

FIRST NATIONAL COMMUNITY BANCORP INC  
Form 10-Q  
November 10, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended September 30, 2014**

**OR**

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

**For the transition period from                      to**

**Commission File No. 000-53869**

**FIRST NATIONAL COMMUNITY BANCORP, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Pennsylvania** **23-2900790**  
(State or Other Jurisdiction (I.R.S. Employer  
of Incorporation or Organization) Identification No.)

**102 E. Drinker St., Dunmore, PA 18512**  
(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code **(570) 346-7667**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

Large Accelerated Filer  Accelerated Filer

Non-Accelerated Filer  Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

|                                       |                                    |
|---------------------------------------|------------------------------------|
| <b>Common Stock, \$1.25 par value</b> | <b>16,471,569 shares</b>           |
| (Title of Class)                      | (Outstanding at November 10, 2014) |

Contents

|   |    |
|---|----|
| <u>Part I - Financial Information</u>   | 3  |
| <u>Item 1 - Financial Statements</u>  | 3  |
| <u>Consolidated Statements of Financial Condition</u>   | 3  |
| <u>Consolidated Statements of Operations</u>  | 4  |
| <u>Consolidated Statements of Comprehensive Income</u>  | 5  |
| <u>Consolidated Statements of Changes in Shareholder's Equity</u>                                     | 6  |
| <u>Consolidated Statements of Cash Flows</u>  | 7  |
| <u>Notes to Consolidated Financial Statements</u>   | 8  |
| <u>Item 2 - Management's Discussion and Analysis Of Financial Condition and Results of Operations</u> | 43 |
| <u>Item 3 - Quantitative And Qualitative Disclosures About Market Risk</u>                            | 67 |
| <u>Item 4 - Controls and Procedures</u>   | 68 |
| <u>Part II Other Information</u>  | 68 |
| <u>Item 1 - Legal Proceedings.</u>  | 68 |
| <u>Item 1A. - Risk Factors.</u>   | 69 |
| <u>Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds.</u>                          | 69 |
| <u>Item 3 - Defaults upon Senior Securities.</u>  | 69 |
| <u>Item 4 - Mine Safety Disclosures.</u>  | 69 |
| <u>Item 5 - Other Information.</u>  | 69 |
| <u>Item 6 - Exhibits.</u>   | 69 |

## Part I - Financial Information

## Item 1 - Financial Statements

**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****(unaudited)**

| (in thousands, except share data)   | September<br>30,<br>2014 | December 31,<br>2013 |
|---|--------------------------|----------------------|
| <b>Assets</b>   |                          |                      |
| Cash and cash equivalents:  |                          |                      |
| Cash and due from banks   | \$ 21,532                | \$ 19,295            |
| Interest-bearing deposits in other banks                                    | 18,461                   | 84,261               |
| Total cash and cash equivalents   | 39,993                   | 103,556              |
| Securities available for sale, at fair value                                | 217,412                  | 203,867              |
| Securities held to maturity, at amortized cost (fair value \$0 and \$2,424) | -                        | 2,308                |
| Stock in Federal Home Loan Bank of Pittsburgh, at cost                      | 4,356                    | 2,146                |
| Loans held for sale   | 171                      | 820                  |
| Loans, net of allowance for loan and lease losses of \$11,898 and \$14,017  | 666,262                  | 629,880              |
| Bank premises and equipment, net  | 11,094                   | 15,363               |
| Accrued interest receivable   | 2,158                    | 2,191                |
| Intangible assets   | 344                      | 467                  |
| Bank-owned life insurance   | 28,663                   | 28,167               |
| Other real estate owned   | 2,617                    | 4,246                |
| Other assets  | 9,063                    | 10,797               |
| <b>Total assets</b>   | <b>\$ 982,133</b>        | <b>\$ 1,003,808</b>  |
| <b>Liabilities</b>  |                          |                      |
| Deposits:   |                          |                      |
| Demand (non-interest-bearing)   | \$ 148,430               | \$ 157,550           |
| Interest-bearing  | 654,766                  | 727,148              |
| Total deposits  | 803,196                  | 884,698              |
| Borrowed funds  |                          |                      |
| Federal Home Loan Bank of Pittsburgh advances                               | 68,786                   | 27,123               |
| Subordinated debentures   | 25,000                   | 25,000               |
| Junior subordinated debentures  | 10,310                   | 10,310               |
| Total borrowed funds  | 104,096                  | 62,433               |
| Accrued interest payable  | 10,515                   | 8,732                |
| Other liabilities   | 14,005                   | 14,367               |

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

|   |            |              |
|---|------------|--------------|
| Total liabilities   | 931,812    | 970,230      |
| Shareholders' equity  |            |              |
| Preferred shares (\$1.25 par)   |            |              |
| Authorized: 20,000,000 shares at September 30, 2014 and December 31, 2013             |            |              |
| Issued and outstanding: 0 shares at September 30, 2014 and December 31, 2013          | -          | -            |
| Common shares (\$1.25 par)  |            |              |
| Authorized: 50,000,000 shares at September 30, 2014 and December 31, 2013             |            |              |
| Issued and outstanding: 16,471,569 shares at September 30, 2014 and December 31, 2013 | 20,589     | 20,589       |
| Additional paid-in capital  | 61,692     | 61,627       |
| Accumulated deficit   | (32,095)   | (45,546)     |
| Accumulated other comprehensive income (loss)   | 135        | (3,092)      |
| Total shareholders' equity  | 50,321     | 33,578       |
| Total liabilities and shareholders' equity  | \$ 982,133 | \$ 1,003,808 |

The accompanying notes to consolidated financial statements are an integral part of these statements.

**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(unaudited)**

| (in thousands, except share data)                            | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--|-------------------------------------|----------|------------------------------------|----------|
|  | 2014                                | 2013     | 2014                               | 2013     |
| Interest income  |                                     |          |                                    |          |
| Interest and fees on loans                                   | \$6,852                             | \$6,833  | \$19,958                           | \$20,158 |
| Interest and dividends on securities                         |                                     |          |                                    |          |
| U.S. government agencies                                     | 893                                 | 429      | 2,496                              | 1,331    |
| State and political subdivisions, tax-free                   | 409                                 | 761      | 1,679                              | 2,592    |
| State and political subdivisions, taxable                    | 76                                  | 98       | 271                                | 295      |
| Other securities   | 74                                  | 51       | 206                                | 120      |
| Total interest and dividends on securities                   | 1,452                               | 1,339    | 4,652                              | 4,338    |
| Interest on interest-bearing deposits and federal funds sold | 8                                   | 17       | 44                                 | 70       |
| Total interest income  | 8,312                               | 8,189    | 24,654                             | 24,566   |
| Interest expense   |                                     |          |                                    |          |
| Interest on deposits   | 751                                 | 1,037    | 2,435                              | 3,225    |
| Interest on borrowed funds                                   |                                     |          |                                    |          |
| Interest on Federal Home Loan Bank of Pittsburgh advances    | 125                                 | 149      | 334                                | 403      |
| Interest on subordinated debentures                          | 575                                 | 575      | 1,706                              | 1,706    |
| Interest on junior subordinated debentures                   | 50                                  | 51       | 149                                | 153      |
| Total interest on borrowed funds                             | 750                                 | 775      | 2,189                              | 2,262    |
| Total interest expense                                       | 1,501                               | 1,812    | 4,624                              | 5,487    |
| Net interest income before credit for loan and lease losses  | 6,811                               | 6,377    | 20,030                             | 19,079   |
| Credit for loan and lease losses                             | (54                                 | ) (1,159 | ) (5,629                           | ) (2,385 |
| Net interest income after credit for loan and lease losses   | 6,865                               | 7,536    | 25,659                             | 21,464   |
| Non-interest income  |                                     |          |                                    |          |
| Deposit service charges                                      | 781                                 | 758      | 2,217                              | 2,159    |
| Net gain on the sale of securities                           | 2,958                               | 817      | 6,006                              | 2,558    |
| Net gain on the sale of mortgage loans held for sale         | 57                                  | 81       | 223                                | 241      |
| Net loss on the sale of education loans                      | -                                   | -        | (13                                | ) -      |
| Net gain on the sale of other real estate owned              | 35                                  | 5        | 103                                | 94       |
| Gain on branch divestitures                                  | -                                   | -        | 607                                | -        |
| Loan-related fees  | 101                                 | 87       | 292                                | 284      |
| Income from bank-owned life insurance                        | 165                                 | 176      | 496                                | 531      |
| Legal settlements  | -                                   | -        | 2,127                              | 288      |
| Other  | 345                                 | 491      | 799                                | 1,000    |
| Total non-interest income                                    | 4,442                               | 2,415    | 12,857                             | 7,155    |
| Non-interest expense   |                                     |          |                                    |          |
| Salaries and employee benefits                               | 3,316                               | 3,223    | 9,809                              | 9,786    |
| Occupancy expense  | 438                                 | 529      | 1,554                              | 1,663    |

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Equipment expense                                    | 355        | 369        | 1,068      | 1,125      |
| Advertising expense                                  | 109        | 146        | 353        | 402        |
| Data processing expense                              | 508        | 499        | 1,556      | 1,567      |
| Regulatory assessments                               | 266        | 603        | 1,389      | 1,863      |
| Bank shares tax                                      | 21         | 241        | 372        | 723        |
| Expense of other real estate owned                   | 514        | 318        | 2,495      | 768        |
| Provision (credit) for off-balance sheet commitments | 3          | (56)       | (201)      | (232)      |
| Legal expense  | 268        | 657        | 1,428      | 1,838      |
| Professional fees                                    | 306        | 351        | 1,240      | 1,228      |
| Insurance expenses                                   | 196        | 279        | 757        | 898        |
| Loan collection expense                              | 35         | 58         | 72         | 305        |
| Other operating expenses                             | 1,448      | 847        | 2,847      | 2,347      |
| Total non-interest expense                           | 7,783      | 8,064      | 24,739     | 24,281     |
| Income before income taxes                           | 3,524      | 1,887      | 13,777     | 4,338      |
| Provision for income taxes                           | 166        | -          | 326        | -          |
| Net income   | \$3,358    | \$1,887    | \$13,451   | \$4,338    |
| Earnings per share                                   |            |            |            |            |
| Basic  | \$0.20     | \$0.11     | \$0.82     | \$0.26     |
| Diluted  | \$0.20     | \$0.11     | \$0.82     | \$0.26     |
| Cash dividends declared per common share             | \$-        | \$-        | \$-        | \$-        |
| WEIGHTED AVERAGE NUMBER OF SHARES<br>OUTSTANDING:    |            |            |            |            |
| Basic  | 16,471,569 | 16,457,169 | 16,471,569 | 16,457,169 |
| Diluted  | 16,471,569 | 16,457,169 | 16,471,851 | 16,457,169 |

The accompanying notes to consolidated financial statements are an integral part of these statements.



**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(unaudited)**

| (in thousands)   | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |             |
|--|-------------------------------------|----------|------------------------------------|-------------|
|  | 2014                                | 2013     | 2014                               | 2013        |
| Net income   | \$ 3,358                            | \$ 1,887 | \$ 13,451                          | \$ 4,338    |
| Other comprehensive (loss) income:                           |                                     |          |                                    |             |
| Unrealized (losses) gains on securities available for sale   | (482 )                              | (132 )   | 10,528                             | (10,270 )   |
| Taxes  | 163                                 | 45       | (3,580 )                           | 3,492       |
| Net of tax amount  | (319 )                              | (87 )    | 6,948                              | (6,778 )    |
| Reclassification adjustment for gains included in net income | (2,958 )                            | (817 )   | (5,638 )                           | (2,558 )    |
| Taxes  | 1,006                               | 278      | 1,917                              | 870         |
| Net of tax amount  | (1,952 )                            | (539 )   | (3,721 )                           | (1,688 )    |
| Total other comprehensive (loss) income                      | (2,271 )                            | (626 )   | 3,227                              | (8,466 )    |
| Total comprehensive income (loss)                            | \$ 1,087                            | \$ 1,261 | \$ 16,678                          | \$ (4,128 ) |

The accompanying notes to consolidated financial statements are an integral part of these statements.

**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY****For the Nine Months Ended September 30, 2014 and 2013****(Unaudited)**

| (in thousands, except per share data)                | Number<br>of Common<br>Shares | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Accumulated<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders'<br>Equity |
|--|-------------------------------|-----------------|----------------------------------|------------------------|--|----------------------------------|
| Balances, December 31, 2012                          | 16,457,169                    | \$20,571        | \$61,584                         | \$(51,928)             | \$6,698  | \$36,925                         |
| Net income for the period                            | -                             | -               | -                                | 4,338                  | -  | 4,338                            |
| Other comprehensive loss, net of tax of<br>\$4,362   | -                             | -               | -                                | -                      | (8,466)  | (8,466)                          |
| Balances, September 30, 2013                         | 16,457,169                    | \$20,571        | \$61,584                         | \$(47,590)             | \$(1,768)  | \$32,797                         |
| Balances, December 31, 2013                          | 16,471,569                    | \$20,589        | \$61,627                         | \$(45,546)             | \$(3,092)  | \$33,578                         |
| Net income for the period                            | -                             | -               | -                                | 13,451                 | -  | 13,451                           |
| Restricted stock awards                              | -                             | -               | 65                               | -                      | -  | 65                               |
| Other comprehensive income, net of tax of<br>\$1,663 | -                             | -               | -                                | -                      | 3,227  | 3,227                            |
| Balances, September 30, 2014                         | 16,471,569                    | \$20,589        | \$61,692                         | \$(32,095)             | \$135  | \$50,321                         |

The accompanying notes to consolidated financial statements are an integral part of these statements.

**FIRST NATIONAL COMMUNITY BANCORP, INC AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

| (in thousands)  | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2014                               | 2013      |
| Operating activities:   |                                    |           |
| Net income  | \$ 13,451                          | \$ 4,338  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |           |
| Investment securities amortization (accretion), net                               | 953                                | 240       |
| Equity in trust   | (4 )                               | (5 )      |
| Depreciation and amortization   | 1,068                              | 924       |
| Stock-based compensation  | 65                                 | -         |
| Credit for loan and lease losses  | (5,629 )                           | (2,385 )  |
| Credit for off balance sheet commitments  | (201 )                             | (232 )    |
| Gain on the sale of available-for-sale securities                                 | (5,638 )                           | (2,558 )  |
| Gain on the sale of held-to-maturity securities                                   | (368 )                             | -         |
| Gain on the sale of loans held for sale   | (223 )                             | (241 )    |
| Loss on the sale of education loans   | 13                                 | -         |
| Gain on branch divestitures   | (607 )                             | -         |
| Loss on abandonment of fixed assets   | 352                                | -         |
| Gain on the sale of other real estate owned                                       | (103 )                             | (94 )     |
| Valuation adjustment of other real estate owned                                   | 2,199                              | 257       |
| Income from bank-owned life insurance   | (496 )                             | (531 )    |
| Proceeds from the sale of loans held for sale                                     | 6,806                              | 9,238     |
| Funds used to originate loans held for sale                                       | (5,934 )                           | (8,266 )  |
| Decrease (increase) in accrued interest receivable                                | 33                                 | (121 )    |
| Decrease in refundable federal income taxes                                       | -                                  | 11,582    |
| (Increase) decrease in other assets   | (64 )                              | 4,418     |
| Increase in accrued interest payable  | 1,783                              | 1,807     |
| Increase (decrease) in other liabilities  | (333 )                             | (1,562 )  |
| Total adjustments   | (6,328 )                           | 12,471    |
| Net cash provided by operating activities   | 7,123                              | 16,809    |
| Cash flows from investing activities:   |                                    |           |
| Maturities, calls and principal payments of available-for-sale securities         | 5,965                              | 12,086    |
| Proceeds from the sale of available-for-sale securities                           | 78,582                             | 51,066    |
| Proceeds from the sale of held-to-maturity securities                             | 2,686                              | -         |
| Purchases of available-for-sale securities  | (88,528 )                          | (73,997 ) |
| Net (purchase) redemption of Federal Home Loan Bank of Pittsburgh stock           | (2,210 )                           | 3,407     |
| Proceeds from the sale of education loans   | 2,537                              | -         |
| Net increase in loans to customers  | (33,095 )                          | (56,979 ) |
| Proceeds from the sale of other real estate owned                                 | 1,268                              | 1,489     |

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

|   |           |           |
|---|-----------|-----------|
| Proceeds from the sale of bank premises and equipment through branch divestitures | 2,504     | -         |
| Purchases of property and equipment   | (982 )    | (583 )    |
| Net cash used in investing activities   | (31,273 ) | (63,511 ) |
| Cash flows from financing activities:   |           |           |
| Net decrease in deposits  | (81,076 ) | (803 )    |
| Proceeds from Federal Home Loan Bank of Pittsburgh advances                       | 194,235   | 32,250    |
| Repayment of Federal Home Loan Bank of Pittsburgh advances                        | (152,572) | (13,630 ) |
| Net cash (used in) provided by financing activities                               | (39,413 ) | 17,817    |
| Net decrease in cash and cash equivalents   | (63,563 ) | (28,885 ) |
| Cash and cash equivalents at beginning of period                                  | 103,556   | 115,271   |
| Cash and cash equivalents at end of period  | \$39,993  | \$86,386  |
| Supplemental cash flow information  |           |           |
| Cash paid (received) during the period for:                                       |           |           |
| Interest  | \$2,841   | \$3,680   |
| Income taxes  | 238       | (11,582 ) |
| Other transactions:   |           |           |
| Principal balance of loans transferred to other real estate owned                 | 13        | 255       |
| Bank premises transferred to other real estate owned                              | 1,749     | 1,819     |
| Change in deferred gain on sale of other real estate owned                        | 27        | -         |

**FIRST NATIONAL COMMUNITY BANCORP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Notes to Consolidated Financial Statements**

**Note 1. Basis of Presentation**

The consolidated financial statements are comprised of the accounts of First National Community Bancorp, Inc., and its wholly owned subsidiary, First National Community Bank (the “Bank”), as well as the Bank’s wholly owned subsidiaries (collectively, the “Company”). The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”) and general practices within the banking industry. In the opinion of management, all adjustments necessary for a fair presentation of the results for the three and nine month periods ended September 30, 2014 have been included in the consolidated financial statements. All intercompany balances and transactions have been eliminated in consolidation. Prior period amounts have been reclassified when necessary to conform to the current period’s presentation. These reclassifications did not have an impact on the operating results or financial position of the Company. The operating results and financial position of the Company for the three and nine months ended September 30, 2014, may not be indicative of its future results of operations and financial position.

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to change in the near term are the allowance for loan and lease losses (“ALLL”), investment security valuations, the evaluation of investment securities and other real estate owned (“OREO”) for impairment, and the evaluation of deferred income taxes.

These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s audited financial statements, included in its Annual Report filed on Form 10-K as of and for the year ended December 31, 2013 and the Company’s Quarterly Reports filed on Form 10-Q for the periods ended March 31, 2014 and June 30, 2014.

**Note 2. New Authoritative Accounting Guidance**

ASU 2013-11, Income Taxes (Topic 740): “Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists,” requires an unrecognized tax benefit, or a portion of an unrecognized tax benefit, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. If a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date, the unrecognized tax benefit should be presented in the financial statements as a liability and not combined with deferred tax assets. The Company adopted ASU 2013-11 on January 1, 2014. The adoption of this new guidance did not have an effect on the operating results or financial position of the Company.

### **Accounting Guidance to be Adopted in Future Periods**

ASU 2014-04, Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure,” clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (a) the creditor obtaining legal title to residential real estate property upon completion of a foreclosure or (b) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. This guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014, with early adoption permitted. The adoption of this guidance on January 1, 2015 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): “Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,” changes the criteria for reporting a discontinued operation. Under the new guidance, a disposal of a component of an entity or group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on the entity’s operations and financial results. This new guidance reduces complexity by removing the complex and extensive implementation guidance and illustrations that are necessary to apply the current definition of a discontinued operation. The new guidance also requires expanded disclosures about discontinued operations that will provide users with more information about the assets, liabilities, revenues and expenses of a discontinued operation and will require pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting, which will provide users with information about the ongoing trends in a reporting organization’s results from continuing operations. A public company or not-for-profit organization that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market is required to apply the new guidance prospectively to all disposals (or classifications as held for sale) of components of an organization and all business or nonprofit activities that, on acquisition, are classified as held for sale that occur within annual periods beginning on or after December 15, 2014, and interim periods within those years. The adoption of this guidance on January 1, 2015 is not expected to have a material effect on the operating results or financial position of the Company.



ASU 2014-09, Revenue from Contracts with Customers (Topic 606): Section A, “Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs-Contract with Customers (Subtopic 340-40);” Section B, “Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables;” and Section C, “Background Information and Basis for Conclusions,” provides a robust framework for addressing revenue recognition issues, upon its effective date, replaces almost all existing revenue recognition guidance, including industry specific guidance, in current GAAP. The core principle of ASU 2014-09 is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 will also result in enhanced interim and annual disclosures, both qualitative and quantitative, about revenue in order to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. ASU 2014-09 is effective in annual reporting periods beginning after December 15, 2016 and the interim periods within that year for public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or over-the-counter market and employee benefit plans that file or furnish financial statements to the SEC. Accordingly, the Company will adopt this guidance on January 1, 2017 and is currently evaluating the effect this guidance may have on its operating results or financial position.

ASU 2014-11, Transfers and Servicing (Topic 860): “Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures,” changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements by aligning the accounting for these transactions with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial assets and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward arrangement, which has resulted in outcomes referred to as off-balance sheet accounting. ASU 2014-11 also requires a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction, and requires expanded disclosure about the nature of the collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. Accounting changes in ASU 2014-11 are effective for public companies for interim and annual periods beginning after December 15, 2014. In addition, the disclosure for certain transactions accounted for as a sale is effective for the first interim or annual period beginning on or after December 15, 2014, and the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. The adoption of this guidance on the appropriate effective dates is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-12, Compensation – Stock Compensation (Topic 718): “Accounting for Share-Based Payments When the Terms of an Award Provide that a Performance Target Could be Achieved after the Requisite Service Period,” requires a performance target that affects vesting and that can be achieved after the requisite service period to be treated as a performance condition. To account for such awards, an entity should apply existing guidance as it relates to awards with performance conditions that affect vesting. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service periods. The total amount of compensation cost



should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-14, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure,” requires that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure; (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. ASU 2014-14 is effective for public companies for interim and annual periods beginning after December 15, 2014. For all other entities, the new standard is effective for annual periods ending after December 15, 2015 and interim periods beginning after December 15, 2015. The adoption of this guidance on January 1, 2015 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern,” defines management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and provide guidance for related footnote disclosures. ASU 2014-15 requires an entity’s management to assess the entity’s ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically ASU 2014-15: (1) provides a definition of the term substantial doubt; (2) requires an evaluation as to whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable); (3) provides principles for considering the mitigating effect of management’s plans; (4) requires certain disclosures when substantial doubt is alleviated; and (5) require an express statement and other disclosures when substantial doubt is not alleviated. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The adoption of this guidance on December 31, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

### **Note 3. Regulatory Matters**

The Bank is under a Consent Order (the “Order”) from the Office of the Comptroller of the Currency (“OCC”) dated September 1, 2010. The Company is also subject to a Written Agreement (the “Agreement”) with the Federal Reserve Bank of Philadelphia (the “Reserve Bank”) dated November 24, 2010.

