense ratio increased because of higher non-interest expenses during the year ended December 31, 2017 compared to the year ended December 31, 2016. The efficiency ratio also increased from 63.20% at December 31, 2016 to 66.25% at December 31, 2017 due to higher non-interest expenses.

Provision for income taxes

The Company’s effective income tax rate approximated 12.2% in 2017 and 26.5% in 2016. The difference between the effective rate and the enacted statutory corporate rate of 34% is due mostly to a $1.1 million adjustment made that reduced the provision for income taxes at the end of 2017 as a result of the Tax Act. On December 22, 2017, the Tax Act was signed into law and as a result the Company’s federal corporate tax rate was reduced from 34% to 21% effective January 1, 2018. The Company was required to re-measure its deferred tax assets and liabilities for the change in tax rate and record the adjustment in the provision for income taxes in 2017. The provision for income taxes decreased $1.6 million, or 56%, from $2.8 million at December 31, 2016 to $1.2 million at December 31, 2017. The tax reform adjustment coupled with lower income before taxes in 2017 caused the decrease in the 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 and capital lease commitments. Operating lease commitments are obligations under various non-cancelable operating leases on buildings and land used for office space and banking purposes. Capital lease commitments are obligations under one capital lease on equipment.

Table Of Contents

The following table presents, as of December 31, 2018, 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 or less	Over one year through three years	Over three years through five years	Over five years	Total
Contractual obligations:					
Certificates of deposit	$ 74,799	$ 36,953	$ 3,950	$ 584	$ 116,286
FHLB advances	16,704	5,000	10,000	-	31,704
Short-term borrowings	76,366	-	-	-	76,366
Operating leases	354	811	831	8,486	10,482
Capital leases	77	154	129	-	360
Commitments:					
Letters of credit	1,983	347	210	150	2,690
Loan commitments (1)	22,739	-	-	-	22,739
Total	$ 193,022	$ 43,265	$ 15,120	$ 9,220	$ 260,627

(1) Available credit to borrowers in the amount of $122.0 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.

Capital Resources

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 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 ratios for capital adequacy purposes. Refer to the information with respect to capital requirements 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, 2018, total shareholders' equity increased $6.2 million, or 7%, due principally from the $11.0 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), $0.9 million from stock-based compensation expense from the ESPP and unvested restricted stock and $0.3 million from issuance of stock through the dividend reinvestment program. These items were partially offset by $3.7 million of cash dividends declared on the Company’s common stock and the $2.5 million, after tax reduction in the net unrealized gain position in the Company’s investment portfolio. The Company’s dividend payout ratio, defined as the rate at which current earnings are paid to shareholders, was 33.7% for the year ended December 31, 2018. The balance of earnings is retained to further strengthen the Company’s

Table Of Contents

capital position. The Company’s sources (uses) of capital during the previous five years are indicated below:

(dollars in thousands)	Net income	Cash dividends declared	Other retained earnings adjustments	Earnings retained	DRP and ESPP infusion	Changes in AOCI and other changes	Capital retained
2018	$ 11,006	$ (3,708)	$ 421	$ 7,719	$ 460	$ (2,005)	$ 6,174
2017	8,716	(3,285)	(308)	5,123	457	1,172	6,752
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

As of December 31, 2018, the Company reported a net unrealized loss position of $1.1 million, net of tax, from the securities AFS portfolio compared to a net unrealized gain of $1.8 million as of December 31, 2017. The decline during 2018 was primarily from $2.5 million in net unrealized losses on AFS securities, net of tax and to a lesser extent a $0.4 million adjustment to re-classify unrealized gains on equity securities. Higher net unrealized losses on municipal and mortgage-backed securities caused the net unrealized losses in investment portfolio. 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 expected 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 2018, the Company utilized both methods of fulfilling 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.

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

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, 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, 2018, 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, 2018, the Company accumulated $1.7 million of cash. During the period, the Company's operations provided approximately $13.7 million mostly from $31.3 million of net cash inflow from the components of net interest income partially offset by net non-interest expense/income related payments of $13.2 million, $0.6 million in estimated tax payments, a $1.7 million increase in the residual value from the Company's automobile leasing activities and $2.1 million in originations of loans HFS over proceeds. Cash inflow from interest-earning assets, deposits, borrowings and the sale of securities were used to purchase investment securities and replace maturing and cash runoff of

Table Of Contents

securities, fund the loan portfolio, purchase premises and equipment and make 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.

As of December 31, 2018, the Company maintained $17.5 million in cash and cash equivalents and $188.5 million of investments AFS and loans HFS. Also as of December 31, 2018, the Company had approximately $124.9 million available to borrow from the FHLB, $21.0 million from correspondent banks, $91.5 million from the FRB and $47.5 million from the CDARS program. The combined total of $490.9 million represented 50% of total assets at December 31, 2018. 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 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. At December 31, 2018, the Company maintained a one-year cumulative gap of positive (asset sensitive) $2.0 million, or less than 1%, 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

Table Of Contents

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.

The following table reflects the re-pricing of the balance sheet or "gap" position at December 31, 2018:

(dollars in thousands)	Three months or less	More than three months to twelve months	More than one year to three years	More than three years	Total
Cash and cash equivalents	$ 1,460	$ -	$ -	$ 16,025	$ 17,485
Investment securities (1)(2)	8,927	21,427	35,911	122,884	189,149
Loans and leases(2)	186,501	127,326	214,202	184,911	712,940
Fixed and other assets	-	20,615	-	40,913	61,528
Total assets	$ 196,888	$ 169,368	$ 250,113	$ 364,733	$ 981,102
Total cumulative assets	$ 196,888	$ 366,256	$ 616,369	$ 981,102	
Non-interest-bearing transaction deposits (3)	$ -	$ 19,493	$ 53,512	$ 121,726	$ 194,731
Interest-bearing transaction deposits (3)	176,936	-	141,115	141,115	459,166
Certificates of deposit	18,536	56,263	36,953	4,534	116,286
Short-term borrowings	76,366	-	-	-	76,366
FHLB advances	10,000	6,704	5,000	10,000	31,704
Other liabilities	-	-	-	9,292	9,292
Total liabilities	$ 281,838	$ 82,460	$ 236,580	$ 286,667	$ 887,545
Total cumulative liabilities	$ 281,838	$ 364,298	$ 600,878	$ 887,545	
Interest sensitivity gap	$ (84,950)	$ 86,908	$ 13,533	$ 78,066	
Cumulative gap	$ (84,950)	$ 1,958	$ 15,491	$ 93,557	
Cumulative gap to total assets	-8.7%	0.2%	1.6%	9.5%	

(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.

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

Table Of Contents

assumed that the adjusted interest-earning asset and interest-bearing liability levels at December 31, 2018 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, 2018 levels:

	% change	
	Rates +200	Rates -200
Earnings at risk:		
Net interest income	(2.7) %	(4.6) %
Net income	(5.2)	(10.6)
Economic value at risk:		
Economic value of equity	(3.1)	(30.3)
Economic value of equity as a percent of total assets	(0.5)	(4.9)

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, 2018, the Company's risk-based capital ratio was 14.75%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning January 1, 2019, under alternate interest rate scenarios using the income simulation model described above:

(dollars in thousands)	Net interest income	$ variance	% variance
Simulated change in interest rates			
+200 basis points	$ 32,852	$ (898)	(2.7) %
+100 basis points	33,385	(365)	(1.1)
Flat rate	33,750	-	-
-100 basis points	33,251	(499)	(1.5)
-200 basis points	32,213	(1,537)	(4.6)

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.