*OCC Consent Order.* The Bank, pursuant to a Stipulation and Consent to the Issuance of a Consent Order dated September 1, 2010, without admitting or denying any wrongdoing, consented and agreed to the issuance of the Order by the OCC, the Bank’s primary regulator. The Order requires the Bank to undertake certain actions within designated timeframes, and to operate in compliance with the provisions thereof during its term. The Order is based on the results of an examination of the Bank as of March 31, 2009. Since the examination, management has engaged in ongoing discussions with the OCC and has taken steps to improve the condition, policies and procedures of the Bank. Compliance with the Order is monitored by a committee (the “Committee”) of at least three directors, none of whom is an employee or controlling shareholder of the Bank or its affiliates or a family member of any such person. The Committee had been required to submit written progress reports to the OCC on a monthly basis. Effective April 10, 2014, the written progress report requirement was changed from monthly to quarterly as of quarter-end March 31, 2014. The Committee has submitted each of the required progress reports with the OCC. The members of the Committee are John P. Moses, William G. Bracey, Joseph Coccia, Keith W. Eckel and Thomas J. Melone. The material provisions of the Order are set forth below with a description of the status of the Bank’s effort to comply with such provisions:

(i) By October 31, 2010, the Board of Directors of the Bank (the “Board”) was required to adopt and implement a three-year strategic plan (a “Strategic Plan”) which must be submitted to the OCC for review and prior determination of no supervisory objection; the Strategic Plan must establish objectives for the Bank’s overall risk profile, earnings performance, growth, balance sheet mix, off-balance sheet activities, liability structure, capital adequacy, reduction in

the volume of nonperforming assets, product line development, and market segments that the Bank intends to promote or develop, and is to include strategies to achieve those objectives; if the Strategic Plan involves the sale or merger of the Bank, it must address the timeline and steps to be followed to provide for a definitive agreement within 90 days after the receipt of a determination of no supervisory objection;

The Bank has developed a Strategic Plan that it believes complies with the Order requirements. A three-year Strategic Plan for the period January 1, 2011 to December 31, 2013 was prepared and submitted to the OCC for review. On an annual basis, the Bank prepares an updated and revised Strategic Plan. Strategic Plans for the three-year periods January 1, 2012 to December 31, 2014 and January 1, 2013 to December 31, 2015 were submitted to the OCC for review. The Strategic Plan for the three-year period January 1, 2014 to December 31, 2016 was completed and submitted to the OCC for review in April 2014. The OCC issued a written determination of supervisory non-objection to the Strategic Plan in June 2014. The Strategic Plan was adopted by the Board of Directors in June 2014.

(ii) by October 31, 2010, the Board was required to adopt and implement a three year capital plan (a “Capital Plan”), which must be submitted to the OCC for review and prior determination of no supervisory objection;

The Bank has developed a Capital Plan that it believes complies with the Order requirements to ensure that the Bank's leverage ratio equals or exceeds 9% and the Bank's total risk-based capital ratio equals or exceeds 13%. This Capital Plan for the period January 1, 2011 through December 31, 2013 and its annual update and revisions for 2012 and 2013 were submitted to the OCC for review. The annual update and revision to the Capital Plan for the three-year period January 1, 2014 to December 31, 2016 was completed and forwarded to the OCC for review in April 2014. The OCC issued a written determination of supervisory non-objection to the Capital Plan in June 2014. The Capital Plan was adopted by the Board of Directors in June 2014.

(iii) by November 30, 2010, the Bank was required to achieve and thereafter maintain a total risk-based capital equal to at least 13% of risk-weighted assets and a Tier 1 capital equal to at least 9% of adjusted total assets;

The Bank's total risk-based capital ratio was 15.28% at September 30, 2014, which was above the 13.00% required by the Order. The Bank's leverage capital ratio was 10.05% at September 30, 2014, which was above the 9.00% required by the Order. The Bank's total risk-based capital increased 185 basis points, while the Bank's leverage ratio increased 173 basis points at September 30, 2014 compared to December 31, 2013.

(iv) the Bank may not pay any dividend or capital distribution unless it is in compliance with the higher capital requirements required by the Order, the Capital Plan, applicable legal requirements and, then only after receiving a determination of no supervisory objection from the OCC;

The Board has acknowledged the prohibition on payment of dividends or any other capital distributions unless the Bank receives a determination of no supervisory objection from the OCC. The Bank has not paid any dividends or capital distributions since the effective date of the Order.

On September 8, 2014, the Company sent to the OCC a request for a determination of no supervisory objection of a \$1.0 million capital distribution from the Bank to the Company to both cure the trust preferred securities interest deferral and to make regular quarterly interest payments going forward. As of the date of this filing, the Company has not received a determination of no supervisory objection from the OCC.

(v) by November 15, 2010, the Committee must have reviewed the Board and the Board's committee structure; by November 30, 2010, the Board was required to prepare or cause to be prepared an assessment of the capabilities of the Bank's executive officers to perform their past and current duties, including those required to respond to the most recent examination report, and to perform annual performance appraisals of each officer;

The Committee completed its review of the Board and the Board committee structure on November 10, 2010 by reviewing the Board Structure Study report completed by an independent consultant engaged by the Committee. The report was forwarded to the OCC on November 24, 2010. The Company has implemented those recommendations and believes it is in compliance with the requirements of this provision. Louis A. DeNaples re-joined the Board in December 2013, William G. Bracey was appointed to the Board in May 2014, and Keith W. Eckel was appointed to the Board in September 2014. One of the Company's directors, Joseph J. Gentile, passed away in August 2014.

The Board completed its assessment of the capabilities of the Bank's executive officers upon receipt of a management study, completed by an independent consultant (the "Management Study"), on October 13, 2010. The Management Study was forwarded to the OCC on October 29, 2010. The Board of Directors completed a successful search for President and Chief Executive Officer in December 2011. Since the effective date of the Order, other changes have been made to the executive management team related to the size and complexity of the organization. The Board believes that it has prepared or caused to be prepared an assessment of the capabilities of the Bank's executive officers to perform their past and current duties, including those required to respond to the most recent examination report.

Annual performance appraisals are prepared for each officer based on established and timely management goals to confirm that each officer is performing the duties outlined in his or her job description.

(vi) by October 31, 2010, the Board was required to adopt, implement and thereafter ensure compliance with a comprehensive Conflict of Interest Policy applicable to the Bank's and the Company's directors, executive officers, principal shareholders and their affiliates and such person's immediate family members and their related interests, employees, and by November 30, 2010, was required to review existing relationships with such persons to identify those, if any, not in compliance with the policy; and review all subsequent proposed transactions with such persons or modifications of transactions;

The Bank's Conflict of Interest Policy has been revised to provide comprehensive guidance and a review was conducted of existing relationships to ensure compliance with the Conflict of Interest Policy. The revised policy was approved by the Board on September 29, 2010 and forwarded to the OCC on October 7, 2010. Additional revisions were approved by the Board on April 29, 2011, October 24, 2012, May 22, 2013 and November 14, 2013. The Board believes that it has adopted, implemented and maintained compliance with a comprehensive Conflict of Interest Policy in accordance with the requirements of the provision.

(vii) by October 31, 2010, the Board was required to develop, implement and ensure adherence to policies and procedures for Bank Secrecy Act (“BSA”) compliance; and account opening and monitoring procedures compliance;

The Board believes it has developed and implemented a written program of policies and procedures to provide for compliance with the requirements of the BSA as well as compliance with account opening and monitoring procedures.

(viii) by October 31, 2010, the Board was required to ensure the BSA audit function is supported by an adequately staffed department or third party firm; to adopt, implement and ensure compliance with an independent BSA audit; and to assess the capabilities of the BSA officer and supporting staff to perform present and anticipated duties;

The Board believes that the Bank’s BSA audit function is adequately staffed; and the BSA officer and staff have been assessed to determine their ability to implement and maintain compliance with the BSA policies and programs detailed above.

(ix) by October 31, 2010, the Board was required to adopt, implement and ensure adherence to a written credit policy (the “Loan Policy”), including specified features, to improve the Bank’s loan portfolio management;

The Bank’s written Loan Policy has been revised to improve guidance and control over the Bank’s lending functions. The revised policy was approved by the Board on October 27, 2010. Additional periodic Loan Policy revisions were approved by the Board from November 24, 2010 through October 2014 for purposes of continued compliance with this provision.

(x) the Board was required to take certain actions to resolve certain credit and collateral exceptions;

The Board believes that it has taken action to appropriately address the credit and collateral exceptions concerns detailed in the Order.

(xi) by October 31, 2010, the Board was required to establish an effective, independent and ongoing loan review system to review, at least quarterly, the Bank’s loan and lease portfolios to assure the timely identification and categorization of problem credits; by October 31, 2010, to adopt and adhere to a program for the maintenance of an adequate ALLL, and to review the adequacy of the Bank’s ALLL at least quarterly;

The Board has established an independent and ongoing loan review program on a quarterly basis that it believes provides for the timely identification and categorization of problem credits.

The ALLL policy and methodologies have been reviewed and revised to determine the appropriate level of the ALLL, including documenting the analysis in accordance with GAAP and other applicable regulatory guidelines. The revised policy was approved by the Board on October 27, 2010 and is updated on an annual basis. The Board reviews the ALLL methodology analysis on a quarterly basis as part of the financial reporting process.

(xii) by October 31, 2010, the Board was required to adopt and the Bank implement and adhere to a program to protect the Bank's interest in criticized assets; and the Bank may only extend additional credit (including renewals) to a borrower whose loans are criticized under specified circumstances;

The Board committed to a program to reduce the Bank's risk exposure to criticized assets by implementing a detailed monthly reporting and monitoring process. The Board believes that this program has resulted in a substantial reduction in criticized assets.

In accordance with the requirements of the Order, since the date of the Order, the Bank has not extended any additional credit to, or for the benefit of, any borrower who has a loan or other extension of credit that either has been charged off or criticized without the prior approval of the Bank's Board, or loan committee under specified circumstances, since the date of the Order.

(xiii) by October 31, 2010, the Board was required to adopt and ensure adherence to action plans for each piece of other real estate owned;

The Board committed to action plans for each piece of other real estate owned centered around a robust reporting and monitoring process. The Board believes that this program has resulted in a substantial reduction in other real estate owned balances.

(xiv) by November 30, 2010, the Board was required to develop, implement and ensure adherence to a policy for effective monitoring and management of concentrations of credit;

The Board believes it developed and implemented a written concentration management program consistent with OCC Bulletin 2006-46 on November 24, 2010. This program was forwarded to the OCC on November 30, 2010. Loan concentration analysis reports are prepared and reviewed quarterly by the Board as part of the Bank's loan portfolio management practices.

(xv) by October 31, 2010, the Board was required to revise and implement the Bank's Other Than Temporary Impairment Policy;

The Board believes that the Other Than Temporary Impairment Policy has been reviewed and revised so that the quarterly other than temporary impairment ("OTTI") analysis process identifies and measures OTTI in accordance with GAAP and supervisory guidance, including Financial Accounting Standards Board Accounting Standards Codification 320-10-35 (Recognition and Presentation of Other-than-Temporary Impairments), OCC Bulletin 2009-11 dated April 17, 2009, "Other-than-Temporary Impairment Accounting", OCC Bulletin 2013-28, "Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions" and OCC Call Report Instructions.

(xvi) by October 31, 2010, the Board was required to take action to maintain adequate sources of stable funding and liquidity and a contingency funding plan; by October 31, 2010, the Board was required to adopt, implement and ensure compliance with an independent, internal audit program;

The Board believes that it has taken action to maintain adequate sources of stable funding and liquidity and developed an appropriate contingency funding plan for the Bank. A liquidity funding policy that addresses liquidity needs, funding sources and contingency funding was approved by the Board on November 24, 2010 and has been implemented and is reviewed and updated annually. Additional policies related to liquidity, funding and contingency funding have since been created and are updated annually since the Order was executed.

The Board believes that it has taken appropriate steps to adopt, implement and comply with an independent, adequately-staffed internal audit program.

(xvii) take actions to correct cited violations of law; and adopt procedures to prevent future violations and address compliance management.

The Board and management believe that they have taken appropriate action to correct cited violations and adopted procedures designed to prevent future violations and address compliance management.



*Federal Reserve Agreement.* On November 24, 2010, the Company entered into the Agreement with the Reserve Bank. The Agreement requires the Company to undertake certain actions within designated timeframes, and to operate in compliance with the provisions thereof during its term. The material provisions of the Agreement are set forth below with a description of the status of the Company's efforts to comply with such provisions:

(i) the Company's Board was required to take appropriate steps to fully utilize the Company's financial and managerial resources to serve as a source of strength to the Bank, including taking steps to ensure that the Bank complies with its Consent Order entered into with the OCC;

The Company has taken, and continues to take, steps the Board believes are appropriate to use the Company's financial and managerial resources to serve as a source of strength to the Bank. The steps the Bank has taken to comply with the Order are discussed above.

(ii) the Company may not declare or pay any dividends without the prior written approval of the Reserve Bank and the Director of the Division of Banking Supervision and Regulation (the "Director") of the Federal Reserve Board;

The Company has acknowledged the prohibition on payment of dividends without the prior written consent of the Reserve Bank and Director. The Company has not paid any dividends since the effective date of the Agreement.

(iii) the Company may not take dividends or other payments representing a reduction of the Bank's capital without the prior written approval of the Reserve Bank;

The Company has acknowledged the prohibition on taking dividends or any other capital distributions from the Bank without the prior written consent of the Reserve Bank. The Bank has not paid and the Company has not received any dividends or capital distributions from the Bank since the effective date of the Agreement.

(iv) the Company and its nonbank subsidiary may not make any payment of interest, principal or other amounts on the Company's subordinated debentures or trust preferred securities without the prior written approval of the Reserve Bank and the Director;

The Company has acknowledged the prohibition on any payment related to the Company's subordinated debentures and trust preferred securities without the written approval of the Reserve Bank and Director. The Company has not made any payments of interest, principal or other amounts on the Company's subordinated debentures or trust preferred securities since the effective date of the Agreement.

On September 8, 2014 the Company sent to the Reserve Bank requests for approval for the Company to receive a \$1.0 million capital distribution from the Bank, and to make a distribution on the trust preferred securities to cure the interest deferral and resume regular quarterly interest payments commencing on March 15, 2015. As of the date of this filing the Company has not received approval from the Reserve Bank.

(v) the Company may not make any payment of interest, principal or other amounts on debt owed to insiders of the Company without the prior written approval of the Reserve Bank and Director;

The Company has acknowledged the prohibition on any payment related to the debt owed to insiders of the Company without the written approval of the Reserve Bank and Director. The Company has not made any payments related to debt owed to insiders since the effective date of the Agreement.

(vi) the Company and its nonbank subsidiary may not incur, increase or guarantee any debt without the prior written approval of the Reserve Bank;

The Company has acknowledged the prohibition on incurring, increasing or guaranteeing any debt without the written approval of the Reserve Bank other than permitted borrowings by the Bank from the Federal Home Loan Bank ("FHLB"). The Company has not incurred, increased or guaranteed any debt since the effective date of the Agreement.

(vii) the Company may not purchase or redeem any shares of its stock without the prior written approval of the Reserve Bank;

The Company has acknowledged the prohibition on purchasing or redeeming any shares of its stock without the written approval of the Reserve Bank. The Company has not purchased or redeemed any shares of its stock since the effective date of the Agreement.

(viii) the Company was required to submit to the Reserve Bank, by January 23, 2011, an acceptable written plan to maintain sufficient capital at the Company on a consolidated basis. Thereafter, the Company must notify the Reserve Bank within 45 days of the end of any quarter in which the Company's capital ratios fall below the approved capital plan's minimum ratios, and submit an acceptable written plan to increase the Company's capital ratios above the capital plan's minimums;

The Company has developed a Capital Plan that it believes is acceptable and maintains sufficient capital at the Company on a consolidated basis. The Capital Plan was submitted to the Reserve Bank on January 11, 2011. The Capital Plan has since been updated at least annually and forwarded to the Reserve Bank. The annual update and revision to the Capital Plan for the three-year period January 1, 2014 to December 31, 2016 was completed in conjunction with the annual budget and strategic planning initiatives and provided to the Reserve Bank in April 2014. The Company notified the Reserve Bank that the OCC issued a written determination of supervisory non-objection to the Capital Plan in June 2014, and that the Bank's Board of Directors adopted the plan in June 2014.

The Bank's total risk-based capital ratio was 15.28% at September 30, 2014, which was above the 13.00% minimum required by the Order. The Bank's leverage ratio was 10.05% at September 30, 2014, which was also above the 9.00% required by the Order.

(ix) the Company was required to immediately take all actions necessary to ensure that: (1) each regulatory report accurately reflects the Company's condition on the date for which it is filed and all material transactions between the Company and its subsidiaries; (2) each such report is prepared in accordance with its instructions; and (3) all records indicating how the report was prepared are maintained for supervisory review;

The Company believes that it has taken actions to ensure that all required regulatory reports are filed to accurately reflect its financial condition on the date filed, are prepared in accordance with instructions and that records detailing how the reports were filed are maintained and available for supervisory review.

(x) the Company was required to submit to the Reserve Bank, by January 23, 2011, acceptable written procedures to strengthen and maintain internal controls to ensure all required regulatory reports and notices filed with the Board of Governors are accurate and filed in accordance with the instructions for preparation;

The Company believes that it has designed effective written procedures and strengthened internal controls so that all required Board of Governors reports and notices filed are accurate, timely and in accordance with instructions. The written procedures were provided to the Reserve Bank on January 21, 2011.

(xi) the Company was required to submit to the Reserve Bank, by January 8, 2011, a cash flow projection for 2011, reflecting the Company's planned sources and uses of cash, and submit a cash flow projection for each subsequent calendar year at least one month prior to the beginning of such year;

The Company created a cash flow projection for 2011 and submitted it to the Reserve Bank on January 7, 2011 in accordance with requirements of the Agreement. Similar projections for 2012, 2013, and 2014 were provided to the Reserve Bank within the time requirements prescribed in the Agreement. At the request of the Reserve Bank, the Company provided the Reserve Bank with an updated cash flow projection for 2014-2016 in August of 2013. The cash flow projection for 2015 is scheduled to be delivered to the Federal Reserve Bank in December 2014.

(xii) the Company must comply with: (1) the notice provisions of Section 32 of the FDI Act and Subpart H of Regulation Y in appointing any new director or senior executive officer or changing the duties of any senior executive officer; and (2) the restrictions on indemnification and severance payments of Section 18(k) of the FDI Act and Part 359 of the FDIC's regulations;

The Company has acknowledged the notice requirements on the appointment of any new director or senior executive officer. The Company has filed the appropriate notice for each new director or senior executive officer since the date of the Agreement.

The Company acknowledges the restriction on indemnification and severance payments under Section 18(k) of the FDI Act and Part 359 of the FDIC's regulations. The Company has not made any such indemnification or severance payments since the effective date of the Agreement without obtaining prior regulatory non-objection from the OCC and regulatory concurrence from the FDIC as required by Part 359.

(xiii) the Board must submit written progress reports within 30 days of the end of each calendar quarter.

The Company's Board has filed each of the required written progress reports with the Reserve Bank since the Agreement was executed.

Banking regulations also limit the amount of dividends that may be paid without prior approval of the Bank's regulatory agency. At September 30, 2014, the Company and the Bank are restricted from paying any dividends, without regulatory approval.

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material adverse effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices must be met. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Current quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).

In accordance with the Order, the Bank is required to achieve and thereafter maintain a total risk-based capital ratio equal to at least 13.00% of risk-weighted assets and a Tier I capital ratio equal to at least 9.00% of adjusted total assets. As of September 30, 2014, the Bank met both the 13.00% minimum requirement for the total-risk based capital ratio and the 9.00% minimum requirement for the Tier I leverage ratio. The minimum capital requirements under the Order take precedence over the standard regulatory capital adequacy definitions described in the tables below.

The Company's and the Bank's actual capital positions, risk-weighted assets, and total average assets for the Tier I leverage ratio at September 30, 2014 and December 31, 2013 are presented in the following table:

### Capital Analysis

| (in thousands)                                   | September 30,<br>2014 | December 31,<br>2013 |
|--|-----------------------|----------------------|
| Company  |                       |                      |
| Tier I capital:                                  |                       |                      |
| Total tier I capital                             | \$ 59,810             | \$ 46,165            |
| Tier II capital:                                 |                       |                      |
| Subordinated notes                               | 25,000                | 23,085               |
| Allowable portion of allowance for loan losses   | 8,703                 | 8,462                |
| Total tier II capital                            | 33,703                | 31,547               |
| Total risk-based capital                         | \$ 93,513             | \$ 77,712            |
| <br>   |                       |                      |
| Total risk-weighted assets                       | \$ 692,693            | \$ 670,894           |
| <br>   |                       |                      |
| Total average assets (for Tier I leverage ratio) | \$ 965,740            | \$ 980,754           |
| <br>Bank   |                       |                      |
| Tier I capital:                                  |                       |                      |
| Total tier I capital                             | \$ 97,096             | \$ 81,581            |
| Tier II capital:                                 |                       |                      |
| Allowable portion of allowance for loan losses   | 8,698                 | 8,456                |
| Total tier II capital                            | 8,698                 | 8,456                |
| Total risk-based capital                         | \$ 105,794            | \$ 90,037            |
| <br>   |                       |                      |
| Total risk-weighted assets                       | \$ 692,314            | \$ 670,416           |
| <br>   |                       |                      |
| Total average assets (for Tier I leverage ratio) | \$ 965,709            | \$ 980,747           |

The following tables present summary information regarding the Company's and the Bank's risk-based capital and related ratios at September 30, 2014 and December 31, 2013:

| (dollars in thousands)                   | Actual    |        | For Capital Adequacy Purposes |         | To Be Well Capitalized Under Prompt Corrective Action Provision |          |
|--|-----------|--------|-------------------------------|---------|---|----------|
|  | Amount    | Ratio  | Amount                        | Ratio   | Amount  | Ratio    |
| September 30, 2014                       |           |        |                               |         |   |          |
| Total capital (to risk-weighted assets)  |           |        |                               |         |   |          |
| Company                                  | \$93,513  | 13.50% | \$ >55,415                    | >8.00 % | N/A   | N/A      |
| Bank                                     | \$105,794 | 15.28% | \$ >55,385                    | >8.00 % | \$ >69,231  | >10.00 % |
| Tier I capital (to risk-weighted assets) |           |        |                               |         |   |          |
| Company                                  | \$59,810  | 8.63 % | \$ >27,708                    | >4.00 % | N/A   | N/A      |
| Bank                                     | \$97,096  | 14.02% | \$ >27,693                    | >4.00 % | \$ >41,539  | >6.00 %  |
| Tier I capital (to average assets)       |           |        |                               |         |   |          |
| Company                                  | \$59,810  | 6.19 % | \$ >38,630                    | >4.00 % | N/A   | N/A      |
| Bank                                     | \$97,096  | 10.05% | \$ >38,628                    | >4.00 % | \$ >48,285  | >5.00 %  |

| (dollars in thousands)                   | Actual   |        | For Capital Adequacy Purposes |         | To Be Well Capitalized Under Prompt Corrective Action Provision |          |
|--|----------|--------|-------------------------------|---------|---|----------|
|  | Amount   | Ratio  | Amount                        | Ratio   | Amount  | Ratio    |
| December 31, 2013                        |          |        |                               |         |   |          |
| Total capital (to risk-weighted assets)  |          |        |                               |         |   |          |
| Company                                  | \$77,712 | 11.58% | \$ >53,672                    | >8.00 % | N/A   | N/A      |
| Bank                                     | \$90,037 | 13.43% | \$ >53,633                    | >8.00 % | \$ >67,042  | >10.00 % |
| Tier I capital (to risk-weighted assets) |          |        |                               |         |   |          |
| Company                                  | \$46,165 | 6.88 % | \$ >26,836                    | >4.00 % | N/A   | N/A      |
| Bank                                     | \$81,581 | 12.17% | \$ >26,817                    | >4.00 % | \$ >40,225  | >6.00 %  |
| Tier I capital (to average assets)       |          |        |                               |         |   |          |
| Company                                  | \$46,165 | 4.71 % | \$ >39,230                    | >4.00 % | N/A   | N/A      |
| Bank                                     | \$81,581 | 8.32 % | \$ >39,230                    | >4.00 % | \$ >49,038  | >5.00 %  |

#### Note 4. Loans

The following table summarizes loans receivable, net, by category at September 30, 2014 and December 31, 2013:

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

| (in thousands)                                 | September 30,<br>2014 | December 31,<br>2013 |
|--|-----------------------|----------------------|
| Residential real estate                        | \$ 124,375            | \$ 114,925           |
| Commercial real estate                         | 237,437               | 218,524              |
| Construction, land acquisition and development | 17,561                | 24,382               |
| Commercial and industrial                      | 135,283               | 127,021              |
| Consumer                                       | 122,573               | 118,645              |
| State and political subdivisions               | 40,210                | 39,875               |
| Total loans, gross                             | 677,439               | 643,372              |
| Unearned income                                | (115 )                | (143 )               |
| Net deferred loan fees and costs               | 836                   | 668                  |
| Allowance for loan and lease losses            | (11,898 )             | (14,017 )            |
| Loans, net                                     | \$ 666,262            | \$ 629,880           |

The Company has granted loans, letters of credit and lines of credit to certain executive officers and directors of the Company as well as to certain related parties of executive officers and directors. These loans, letters of credit and lines of credit were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and, when made, did not involve more than the normal risk of collectability. See Note 10 to these consolidated financial statements for more information about related party transactions.