Tax Cuts and Jobs Act of 2017

On December 22, 2017, the Tax Cuts and Jobs Act (the “Tax Act”) was signed into law. Among other changes, the Tax Act reduces the Company’s federal corporate income tax rate from 34% to 21% effective January 1, 2018. The Company anticipates that this tax rate change should reduce its federal income tax liability in future years beginning with 2018. However, the Company did recognize certain effects of the tax law changes in 2017. U.S. generally accepted accounting principles require companies to re-value their deferred tax assets and liabilities as of the date of enactment, with resulting tax effects accounted for in the reporting period of enactment. Since the enactment took place in December 2017, the Company revalued its net deferred tax liabilities in the fourth quarter of 2017 resulting in a $1.1 million addition to earnings in 2017.

Table Of Contents

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.

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.

Table Of Contents

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 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 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

Table Of Contents

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 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 and results of operations. 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 and lags national economic trends. Uncertainty surrounding deposit costs from an increasing competitive environment in 2019 is the Company's greatest interest rate risk. However, continued growth in earning-asset yields is expected throughout the year stemming from recent rising rates. A consensus of top analysts predicts slower growth in the economy for 2019 into 2020. It is uncertain whether the Federal Reserve will continue recent policy to normalize interest rates. Jobs improved in December 2018 from a year earlier in the Scranton/Wilkes-Barre metropolitan statistical area. According to Zillow Research, the percentage of delinquent mortgages in the Scranton Metro market is above the national average at 1.5%. 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.

Table Of Contents

ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors of Fidelity D & D Bancorp, Inc. and Subsidiary

Opinion on the Internal Control Over Financial Reporting

We have audited Fidelity D & D Bancorp, Inc. and its subsidiary's (the Company) internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated financial statements of the Company and our report dated March 13, 2019 expressed an unqualified opinion.

Basis for Opinion

The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying Management’s Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ RSM US LLP

Blue Bell, Pennsylvania

March 13, 2019

Table Of Contents

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors of Fidelity D & D Bancorp, Inc. and Subsidiary

We have audited the accompanying consolidated balance sheets of Fidelity D & D Bancorp, Inc. and its subsidiary (the Company) as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 13, 2019 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ RSM US LLP

We have served as the Company's auditor since 2015.

Blue Bell, Pennsylvania

March 13, 2019

Table Of Contents

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

(dollars in thousands)	December 31, 2018	December 31, 2017
Assets:		
Cash and due from banks	$ 16,025	$ 14,143
Interest-bearing deposits with financial institutions	1,460	1,682
Total cash and cash equivalents	17,485	15,825
Available-for-sale securities	182,810	157,385
Federal Home Loan Bank stock	6,339	2,832
Loans and leases, net (allowance for loan losses of $9,747 in 2018; $9,193 in 2017)	707,233	628,767
Loans held-for-sale (fair value $5,789 in 2018, $2,221 in 2017)	5,707	2,181
Foreclosed assets held-for-sale	190	973
Bank premises and equipment, net	18,289	16,576
Leased property under capital leases, net	333	-
Cash surrender value of bank owned life insurance	20,615	20,017
Accrued interest receivable	3,271	2,786
Goodwill	209	209
Other assets	18,621	16,086
Total assets	$ 981,102	$ 863,637
Liabilities:		
Deposits:		
Interest-bearing	$ 575,452	$ 551,515
Non-interest-bearing	194,731	178,631
Total deposits	770,183	730,146
Accrued interest payable and other liabilities	8,956	6,402
Capital lease obligation	336	-
Short-term borrowings	76,366	18,502
FHLB advances	31,704	21,204
Total liabilities	887,545	776,254
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-
Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 3,759,426 in 2018; and 3,734,478 in 2017)	29,715	28,361
Retained earnings	64,937	57,218
Accumulated other comprehensive (loss) income	(1,095)	1,804
Total shareholders' equity	93,557	87,383
Total liabilities and shareholders' equity	$ 981,102	$ 863,637