The Company originates one- to four-family mortgage loans primarily for sale in the secondary market. During the three and nine month periods ended September 30, 2014, the Company sold \$1.7 million and \$6.6 million, respectively, of one- to four-family mortgages. The Company retained servicing rights on these mortgages. The Company had \$171 thousand and \$820 thousand in loans held-for-sale at September 30, 2014 and December 31, 2013, respectively. All loans held for sale are one- to four-family residential mortgage loans.

The Company sold substantially all of its education loans, which are categorized as consumer loans, to a third party during the nine months ended September 30, 2014. The education loans had a recorded investment of \$2.6 million at the time of sale. The Company recognized a loss of \$13 thousand upon the sale of these loans which is included in non-interest income for the nine months ended September 30, 2014.

The Company does not have any lending programs commonly referred to as subprime lending. Subprime lending generally targets borrowers with weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, bankruptcies, or borrowers with questionable repayment capacity as evidenced by low credit scores or high debt-burden ratios.

See Note 2 to the Company's consolidated financial statements included in the 2013 Form 10-K for information about the risk characteristics related to the Company's loan segments.

The Company provides for loan losses based on the consistent application of its documented ALLL methodology. Loan losses are charged to the ALLL and recoveries are credited to it. Additions to the ALLL are provided by charges against income based on various factors which, in management's judgment, deserve current recognition of estimated probable losses. Loan losses are charged-off in the period the loans, or portions thereof, are deemed uncollectible. Generally, the Company will record a loan charge-off (including a partial charge-off) to reduce a loan to the estimated recoverable amount based on its methodology detailed below. The Company regularly reviews the loan portfolio and makes adjustments for loan losses in order to maintain the ALLL in accordance with GAAP. The ALLL consists primarily of the following two components:

Specific allowances are established for impaired loans, which are defined by the Company as all loan relationships with an aggregate outstanding balance greater than \$100 thousand that are rated substandard and on non-accrual status, rated doubtful or loss, and all troubled debt restructured loans ("TDRs"). The amount of impairment provided for as an allowance is represented by the deficiency, if any, between the carrying value of the loan and either (a) (1) the present value of expected future cash flows discounted at the loan's effective interest rate, (b) the loan's observable market price, or (c) the fair value of the underlying collateral, less estimated costs to sell, for collateral dependent loans. Impaired loans that have no impairment losses are not considered for general valuation allowances described below. If the Company determines that collection of the impairment amount is remote, the Company will record a charge-off.

General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired. The Company divides its portfolio into loan segments for loans exhibiting similar characteristics. Loans rated special mention or substandard and accruing, which are embedded in these loan segments, are then separated from these loan segments. These loans are then subject to an analysis placing increased emphasis on the credit risk associated with these specific loans. The Company applies an estimated loss rate to each loan group. The loss rates applied are based on the Company's own historical loss experience based on the loss rate for each segment of loans with similar risk characteristics in its portfolio. In addition, management evaluates and applies certain qualitative or environmental factors that are likely to cause estimated credit losses associated with the Company's existing portfolio to differ from historical experience, which are discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the ALLL that is established, which could have a material negative effect on the Company's operating results or financial condition.

Management makes adjustments for loan losses based on its evaluation of several qualitative and environmental factors, including but not limited to:

- Changes in national, local, and business economic conditions and developments, including the condition of various market segments;

  - Changes in the nature and volume of the Company's loan portfolio;

  - Changes in the Company's lending policies and procedures, including underwriting standards, collection, charge-off and recovery practices and results;

  - Changes in the experience, ability and depth of the Company's lending management and staff;

- Changes in the quality of the Company's loan review system and the degree of oversight by the Company's Board of Directors;

Changes in the trend of the volume and severity of past due and classified loans, including trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications;

- The existence and effect of any concentrations of credit and changes in the level of such concentrations;
- The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Company's current loan portfolio; and
- Analysis of customers' credit quality, including knowledge of their operating environment and financial condition.

Management evaluates the ALLL based on the combined total of the impaired and general components. Generally, when the loan portfolio increases, absent other factors, the ALLL methodology results in a higher dollar amount of estimated probable losses. Conversely, when the loan portfolio decreases, absent other factors, the ALLL methodology results in a lower dollar amount of estimated probable losses.

Each quarter, management evaluates the ALLL and adjusts the ALLL as appropriate through a provision for loan losses. While the Company uses the best information available to make evaluations, future adjustments to the ALLL may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of its examination process, the OCC periodically reviews the Company's ALLL. The OCC may require the Company to adjust the ALLL based on its analysis of information available to it at the time of its examination.

The following table summarizes the activity in the ALLL by loan category for the three and nine months ended September 30, 2014 and 2013:

| (in thousands)                         | Real Estate    |                | Construction,<br>Land<br>Acquisition<br>and<br>Development | Commercial<br>and<br>Industrial | Consumer | State and<br>Political<br>Subdivisions | Total    |
|--|----------------|----------------|--|---------------------------------|----------|--|----------|
|  | Real<br>Estate | Real<br>Estate |  |                                 |          |  |          |
| Three months ended September 30, 2014: |                |                |  |                                 |          |  |          |
| Allowance for loan losses:             |                |                |  |                                 |          |  |          |
| Beginning balance, July 1, 2014        | \$2,112        | \$ 5,133       | \$ 923   | \$ 1,758                        | \$ 1,681 | \$ 568                                 | \$12,175 |
| Charge-offs                            | (67 )          | -              | -  | (22 )                           | (270 )   | -                                      | (359 )   |
| Recoveries                             | 9              | -              | -  | 69                              | 58       | -                                      | 136      |
| Provisions (credits)                   | (307 )         | 128            | (148 )   | -                               | 258      | 15                                     | (54 )    |
| Ending balance, September 30, 2014     | \$1,747        | \$ 5,261       | \$ 775   | \$ 1,805                        | \$ 1,727 | \$ 583                                 | \$11,898 |

Three months ended September 30, 2013:

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

Allowance for loan losses:

|                                    |         |          |          |          |          |        |          |
|------------------------------------|---------|----------|----------|----------|----------|--------|----------|
| Beginning balance, July 1, 2013    | \$2,145 | \$ 7,823 | \$ 2,390 | \$ 3,487 | \$ 1,760 | \$ 983 | \$18,588 |
| Charge-offs                        | (98 )   | -        | (65 )    | (116 )   | (74 )    | -      | (353 )   |
| Recoveries                         | 9       | 362      | 5        | 71       | 95       | -      | 542      |
| Provisions (credits)               | 215     | (869 )   | (141 )   | (225 )   | 105      | (244 ) | (1,159 ) |
| Ending balance, September 30, 2013 | \$2,271 | \$ 7,316 | \$ 2,189 | \$ 3,217 | \$ 1,886 | \$ 739 | \$17,618 |

Nine months ended September 30, 2014:

Allowance for loan losses:

|                                    |         |          |          |          |          |        |          |
|------------------------------------|---------|----------|----------|----------|----------|--------|----------|
| Beginning balance, January 1, 2014 | \$2,287 | \$ 6,017 | \$ 924   | \$ 2,321 | \$ 1,789 | \$ 679 | \$14,017 |
| Charge-offs                        | (152 )  | -        | -        | (172 )   | (637 )   | -      | (961 )   |
| Recoveries                         | 79      | 355      | 3,539    | 195      | 303      | -      | 4,471    |
| Provisions (credits)               | (467 )  | (1,111 ) | (3,688 ) | (539 )   | 272      | (96 )  | (5,629 ) |
| Ending balance, September 30, 2014 | \$1,747 | \$ 5,261 | \$ 775   | \$ 1,805 | \$ 1,727 | \$ 583 | \$11,898 |

Nine months ended September 30, 2013:

Allowance for loan losses:

|                                    |         |          |          |          |          |        |          |
|------------------------------------|---------|----------|----------|----------|----------|--------|----------|
| Beginning balance, January 1, 2013 | \$1,764 | \$ 8,062 | \$ 2,162 | \$ 4,167 | \$ 1,708 | \$ 673 | \$18,536 |
| Charge-offs                        | (445 )  | (48 )    | (175 )   | (244 )   | (433 )   | -      | (1,345 ) |
| Recoveries                         | 190     | 471      | 124      | 1,656    | 371      | -      | 2,812    |
| Provisions (credits)               | 762     | (1,169 ) | 78       | (2,362 ) | 240      | 66     | (2,385 ) |
| Ending balance, September 30, 2013 | \$2,271 | \$ 7,316 | \$ 2,189 | \$ 3,217 | \$ 1,886 | \$ 739 | \$17,618 |

The following table presents the allocation of the ALLL and the related loan balance disaggregated based on the impairment methodology for each loan category at September 30, 2014 and December 31, 2013:

| (in thousands)                        | Real Estate      |                   | Construction,<br>Land<br>Acquisition<br>and<br>Development | Commercial<br>and<br>Industrial | Consumer          | State and<br>Political<br>Subdivisions | Total             |
|---------------------------------------|------------------|-------------------|--|---------------------------------|-------------------|--|-------------------|
|                                       | Real Estate      | Real Estate       |  |                                 |                   |  |                   |
| <b>September 30, 2014</b>             |                  |                   |  |                                 |                   |  |                   |
| Allowance for loan losses:            |                  |                   |  |                                 |                   |  |                   |
| Individually evaluated for impairment | \$6              | \$ 341            | \$ 1   | \$ -                            | \$ 1              | \$ -                                   | \$ 349            |
| Collectively evaluated for impairment | 1,741            | 4,920             | 774  | 1,805                           | 1,726             | 583                                    | 11,549            |
| <b>Total</b>                          | <b>\$1,747</b>   | <b>\$ 5,261</b>   | <b>\$ 775</b>  | <b>\$ 1,805</b>                 | <b>\$ 1,727</b>   | <b>\$ 583</b>                          | <b>\$ 11,898</b>  |
| <b>Loans receivable:</b>              |                  |                   |  |                                 |                   |  |                   |
| Individually evaluated for impairment | \$2,583          | \$ 6,608          | \$ 259   | \$ -                            | \$ 363            | \$ -                                   | \$ 9,813          |
| Collectively evaluated for impairment | 121,792          | 230,829           | 17,302   | 135,283                         | 122,210           | 40,210                                 | 667,626           |
| <b>Total</b>                          | <b>\$124,375</b> | <b>\$ 237,437</b> | <b>\$ 17,561</b>   | <b>\$ 135,283</b>               | <b>\$ 122,573</b> | <b>\$ 40,210</b>                       | <b>\$ 677,439</b> |
| <b>December 31, 2013</b>              |                  |                   |  |                                 |                   |  |                   |
| Allowance for loan losses:            |                  |                   |  |                                 |                   |  |                   |
| Individually evaluated for impairment | \$12             | \$ 296            | \$ 1   | \$ -                            | \$ 1              | \$ -                                   | \$ 310            |
| Collectively evaluated for impairment | 2,275            | 5,721             | 923  | 2,321                           | 1,788             | 679                                    | 13,707            |
| <b>Total</b>                          | <b>\$2,287</b>   | <b>\$ 6,017</b>   | <b>\$ 924</b>  | <b>\$ 2,321</b>                 | <b>\$ 1,789</b>   | <b>\$ 679</b>                          | <b>\$ 14,017</b>  |
| <b>Loans receivable:</b>              |                  |                   |  |                                 |                   |  |                   |
| Individually evaluated for impairment | \$1,985          | \$ 6,626          | \$ 306   | \$ -                            | \$ 316            | \$ -                                   | \$ 9,233          |
| Collectively evaluated for impairment | 112,940          | 211,898           | 24,076   | 127,021                         | 118,329           | 39,875                                 | 634,139           |
| <b>Total</b>                          | <b>\$114,925</b> | <b>\$ 218,524</b> | <b>\$ 24,382</b>   | <b>\$ 127,021</b>               | <b>\$ 118,645</b> | <b>\$ 39,875</b>                       | <b>\$ 643,372</b> |

#### Credit Quality Indicators – Commercial Loans

Management continuously monitors the credit quality of the Company's commercial loans by regularly reviewing certain credit quality indicators. Management utilizes credit risk ratings as the key credit quality indicator for evaluating the credit quality of the Company's loan receivables.

The Bank's commercial loan classification and credit grading processes are part of the lending, underwriting, and credit administration functions to ensure an ongoing assessment of credit quality. Accurate and timely loan classification and credit grading is a critical component of loan portfolio management. Loan officers are required to review their loan portfolio risk ratings regularly for accuracy. The loan review function uses the same risk rating system in the loan review process. This allows an independent third party to assess the quality of the portfolio and compare the accuracy of ratings with the loan officer's and management's assessment.

A formal loan classification and credit grading system reflects the risk of default and credit losses. A written description of the risk ratings is maintained that includes a discussion of the factors used to assign appropriate classifications of credit grades to loans. The process identifies groups of loans that warrant the special attention of management. The risk grade groupings provide a mechanism to identify risk within the loan portfolio and provide management and the Board with periodic reports by risk category. The credit risk ratings play an important role in the establishment and evaluation of the provision for loan and lease losses and the ALLL. After determining the historical loss factor which is adjusted for qualitative and environmental factors for each portfolio segment, the portfolio segment balances that have been collectively evaluated for impairment are multiplied by the general reserve loss factor for the respective portfolio segments to determine the general reserve. Loans that have an internal credit rating of special mention or substandard follow the same process; however, the qualitative and environmental factors are further adjusted for the increased risk.

The Company utilizes a loan rating system that assigns a degree of risk to commercial loans based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. Management analyzes these non-homogeneous loans individually by grading the loans as to credit risk and probability of collection for each type of loan. Commercial loans include commercial indirect auto loans which are not individually risk rated, and construction, land acquisition and development loans include residential construction loans which are also not individually risk rated. These loans are monitored on a pool basis due to their homogeneous nature as described in "Credit Quality Indicators – Other Loans" below. The Company risk rates certain residential real estate loans and consumer loans that are part of a larger commercial relationship using its credit grading system as described in "Credit Quality Indicators – Commercial Loans." The grading system contains the following basic risk categories:

1. Minimal Risk
2. Above Average Credit Quality
3. Average Risk
4. Acceptable Risk



5. Pass - Watch
6. Special Mention
7. Substandard - Accruing
8. Substandard - Non-Accrual
9. Doubtful
10. Loss

This analysis is performed on a quarterly basis using the following definitions for risk ratings:

Pass - Assets rated 1 through 5 are considered pass ratings. These assets show no current or potential problems and are considered fully collectible. All such loans are considered collectively for ALLL calculation purposes. However, accruing TDRs that have been performing for an extended period of time, do not represent a higher risk of loss, and have been upgraded to a pass rating are evaluated individually for impairment.

Special Mention – Assets classified as special mention do not currently expose the Company to a sufficient degree of risk to warrant an adverse classification but do possess credit deficiencies or potential weaknesses deserving close attention. Special Mention assets have a potential weakness or pose an unwarranted financial risk which, if not corrected, could weaken the asset and increase risk in the future.

Substandard - Assets classified as substandard have well defined weaknesses based on objective evidence, and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful - Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable based on current circumstances.

Loss - Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted.



Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

The following tables present the recorded investment in loans receivable by loan category and credit quality indicator at September 30, 2014 and December 31, 2013:

Commercial Credit Quality Indicators

September 30, 2014

| (in thousands)              | Real Estate     |                   | Construction,<br>Land | Commercial<br>and |                 | State and<br>Political | Total            |
|-----------------------------|-----------------|-------------------|-----------------------|-------------------|-----------------|------------------------|------------------|
|                             | Residential     | Commercial        | Acquisition and       | Industrial        | Consumer        | Subdivisions           |                  |
|                             | Real Estate     | Real Estate       | Development           |                   |                 |                        |                  |
| <b>Internal risk rating</b> |                 |                   |                       |                   |                 |                        |                  |
| Pass                        | \$21,865        | \$ 207,322        | \$ 9,053              | \$125,170         | \$ 3,302        | \$ 38,556              | \$405,268        |
| Special mention             | 453             | 16,445            | 1,625                 | 2,098             | -               | 1,026                  | 21,647           |
| Substandard                 | 1,201           | 13,670            | 5,616                 | 2,534             | 127             | 628                    | 23,776           |
| Doubtful                    | -               | -                 | -                     | -                 | -               | -                      | -                |
| Loss                        | -               | -                 | -                     | -                 | -               | -                      | -                |
| <b>Total</b>                | <b>\$23,519</b> | <b>\$ 237,437</b> | <b>\$ 16,294</b>      | <b>\$129,802</b>  | <b>\$ 3,429</b> | <b>\$ 40,210</b>       | <b>\$450,691</b> |

Commercial Credit Quality Indicators

December 31, 2013

| (in thousands)              | Real Estate     |                   | Construction,<br>Land | Commercial<br>and |                 | State and<br>Political | Total            |
|-----------------------------|-----------------|-------------------|-----------------------|-------------------|-----------------|------------------------|------------------|
|                             | Residential     | Commercial        | Acquisition and       | Industrial        | Consumer        | Subdivisions           |                  |
|                             | Real Estate     | Real Estate       | Development           |                   |                 |                        |                  |
| <b>Internal risk rating</b> |                 |                   |                       |                   |                 |                        |                  |
| Pass                        | \$19,050        | \$ 191,601        | \$ 13,781             | \$ 113,048        | \$ 2,546        | \$ 39,151              | \$379,177        |
| Special mention             | 869             | 12,568            | 1,361                 | 3,777             | -               | -                      | 18,575           |
| Substandard                 | 1,347           | 14,355            | 6,168                 | 4,525             | 157             | 724                    | 27,276           |
| Doubtful                    | -               | -                 | -                     | -                 | -               | -                      | -                |
| Loss                        | -               | -                 | -                     | -                 | -               | -                      | -                |
| <b>Total</b>                | <b>\$21,266</b> | <b>\$ 218,524</b> | <b>\$ 21,310</b>      | <b>\$ 121,350</b> | <b>\$ 2,703</b> | <b>\$ 39,875</b>       | <b>\$425,028</b> |

**Credit Quality Indicators – Other Loans**

Certain residential real estate loans, consumer loans, and commercial indirect auto loans are monitored on a pool basis due to their homogeneous nature. Loans that are delinquent 90 days or more are placed on non-accrual status unless collection of the loan is in process and reasonably assured. The Company utilizes accruing versus non-accruing status as the credit quality indicator for these loan pools. The following tables present the recorded investment in residential real estate loans, residential construction, land acquisition and development loans, commercial indirect auto loans, and consumer loans based on payment activity at September 30, 2014 and December 31, 2013:

| (in thousands)   | September 30, 2014 |                       |            |
|--|--------------------|-----------------------|------------|
|  | Accruing<br>Loans  | Non-Accruing<br>Loans | Total      |
| Residential real estate                                      | \$99,912           | \$ 944                | \$ 100,856 |
| Construction, land acquisition and development - residential | 1,267              | -                     | 1,267      |
| Commercial - indirect auto                                   | 5,481              | -                     | 5,481      |
| Consumer   | 118,929            | 215                   | 119,144    |
| Total  | \$225,589          | \$ 1,159              | \$ 226,748 |

| (in thousands)   | December 31, 2013 |                       |            |
|--|-------------------|-----------------------|------------|
|  | Accruing<br>Loans | Non-Accruing<br>Loans | Total      |
| Residential real estate                                      | \$92,181          | \$ 1,478              | \$ 93,659  |
| Construction, land acquisition and development - residential | 3,072             | -                     | 3,072      |
| Commercial - indirect auto                                   | 5,671             | -                     | 5,671      |
| Consumer   | 115,809           | 133                   | 115,942    |
| Total  | \$216,733         | \$ 1,611              | \$ 218,344 |

Included in loans receivable are loans for which the accrual of interest income has been discontinued due to deterioration in the financial condition of the borrowers. The recorded investment in these non-accrual loans was \$5.5 million and \$6.4 million at September 30, 2014 and December 31, 2013, respectively. Generally, loans are placed on non-accruing status when they become 90 days or more delinquent, and remain on non-accrual status until they are brought current, have six months of performance under the loan terms, and factors indicating reasonable doubt about the timely collection of payments no longer exist. Therefore, loans may be current in accordance with their loan terms, or may be fewer than 90 days delinquent and still be on a non-accrual status. Loans past due 90 days or more and still accruing interest were \$49 thousand and \$19 thousand at September 30, 2014 and December 31, 2013, and consisted of loans that are well secured and are in the process of collection.

The following tables present the delinquency status of past due and non-accrual loans by loan category at September 30, 2014 and December 31, 2013:

| (in thousands)                                 | September 30, 2014       |                        |                        |                        | Total      |
|--|--------------------------|------------------------|------------------------|------------------------|------------|
|  | Delinquency Status       |                        |                        |                        |            |
|  | 0-29<br>Days<br>Past Due | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | >= 90 Days<br>Past Due |            |
| Performing (accruing) loans:                   |                          |                        |                        |                        |            |
| Real estate:                                   |                          |                        |                        |                        |            |
| Residential real estate                        | \$ 122,894               | \$ 263                 | \$ 44                  | \$ -                   | \$ 123,201 |
| Commercial real estate                         | 233,190                  | 73                     | 112                    | 49                     | 233,424    |
| Construction, land acquisition and development | 17,516                   | -                      | -                      | -                      | 17,516     |
| Total real estate                              | 373,600                  | 336                    | 156                    | 49                     | 374,141    |
| Commercial and industrial                      | 134,857                  | 179                    | 155                    | -                      | 135,191    |
| Consumer                                       | 120,892                  | 1,119                  | 347                    | -                      | 122,358    |
| State and political subdivisions               | 40,210                   | -                      | -                      | -                      | 40,210     |
| Total performing (accruing) loans              | 669,559                  | 1,634                  | 658                    | 49                     | 671,900    |
| Non-accrual loans:                             |                          |                        |                        |                        |            |
| Real estate:                                   |                          |                        |                        |                        |            |
| Residential real estate                        | 417                      | 121                    | 39                     | 597                    | 1,174      |
| Commercial real estate                         | 3,969                    | -                      | -                      | 44                     | 4,013      |
| Construction, land acquisition and development | -                        | -                      | -                      | 45                     | 45         |
| Total real estate                              | 4,386                    | 121                    | 39                     | 686                    | 5,232      |
| Commercial and industrial                      | 32                       | 20                     | -                      | 40                     | 92         |
| Consumer                                       | 39                       | 7                      | 38                     | 131                    | 215        |
| State and political subdivisions               | -                        | -                      | -                      | -                      | -          |
| Total non-accrual loans                        | 4,457                    | 148                    | 77                     | 857                    | 5,539      |
| Total loans receivable                         | \$ 674,016               | \$ 1,782               | \$ 735                 | \$ 906                 | \$ 677,439 |

| (in thousands)                                 | December 31, 2013<br>Delinquency Status |            |            |            | Total      |
|--|---|------------|------------|------------|------------|
|  | 0-29<br>Days                            | 30-59 Days | 60-89 Days | >= 90 Days |            |
|  | Past Due                                | Past Due   | Past Due   | Past Due   |            |
| Performing (accruing) loans:                   |   |            |            |            |            |
| Real estate:                                   |   |            |            |            |            |
| Residential real estate                        | \$ 112,519                              | \$ 571     | \$ 116     | \$ -       | \$ 113,206 |
| Commercial real estate                         | 213,660                                 | 629        | -          | -          | 214,289    |
| Construction, land acquisition and development | 24,259                                  | 78         | -          | -          | 24,337     |
| Total real estate                              | 350,438                                 | 1,278      | 116        | -          | 351,832    |
| Commercial and industrial                      | 126,441                                 | 232        | 125        | 19         | 126,817    |
| Consumer                                       | 116,710                                 | 1,420      | 362        | -          | 118,492    |
| State and political subdivisions               | 39,875                                  | -          | -          | -          | 39,875     |
| Total performing (accruing) loans              | 633,464                                 | 2,930      | 603        | 19         | 637,016    |
| Non-accrual loans:                             |   |            |            |            |            |
| Real estate:                                   |   |            |            |            |            |
| Residential real estate                        | 570                                     | 73         | 51         | 1,025      | 1,719      |
| Commercial real estate                         | 4,183                                   | 52         | -          | -          | 4,235      |
| Construction, land acquisition and development | -                                       | -          | 45         | -          | 45         |
| Total real estate                              | 4,753                                   | 125        | 96         | 1,025      | 5,999      |
| Commercial and industrial                      | 181                                     | -          | 23         | -          | 204        |
| Consumer                                       | 14                                      | 31         | 16         | 92         | 153        |
| State and political subdivisions               | -                                       | -          | -          | -          | -          |
| Total non-accrual loans                        | 4,948                                   | 156        | 135        | 1,117      | 6,356      |
| Total loans receivable                         | \$ 638,412                              | \$ 3,086   | \$ 738     | \$ 1,136   | \$ 643,372 |

The following tables present a distribution of the recorded investment, unpaid principal balance and the related allowance for the Company's impaired loans, which have been analyzed for impairment under ASC 310, at September 30, 2014 and December 31, 2013. Non-accrual loans, other than TDRs, with aggregate loan relationship balances less than the \$100 thousand loan relationship threshold are not evaluated individually for impairment and are accordingly not included in the following tables. However, these loans are evaluated collectively for impairment as homogenous pools in the general allowance under ASC 450. Total non-accrual loans, other than TDRs, with balances less than the \$100 thousand loan relationship threshold, that were evaluated under ASC 450 amounted to \$1.1 million at both September 30, 2014 and December 31, 2013.

| (in thousands)  | September 30, 2014  |                          |                   |
|---|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no allowance recorded:                             |                     |                          |                   |
| Real estate:  |                     |                          |                   |
| Residential real estate                                 | \$715               | \$837                    | \$ -              |
| Commercial real estate                                  | 4,523               | 5,101                    | -                 |
| Construction, land acquisition and development          | 68                  | 68                       | -                 |
| Total real estate                                       | 5,306               | 6,006                    | -                 |
| Commercial and industrial                               | -                   | -                        | -                 |
| Consumer  | -                   | -                        | -                 |
| State and political subdivisions                        | -                   | -                        | -                 |
| Total impaired loans with no related allowance recorded | 5,306               | 6,006                    | -                 |
| With a related allowance recorded:                      |                     |                          |                   |
| Real estate:  |                     |                          |                   |
| Residential real estate                                 | 1,868               | 1,868                    | 6                 |
| Commercial real estate                                  | 2,085               | 2,085                    | 341               |
| Construction, land acquisition and development          | 191                 | 191                      | 1                 |
| Total real estate                                       | 4,144               | 4,144                    | 348               |
| Commercial and industrial                               | -                   | -                        | -                 |
| Consumer  | 363                 | 363                      | 1                 |
| State and political subdivisions                        | -                   | -                        | -                 |
| Total impaired loans with a related allowance recorded  | 4,507               | 4,507                    | 349               |
| Total impaired loans:                                   |                     |                          |                   |
| Real estate:  |                     |                          |                   |
| Residential real estate                                 | 2,583               | 2,705                    | 6                 |
| Commercial real estate                                  | 6,608               | 7,186                    | 341               |
| Construction, land acquisition and development          | 259                 | 259                      | 1                 |

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

|                                  |         |          |        |
|----------------------------------|---------|----------|--------|
| Total real estate                | 9,450   | 10,150   | 348    |
| Commercial and industrial        | -       | -        | -      |
| Consumer                         | 363     | 363      | 1      |
| State and political subdivisions | -       | -        | -      |
| Total impaired loans             | \$9,813 | \$10,513 | \$ 349 |

25

| (in thousands)  | December 31, 2013      |                                |                      |
|---|------------------------|--------------------------------|----------------------|
|   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
| With no allowance recorded:                             |                        |                                |                      |
| Real estate:  |                        |                                |                      |
| Residential real estate                                 | \$1,043                | \$ 1,125                       | \$ -                 |
| Commercial real estate                                  | 4,060                  | 4,435                          | -                    |
| Construction, land acquisition and development          | -                      | -                              | -                    |
| Total real estate                                       | 5,103                  | 5,560                          | -                    |
| Commercial and industrial                               | -                      | -                              | -                    |
| Consumer  | -                      | -                              | -                    |
| State and political subdivisions                        | -                      | -                              | -                    |
| Total impaired loans with no related allowance recorded | 5,103                  | 5,560                          | -                    |
| With a related allowance recorded:                      |                        |                                |                      |
| Real estate:  |                        |                                |                      |
| Residential real estate                                 | 942                    | 946                            | 12                   |
| Commercial real estate                                  | 2,566                  | 2,566                          | 296                  |
| Construction, land acquisition and development          | 306                    | 306                            | 1                    |
| Total real estate                                       | 3,814                  | 3,818                          | 309                  |
| Commercial and industrial                               | -                      | -                              | -                    |
| Consumer  | 316                    | 316                            | 1                    |
| State and political subdivisions                        | -                      | -                              | -                    |
| Total impaired loans with a related allowance recorded  | 4,130                  | 4,134                          | 310                  |
| Total impaired loans:                                   |                        |                                |                      |
| Real estate:  |                        |                                |                      |
| Residential real estate                                 | 1,985                  | 2,071                          | 12                   |
| Commercial real estate                                  | 6,626                  | 7,001                          | 296                  |
| Construction, land acquisition and development          | 306                    | 306                            | 1                    |
| Total real estate                                       | 8,917                  | 9,378                          | 309                  |
| Commercial and industrial                               | -                      | -                              | -                    |
| Consumer  | 316                    | 316                            | 1                    |
| State and political subdivisions                        | -                      | -                              | -                    |
| Total impaired loans                                    | \$9,233                | \$ 9,694                       | \$ 310               |

The following table presents the average balance and interest income recognized on impaired loans by loan category for the three and nine months ended September 30, 2014 and 2013:

| (in thousands)                                 | Three Months Ended September 30, |                     |                 |                     | Nine Months Ended September 30, |                     |                 |                     |
|--|----------------------------------|---------------------|-----------------|---------------------|---------------------------------|---------------------|-----------------|---------------------|
|  | 2014                             |                     | 2013            |                     | 2014                            |                     | 2013            |                     |
|  | Average Balance                  | Interest Income (1) | Average Balance | Interest Income (1) | Average Balance                 | Interest Income (1) | Average Balance | Interest Income (1) |
| Residential real estate                        | \$ 2,490                         | \$ 25               | \$ 2,061        | \$ 2                | \$ 2,144                        | \$ 62               | \$ 2,204        | \$ 6                |
| Commercial real estate                         | 6,628                            | 30                  | 9,767           | 80                  | 6,613                           | 91                  | 10,503          | 254                 |
| Construction, land acquisition and development | 273                              | 4                   | 739             | 6                   | 293                             | 12                  | 894             | 22                  |
| Total real estate                              | 9,391                            | 59                  | 12,567          | 88                  | 9,050                           | 165                 | 13,601          | 282                 |
| Commercial and industrial                      | 66                               | -                   | -               | -                   | 98                              | -                   | -               | -                   |
| Consumer                                       | 363                              | 3                   | -               | -                   | 337                             | 8                   | -               | -                   |
| State and political subdivisions               | -                                | -                   | -               | -                   | -                               | -                   | -               | -                   |
| Total impaired loans                           | \$ 9,820                         | \$ 62               | \$ 12,567       | \$ 88               | \$ 9,485                        | \$ 173              | \$ 13,601       | \$ 282              |

(1) Interest income represents income recognized on performing TDRs.

The additional interest income that would have been earned on non-accrual and restructured loans in accordance with their original terms approximated \$100 thousand and \$307 thousand for the three and nine months ended September 30, 2014, respectively, and \$138 thousand and \$457 thousand for the three and nine months ended September 30, 2013, respectively.

### Troubled Debt Restructured Loans

TDRs at September 30, 2014 and December 31, 2013 were \$9.1 million and \$8.1 million, respectively. Accruing and non-accruing TDRs were \$5.3 million and \$3.8 million, respectively at September 30, 2014 and \$4.0 million and \$4.1 million, respectively at December 31, 2013. Approximately \$349 thousand and \$301 thousand in specific reserves have been established for these loans as of September 30, 2014 and December 31, 2013, respectively.

The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan, an extension of the maturity date, capitalization of real estate taxes, or a permanent reduction



of the recorded investment in the loan.

The following tables present the pre- and post- modification recorded investment in loans modified as TDRs by loan category during the three and nine months ended September 30, 2014 and 2013:

| (in thousands)                                 | Three Months Ended September 30, 2014 |                                  |                                  | Nine Months Ended September 30, 2014 |                                  |                                  |
|--|---------------------------------------|----------------------------------|----------------------------------|--------------------------------------|----------------------------------|----------------------------------|
|  | Number of Contracts                   | Pre-Modification                 | Post-Modification                | Number of Contracts                  | Pre-Modification                 | Post-Modification                |
|  |                                       | Outstanding Recorded Investments | Outstanding Recorded Investments |                                      | Outstanding Recorded Investments | Outstanding Recorded Investments |
| Troubled debt restructurings:                  |                                       |                                  |                                  |                                      |                                  |                                  |
| Residential real estate                        | 6                                     | \$ 411                           | \$ 413                           | 12                                   | \$ 780                           | \$ 862                           |
| Commercial real estate                         | -                                     | -                                | -                                | 4                                    | 238                              | 238                              |
| Construction, land acquisition and development | -                                     | -                                | -                                | -                                    | -                                | -                                |
| Commercial and industrial                      | -                                     | -                                | -                                | -                                    | -                                | -                                |
| Consumer                                       | -                                     | -                                | -                                | 2                                    | 182                              | 187                              |
| Total new troubled debt restructurings         | 6                                     | \$ 411                           | \$ 413                           | 18                                   | \$ 1,200                         | \$ 1,287                         |

| (in thousands)                                 | Three Months Ended September 30, 2013 |                                  |                                  | Nine Months Ended September 30, 2013 |                                  |                                  |
|--|---------------------------------------|----------------------------------|----------------------------------|--------------------------------------|----------------------------------|----------------------------------|
|  | Number of Contracts                   | Pre-Modification                 | Post-Modification                | Number of Contracts                  | Pre-Modification                 | Post-Modification                |
|  |                                       | Outstanding Recorded Investments | Outstanding Recorded Investments |                                      | Outstanding Recorded Investments | Outstanding Recorded Investments |
| Troubled debt restructurings:                  |                                       |                                  |                                  |                                      |                                  |                                  |
| Residential real estate                        | -                                     | \$ -                             | \$ -                             | -                                    | \$ -                             | \$ -                             |
| Commercial real estate                         | -                                     | -                                | -                                | 2                                    | 4,561                            | 4,561                            |
| Construction, land acquisition and development | -                                     | -                                | -                                | -                                    | -                                | -                                |
| Commercial and industrial                      | -                                     | -                                | -                                | -                                    | -                                | -                                |
| Consumer                                       | -                                     | -                                | -                                | -                                    | -                                | -                                |
| Total new troubled debt restructurings         | -                                     | \$ -                             | \$ -                             | 2                                    | \$ 4,561                         | \$ 4,561                         |

The eighteen loans modified as TDRs during the nine months ended September 30, 2014 increased the ALLL by \$2 thousand at September 30, 2014.

The following tables present the types of modifications made during the three and nine months ended September 30, 2014 and 2013:

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

| (in thousands)                                | Three Months Ended September 30, 2014 |                           |          |        | Nine Months Ended September 30, 2014 |                           |          |          |
|---|---------------------------------------|---------------------------|----------|--------|--------------------------------------|---------------------------|----------|----------|
|   | Residential<br>Real Estate            | Commercial<br>Real Estate | Consumer | Total  | Residential<br>Real Estate           | Commercial<br>Real Estate | Consumer | Total    |
| Type of modification:                         |                                       |                           |          |        |                                      |                           |          |          |
| Extension of term                             | \$ 148                                | \$ -                      | \$ -     | \$ 148 | \$ 263                               | \$ 238                    | \$ 135   | \$ 636   |
| Extension of term and capitalization of taxes | 40                                    | -                         | -        | 40     | 339                                  | -                         | 52       | 391      |
| Capitalization of taxes                       | -                                     | -                         | -        | -      | 35                                   | -                         | -        | 35       |
| Principal Forbearance                         | 225                                   | -                         | -        | 225    | 225                                  | -                         | -        | 225      |
| Total modifications                           | \$ 413                                | \$ -                      | \$ -     | \$ 413 | \$ 862                               | \$ 238                    | \$ 187   | \$ 1,287 |

| (in thousands)        | Three Months Ended September 30, 2013 |                           |          |       | Nine Months Ended September 30, 2013 |                           |          |          |
|-----------------------|---------------------------------------|---------------------------|----------|-------|--------------------------------------|---------------------------|----------|----------|
|                       | Residential<br>Real Estate            | Commercial<br>Real Estate | Consumer | Total | Residential<br>Real Estate           | Commercial<br>Real Estate | Consumer | Total    |
| Type of modification: |                                       |                           |          |       |                                      |                           |          |          |
| Principal forbearance | \$ -                                  | \$ -                      | \$ -     | \$ -  | \$ -                                 | \$ 4,561                  | \$ -     | \$ 4,561 |
| Total modifications   | \$ -                                  | \$ -                      | \$ -     | \$ -  | \$ -                                 | \$ 4,561                  | \$ -     | \$ 4,561 |

There were no TDRs which re-defaulted (defined as past due 90 days) during the three months ended September 30, 2014 and 2013 and for which the payment re-default occurred within one year of the modification.

**Note 5. Other Real Estate Owned**

The following table presents the composition of OREO at September 30, 2014 and December 31, 2013:

| (in thousands)                | September 30,<br>2014 | December 31,<br>2013 |
|-------------------------------|-----------------------|----------------------|
| Land/lots                     | \$ 1,476              | \$ 3,549             |
| Commercial real estate        | 1,114                 | 647                  |
| Residential real estate       | 27                    | 50                   |
| Total other real estate owned | \$ 2,617              | \$ 4,246             |

The following table presents the activity in OREO for the nine months ended September 30, 2014 and 2013:

| (in thousands)                    | Three Months Ended September 30, |          | Nine Months Ended September 30, |          |
|-----------------------------------|----------------------------------|----------|---------------------------------|----------|
|                                   | 2014                             | 2013     | 2014                            | 2013     |
| Balance, beginning of period      | \$ 3,182                         | \$ 2,778 | \$ 4,246                        | \$ 3,983 |
| Property foreclosures             | -                                | 96       | 13                              | 255      |
| Bank premises transferred to OREO | -                                | 1,819    | 1,749                           | 1,819    |
| Valuation adjustments             | (429 )                           | (152 )   | (2,199 )                        | (257 )   |
| Carrying value of OREO sold       | (136 )                           | (136 )   | (1,192 )                        | (1,395 ) |
| Balance, end of period            | \$ 2,617                         | \$ 4,405 | \$ 2,617                        | \$ 4,405 |

Due to a change in strategic purpose, the Company transferred the Stroudsburg office from bank premises and equipment to OREO for disposition during the nine months ended September 30, 2014. The deposits and loans of this branch were sold to ESSA Bank and Trust pursuant to a Branch Purchase and Deposit/Loan Assumption Agreement. The Company retained this facility and was initially planning to use it for other bank-related purposes. This property with a carrying value of \$1.7 million was written down to its appraised value less cost to sell of \$0.8 million at the time of transfer. A valuation adjustment of \$0.9 million, included in non-interest expense, was recorded at the time of transfer.

In the third quarter of 2013, the Company transferred three vacant lots from bank premises and equipment that were previously held for future expansion to OREO. One of the properties was subsequently sold during the nine months ended September 30, 2014. There was no gain or loss realized upon the sale. The Company had one of the properties located in Monroe County, Pennsylvania re-appraised during the third quarter of 2014 due to continued decline in real estate values, which resulted in a valuation adjustment of \$0.3 million and is included in non-interest expense for the three months and nine months ended September 30, 2014.

In addition, four properties that have been held in OREO for a significant amount of time are approaching the regulatory holding period threshold of five years. In an effort to aggressively dispose of these properties, management requested independent appraisals using a liquidation value basis for each of the properties. Accordingly, the Company incurred valuation adjustments to these four properties totaling \$0.7 million for the nine months ended September 30, 2014. Valuation adjustments to the carrying value of OREO included in non-interest expense were \$0.4 million and \$2.2 million for the three months and nine months ended September 30, 2014.

The following table presents the components of net expense of OREO for the three months and nine months ended September 30, 2014 and 2013:

| (in thousands)                                     | Three Months Ended |        | Nine Months Ended |        |
|--|--------------------|--------|-------------------|--------|
|  | September 30,      |        | September 30,     |        |
|  | 2014               | 2013   | 2014              | 2013   |
| Insurance  | \$ 26              | \$ 70  | \$ 66             | \$ 133 |
| Legal fees   | 14                 | 40     | 38                | 122    |
| Maintenance  | 2                  | 16     | 17                | 43     |
| Professional fees                                  | 5                  | 21     | 83                | 44     |
| Real estate taxes                                  | 28                 | 25     | 123               | 127    |
| Utilities  | 4                  | -      | 8                 | 9      |
| Other  | 6                  | 3      | 11                | 59     |
| Valuation adjustments                              | 429                | 152    | 2,199             | 257    |
| Total expense                                      | 514                | 327    | 2,545             | 794    |
| Income from the operation of foreclosed properties | -                  | (9 )   | (50 )             | (26 )  |
| Net expense of OREO                                | \$ 514             | \$ 318 | \$ 2,495          | \$ 768 |

#### Note 6. Securities

Securities have been classified as available-for-sale or held-to-maturity in the consolidated financial statements according to management's intent. The following tables present the amortized cost, gross unrealized gains and losses, and the fair value of the Company's securities at September 30, 2014 and December 31, 2013:

| (in thousands)                                  | September 30, 2014 |                     |                      |            |
|---|--------------------|---------------------|----------------------|------------|
|   | Amortized Cost     | Gross Holding Gains | Gross Holding Losses | Fair Value |
| Available-for-sale:                             |                    |                     |                      |            |
| Obligations of U.S. government agencies         | \$18,885           | \$ 357              | \$ -                 | \$ 19,242  |
| Obligations of state and political subdivisions | 23,450             | 1,065               | 10                   | 24,505     |
| Government-sponsored agency:                    |                    |                     |                      |            |
| Collateralized mortgage obligations             | 85,622             | 304                 | 1,044                | 84,882     |
| Residential mortgage-backed securities          | 87,740             | 407                 | 760                  | 87,387     |
| Corporate debt securities                       | 500                | -                   | 65                   | 435        |
| Equity securities                               | 1,010              | -                   | 49                   | 961        |
| Total available-for-sale securities             | \$217,207          | \$ 2,133            | \$ 1,928             | \$ 217,412 |

December 31, 2013

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

| (in thousands)                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses | Fair Value |
|---|-------------------|---|--|------------|
| Available-for-sale:                             |                   |   |  |            |
| Obligations of state and political subdivisions | \$79,488          | \$ 1,422                                | \$ 2,856                                 | \$ 78,054  |
| Government-sponsored agency:                    |                   |   |  |            |
| Collateralized mortgage obligations             | 35,906            | 46                                      | 1,153                                    | 34,799     |
| Residential mortgage-backed securities          | 91,648            | 98                                      | 2,090                                    | 89,656     |
| Corporate debt securities                       | 500               | -                                       | 93                                       | 407        |
| Equity securities                               | 1,010             | -                                       | 59                                       | 951        |
| Total available-for-sale securities             | \$208,552         | \$ 1,566                                | \$ 6,251                                 | \$ 203,867 |
| Held-to-maturity:                               |                   |   |  |            |
| Obligations of state and political subdivisions | \$2,308           | \$ 116                                  | \$ -                                     | \$ 2,424   |

At September 30, 2014 and December 31, 2013, securities with a carrying amount of \$215.9 million and \$204.2 million, respectively, were pledged as collateral to secure public deposits and for other purposes.

The following table presents the amortized cost and approximate fair value of the Company's available-for-sale debt securities at September 30, 2014 by contractual maturities. Expected maturities will differ from contractual maturity because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Because collateralized mortgage obligations and residential mortgage-backed securities are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

| (in thousands)                         | September 30, 2014 |            |
|--|--------------------|------------|
|  | Amortized Cost     | Fair Value |
| Amounts maturing in:                   |                    |            |
| One year or less                       | \$150              | \$149      |
| After one year through five years      | -                  | -          |
| After five years through ten years     | 25,980             | 26,544     |
| After ten years                        | 16,705             | 17,489     |
| Collateralized mortgage obligations    | 85,622             | 84,882     |
| Residential mortgage-backed securities | 87,740             | 87,387     |
| Total                                  | \$216,197          | \$216,451  |

Gross proceeds from the sale of available-for-sale securities were \$40.0 million and \$78.6 million for the three and nine months ended September 30, 2014, respectively, with gross gains of \$2.9 million and \$5.6 million, respectively realized upon the sales. The Company sold its entire held-to-maturity portfolio consisting of four obligations of states and political subdivisions with an aggregate amortized cost of \$2.3 million in January, 2014. Gross proceeds received from the sale of the held-to-maturity portfolio were \$2.7 million for the nine months ended September 30, 2014, with gross gains of \$0.4 million realized upon the sale. The four securities were zero-coupon bonds of California municipalities. These securities were sold as part of management's strategy to reduce the amount of potential credit risk within the investment portfolio.

Gross proceeds from the sale of available-for-sale securities were \$10.9 million and \$51.1 million for the three and nine months ended September 30, 2013, respectively. Gross realized gains were \$0.8 million and \$3.0 million for the three and nine months ended September 30, 2013, respectively. There were no gross realized losses for the three months ended September 30, 2013. Gross realized losses were \$408 thousand for the nine months ended September 30, 2013.