See notes to consolidated financial statements

Table Of Contents

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Income

	Years ended December 31,		
(dollars in thousands except per share data)	2018	2017	2016
Interest income:			
Loans and leases:			
Taxable	$ 29,155	$ 26,035	$ 23,609
Nontaxable	958	860	753
Interest-bearing deposits with financial institutions	104	48	67
Restricted regulatory securities	194	135	54
Investment securities:			
U.S. government agency and corporations	3,314	2,515	1,709
States and political subdivisions (nontaxable)	1,594	1,449	1,282
Other securities	11	22	21
Total interest income	35,330	31,064	27,495
Interest expense:			
Deposits	3,811	2,750	2,309
Securities sold under repurchase agreements	16	21	20
Other short-term borrowings and other	667	205	29
FHLB advances	379	247	-
Total interest expense	4,873	3,223	2,358
Net interest income	30,457	27,841	25,137
Provision for loan losses	1,450	1,450	1,025
Net interest income after provision for loan losses	29,007	26,391	24,112
Other income:			
Service charges on deposit accounts	2,244	2,227	2,139
Interchange fees	2,051	1,756	1,551
Fees from trust fiduciary activities	1,319	1,040	721
Fees from financial services	759	596	586
Service charges on loans	579	728	859
Fees and other revenue	969	872	783
Earnings on bank-owned life insurance	598	581	353
Gain (loss) on write-down, sale or disposal of:			
Loans	645	878	1,009
Available-for-sale debt securities	10	(147)	9
Equity securities	44	-	-
Premises and equipment	(18)	(164)	(5)
Total other income	9,200	8,367	8,005
Other expenses:			
Salaries and employee benefits	13,678	13,072	11,594
Premises and equipment	3,775	3,838	3,543
Advertising and marketing	1,656	1,859	1,223

Professional services	1,606	1,863	1,561
Data processing and communication	1,470	1,233	981
Automated transaction processing	784	735	607
Office supplies and postage	399	460	472
FDIC assessment	267	267	351
PA shares tax	242	262	320
Loan collection	132	224	194
Other real estate owned	177	200	207
Other	886	823	602
Total other expenses	25,072	24,836	21,655
Income before income taxes	13,135	9,922	10,462
Provision for income taxes	2,129	1,206	2,769
Net income	$ 11,006	$ 8,716	$ 7,693
Per share data :			
Net income - basic	$ 2.93	$ 2.35	$ 2.09
Net income - diluted	$ 2.90	$ 2.33	$ 2.09
Dividends	$ 0.98	$ 0.88	$ 0.83

See notes to consolidated financial statements

Table Of Contents

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Comprehensive Income

	Years ended December 31,		
(dollars in thousands)	2018	2017	2016
Net income	$ 11,006	$ 8,716	$ 7,693
Other comprehensive (loss) income, before tax:			
Unrealized holding (loss) gain on available-for-sale debt securities	(3,127)	44	(1,213)
Reclassification adjustment for net gains realized in income	(10)	147	(9)
Net unrealized (loss) gain	(3,137)	191	(1,222)
Tax effect	659	(65)	415
Unrealized (loss) gain, net of tax	(2,478)	126	(807)
Other comprehensive (loss) income, net of tax	(2,478)	126	(807)
Total comprehensive income, net of tax	$ 8,528	$ 8,842	$ 6,886

See notes to consolidated financial statements

Table Of Contents

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Changes in Shareholders' Equity
For the years ended December 31, 2018, 2017 and 2016

(dollars in thousands)	Capital stock Shares	Amount	Retained earnings	Accumulated other comprehensive income (loss)	Total
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
Net income			8,716		8,716
Other comprehensive income				126	126
Effect of adopting ASU 2018-02			(297)	297	-
Issuance of common stock through Employee Stock Purchase Plan	4,085	126			126
Issuance of common stock through Dividend Reinvestment Plan	7,744	331			331
Issuance of common stock from vested restricted share grants through stock compensation plans	9,657				
Issuance of common stock through exercise of stock options	16,000	416			416
Stock-based compensation expense		333			333
Issuance of common stock from stock split	1,243,187				
Cash in lieu of fractional shares paid due to the stock split			(11)		(11)
Cash dividends declared					