The following tables present the number of, fair value and gross unrealized losses of available-for-sale securities with unrealized losses at September 30, 2014 and December 31, 2013, aggregated by investment category and length of



time the securities have been in an unrealized loss position.

|  | September 30, 2014   |            |                         |                      |            |                         |                      |            |                         |
|--|----------------------|------------|-------------------------|----------------------|------------|-------------------------|----------------------|------------|-------------------------|
|  | Less than 12 Months  |            |                         | 12 Months or Greater |            |                         | Total                |            |                         |
| (dollars in thousands)   | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses |
| Obligations of U.S. government agencies                          | -                    | \$-        | \$ -                    | -                    | \$-        | \$ -                    | -                    | \$-        | \$ -                    |
| Obligations of state and political subdivisions                  | -                    | -          | -                       | 3                    | 736        | 10                      | 3                    | 736        | 10                      |
| Government-sponsored agency: Collateralized mortgage obligations | 10                   | 49,973     | 733                     | 3                    | 8,544      | 311                     | 13                   | 58,517     | 1,044                   |
| Residential mortgage-backed securities                           | 2                    | 7,061      | 54                      | 8                    | 48,689     | 706                     | 10                   | 55,750     | 760                     |
| Corporate debt securities  | -                    | -          | -                       | 1                    | 435        | 65                      | 1                    | 435        | 65                      |
| Equity securities  | -                    | -          | -                       | 1                    | 951        | 49                      | 1                    | 951        | 49                      |
| Total  | 12                   | \$57,034   | \$ 787                  | 16                   | \$59,355   | \$ 1,141                | 28                   | \$ 116,389 | \$ 1,928                |

|   | December 31, 2013    |            |                         |                      |            |                         |                      |            |                         |
|---|----------------------|------------|-------------------------|----------------------|------------|-------------------------|----------------------|------------|-------------------------|
|   | Less than 12 Months  |            |                         | 12 Months or Greater |            |                         | Total                |            |                         |
| (dollars in thousands)                          | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses |
| Obligations of state and political subdivisions | 58                   | \$33,835   | \$ 1,837                | 18                   | \$4,756    | \$ 1,019                | 76                   | \$38,591   | \$ 2,856                |
| Government-sponsored agency:                    |                      |            |                         |                      |            |                         |                      |            |                         |
| Collateralized mortgage obligations             | 11                   | 31,683     | 1,139                   | 1                    | 833        | 14                      | 12                   | 32,516     | 1,153                   |
| Residential mortgage-backed securities          | 13                   | 79,046     | 1,961                   | 2                    | 7,506      | 129                     | 15                   | 86,552     | 2,090                   |
| Corporate debt securities                       | -                    | -          | -                       | 1                    | 407        | 93                      | 1                    | 407        | 93                      |
| Equity securities                               | -                    | -          | -                       | 1                    | 941        | 59                      | 1                    | 941        | 59                      |
| Total   | 82                   | \$144,564  | \$ 4,937                | 23                   | \$14,443   | \$ 1,314                | 105                  | \$159,007  | \$ 6,251                |

Substantially all of the Company's securities portfolio is comprised of debt securities, specifically single-maturity bonds of U.S. government agencies, obligations of states and political subdivisions, and residential mortgage-backed securities, including home equity conversion mortgages, and collateralized mortgage obligations ("CMOs") of U.S. government-sponsored agencies. The Company held 28 securities that were in an unrealized loss position at September 30, 2014, of which 26 securities, or 94.1% of the total unrealized losses, were related to these debt securities.

In determining whether unrealized losses are other-than-temporary, management considers the following factors:

- The causes of the decline in fair value, such as credit deterioration, interest rate fluctuations, or market volatility;
- The severity and duration of the decline;
- Whether or not the Company expects to receive all contractual cash flows;
- The Company's ability and intent to hold the security to allow for recovery in fair value, as well as the likelihood of such a recovery in the near term;
- The Company's intent to sell the security, or if it is more likely than not that the Company will be required to sell the security, before recovery of its amortized cost basis, less any current-period credit loss.

Management performed a review of the fair values of all securities at September 30, 2014 and determined that movements in the values of the securities were consistent with the change in market interest rates. As a result of its review and considering the attributes of these debt securities, the Company concluded that OTTI did not exist at September 30, 2014. To date, the Company has received all scheduled principal and interest payments and expects to fully collect all future contractual principal and interest payments. The Company does not intend to sell the securities nor is it more likely than not that the Company will be required to sell the securities.

Management does not believe that any individual unrealized loss at September 30, 2014 represents OTTI. The unrealized losses reported for residential mortgage-backed securities and CMOs relate entirely to securities issued by GNMA, FHLMC and FNMA that are currently rated AAA or Aaa by Moody's Investor Services or by Standard & Poor's, respectively, and are guaranteed by the U.S. government. The obligations of state and political subdivisions are comprised entirely of general-purpose debt obligations. The majority of these obligations have a credit quality rating of A or better and are secured by the unlimited taxing power of the issuer. In addition, the Company utilized a third party to perform an independent credit analysis of its state and political subdivision bonds that were either non-rated or had a rating below A. There was one obligation of a state and political subdivision that had a rating below A at September 30, 2014. According to the independent credit analysis, this bond was considered investment grade at September 30, 2014. In addition, this bond is scheduled to mature by December 31, 2014.

Investments in FHLB and Federal Reserve Bank ("FRB") stock, which have limited marketability, are carried at cost and totaled \$5.7 million and \$3.5 million at September 30, 2014 and December 31, 2013, respectively. FRB stock of \$1.3 million is included in Other Assets at September 30, 2014 and December 31, 2013. Management noted no indicators of impairment for the FHLB of Pittsburgh and FRB of Philadelphia at September 30, 2014.

#### **Note 7. Fair Value Measurements**

In determining fair value, the Company uses various valuation approaches, including market, income and cost approaches. Accounting standards establish a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability, which are developed based on market data obtained from sources independent of the Company. Unobservable inputs reflects the Company's assumptions about the assumptions the market participants would use in pricing an asset or liability, which are developed based on the best information available in the circumstances.

The fair value hierarchy gives the highest priority to unadjusted quoted market prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). A financial asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The fair value hierarchy is broken down into three levels based on the reliability of inputs as follows:

· Level 1 valuation is based upon unadjusted quoted market prices for identical instruments traded in active markets.

· Level 2 valuation is based upon quoted market prices for similar instruments traded in active markets, quoted market prices for identical or similar instruments traded in markets that are not active and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by market data; and

· Level 3 valuation is derived from other valuation methodologies including discounted cash flow models and similar techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in determining fair value.

A description of the valuation methodologies used for assets recorded at fair value, and for estimating fair value of financial instruments not recorded at fair value, is set forth below.

### **Cash, Short-term Investments, Accrued Interest Receivable and Accrued Interest Payable**

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

### **Securities**

The estimated fair values of available-for-sale equity securities are determined by obtaining quoted prices on nationally recognized exchanges (Level 1 inputs). The estimated fair values for the Company's investments in obligations of U.S. government agencies, obligations of state and political subdivisions, government-sponsored agency CMOs, government-sponsored agency residential mortgage-backed securities, and corporate debt securities are obtained by the Company from a nationally-recognized pricing service. This pricing service develops estimated fair values by analyzing like securities and applying available market information through processes such as benchmark curves, benchmarking of like securities, sector groupings and matrix pricing (Level 2 inputs), to prepare valuations. Matrix pricing is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities. The fair value measurements consider observable data that may include dealer

quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things and are based on market data obtained from sources independent from the Company. The Level 2 investments in the Company's portfolio are priced using those inputs that, based on the analysis prepared by the pricing service, reflect the assumptions that market participants would use to price the assets. The Company has determined that the Level 2 designation is appropriate for these securities because, as with most fixed-income securities, those in the Company's portfolio are not exchange-traded, and such non-exchange-traded fixed income securities are typically priced by correlation to observed market data. The Company has reviewed the pricing service's methodology to confirm its understanding that such methodology results in a valuation based on quoted market prices for similar instruments traded in active markets, quoted markets for identical or similar instruments traded in markets that are not active and model-based valuation techniques for which the significant assumptions can be corroborated by market data as appropriate to a Level 2 designation.

For those securities for which the inputs used by an independent pricing service were derived from unobservable market information, the Company evaluated the appropriateness and quality of each price. The Company reviewed the volume and level of activity for all classes of securities and attempted to identify transactions which may not be orderly or reflective of a significant level of activity and volume. For securities meeting these criteria, the quoted prices received from either market participants or an independent pricing service may be adjusted, as necessary, to estimate fair value (fair values based on Level 3 inputs). If applicable, the adjustment to fair value was derived based on present value cash flow model projections prepared by the Company or obtained from third party providers utilizing assumptions similar to those incorporated by market participants.

The Company owned one security issued by a state and political subdivision that was valued using level 3 inputs. This security had an amortized cost of \$150 thousand and \$595 thousand at September 30, 2014 and December 31, 2013, respectively. This security had a credit rating that was either withdrawn or downgraded by nationally recognized credit rating agencies, and as a result the market for these securities was inactive at both September 30, 2014 and December 31, 2013. This security was historically priced using Level 2 inputs. The credit ratings withdrawal and downgrade have resulted in a decline in the level of significant other observable inputs for this investment security at the measurement dates. Broker pricing and bid/ask spreads are very limited for this security. At September 30, 2014 and December 31, 2013, the Company obtained a bid indication from a third-party municipal trading desk to determine the fair value of this security.

## **Loans**

Except for collateral dependent impaired loans, fair values of loans are estimated by discounting the projected future cash flows using market discount rates that reflect the credit, liquidity, and interest rate risk inherent in the loan. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. The estimated fair value of collateral dependent impaired loans is based on the appraised loan value or other reasonable offers less estimated costs to sell. The Company does not record loans at fair value on a recurring basis. However from time to time, a loan is considered impaired and an allowance for credit losses is established. The specific reserves for collateral dependent impaired loans are based on the fair value of the collateral less estimated costs to sell. The fair value of the collateral is generally based on appraisals. In some cases, adjustments are made to the appraised values due to various factors including age of the appraisal, age of comparables included in the appraisal, and known changes in the market and in the collateral. When significant adjustments are based on unobservable inputs, the resulting fair value measurement is categorized as a Level 3 measurement.

## **Loans Held For Sale**

Fair values of mortgage loans held for sale are based on commitments on hand from investors or prevailing market prices.

## **Mortgage Servicing Rights**

The fair value of mortgage servicing rights is estimated using a discounted cash flow model that applies current estimated prepayments derived from the mortgage-backed securities market and utilizes a current market discount rate for observable credit spreads. The Company does not record mortgage servicing rights at fair value on a recurring basis.

## **Restricted Stock**

Ownership in equity securities of FHLB of Pittsburgh and the FRB is restricted and there is no established market for their resale. The carrying amount is a reasonable estimate of fair value.

## **Deposits**

The fair value of demand deposits, savings deposits, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated based on discounted cash flows using FHLB advance rates currently offered for similar remaining maturities.

### **Borrowed funds**

The Company uses discounted cash flows using rates currently available for debt with similar terms and remaining maturities to estimate fair value.

### **Commitments to extend credit and standby letters of credit**

The fair value of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of off-balance sheet commitments is insignificant and therefore not included in the table for non-recurring assets and liabilities.

**Assets measured at fair value on a recurring basis**

The following tables present financial assets that are measured at fair value on a recurring basis at September 30, 2014 and December 31, 2013, and the fair value hierarchy of the respective valuation technique utilized by the Company to determine the fair value:

| (in thousands)                                  | Fair Value Measurements at September 30, 2014 |   |  |  |
|---|---|---|--|--|
|   | Fair Value                                    | Quoted Prices<br>in Active Markets<br>for Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-sale securities:                  |   |   |  |  |
| Obligations of U.S. government agencies         | \$ 19,242                                     | \$ -  | \$ 19,242  | \$ -   |
| Obligations of state and political subdivisions | 24,505  | -   | 24,356   | 149  |
| Government-sponsored agency:                    |   |   |  |  |
| Collateralized mortgage obligations             | 84,882  | -   | 84,882   | -  |
| Residential mortgage-backed securities          | 87,387  | -   | 87,387   | -  |
| Corporate debt securities                       | 435   | -   | 435  | -  |
| Equity securities                               | 961   | 961   | -  | -  |
| Total available-for-sale securities             | \$ 217,412                                    | \$ 961  | \$ 216,302                                       | \$ 149   |

| (in thousands)                                  | Fair Value Measurements at December 31, 2013 |   |  |  |
|---|--|---|--|--|
|   | Fair Value                                   | Quoted Prices<br>in Active Markets<br>for Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-sale securities:                  |  |   |  |  |
| Obligations of state and political subdivisions | \$ 78,054                                    | \$ -  | \$ 77,483  | \$ 571   |
| Government-sponsored agency:                    |  |   |  |  |
| Collateralized mortgage obligations             | 34,799                                       | -   | 34,799   | -  |
| Residential mortgage-backed securities          | 89,656                                       | -   | 89,656   | -  |
| Corporate debt securities                       | 407  | -   | 407  | -  |
| Equity securities                               | 951  | 951   | -  | -  |
| Total available-for-sale securities             | \$ 203,867                                   | \$ 951  | \$ 202,345                                       | \$ 571   |



The following table presents a reconciliation and statement of operations classifications of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3), which consisted entirely of obligations of states and political subdivisions, for the three and nine month periods ended September 30, 2014 and 2013:

#### Fair Value Measurements

##### Using Significant Unobservable Inputs (Level 3)

| (in thousands)                               | Three Months Ended    |        | Nine Months Ended     |          |
|--|-----------------------|--------|-----------------------|----------|
|  | September 30,<br>2014 | 2013   | September 30,<br>2014 | 2013     |
| Balance, beginning of period                 | \$ 294                | \$ 845 | \$ 571                | \$ 1,739 |
| Amortization                                 | -                     | -      | -                     | -        |
| Accretion                                    | -                     | -      | -                     | -        |
| Principal payments received                  | (150 )                | (140 ) | (445 )                | (425 )   |
| Sales  | -                     | -      | -                     | (622 )   |
| Total gains or losses (realized/unrealized): |                       |        |                       |          |
| Included in earnings                         | -                     | -      | -                     | 2        |
| Included in other comprehensive income       | 5                     | 5      | 23                    | 16       |
| Balance, end of period                       | \$ 149                | \$ 710 | \$ 149                | \$ 710   |

There were no transfers between levels within the fair value hierarchy during the three and nine months ended September 30, 2014 and 2013.

#### Assets measured at fair value on a non-recurring basis

The following tables present assets that are measured at fair value on a non-recurring basis at September 30, 2014 and December 31, 2013, and the fair value hierarchy of the respective valuation technique utilized by the Company to determine fair value:

| (in thousands)                      | Fair Value Measurements at September 30, 2014 |   |  |  |
|-------------------------------------|---|---|--|--|
|                                     | Fair Value (1)                                | Quoted Prices<br>in Active Markets<br>for Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Collateral-dependent impaired loans | \$ 5,399                                      | \$ -  | \$ -   | \$ 5,399   |
| Other real estate owned             | \$ 2,450                                      | \$ -  | \$ -   | \$ 2,450   |

#### Fair Value Measurements at December 31, 2013

| (in thousands)                      | Fair Value (1) | Quoted Prices<br>in Active Markets<br>for Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------------------|----------------|---|--|--|
| Collateral-dependent impaired loans | \$ 5,229       | \$ -  | \$ -   | \$ 5,229   |
| Other real estate owned             | \$ 3,931       | \$ -  | \$ -   | \$ 3,931   |

Represents carrying value and related write-downs for which adjustments are based on appraised value.

(1) Management makes adjustments to the appraised values as necessary to consider declines in real estate values since the time of the appraisal. Such adjustments are based on management's knowledge of the local real estate markets.

Collateral-dependent impaired loans are classified as Level 3 assets and the estimated fair value of the collateral is based on the appraised value or other reasonable offers less estimated costs to sell. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance or is charged off. The amount shown is the balance of impaired loans, net of any charge-offs and the related allowance for loan losses.

OREO properties are recorded at fair value less the estimated cost to sell at the date of the Company's acquisition of the property. Subsequent to the Company's acquisition, the balance may be written down further. It is the Company's policy to obtain certified external appraisals of real estate collateral underlying impaired loans and OREO, and estimate fair value using those appraisals. Other valuation sources may be used, including broker price opinions, letters of intent and executed sale agreements.

The Company discloses fair value information about financial instruments, whether or not recognized in the Statement of Financial Condition, for which it is practicable to estimate that value. The following estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, management judgment is required to interpret data and develop fair value estimates. Accordingly, the estimates below are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The following table presents the carrying values and estimated fair values of the Company's financial instruments at September 30, 2014 and at December 31, 2013:

| (in thousands)                | Fair Value Measurement | September 30, 2014 |            | December 31, 2013 |            |
|-------------------------------|------------------------|--------------------|------------|-------------------|------------|
|                               |                        | Carrying Value     | Fair Value | Carrying Value    | Fair Value |
| <b>Financial assets:</b>      |                        |                    |            |                   |            |
| Cash and cash equivalents     | Level 1                | \$39,993           | \$39,993   | \$103,556         | \$103,556  |
| Securities available for sale | See previous table     | 217,412            | 217,412    | 203,867           | 203,867    |
| Securities held to maturity   | Level 2                | -                  | -          | 2,308             | 2,424      |
| FHLB and FRB Stock            | Level 2                | 5,706              | 5,706      | 3,496             | 3,496      |
| Loans held for sale           | Level 2                | 171                | 171        | 820               | 820        |
| Loans, net                    | Level 3                | 666,262            | 666,879    | 629,880           | 632,536    |
| Accrued interest receivable   | Level 2                | 2,158              | 2,158      | 2,191             | 2,191      |
| Mortgage servicing rights     | Level 3                | 381                | 961        | 529               | 990        |
| <b>Financial liabilities:</b> |                        |                    |            |                   |            |
| Deposits                      | Level 2                | 803,196            | 804,688    | 884,698           | 887,056    |
| Borrowed funds                | Level 2                | 104,096            | 107,476    | 62,433            | 65,642     |
| Accrued interest payable      | Level 2                | 10,515             | 10,515     | 8,732             | 8,732      |

## Note 8. Earnings per Share

For the Company, the numerator of both the basic and diluted earnings per common share is net income available to common shareholders (which is equal to net income less dividends on preferred stock and related discount accretion). The weighted average number of common shares outstanding used in the denominator for basic earnings per common share is increased to determine the denominator used for diluted earnings per common share by the effect of potentially dilutive common share equivalents utilizing the treasury stock method. For the Company, common share equivalents are outstanding stock options to purchase the Company's common shares and unvested restricted stock.

The following table presents the calculation of both basic and diluted earnings per common share for the three and nine months ended September 30, 2014 and 2013:

| (in thousands, except share data) | Three Months Ended |            | Nine Months Ended  |            |
|-----------------------------------|--------------------|------------|--------------------|------------|
|                                   | September 30, 2014 | 2013       | September 30, 2014 | 2013       |
| Net income                        | \$3,358            | \$1,887    | \$13,451           | \$4,338    |
|                                   | 16,471,569         | 16,457,169 | 16,471,569         | 16,457,169 |

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Basic weighted-average number of common shares outstanding   |            |            |            |            |
| Plus: common share equivalents                               | -          | -          | 282        | -          |
| Diluted weighted-average number of common shares outstanding | 16,471,569 | 16,457,169 | 16,471,851 | 16,457,169 |
| Income per common share:                                     |            |            |            |            |
| Basic  | \$0.20     | \$0.11     | \$0.82     | \$0.26     |
| Diluted  | \$0.20     | \$0.11     | \$0.82     | \$0.26     |

For the nine months ended September 30, 2014, common share equivalents in the table above are related entirely to the incremental shares of unvested restricted stock. Stock options of 73,276 and 114,348, respectively for the nine months ended September 30, 2014 and 2013 were excluded from common share equivalents. The exercise prices of stock options exceeded the average market price of the Company's common shares during the periods presented. Similarly, the weighted-average stock price for the Company's common stock for the three months ended September 30, 2014 exceeded the fair market value of the restricted stock at the date of grant, therefore, inclusion of these common share equivalents would be anti-dilutive to the diluted earnings per common share calculation.

**Note 9. Other Comprehensive Income (Loss)**

The following tables summarize the reclassifications out of accumulated other comprehensive income (loss) for the three and nine months ended September 30, 2014 and 2013:

|  | Three Months Ended September 30, 2014  |   | Nine Months Ended September 30, 2014   |   |
|--|--|---|--|---|
|  | Amount<br>Reclassified<br>from<br>Accumulated<br>Other Comprehensive<br>Income<br>(Loss) | Affected Line Item<br>in the Consolidated<br>Statements of Operations | Amount<br>Reclassified<br>from<br>Accumulated<br>Other Comprehensive<br>Income<br>(Loss) | Affected Line Item<br>in the Consolidated<br>Statements of Operations |
| (in thousands)   |  |   |  |   |
| Available-for-sale securities:<br>Reclassification adjustment for<br>net gains reclassified into net<br>income | \$ (2,958 )  | Net gain on sale of securities  | \$ (5,638 )  | Net gain on sale of securities  |
| Taxes  | 1,006  | Income taxes  | 1,917  | Income taxes  |
| Net of tax amount  | \$ (1,952 )  |   | \$ (3,721 )  |   |
|  |  |   |  |   |
|  | Three Months Ended September 30, 2013  |   | Nine Months Ended September 30, 2013   |   |
|  | Amount<br>Reclassified<br>from<br>Accumulated<br>Other Comprehensive<br>Income<br>(Loss) | Affected Line Item<br>in the Consolidated<br>Statements of Operations | Amount<br>Reclassified<br>from<br>Accumulated<br>Other Comprehensive<br>Income<br>(Loss) | Affected Line Item<br>in the Consolidated<br>Statements of Operations |
| (in thousands)   |  |   |  |   |
| Available-for-sale securities:<br>Reclassification adjustment for<br>net gains reclassified into net<br>income | \$ (817 )  | Net gain on sale of securities  | \$ (2,558 )  | Net gain on sale of securities  |
| Taxes  | 278  | Income taxes  | 870  | Income taxes  |
| Net of tax amount  | \$ (539 )  |   | \$ (1,688 )  |   |

The following table summarizes the changes in accumulated other comprehensive income (loss), net of tax for the three and nine months ended September 30, 2014 and 2013:

| (in thousands)  | Three Months Ended |             | Nine Months Ended |             |
|---|--------------------|-------------|-------------------|-------------|
|   | September 30,      |             | September 30,     |             |
|   | 2014               | 2013        | 2014              | 2013        |
| Balance, beginning of period  | \$ 2,406           | \$ (1,142 ) | \$ (3,092 )       | \$ 6,698    |
| Other comprehensive (loss) income before reclassifications              | (319 )             | (87 )       | 6,948             | (6,778 )    |
| Amounts reclassified from accumulated other comprehensive income (loss) | (1,952 )           | (539 )      | (3,721 )          | (1,688 )    |
| Net other comprehensive (loss) income during the period                 | (2,271 )           | (626 )      | 3,227             | (8,466 )    |
| Balance, end of period  | \$ 135             | \$ (1,768 ) | \$ 135            | \$ (1,768 ) |

#### Note 10. Related Party Transactions

The Company and the Bank have engaged in, and intend to continue to engage in, banking and financial transactions in the conduct of its business with directors and the executive officers of the Company and the Bank and their related parties.

The Bank has granted loans, letters of credit and lines of credit to directors, executive officers and their related parties. During the nine months ended September 30, 2014, the Company appointed two additional directors to the board. The following table summarizes the changes in the gross amounts of such outstanding loans, advances under lines of credit as well as repayments during the three months and nine months ended September 30, 2014 and 2013:

| (in thousands)                    | For the Three Months Ended |           | For the Nine Months Ended |           |
|-----------------------------------|----------------------------|-----------|---------------------------|-----------|
|                                   | September 30,              |           | September 30,             |           |
|                                   | 2014                       | 2013      | 2014                      | 2013      |
| Balance, beginning of period      | \$ 34,152                  | \$ 35,366 | \$ 32,506                 | \$ 33,296 |
| Additions, new loans and advances | 30,788                     | 11,239    | 62,683                    | 38,669    |
| Repayments                        | (18,382 )                  | (13,646 ) | (48,631 )                 | (38,750 ) |
| Other (1)                         | (248 )                     | -         | (248 )                    | (256 )    |
| Balance, end of period            | \$ 46,310                  | \$ 32,959 | \$ 46,310                 | \$ 32,959 |

(1) Represents loans to related parties that ceased being related parties during the period.

At September 30, 2014 there was one loan to a related party in the amount of \$90 thousand which was not performing in accordance with the terms of the loan agreement.

Included in related party loans is a commercial line of credit with a company owned by a director with a total aggregate balance of \$9.6 million at September 30, 2014. The Company also sold a participation interest in this line to the same director in the amount of \$5.2 million, of which \$3.8 million was outstanding at September 30, 2014. The Bank receives a 25 basis point annual servicing fee from this director on the participation balance.

Deposits from directors, executive officers and their related parties held by the Bank at September 30, 2014 and December 31, 2013 amounted to \$78.1 million and \$115.5 million, respectively. Interest paid on the deposits amounted to \$69 thousand and \$55 thousand for the nine months ended September 30, 2014 and 2013, respectively.

In the course of its operations, the Company acquires goods and services from and transacts business with various companies affiliated with related parties. The Company believes these transactions were made on the same terms as those for comparable transactions with unrelated parties. The Company recorded payments to related parties for these services of \$1.2 million and \$2.2 million, respectively, for the three and nine months ended September 30, 2014, and \$0.9 million and \$2.4 million for the respective periods of 2013.

Subordinated notes held by officers and directors and/or their related parties totaled \$9.0 million at September 30, 2014 and \$10.0 million at December 31, 2013. During the third quarter of 2014, one of the Company's directors, Joseph J. Gentile, passed away and is no longer considered a related party. Mr. Gentile held \$1.0 million in the Company's subordinated notes. There was no interest paid to directors on these notes for the nine months ended September 30, 2014 and 2013. Interest expense recorded on subordinated notes to directors amounted to \$0.2 million and \$0.7 million for the three and nine months ended September 30, 2014, and \$0.2 million and \$0.7 million for the respective periods of 2013. Interest accrued and unpaid on loans to directors totaled \$3.9 million at September 30, 2014.

#### **Note 11. Stock Compensation Plans**

On August 30, 2000, the Company's Board adopted the 2000 Employee Stock Incentive Plan (the "Stock Incentive Plan") in which options may be granted to key officers and other employees of the Company. The aggregate number of shares which may be issued upon exercise of the options under the plan cannot exceed 1,100,000 shares. Options and rights granted under the Stock Incentive Plan become exercisable six months after the date the options are awarded and expire ten years after the award date. Upon exercise, the shares are issued from the Company's authorized but unissued stock. The Stock Incentive Plan expired on August 30, 2010. Therefore, no further grants will be made under the plan.

The Board also adopted on August 30, 2000, the 2000 Independent Directors Stock Option Plan (the "Directors' Stock Plan") for directors who are not officers or employees of the Company. The aggregate number of shares issuable under the Directors' Stock Plan cannot exceed 550,000 shares and are exercisable six months from the date the awards are granted and expire three years after the award date. Upon exercise, the shares are issued from the Company's authorized but unissued shares. The Directors' Stock Plan expired on August 30, 2010, therefore, no further grants will be made under the plan.

No compensation expense related to options under either the Stock Incentive Plan or the Directors' Stock Plan was required to be recorded in the nine months ended September 30, 2014 and 2013.



The following table summarizes the activity related to the Company's stock option plans for the nine months ended September 30, 2014 and 2013:

|  | Nine Months Ended September 30, |                                 |           |                                 |
|--|---------------------------------|---------------------------------|-----------|---------------------------------|
|  | 2014                            |                                 | 2013      |                                 |
|  | Shares                          | Weighted Average Exercise Price | Shares    | Weighted Average Exercise Price |
| Outstanding at January 1,  | 82,598                          | \$ 15.98                        | 129,170   | \$ 14.26                        |
| Granted  | -                               | -                               | -         | -                               |
| Exercised  | -                               | -                               | -         | -                               |
| Forfeited  | (9,322 )                        | 16.05                           | (14,822 ) | 13.81                           |
| Outstanding at September 30,                                     | 73,276                          | \$ 15.97                        | 114,348   | \$ 14.32                        |
| Options exercisable at September 30,                             | 73,276                          | \$ 15.97                        | 114,348   | \$ 14.32                        |
| Weighted average fair value of options granted during the period |                                 | \$ -                            |           | \$ -                            |
| Stock-based compensation expense                                 |                                 | \$ -                            |           | \$ -                            |

At September 30, 2014 and 2013 the exercisable options had no total intrinsic value and there was no unrecognized compensation expense.

The following table presents information pertaining to options outstanding at September 30, 2014:

| Range of Exercise Price | Options Outstanding |                                   |                                 | Options Exercisable |                                 |
|-------------------------|---------------------|-----------------------------------|---------------------------------|---------------------|---------------------------------|
|                         | Number Outstanding  | Weighted Average Contractual Life | Weighted Average Exercise Price | Number Exercisable  | Weighted Average Exercise Price |
| \$10.81 - \$23.13       | 73,276              | 2.8                               | \$ 15.97                        | 73,276              | \$ 15.97                        |

On November 28, 2012, the Board of Directors adopted the 2012 Employee Stock Grant Plan (the "2012 Stock Grant Plan") under which shares of common stock not to exceed 16,000 were authorized to be granted to employees. On December 17, 2012, the Company granted 50 shares of the Company's common stock to each active full and part time employee. There were 15,050 shares granted under the 2012 Stock Grant Plan at a fair value of \$3.05 per share. On November 27, 2013, the Board of Directors adopted the 2013 Employee Stock Grant Plan (the "2013 Stock Grant Plan") under which shares of common stock not to exceed 15,000 were authorized to be granted to employees. On December 2, 2013, the Company granted 50 shares of the Company's common stock to each active full and part time employee. There were 14,400 shares granted under the 2013 Stock Grant Plan at a fair value of \$4.26 per share. The total cost of these grants, which was included in salary expense in the Consolidated Statements of Operations, amounted to \$61

thousand and \$46 thousand for the years ended December 31, 2013 and 2012, respectively. No additional shares were granted under either plan. On October 29, 2014, the Board of Directors adopted a 2014 Employee Stock Grant Plan (the "2014 Stock Grant Plan") under which shares of common stock not to exceed 13,500 were authorized to be granted to employees. The Company has not granted any shares under the 2014 Stock Grant Plan.

The Board of Directors, upon the recommendation of the Compensation Committee, formally adopted a Long-Term Incentive Compensation Plan ("LTIP") on October 23, 2013. The LTIP was ratified at the 2013 Annual Shareholders Meeting on December 23, 2013. The LTIP is designed to reward executives and key employees for their contributions to the long-term success of the Company, primarily as measured by the increase in the Company's stock price. The LTIP authorizes up to 1,200,000 shares of common stock for issuance and provides the Board with the authority to offer several different types of long-term incentives, including stock options, stock appreciation rights, restricted stock, restricted stock units, performance units and performance shares. The Board approved initial awards under the terms of the LTIP, which were granted to executives and key employees on March 1, 2014. The initial grant was comprised solely of 45,750 shares of restricted stock. At September 30, 2014, there were 1,154,250 shares of common stock available for award under the LTIP. For the nine months ended September 30, 2014, stock-based compensation expense totaled \$65 thousand and was included in salaries and employee benefits expense in the Consolidated Statements of Operations. Total unrecognized compensation expense related to unvested restricted stock awards at September 30, 2014 was \$242 thousand.

The following table summarizes the activity related to the Company's unvested restricted stock awards during the nine months ended September 30, 2014:

|   | Nine Months Ended September 30,<br>2014 |  |
|---|---|--|
|   | Restricted<br>Shares                    | Weighted-<br>Average<br>Grant Date<br>Fair Value |
| Unvested unrestricted stock awards at January 1,    | -                                       | \$ -   |
| Awards granted                                      | 45,750                                  | 6.70   |
| Forfeitures   | -                                       | -  |
| Vestings  | -                                       | -  |
| Unvested unrestricted stock awards at September 30, | 45,750                                  | \$ 6.70  |

#### Note 12. Income taxes

The determination of the amount of deferred income taxes which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change in response to economic conditions and other factors. A valuation allowance related to deferred tax assets is required when it is considered more likely than not that all or part of the benefit related to such assets will not be realized. The Company's deferred tax position has been affected by several significant transactions that occurred in prior years. These transactions included the provision for loan losses, the level of non-accrual loans, valuation of other real estate owned and other-than-temporary impairment losses incurred on certain available-for-sale securities, and resulted in the Company being in a cumulative deficit position since 2009. Accordingly, under applicable accounting guidance, the Company established a full valuation allowance for its net deferred tax assets. At September 30, 2014 and December 31, 2013, the Company had established valuations allowances related to net deferred tax assets of \$30.5 million and \$34.1 million, respectively.

Management has reviewed the deferred tax positions of the Company at September 30, 2014. The valuation allowance is analyzed quarterly for changes affecting deferred tax assets. The Company reported taxable income for the third quarter of 2014, which was the seventh consecutive profitable quarter. However, based on current accounting guidance, the Company has not generated taxable income for a sufficient length of time in order to reverse the deferred tax asset valuation allowance. In the future, when the Company has generated taxable income on a more sustained basis, management's conclusion regarding the need for a deferred tax asset valuation allowance could change, resulting in the reversal of all or a portion of the deferred tax asset valuation allowance.

For the three months and nine months ended September 30, 2014, the Company recorded income tax expense of \$166 thousand and \$326 thousand, which was entirely related to alternative minimum tax.

### Note 13. Contingencies

On August 8, 2011, the Company announced that it had received document subpoenas from the SEC. The information requested generally relates to disclosure and financial reporting by the Company and the restatement of the Company's financial statements for the year ended December 31, 2009, and the quarters ended March 31, 2010 and June 30, 2010. The Company is presently cooperating with the SEC in this matter. Discussions have been conducted between the Company and the SEC seeking to resolve issues related to disclosure and financial reporting and the restatements of the Company's financial statements for the year ended December 31, 2009 and the quarters ended March 31, 2010 and June 30, 2010. There can be no assurance that these discussions will lead to the resolution of the issues in a matter acceptable to the Company.

On May 24, 2012, a putative shareholder filed a complaint in the Court of Common Pleas for Lackawanna County ("Shareholder Derivative Suit") against certain present and former directors and officers of the Company (the "Individual Defendants") alleging, inter alia, breach of fiduciary duty, abuse of control, corporate waste, and unjust enrichment. The Company was named as a nominal defendant. The parties to the Shareholder Derivative Suit commenced settlement discussions and on December 18, 2013, the Court entered an Order Granting Preliminary Approval of Proposed Settlement subject to notice to shareholders. On February 4, 2014, the Court issued a Final Order and Judgment for the matter granting approval of a Stipulation of Settlement (the "Settlement") and dismissing all claims against the Company and the Individual Defendants. As part of the Settlement, there was no admission of liability by the Individual Defendants. Pursuant to the Settlement, the Individual Defendants, without admitting any fault, wrongdoing or liability, agreed to settle the derivative litigation for \$5.0 million. The \$5.0 million Settlement payment was made to the Company on March 28, 2014. The Individual Defendants reserved their rights to indemnification under the Company's Articles of Incorporation and Bylaws, resolutions adopted by the Board, the Pennsylvania Business Corporation Law and any and all rights they have against the Company's and the Bank's insurance carriers. In accordance, the Company had recorded a liability for this indemnification in other liabilities. In addition, in conjunction with the Settlement, the Company accrued \$2.5 million related to fees and costs of the plaintiff's attorneys, which was included in non-interest expense in the consolidated statements of operations for the year ended December 31, 2013. On April 1, 2014, the Company paid the \$2.5 million related to fees and costs of the plaintiff's attorneys and partial indemnification of the Individual Defendants in the amount of \$2.5 million, and as such, as of September 30, 2014 \$2.5 million remains accrued in other liabilities related to the potential indemnification of the Individual Defendants. The Company settled any and all claims it had or may have had against Demetrius & Company, LLC, John Demetrius and Robert L. Rossi & Company in connection with the Shareholder Derivative Suit.

On September 5, 2012, Fidelity and Deposit Company of Maryland (“F&D”) filed an action against the Company and its subsidiary, First National Community Bank, as well as several current and former officers and directors of the Company, in the United States District Court for the Middle District of Pennsylvania. F&D has asserted a claim for the rescission of a directors’ and officers’ insurance policy and a bond that it had issued to the Company. On November 9, 2012, the Company and the Bank answered the claim and asserted counterclaims for the losses and expenses already incurred by the Company and the Bank. The Company and the other defendants are defending the claims and have opposed F&D’s requested relief by way of counterclaims, breaches of contract and bad faith claims against F&D for its failure to fulfill its obligations to the Company and the Bank under the insurance policy. At this time, the matter is in the discovery stage and the Company cannot reasonably determine the outcome or potential range of loss in connection with this matter.

On August 13, 2013, Steven Antonik, individually, as Administrator of the Estate of Linda Kluska, William R. Howells, and Louise A. Howells, on behalf of themselves and others similarly situated, filed a consumer protection class action against the Company and Bank in the Lackawanna County Court of Common Pleas, seeking equitable, injunction and monetary relief to address an alleged pattern and practice of wrong doing by the Bank relating to the repossession and sale of the Plaintiffs’ and class members’ financed motor vehicles. This matter is in the discovery stage. At this time the Company cannot reasonably determine the outcome or potential range of loss.

On September 17, 2013, Charles Saxe, III individually and on behalf of all others similarly situated filed a consumer class action against the Bank in the Lackawanna County Court of Common Pleas alleging violations of the Pennsylvania Uniform Commercial Code in connection with the repossession and resale of financed vehicles. This matter is in the discovery stage. At this time the Company cannot reasonably determine the outcome or potential range of loss.

The Company has been subject to tax audits and is also a party to routine litigation involving various aspects of its business, such as claims to enforce liens, condemnation proceedings on properties in which the Company holds security interests, claims involving the making and servicing of real property loans and other issues incident to its business, none of which is expected to have a material adverse impact on the consolidated financial condition, results of operations or liquidity of the Company.

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

This Quarterly Report should be read in conjunction with the more detailed and comprehensive disclosures included on the Company's Form 10-K for the year ended December 31, 2013 and the Company's Quarterly Report filed on Form 10-Q for the periods ended March 31, 2014 and June 30, 2014. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

The Company is in the business of providing customary retail and commercial banking services to individuals and businesses within its primary market located in Northeastern Pennsylvania.

### **FORWARD-LOOKING STATEMENTS**

The Company may from time to time make written or oral "forward-looking statements," including statements contained in the Company's filings with the Securities and Exchange Commission ("SEC"), in its reports to shareholders, and in other communications by the Company, which are made in good faith by the Company pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995.

These forward-looking statements include statements with respect to the Company's beliefs, plans, objectives, goals, expectations, anticipations, estimates and intentions, that are subject to significant risks and uncertainties, and are subject to change based on various factors (some of which are beyond the Company's control). The words "may," "could," "should," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan" and similar expressions are intended to identify forward-looking statements. The following factors, among others, could cause the Company's financial performance to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements: the strength of the United States economy in general and the strength of the local economies in the Company's markets; the effects of, and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System; inflation, interest rate, market and monetary fluctuations; the timely development of and acceptance of new products and services; the ability of the Company to compete with other institutions for business; the composition and concentrations of the Company's lending risk and the adequacy of the Company's reserves to manage those risks; the valuation of the Company's investment securities; the ability of the Company to pay dividends or repurchase common shares; the ability of the Company to retain key personnel; the impact of any pending or threatened litigation against the Company; the marketability of shares of the Company and fluctuations in the value of the Company's share price; the impact of the Company's ability to comply with its regulatory agreements and orders; the effectiveness of the Company's system of internal controls; the ability of the Company to attract additional capital investment; the impact of changes in financial services' laws and regulations (including laws concerning capital adequacy, taxes, banking, securities and insurance); the impact of technological changes and security risks upon the Company's information technology systems; changes in consumer spending and

saving habits; the nature, extent, and timing of governmental actions and reforms, and the success of the Company at managing the risks involved in the foregoing and other risks and uncertainties, including those detailed in the Company's filings with the SEC.

The Company cautions that the foregoing list of important factors is not all inclusive. Readers are also cautioned not to place undue reliance on any forward-looking statements, which reflect management's analysis only as of the date of this report, even if subsequently made available by the Company on its website or otherwise. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company to reflect events or circumstances occurring after the date of this report.

Readers should carefully review the risk factors described in the Annual Report and other documents that the Company periodically files with the Securities and Exchange Commission, including its Form 10-K for the year ended December 31, 2013.

## **CRITICAL ACCOUNTING POLICIES**

In preparing the consolidated financial statements, management has made estimates, judgments and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated statements of condition and results of operations for the periods indicated. Actual results could differ significantly from those estimates.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of its financial condition and results of operations. Management has identified the policies on the determination of the allowance for loan and lease losses ("ALLL"), securities valuation and impairment evaluation, and valuation of other real estate owned ("OREO") and income taxes to be critical, as management is required to make subjective and/or complex judgments about matters that are inherently uncertain and could be most subject to revision as new information becomes available.

The judgments used by management in applying the critical accounting policies discussed below may be affected by a further and prolonged deterioration in the economic environment, which may result in changes to future financial results. Specifically, subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the ALLL in future periods, and the inability to collect on outstanding loans could result in increased loan losses. In addition, the valuation of certain securities in the Company's investment portfolio could be negatively impacted by illiquidity or dislocation in marketplaces resulting in significantly depressed market prices thus leading to impairment losses.

### *Allowance for Loan and Lease Losses*

Management continually evaluates the credit quality of the Company's loan portfolio, and performs a formal review of the adequacy of the ALLL on a quarterly basis. The ALLL is established through a provision for loan losses charged to earnings and is maintained at a level management considers adequate to absorb estimated probable losses inherent in the loan portfolio as of the evaluation date. Loans, or portions of loans, determined by management to be uncollectible are charged off against the ALLL, while recoveries of amounts previously charged off are credited to the ALLL.



Determining the amount of the ALLL is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, qualitative factors, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. Various banking regulators, as an integral part of their examination of the Company, also review the ALLL. Such regulators may require, based on their judgments about information available to them at the time of their examination, that certain loan balances be charged off or require that adjustments be made to the ALLL. Additionally, the ALLL is determined, in part, by the composition and size of the loan portfolio.

The ALLL consists of two components, a specific component and a general component. The specific component relates to loans that are classified as impaired. For such loans, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers all other loans and is based on historical loss experience adjusted by qualitative factors. The general reserve component of the ALLL is based on pools of unimpaired loans segregated by loan segment and risk rating categories of "Pass", "Special Mention" or "Substandard and Accruing." Historical loss factors and various qualitative factors are applied based on the risk profile in each risk rating category to determine the appropriate reserve related to those loans. Substandard loans on nonaccrual status above the \$100 thousand loan relationship threshold and all loans considered troubled debt restructurings ("TDRs") are classified as impaired.

See Note 4 - "Loans" of the consolidated financial statements included in Item 1 hereof for additional information about the ALLL.

### *Securities Valuation*

Management utilizes various inputs to determine the fair value of its investment portfolio. To the extent they exist, unadjusted quoted market prices in active markets (Level 1) or quoted prices for similar assets or models using inputs that are observable, either directly or indirectly (Level 2) are utilized to determine the fair value of each investment in the portfolio. In the absence of observable inputs or if markets are illiquid, valuation techniques are used to determine fair value of any investments that require inputs that are both unobservable and significant to the fair value measurement (Level 3). For Level 3 inputs, valuation techniques are based on various assumptions, including, but not limited to, cash flows, discount rates, adjustments for nonperformance and liquidity, and liquidation values. A significant degree of judgment is involved in valuing investments using Level 3 inputs. The use of different assumptions could have a positive or negative effect on the consolidated statements of financial condition or results of operations. See Note 6-"Securities" and Note 7-"Fair Value Measurements" of the notes to consolidated financial statements included in Item 1 hereof for additional information about the Company's securities valuation techniques.

On a quarterly basis, management evaluates individual investment securities classified as held-to-maturity and available-for-sale having unrealized losses to determine whether or not the security is other-than-temporarily-impaired

("OTTI"). The analysis of OTTI requires the use of various assumptions, including but not limited to, the length of time an investment's fair value is less than book value, the severity of the investment's decline, any credit deterioration of the issuer, whether management intends to sell the security, and whether it is more-likely-than-not that the Company will be required to sell the security prior to recovery of its amortized cost basis. Debt investment securities deemed to be OTTI are written down by the impairment related to the estimated credit loss, and the non-credit related impairment loss is recognized in other comprehensive income. The Company did not recognize OTTI charges on investment securities for the three and nine months ended September 30, 2014 and 2013 within the consolidated statements of operations.

#### *Other Real Estate Owned*

OREO consists of property acquired by foreclosure, abandonment or conveyance of deed in-lieu of foreclosure of a loan, and bank premises that is no longer used for operation or for future expansion. OREO is held for sale and is initially recorded at fair value less costs to sell at the date of acquisition or transfer, which establishes a new cost basis. Upon acquisition of the property through foreclosure or deed-in-lieu of foreclosure, any write-down to fair value less estimated selling costs is charged to the ALLL. The determination is made on an individual asset basis. Bank premises no longer used for operations or future expansion is transferred to OREO at its fair value less estimated selling costs with any related write-down included in non-interest expense unless conditions warrant an adjustment to value, as determined by management. Subsequent to acquisition, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value less cost to sell. Fair value is determined through external appraisals, current letters of intent, broker price opinions or executed agreements of sale. Costs relating to the development and improvement of the OREO properties may be capitalized; holding period costs and any subsequent changes to the valuation allowance are charged to expense as incurred.

### *Income Taxes*

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in our consolidated financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences could impact our consolidated financial condition or results of operations.

The Company records an income tax provision or benefit based on the amount of tax currently payable or receivable and the change in deferred tax assets and liabilities. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial and tax reporting purposes. Management conducts quarterly assessments of all available evidence to determine the amount of deferred tax assets that will more-likely-than-not be realized. The available evidence used in connection with these assessments includes taxable income in current and prior periods, cumulative losses in prior periods, projected future taxable income, potential tax-planning strategies, and projected future reversals of deferred tax items. Management's assumptions and estimates take into consideration its interpretation of tax laws and possible outcomes of current and future audits conducted by tax authorities. These assessments involve a certain degree of subjectivity which may change significantly depending on the related circumstances. If actual results differ from the assumptions and other considerations used in estimating the amount and timing of tax recognized, there can be no assurance that additional expenses will not be required in future periods.

In connection with determining the income tax provision or benefit, the Company considers maintaining liabilities for uncertain tax positions and tax strategies that management believes contain an element of uncertainty. Periodically, the Company evaluates each of its tax positions and strategies to determine whether a liability for uncertain tax benefits is required. As of September 30, 2014 and December 31, 2013, the Company did not have any uncertain tax positions or tax strategies and no liability was required to be recorded.

### **New Authoritative Accounting Guidance**

ASU 2013-11, Income Taxes (Topic 740): "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," requires an unrecognized tax benefit, or a portion of an unrecognized tax benefit, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. If a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date, the unrecognized tax benefit should be presented in the financial statements as a liability and not combined with deferred tax assets. The Company adopted ASU 2013-11 on January 1, 2014. The adoption of this new guidance did not have an effect on the operating results or financial position of the Company.

### **Accounting Guidance to be Adopted in Future Periods**

ASU 2014-04, Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure,” clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (a) the creditor obtaining legal title to residential real estate property upon completion of a foreclosure or (b) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. This guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014, with early adoption permitted. The adoption of this guidance on January 1, 2015 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): “Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,” changes the criteria for reporting a discontinued operation. Under the new guidance, a disposal of a component of an entity or group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on the entity’s operations and financial results. This new guidance reduces the complexity by removing the complex and extensive implementation guidance and illustrations that are necessary to apply the current definition of a discontinued operation. The new guidance also requires expanded disclosures about discontinued operations that will provide users with more information about the assets, liabilities, revenues and expenses of a discontinued operation and will require pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting, which will provide users with information about the ongoing trends in a reporting organization’s results from continuing operations. Public companies and not-for-profit organizations that have issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market should apply the new guidance prospectively to all disposals (or classifications as held for sale) of components of an organization and all business or nonprofit activities that, on acquisition, are classified as held for sale that occur within annual periods beginning on or after December 15, 2014, and interim periods within those years. The adoption of this guidance on January 1, 2015 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-09, Revenue from Contracts with Customers (Topic 606): Section A, “Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs-Contract with Customers (Subtopic 340-40);” Section B, “Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables;” and Section C, “Background Information and Basis for Conclusions,” provides a robust framework for addressing revenue recognition issues, upon its effective date, replaces almost all existing revenue recognition guidance, including industry specific guidance, in current GAAP. The core principle of ASU 2014-09 is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 will also result in enhanced interim and annual disclosures, both qualitative and quantitative, about revenue in order to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. ASU 2014-09 is effective in annual reporting periods beginning after December 15, 2016 and the interim periods within that year for public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or over-the-counter market and employee benefit plans that file or furnish financial statements to the SEC. Accordingly, the Company will adopt this guidance on January 1, 2017 and is currently evaluating the effect this guidance may have on its operating results or financial position.

ASU 2014-11, Transfers and Servicing (Topic 860): “Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures,” changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements by aligning the accounting for these transactions with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward arrangement, which has resulted in outcomes referred to as off-balance sheet accounting. ASU 2014-11 also requires a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction, and requires expanded disclosure about the nature of the collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. Accounting changes in ASU 2014-11 are effective for public companies for interim and annual periods beginning after December 15, 2014. In addition, the disclosure for certain transactions accounted for as a sale is effective for the first interim or annual period beginning on or after December 15, 2014, and the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. The adoption of this guidance on the appropriate effective dates is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-12, Compensation – Stock Compensation (Topic 718): “Accounting for Share-Based Payments When the Terms of an Award Provide that a Performance Target Could be Achieved after the Requisite Service Period,” requires a performance target that affects vesting and that can be achieved after the requisite service period to be treated as a performance condition. To account for such awards, an entity should apply existing guidance as it relates to awards with performance conditions that affect vesting. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service periods. The total amount of compensation cost

should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-14, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure,” requires that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure; (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. ASU 2014-14 is effective for public companies for interim and annual periods beginning after December 15, 2014. For all other entities, the new standard is effective for annual periods ending after December 15, 2015 and interim periods beginning after December 15, 2015. The adoption of this guidance on January 1, 2015 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern,” defines management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and provide guidance for related footnote disclosures. ASU 2014-15 require an entity’s management to assess the entity’s ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically ASU 2014-15: (1) provides a definition of the term substantial doubt; (2) requires an evaluation as to whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable); (3) provides principles for considering the mitigating effect of management’s plans; (4) requires certain disclosures when substantial doubt is alleviated; and (5) requires an express statement and other disclosures when substantial doubt is not alleviated. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The adoption of this guidance on December 31, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

## **Executive Summary**

The following overview should be read in conjunction with this Management’s Discussion and Analysis in its entirety.

Management continued to take proactive measures in order to reduce risk, improve asset quality and strengthen the Company’s and the Bank’s capital positions. In addition to these strategies, management focused on improving efficiency through management of its net interest margin, profit enhancement initiatives aimed at developing new sources of non-interest revenue, reducing the level of non-interest expense, improving processes and reevaluating current staffing requirements.

The Company recorded net income of \$3.4 million, or \$0.20 per diluted common share, for the three month period ended September 30, 2014, an increase of \$1.5 million, or 78.9%, compared to net income of \$1.9 million, or \$0.11 per diluted common share, for the comparable three months of 2013. The earnings improvement was due primarily to increases in non-interest income and net interest income, partially offset by a decrease in the credit for loan and lease losses. Net income for the nine months ended September 30, 2014 was \$13.5 million or \$0.82 per diluted common share, an increase of \$9.2 million, compared to net income of \$4.3 million, or \$0.26 per diluted common share, for the same period of 2013. The annualized return on average equity was 26.81% and 41.43%, respectively, for the three- and nine-month periods ended September 30, 2014, compared to 23.27% and 16.80% for the comparable periods in 2013. For the three and nine months ended September 30, the annualized return on average assets was 1.38% and 1.85%, respectively, in 2014 and 0.78% and 0.62%, respectively in 2013. The Company did not pay any dividends during the three or nine months ended September 30, 2014 and 2013.

The \$1.5 million earnings improvement for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013, was largely due to a \$2.0 million increase in non-interest income, which resulted primarily from an increase in gains on the sale of available-for-sale securities of \$2.1 million. Also favorably affecting the Company's earnings performance was a \$434 thousand, or 6.8%, increase in net interest income and a decrease in non-interest expense of \$281 thousand, or 3.5%. Partially offsetting these positive factors was a \$1.1 million decrease in the credit for loan and lease losses, and a \$166 thousand increase in the provision for incomes taxes.

The 6.8% increase in net interest income for the three months ended September 30, 2014 was due primarily to a \$311 thousand decrease in interest expense, coupled with a \$123 thousand increase in interest income. The decrease in interest expense was the result of management's strategy to replace above market rate deposits with low-cost FHLB advances. With regard to the 3.5% decrease in non-interest expense, the Company experienced reductions in FDIC and OCC assessments, bank shares tax and legal expenses, which were partially offset by an increase in other operating expenses primarily related to a loss recorded on the abandonment of software.

Year-to-date net income improved \$9.2 million, or 214.0%, comparing the nine months ended September 30, 2014 and 2013. The improvement was primarily due to a \$5.7 million increase in non-interest income, a \$3.2 million increase in the credit for loan and lease losses, and a \$1.0 million increase in net interest income. Partially offsetting these positive factors was a \$458 thousand increase in non-interest expense. With regard to non-interest income, the Company realized net gains on the sale of securities of \$6.0 million for the nine months ended September 30, 2014, an increase of \$3.4 million compared to \$2.6 million for the same nine months of 2013.

During the second quarter of 2014, the Company received a substantial legal settlement in the amount of \$5.8 million resulting from judgments filed by the Company pursuant to a large credit relationship. Of the total amount received, \$3.6 million represented full recovery of previously charged-off loans, which was the primary factor leading to the increase in the credit for loan and lease losses. The remainder of the settlement represented satisfaction of all past due interest and late charges and reimbursement of all legal fees and other related expenses associated with these credits incurred and paid by the Company. In addition, the settlement contributed \$1.8 million to the overall \$5.7 million increase in non-interest income for the nine months ended September 30, 2014.



In the third quarter of 2013, the Company entered into a Branch Purchase and Deposit/Loan Assumption Agreement (the “Branch Purchase Agreement”) with ESSA Bank and Trust (“ESSA”) for ESSA to acquire certain assets and liabilities of the Bank’s Marshalls Creek and Stroudsburg branches, both located in Monroe County, Pennsylvania. Pursuant to this transaction, which closed on January 24, 2014, the Bank sold deposits of \$8.8 million, real and personal property of \$2.5 million and loans of \$1.1 million. The Company realized a net gain on the branch divestiture of \$607 thousand, which is included in non-interest income in the Consolidated Statements of Operations for the nine months ended September 30, 2014.

Total assets decreased \$21.7 million, or 2.2%, to \$982.1 million at September 30, 2014 as compared to \$1.0 billion at December 31, 2013. The balance sheet contraction primarily reflected an \$81.5 million, or 9.2%, reduction in total deposits, to \$803.2 million at September 30, 2014, from \$884.7 million at December 31, 2013. Interest-bearing deposits decreased \$72.4 million, or 10.0%, while non-interest bearing demand deposits decreased by \$9.1 million, or 5.8%. The decrease in deposits reflected cyclical deposit trends related to the Company’s municipal customers, a reduction in the deposit relationship of a large commercial customer, the sale of the Monroe County branches and continued runoff of certificates of deposit due to the sustained low interest rate environment. The Company experienced strong loan demand, as loans, net of unearned income, net deferred loan fees and costs and the ALLL, increased \$36.4 million, or 5.8%. As a result of these factors, cash and cash equivalents decreased \$63.6 million, while advances from the Federal Home Loan Bank of Pittsburgh (“FHLB”) grew \$41.7 million.

Total shareholders’ equity increased \$16.7 million, or 49.9%, to \$50.3 million at September 30, 2014 from \$33.6 million at December 31, 2013. The capital improvement resulted primarily from net income of \$13.5 million, coupled with a \$3.2 million increase in accumulated other comprehensive income, which resulted entirely from appreciation in the fair value of available-for-sale securities offset by the tax impact of the appreciation. At September 30, 2014, the Bank’s total risk-based capital and Tier I leverage ratios were 15.28% and 10.05%, respectively, which well exceed the respective 13.00% and 9.00% ratios required by the OCC Consent Order.

On May 24, 2012, a putative shareholder filed a complaint in the Court of Common Pleas for Lackawanna County (“Shareholder Derivative Suit”) against certain present and former directors and officers of the Company (the “Individual Defendants”) alleging, inter alia, breach of fiduciary duty, abuse of control, corporate waste, and unjust enrichment. The Company was named as a nominal defendant. The parties to the Shareholder Derivative Suit commenced settlement discussions and on December 18, 2013, the Court entered an Order Granting Preliminary Approval of Proposed Settlement subject to notice to shareholders. On February 4, 2014, the Court issued a Final Order and Judgment for the matter granting approval of a Stipulation of Settlement (the “Settlement”) and dismissing all claims against the Company and the Individual Defendants. As part of the Settlement, there was no admission of liability by the Individual Defendants. Pursuant to the Settlement, the Individual Defendants, without admitting any fault, wrongdoing or liability, agreed to settle the derivative litigation for \$5.0 million. The \$5.0 million Settlement payment was made to the Company on March 28, 2014. The Individual Defendants reserved their rights to indemnification under the Company’s Articles of Incorporation and Bylaws, resolutions adopted by the Board, the Pennsylvania Business Corporation Law and any and all rights they have against the Company’s and the Bank’s insurance carriers. In accordance therewith, the Company had recorded a \$5.0 million liability for this indemnification in other liabilities. The Company netted the income related to the receipt of the \$5.0 million Settlement payment and the \$5.0 million expense associated with recording the liability to indemnify the Individual Defendants and therefore there was no

effect on the operating results of the Company for the nine months ended September 30, 2014. In addition, in conjunction with the Settlement, the Company accrued \$2.5 million related to fees and costs of the plaintiff's attorneys, which was included in non-interest expense in the consolidated statements of operations for the year ended December 31, 2013. On April 1, 2014, the Company paid the \$2.5 million related to the fees and costs of the plaintiff's attorneys, and paid \$2.5 million as partial indemnification to the Individual Defendants, and, as such, as of September 30, 2014, \$2.5 million remains accrued in other liabilities related to the potential indemnification of the Individual Defendants. The Company settled any and all claims it had or may have had against Demetrius & Company, LLC, John Demetrius and Robert L. Rossi & Company in connection with the Shareholder Derivative Suit.

## **Summary of Performance**

### **Net Interest Income**

Net interest income is the difference between (i) interest income - interest and fees on interest-earning assets, and (ii) interest expense - interest paid on the Company's deposits and borrowed funds. Net interest income represents the largest component of the Company's operating income and, as such, is the primary determinant of profitability. Net interest income is impacted by variations in the volume, rate and composition of earning assets and interest-bearing liabilities, changes in general market rates and the level of non-performing assets. Interest income is shown on a fully tax-equivalent basis and is calculated by adjusting tax-free interest using a marginal tax rate of 34.0% in order to equate the yield to that of taxable interest rates. Net interest income on a tax-equivalent basis increased \$243 thousand to \$7.2 million from \$6.9 million comparing the three-month periods ending September 30, 2014 and 2013. In addition, the Company's tax-equivalent net interest margin for the three months ended September 30, 2014 improved 3 basis points to 3.18% in 2014 from 3.15% in 2013. Tax-equivalent net interest margin, a key measurement used in the banking industry to measure income from earning assets relative to the cost to fund those assets, is calculated by dividing tax-equivalent net interest income by average interest-earning assets. The margin improvement was primarily due to a 14 basis point decrease in average funding costs. Rate spread, the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities shown on a fully tax-equivalent basis, was stable at 3.04% for the three months ended September 30, 2014.

The \$243 thousand increase in tax-equivalent net interest income for the third quarter was due to a decrease in interest expense, partially offset by a reduction in tax-equivalent interest income. For the three months ended September 30, 2014, interest expense decreased \$311 thousand, or 17.2%, to \$1.5 million from \$1.8 million for the same three months of 2013. The decrease in interest expense primarily reflected a 14 basis point reduction in the cost of funds to 0.80% for the three months ended September 30, 2014 from 0.94% for the same three months of 2013. The reduction in funding costs resulted primarily from a 175 basis point decrease in the cost of borrowed funds, coupled with a 12 basis point decrease in the cost of interest-bearing deposits, which caused corresponding decreases in interest expense of \$616 thousand and \$109 thousand, respectively. With regard to average balances of interest-bearing liabilities for the third quarter, interest bearing deposits decreased \$58.5 million, or 8.4% to \$640.4 million in 2014 from \$698.9 million in 2013. Despite the decrease, volume changes in average interest-bearing liabilities resulted in additional interest expense of \$414 thousand. Comparing the third quarters of 2014 and 2013, total average deposits decreased \$58.5 million, or 8.4%, and resulted in a corresponding decrease to interest expense of \$177 thousand, while average borrowed funds increased \$43.4 million, or 61.4%, which resulted in additional interest expense of \$591 thousand.

Interest income on a tax-equivalent basis decreased \$68 thousand to \$8.7 million three months ended September 30, 2014 compared to \$8.8 million in 2013. The decrease resulted primarily from a 14 basis point decrease in the tax-equivalent yield on average earning assets to 3.84% in 2014, compared to 3.98% for the same period in 2013, coupled with a negative volume variance due to changes in the average balances of interest-earning assets. Specifically, the tax-equivalent yield on average securities fell 36 basis points, while the tax-equivalent yield on average loans decreased 15 basis points for the three months ended September 30, 2014 compared to the same period in 2013. With respect to investment securities, as part of tax planning strategies and an effort to reduce potential credit and concentration risk within the portfolio, the Company continued to sell certain tax-free municipal bonds during three months ended September 30, 2014. The proceeds were reinvested in U.S. government-sponsored agency bonds and mortgage-backed securities. The decrease in loan yields reflected increased market competition, as well as the Company's asset/liability strategy which focused on originating loans with adjustable interest rates in order to position the balance sheet to react favorably to a rise in market interest rates. Changes in the volumes of earning assets resulted in a \$19 thousand decrease in tax-equivalent interest income, despite a \$24.1 million, or 2.7%, increase in average earning assets, as the effect of the reduction in average tax-free municipal securities overshadowed the effects of increases in average loans and taxable securities. Specifically, a \$27.7 million decrease in average tax-free securities resulted in a corresponding decrease to tax-equivalent interest income of \$476 thousand, which was only partially mitigated by increases of \$42.2 million in average taxable securities and \$24.7 million in total average loans. The increases in average taxable securities and average total loans resulted in additional interest income of \$211 thousand and \$254 thousand, respectively, comparing the three months ended September 30, 2014 and 2013.

For the nine months ended September 30, 2014, net interest income on a tax equivalent basis increased \$466 thousand to \$21.4 million from \$20.9 million for the comparable period in 2013. Similar to the quarterly results, a decrease in interest expense more than entirely offset a decrease in tax-equivalent interest income. For the nine months ended September 30, interest expense decreased \$863 thousand, or 15.7%, to \$4.6 million in 2014 from \$5.5 million in 2013. The reduction in interest expense resulted primarily from a 17 basis point decrease in the cost of funds, which caused a decrease to interest expense of \$2.1 million. Specifically, the cost of borrowed funds decreased 199 basis points and the cost of interest-bearing deposits declined 13 basis points, which resulted in corresponding decreases to interest expense of \$1.7 million and \$464 thousand, respectively. Partially offsetting the reduction in interest expense due to changes in rates was a \$12.3 million, or 1.6% increase in average interest-bearing liabilities to \$770.3 million for the nine months ended September 30, 2014 from \$758.0 million for the same nine month period in 2013. Specifically, for

the nine months ended September 30, 2014, average borrowed funds increased \$33.5 million, or 57.4%, while average interest-bearing deposits decreased \$21.2 million. Changes in the average volumes of interest-bearing liabilities resulted in additional interest expense of \$1.3 million for the nine months ended September 30, 2014.

Tax-equivalent interest income on a year-to-date basis decreased \$397 thousand, or 1.5%, to \$26.0 million in 2014 from \$26.4 million in 2013, due to a reduction in the tax-equivalent yield on earning assets, partially offset by an increase in average earning assets. The tax-equivalent yield on earning assets decreased 24 basis points to 3.82% in 2014 from 4.06% in 2013, which caused a corresponding decrease to tax-equivalent interest income of \$828 thousand. Specifically, the tax-equivalent yield on the loans decreased 28 basis points, which resulted in a reduction in interest income of \$1.3 million comparing the year-to-date periods of 2014 and 2013. Partially offsetting this decrease was an increase in interest income of \$502 thousand due to changes in yields on securities. The yield on taxable securities increased 50 basis points to 2.28% for the nine months ended September 30, 2014 from 1.78% for the same period of 2013. This increase in yield resulted in additional interest income of \$563 thousand, which more than offset a \$61 thousand decrease in interest income due to an 11 basis point reduction in the yield on tax-free securities. Average earning assets increased \$40.7 million, or 4.7%, which resulted in additional interest income of \$431 thousand. Specifically, average total loans increased \$34.7 million, or 5.5%, causing an increase in interest income of \$1.1 million. Partially offsetting the increase in interest income due to changes in loan volume, was a \$658 thousand decrease due to changes in volumes of taxable and tax-free securities. Specifically, a \$25.0 million decrease in average tax-free securities caused a decrease in interest income of \$1.3 million, which was partially mitigated by a \$664 thousand increase due to a \$43.2 million increase in average taxable securities.

Net interest income depends upon the relative amount of interest-earning assets and interest-bearing liabilities and the interest rate earned or paid on them. The following tables present certain information relating to our consolidated statements of financial condition and operations for the three- and nine-month periods ended September 30, 2014 and 2013, and reflect the average yield on assets and average cost of liabilities for the periods indicated. Such yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods shown. Average balances are derived from average daily balances. The yields include amortization of fees which are considered adjustments to yields.

| (dollars in thousands)   | Three months ended September<br>30, 2014 |          |                | Three months ended September<br>30, 2013 |          |                |
|--|--|----------|----------------|--|----------|----------------|
|  | Average<br>Balance                       | Interest | Yield/<br>Cost | Average<br>Balance                       | Interest | Yield/<br>Cost |
| <b>ASSETS</b>  |  |          |                |  |          |                |
| Earning assets (2)(3)  |  |          |                |  |          |                |
| Loans-taxable(4)   | \$ 635,032                               | \$ 6,524 | 4.11 %         | \$ 608,799                               | \$ 6,486 | 4.26 %         |
| Loans-tax free (4)   | 39,849                                   | 497      | 4.99 %         | 41,412                                   | 526      | 5.08 %         |
| Total loans (1)(2)   | 674,881                                  | 7,021    | 4.16 %         | 650,211                                  | 7,012    | 4.31 %         |
| Securities-taxable   | 177,863                                  | 1,043    | 2.35 %         | 135,614                                  | 578      | 1.70 %         |
| Securities-tax free  | 36,246                                   | 620      | 6.84 %         | 63,912                                   | 1,153    | 7.22 %         |
| Total securities (1)(5)  | 214,109                                  | 1,663    | 3.11 %         | 199,526                                  | 1,731    | 3.47 %         |
| Interest-bearing deposits in other banks<br>and federal funds sold | 15,983                                   | 8        | 0.20 %         | 31,166                                   | 17       | 0.22 %         |
| Total earning assets   | 904,973                                  | 8,692    | 3.84 %         | 880,903                                  | 8,760    | 3.98 %         |
| Non-earning assets   | 74,828                                   |          |                | 92,294                                   |          |                |
| Allowance for loan and lease losses                                | (12,246 )                                |          |                | (18,744 )                                |          |                |
| Total assets   | \$ 967,555                               |          |                | \$ 954,453                               |          |                |
| <b>LIABILITIES AND SHAREHOLDERS'<br/>EQUITY</b>                    |  |          |                |  |          |                |
| Interest-bearing liabilities                                       |  |          |                |  |          |                |
| Interest-bearing demand deposits                                   | \$ 301,472                               | 101      | 0.13 %         | \$ 285,245                               | 124      | 0.17 %         |
| Savings deposits   | 88,821                                   | 14       | 0.06 %         | 86,831                                   | 21       | 0.10 %         |
| Time deposits over \$100,000                                       | 120,452                                  | 239      | 0.79 %         | 173,052                                  | 339      | 0.78 %         |
| Other time deposits  | 129,649                                  | 397      | 1.22 %         | 153,788                                  | 553      | 1.44 %         |
| Total interest-bearing deposits                                    | 640,394                                  | 751      | 0.47 %         | 698,916                                  | 1,037    | 0.59 %         |
| Borrowed funds and other<br>interest-bearing liabilities           | 114,137                                  | 750      | 2.63 %         | 70,730                                   | 775      | 4.38 %         |
| Total interest-bearing liabilities                                 | 754,531                                  | 1,501    | 0.80 %         | 769,646                                  | 1,812    | 0.94 %         |
| Demand deposits  | 137,992                                  |          |                | 133,059                                  |          |                |
| Other liabilities  | 25,337                                   |          |                | 19,581                                   |          |                |
| Shareholders' equity   | 49,695                                   |          |                | 32,167                                   |          |                |
| Total liabilities and shareholders' equity                         | \$ 967,555                               |          |                | \$ 954,453                               |          |                |
| Net interest income/interest rate spread<br>(6)                    |  | 7,191    | 3.04 %         |  | 6,948    | 3.04 %         |
| Tax equivalent adjustment  |  | (380 )   |                |  | (571 )   |                |
| Net interest income as reported                                    |  | \$ 6,811 |                |  | \$ 6,377 |                |
| Net interest margin (7)  |  |          | 3.18 %         |  |          | 3.15 %         |

(1) Interest income is presented on a tax equivalent basis using a 34% rate.

(2) Loans are stated net of unearned income.

(3) Non-accrual loans are included in loans within earning assets.

(4) Loan fees included in interest income are not significant.

(5) The yields for securities that are classified as available-for-sale are based on the average historical amortized cost.

- (6) Interest rate spread represents the difference between the average yield on interest-earning assets and the cost of interest-bearing liabilities and is presented on a tax-equivalent basis.
- (7) Net interest income as a percentage of total average interest earning assets.

| (dollars in thousands)   | Nine months ended September 30,<br>2014 |           |                | Nine months ended September 30,<br>2013 |           |                |
|--|---|-----------|----------------|---|-----------|----------------|
|  | Average<br>Balance                      | Interest  | Yield/<br>Cost | Average<br>Balance                      | Interest  | Yield/<br>Cost |
| <b>ASSETS</b>  |   |           |                |   |           |                |
| Earning assets (2)(3)  |   |           |                |   |           |                |
| Loans-taxable (4)  | \$ 622,877                              | \$ 18,976 | 4.06 %         | \$ 590,494                              | \$ 19,147 | 4.32 %         |
| Loans-tax free (4)   | 40,334                                  | 1,488     | 4.92 %         | 37,986                                  | 1,532     | 5.38 %         |
| Total loans (1)(2)   | 663,211                                 | 20,464    | 4.11 %         | 628,480                                 | 20,679    | 4.39 %         |
| Securities-taxable   | 173,883                                 | 2,973     | 2.28 %         | 130,705                                 | 1,746     | 1.78 %         |
| Securities-tax free  | 48,103                                  | 2,544     | 7.05 %         | 73,080                                  | 3,927     | 7.16 %         |
| Total securities (1)(5)  | 221,986                                 | 5,517     | 3.31 %         | 203,785                                 | 5,673     | 3.71 %         |
| Interest-bearing deposits in other banks<br>and federal funds sold | 24,188                                  | 44        | 0.24 %         | 36,438                                  | 70        | 0.26 %         |
| Total earning assets   | 909,385                                 | 26,025    | 3.82 %         | 868,703                                 | 26,422    | 4.06 %         |
| Non-earning assets   | 74,669                                  |           |                | 90,718                                  |           |                |
| Allowance for loan and lease losses                                | (13,446 )                               |           |                | (18,915 )                               |           |                |
| Total assets   | \$ 970,608                              |           |                | \$ 940,506                              |           |                |
| <b>LIABILITIES AND SHAREHOLDERS'<br/>EQUITY</b>                    |   |           |                |   |           |                |
| Interest-bearing liabilities                                       |   |           |                |   |           |                |
| Interest-bearing demand deposits                                   | \$ 312,487                              | 315       | 0.13 %         | \$ 294,414                              | 432       | 0.20 %         |
| Savings deposits   | 88,372                                  | 44        | 0.07 %         | 85,873                                  | 75        | 0.12 %         |
| Time deposits over \$100,000                                       | 142,998                                 | 831       | 0.77 %         | 158,953                                 | 982       | 0.82 %         |
| Other time deposits  | 134,607                                 | 1,245     | 1.23 %         | 160,404                                 | 1,736     | 1.44 %         |
| Total interest-bearing deposits                                    | 678,464                                 | 2,435     | 0.48 %         | 699,644                                 | 3,225     | 0.61 %         |
| Borrowed funds and other<br>interest-bearing liabilities           | 91,822                                  | 2,189     | 3.18 %         | 58,328                                  | 2,262     | 5.17 %         |
| Total interest-bearing liabilities                                 | 770,286                                 | 4,624     | 0.80 %         | 757,972                                 | 5,487     | 0.97 %         |
| Demand deposits  | 132,378                                 |           |                | 127,574                                 |           |                |
| Other liabilities  | 24,537                                  |           |                | 20,441                                  |           |                |
| Shareholders' equity   | 43,407                                  |           |                | 34,519                                  |           |                |
| Total liabilities and shareholders' equity                         | \$ 970,608                              |           |                | \$ 940,506                              |           |                |
| Net interest income/interest rate spread<br>(6)                    |   | 21,401    | 3.02 %         |   | 20,935    | 3.09 %         |
| Tax equivalent adjustment  |   | (1,371 )  |                |   | (1,856 )  |                |
| Net interest income as reported                                    |   | \$ 20,030 |                |   | \$ 19,079 |                |
| Net interest margin (7)  |   |           | 3.14 %         |   |           | 3.21 %         |

(1) Interest income is presented on a tax equivalent basis using a 34% rate.

(2) Loans are stated net of unearned income.

(3) Non-accrual loans are included in loans within earning assets.

(4) Loan fees included in interest income are not significant.

(5) The yields for securities that are classified as available-for-sale are based on the average historical amortized cost.

(6)



Interest rate spread represents the difference between the average yield on interest-earning assets and the cost of interest-bearing liabilities and is presented on a tax-equivalent basis.

(7) Net interest income as a percentage of total average interest earning assets.

### **Rate Volume Analysis**

The most significant impact on net income between periods is derived from the interaction of changes in the volume and rates earned or paid on interest-earning assets and interest-bearing liabilities. The volume of earning assets, specifically loans and investments, compared to the volume of interest-bearing liabilities represented by deposits and borrowings, combined with the spread, produces the changes in net interest income between periods. Components of interest income and interest expense are presented on a tax-equivalent basis using the statutory federal income tax rate of 34%.

The following table summarizes the effect that changes in volumes of earning assets and interest-bearing liabilities and the interest rates earned and paid on these assets and liabilities have on net interest income comparing the three and nine months ended September 30, 2014 and 2013. The net change or mix component attributable to the combined impact of rate and volume changes has been allocated proportionately to the change due to volume and the change due to rate.

| (in thousands)  | Three Months Ended September 30, 2014 vs. 2013 |           |        | Nine Months Ended September 30, 2014 vs. 2013 |             |           |
|---|--|-----------|--------|---|-------------|-----------|
|   | Increase (Decrease) due to change in           |           |        | Increase (Decrease) due to change in          |             |           |
|   | Volume   | Rate      | Total  | Volume  | Rate        | Total     |
| <b>Interest income:</b>   |  |           |        |   |             |           |
| Loans - taxable   | \$ 274   | \$ (236 ) | \$ 38  | \$ 1,020                                      | \$ (1,191 ) | \$ (171 ) |
| Loans - tax free  | (20 )  | (9 )      | (29 )  | 91  | (135 )      | (44 )     |
| Total loans   | 254  | (245 )    | 9      | 1,111   | (1,326 )    | (215 )    |
| Securities - taxable  | 211  | 254       | 465    | 664   | 563         | 1,227     |
| Securities - tax free   | (476 )   | (57 )     | (533 ) | (1,322 )                                      | (61 )       | (1,383 )  |
| Total securities  | (265 )   | 197       | (68 )  | (658 )  | 502         | (156 )    |
| Interest-bearing deposits in other banks and federal funds sold | (8 )   | (1 )      | (9 )   | (22 )   | (4 )        | (26 )     |
| Total interest income   | (19 )  | (49 )     | (68 )  | 431   | (828 )      | (397 )    |
| <b>Interest expense:</b>  |  |           |        |   |             |           |
| Interest-bearing demand deposits                                | 7  | (30 )     | (23 )  | 25  | (142 )      | (117 )    |
| Savings deposits  | -  | (7 )      | (7 )   | 2   | (33 )       | (31 )     |
| Time deposits over \$100,000                                    | (104 )   | 4         | (100 ) | (95 )   | (56 )       | (151 )    |
| Other time deposits   | (80 )  | (76 )     | (156 ) | (258 )  | (233 )      | (491 )    |
| Total interest-bearing deposits                                 | (177 )   | (109 )    | (286 ) | (326 )  | (464 )      | (790 )    |
| Borrowed funds and other interest-bearing liabilities           | 591  | (616 )    | (25 )  | 1,598   | (1,671 )    | (73 )     |
| Total interest expense  | 414  | (725 )    | (311 ) | 1,272   | (2,135 )    | (863 )    |
| Net interest income   | \$ (433 )                                      | \$ 676    | \$ 243 | \$ (841 )                                     | \$ 1,307    | \$ 466    |

### Provision for Loan and Lease Losses

Management closely monitors the loan portfolio and the adequacy of the ALLL, considering underlying borrower financial performance and collateral values and associated credit risks. Future material adjustments may be necessary to the provision for loan and lease losses and the ALLL if economic conditions or loan performance differ substantially from the assumptions management used in making its evaluation of the ALLL. The provision for loan and lease losses is an expense charged against net interest income to provide for estimated losses attributable to uncollectible loans and is based on management's analysis of the adequacy of the ALLL. A credit for loan and lease losses reflects the reversal of amounts previously charged to the ALLL.

Credits for loan and lease losses of \$54 thousand and \$5.6 million were recorded for the three- and nine-month periods ended September 30, 2014, respectively, compared to credits of \$1.2 million and \$2.4 million, respectively, for the same periods in the prior year. The \$3.2 million increase in the credit for loan and lease losses for the nine months ended September 30, 2014 was primarily attributable to the full recovery of \$3.6 million in previously charged-off commercial real estate loans.

Non-performing loans decreased \$0.8 million to \$5.6 million from \$6.4 million at December 31, 2013. The Company recorded net recoveries of \$3.5 million for the nine months ended September 30, 2014, compared to net recoveries of \$1.5 million for the same nine months of 2013. Non-performing loans primarily consist of loans secured by real estate. Management closely monitors the loan portfolio and the adequacy of the ALLL considering underlying borrower financial performance and collateral values and increasing credit risks.

### **Non-interest Income**

Non-interest income totaled \$4.4 million for the three months ended September 30, 2014, an increase of \$2.0 million from the \$2.4 million earned during the comparable period in 2013. The increase in third quarter non-interest income was primarily a result of an increase in net gains on the sale of available-for-sale securities of \$2.1 million to \$2.9 million in 2014 from \$0.8 million in 2013.

Non-interest income amounted to \$12.9 million for the nine months ended September 30, 2014, an increase of \$5.7 million from \$7.2 million for the nine months ended September 30, 2013. The year-to-date increase in non-interest income was primarily attributable a \$3.4 million increase in net gains on the sale of investment securities, a \$1.8 million increase related to the legal settlement received in the second quarter of 2014 as discussed below and a \$0.6 million net gain on the divestiture of the Company's Monroe County branch offices.

As previously mentioned, the Company received a substantial legal settlement in the amount of \$5.8 million resulting from judgments filed by the Company pursuant to a large credit relationship. Of the total amount received, \$3.6 million represented full recovery of previously charged-off loans, which was the primary factor leading to the increase in the credit for loan and lease losses. The remainder of the settlement represented satisfaction of all past due interest and late charges and reimbursement of all legal fees and other related expenses associated with these credits incurred and paid by the Company. In addition, the settlement contributed \$1.8 million to the overall \$5.7 million increase in non-interest income for the nine months ended September 30, 2014.

### **Non-interest Expense**

For the three months ended September 30, 2014, non-interest expense decreased \$0.3 million, or 3.5%, to \$7.8 million, from \$8.1 million for the same three months of 2013. The decrease resulted primarily from reductions in FDIC and OCC assessments, bank shares tax, legal expense and insurance expense, partially offset by an increase in other operating expense. On a year-to-date basis, non-interest expense increased \$0.4 million to \$24.7 million in 2014 from \$24.3 million in 2013. The increase in year-to-date non-interest expense resulted primarily from increases in the expense of other real estate owned and other operating expenses, partially offset by reductions in the expense categories mentioned above for the three-month change.

For the nine months ended September 30, 2014, expenses associated with other real estate owned increased \$1.7 million to \$2.5 million from \$0.8 million for the same period of 2013. The Company recorded valuation adjustments to the cost basis of several OREO properties totaling \$2.2 million. The valuation adjustments reflected the continued decline in real estate values for properties located in Monroe County, Pennsylvania. In addition, the Company adjusted the cost basis of four OREO properties to liquidation value, as these properties were approaching the five-year regulatory holding period threshold.

Year-to-date other operating expenses increased \$500 thousand to \$2.8 million in 2014 from \$2.3 million in 2013. This increase was largely due to a \$352 thousand loss recorded on the abandonment of software.

During the second quarter of 2014, the Company was notified by the Federal Deposit Insurance Corporation (“FDIC”) that its risk category for FDIC assessments had improved from a risk category III to a risk category II based upon the Company’s most recent regulatory examination. Due to the change in risk categories, the Company’s initial base assessment rate for deposit insurance decreased from 0.23 basis points to 0.14 basis points, which was effective with the first assessment period of 2014. The changes in assessment rates resulted in decreases in regulatory assessments of \$337 thousand and \$474 thousand for the three months and nine months ended September 30, 2014 and 2013, respectively.

As a result of the resolution of certain long-standing litigation, legal expense declined \$389 thousand and \$410 thousand for the three months and nine months ended September 30, 2014. The Company anticipates a continued decline in future legal expenses as outstanding litigation continues to be resolved.

Bank shares tax decreased \$220 thousand and \$351 thousand for the three and nine months ended September 30, 2014 due to a reduction in the tax rate enacted in the Commonwealth of Pennsylvania effective January 1, 2014.

During the second quarter of 2014, the Company's professional liability, fidelity bond and errors and omissions insurance policies were renewed at lower rates for the upcoming insurance period. As a result, the Company's insurance expense recorded during the three months and nine months ended September 30, 2014 decreased \$83 thousand and \$141 thousand, respectively. The Company anticipates its insurance expense to continue to decrease for the remainder of 2014.

### **Provision for Income Taxes**

The determination of the amount of deferred income taxes which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change in response to economic conditions and other factors. A valuation allowance related to deferred tax assets is required by GAAP when it is considered more likely than not that all or part of the benefit related to such assets will not be realized. The Company's deferred tax position has been affected by several significant transactions that occurred in prior years. These transactions included the provision for loan losses, the level of non-accrual loans, valuation of other real estate owned and other-than-temporary impairment losses incurred on certain available-for-sale securities, and resulted in the Company being in a cumulative deficit position since 2009. Accordingly, under applicable accounting guidance, the Company established a full valuation allowance for its net deferred tax assets. At September 30, 2014 and December 31, 2013, the Company had established valuations allowances related to net deferred tax assets of \$30.5 million and \$34.1 million, respectively.

Management has reviewed the deferred tax positions of the Company at September 30, 2014. The valuation allowance is analyzed quarterly for changes affecting deferred tax assets. The Company reported taxable income for the third quarter of 2014, which was the seventh consecutive profitable quarter. However, based on current accounting guidance, the Company has not generated taxable income for a sufficient length of time in order to reverse the deferred tax asset valuation allowance. In the future, when the Company has generated taxable income on a more sustained basis, management's conclusion regarding the need for a deferred tax asset valuation allowance could change, resulting in the reversal of all or a portion of the deferred tax asset valuation allowance.

For the three months and nine months ended September 30, 2014, the Company recorded income tax expense of \$166 thousand and \$326 thousand, which was entirely related to alternative minimum tax.

## **Financial Condition**

### **Assets**

Total assets decreased \$21.7 million, or 2.2%, to \$982.1 million at September 30, 2014 from \$1.0 billion at December 31, 2013. The decrease resulted primarily from a decrease in cash and cash equivalents, which was directly related to a reduction in total deposits. Loans, net of unearned income and the ALLL, increased as a result of favorable demand for the Company's lending products. Due to favorable rates as compared to other funding sources, the Company utilized borrowings through the FHLB of Pittsburgh as an additional source of liquidity and as a result, total borrowed funds increased when comparing the end of the third quarter of 2014 to year-end 2013.

As discussed above, in the third quarter of 2013, the Company entered into the Branch Purchase Agreement with ESSA for ESSA to acquire certain assets and liabilities of the Bank's Marshalls Creek and Stroudsburg branches, both located in Monroe County, Pennsylvania. Pursuant to this transaction, which closed on January 24, 2014, the Company sold deposits of \$8.8 million, real and personal property of \$2.5 million and loans of \$1.1 million. The Company realized a net gain on the branch divestiture of \$607 thousand, which is included in non-interest income in the Consolidated Statements of Operations for the nine months ended September 30, 2014.

### **Cash and Cash Equivalents**

Cash and cash equivalents totaled \$40.0 million at September 30, 2014, a decrease of \$63.6 million, or 61.4%, from \$103.6 million at December 31, 2013. The decrease resulted primarily from an \$81.5 million decrease in total deposits, coupled with a \$36.4 million increase in loans, net of the allowance for loan and lease losses. Advances

through the FHLB of Pittsburgh provided additional liquidity and increased \$41.7 million. The Company did not pay any dividends during the three and nine months ended September 30, 2014, as it suspended paying dividends to conserve capital and to comply with regulatory requirements.

## Securities

The Company's investment securities portfolio provides a source of liquidity needed to meet expected loan demand and provides a source of interest income to increase our profitability. Additionally, the Company utilizes the investment securities portfolio to meet pledging requirements to secure public deposits and for other purposes. Investment securities are classified as held-to-maturity and carried at amortized cost when the Company has the positive intent and ability to hold them to maturity. Securities not classified as held-to-maturity are classified as available-for-sale and are carried at fair value, with unrealized holding gains and losses reported as a component of shareholders' equity in accumulated other comprehensive income (loss), net of tax. The Company determines the appropriate classification of investment securities at the time of purchase. The decision to purchase or sell investment securities is based upon the current assessment of long- and short-term economic and financial conditions, including the interest rate environment and asset/liability management strategies. Securities with limited marketability and/or restrictions, such as FHLB of Pittsburgh and FRB stocks, are carried at cost. FRB stock is included in other assets.

At September 30, 2014, the Company's investment portfolio was comprised principally of U.S. government-sponsored agencies, including residential mortgage-backed securities, collateralized mortgage obligations ("CMOs") and single-maturity bonds, and taxable and tax-exempt obligations of state and political subdivisions and obligations. Other than the obligations of U.S. government-sponsored agencies, there were no security issuers whose aggregate carrying value of securities held by the Company exceeded 10.0% of shareholders' equity as of September 30, 2014.

The following table presents the carrying value of available-for-sale securities, which are carried at fair value, and held-to-maturity securities, which are carried at amortized cost, at September 30, 2014 and December 31, 2013:

| (in thousands)                                  | September 30,<br>2014 | December 31,<br>2013 |
|---|-----------------------|----------------------|
| Available-for-sale securities                   |                       |                      |
| Obligations of U.S. government agencies         | \$ 19,242             | \$ -                 |
| Obligations of state and political subdivisions | 24,505                | 78,054               |
| Government-sponsored agency:                    |                       |                      |
| Collateralized mortgage obligations             | 84,882                | 34,799               |
| Residential mortgage-backed securities          | 87,387                | 89,656               |
| Corporate debt securities                       | 435                   | 407                  |
| Equity securities                               | 961                   | 951                  |
| Total   | \$ 217,412            | \$ 203,867           |
| Held-to-maturity securities                     |                       |                      |
| Obligations of state and political subdivisions | \$ -                  | \$ 2,308             |

Management monitors the Company's investment portfolio regularly and adjusts the investment strategy to reflect changes in liquidity needs, asset/liability strategy and tax planning requirements. Management actions for the three and nine months ended September 30, 2014 reflected the Company's current investment strategy designed to reduce potential credit and concentration risk within the balance sheet, manage interest rate risk by shortening the duration of the portfolio, and reduce tax-free holdings as required under tax planning initiatives focused on DTA recognition.

As part of this strategy, during the third quarter of 2014, the Company sold 66 of its state and municipal obligations with an aggregate amortized cost of \$37.1 million. Gross proceeds received totaled \$40.0 million, with net gains of \$2.9 million realized upon the sales and included in non-interest income. All 66 securities sold during the third quarter were designated as available-for-sale.

For the nine months ended September 30, 2014, the aggregate amortized cost of the securities sold totaled \$75.4 million. During the nine months ended September 30, 2014, the Company sold its entire holdings of held-to-maturity securities comprised of four zero-coupon obligations of state and political subdivisions with an aggregate amortized cost of \$2.3 million. Gross proceeds received from the sale of held-to-maturity securities were \$2.7 million, with net gains of \$0.4 million realized upon the sale. For the nine months ended September 30, 2014, gross proceeds received from the sale of available-for-sale securities amounted to \$78.6 million, with year-to-date net gains totaling \$5.6 million included in non-interest income.

Securities purchased during the third quarter of 2014 amounted to \$51.4 million and were comprised entirely of 10 CMOs of U.S. Government-sponsored agencies. Year-to-date security purchases totaled \$88.5 million, including



\$18.3 million in home equity conversion mortgages of a U.S. government agency, \$18.8 million of single-maturity bonds of U.S. government-sponsored agencies and \$51.4 million in U.S government-sponsored CMOs.

The following table presents the maturities of available-for-sale securities at September 30, 2014 and the weighted-average yields of such securities calculated on the basis of the cost and effective yields weighted for the scheduled maturity of each security:

| (dollars in thousands)                              | September 30, 2014 |                  |                 |                  | Collateralized<br>Mortgage<br>Obligations<br>and<br>Mortgage-Backed<br>Securities (3) |        | No Fixed<br>Maturity | Total     |
|---|--------------------|------------------|-----------------|------------------|---|--------|----------------------|-----------|
|   | Within<br>One Year | > 1 – 5<br>Years | 6 - 10<br>Years | Over<br>10 Years |   |        |                      |           |
| Available-for-sale securities                       |                    |                  |                 |                  |   |        |                      |           |
| Obligations of U.S. government agencies             | \$-                | \$-              | \$19,242        | \$-              | \$ -  | \$ -   | \$ -                 | \$19,242  |
| Yield   |                    |                  | 2.65 %          |                  |   |        |                      | 2.65 %    |
| Obligations of state and political subdivisions (1) | 149                | -                | 7,302           | 17,054           | -   | -      | -                    | 24,505    |
| Yield   | 6.42 %             |                  | 3.68 %          | 7.26 %           |   |        |                      | 6.19 %    |
| Government-sponsored agency:                        |                    |                  |                 |                  |   |        |                      |           |
| Collateralized mortgage obligations                 | -                  | -                | -               | -                | 84,882  | -      | -                    | 84,882    |
| Yield   |                    |                  |                 |                  | 2.32 %  |        |                      | 2.32 %    |
| Residential mortgage-backed securities:             |                    |                  |                 |                  |   |        |                      |           |
| Yield   |                    |                  |                 |                  | 2.06 %  |        |                      | 2.06 %    |
| Corporate debt securities                           | -                  | -                | -               | 435              | -   | -      | -                    | 435       |
| Yield   |                    |                  |                 | 0.86 %           |   |        |                      | 0.86 %    |
| Equity securities (2)                               | -                  | -                | -               | -                | -   | 961    | 961                  | 961       |
| Yield   |                    |                  |                 |                  |   | 3.34 % | 3.34 %               | 3.34 %    |
| Total available-for-sale securities                 | \$149              | \$-              | \$26,544        | \$17,489         | \$172,269   | \$961  | \$961                | \$217,412 |
| Weighted yield                                      | 6.42 %             | 0.00 %           | 2.94 %          | 7.10 %           | 2.19 %  | 3.34 % | 3.34 %               | 2.68 %    |

(1) Yields on state and municipal securities have been adjusted to tax-equivalent yields using a 34.0% federal income tax rate.

(2) Yield represents actual return for the three months ended September 30, 2014.

(3) Collateralized mortgage obligations and residential mortgage-backed securities are not due at a single maturity date.

Substantially all of the Company's securities portfolio is comprised of debt securities, specifically single-maturity bonds of U.S. government agencies, obligations of states and political subdivisions, and residential mortgage-backed securities, including home equity conversion mortgages, and CMOs of U.S. government-sponsored agencies. The Company held 28 securities that were in an unrealized loss position at September 30, 2014, of which 26 securities, or 94.1% of the total unrealized losses, were related to these debt securities.

In determining whether unrealized losses are other-than-temporary, management considers the following factors:

- The causes of the decline in fair value, such as credit deterioration, interest rate fluctuations, or market volatility;
- The severity and duration of the decline;
- Whether or not the Company expects to receive all contractual cash flows;
- The Company's ability and intent to hold the security to allow for recovery in fair value, as well as the likelihood of such a recovery in the near term;
- The Company's intent to sell the security, or if it is more likely than not that the Company will be required to sell the security, before recovery of its amortized cost basis, less any current-period credit loss.

Management performed a review of the fair values of all securities at September 30, 2014 and determined that movements in the values of the securities were consistent with the change in market interest rates. As a result of its review and considering the attributes of these debt securities, the Company concluded that OTTI did not exist at September 30, 2014. To date, the Company has received all scheduled principal and interest payments and expects to fully collect all future contractual principal and interest payments. The Company does not intend to sell the securities nor is it more likely than not that the Company will be required to sell the securities.

Management does not believe that any individual unrealized loss at September 30, 2014 represents OTTI. The unrealized losses reported for residential mortgage-backed securities and CMOs relate entirely to securities issued by GNMA, FHLMC and FNMA that are currently rated AAA or Aaa by Moody's Investor Services or by Standard & Poor's, respectively, and are guaranteed by the U.S. government. The obligations of state and political subdivisions are comprised entirely of general-purpose debt obligations. The majority of these obligations have a credit quality rating of A or better and are secured by the unlimited taxing power of the issuer. In addition, the Company utilized a third party to perform an independent credit analysis of its state and political subdivision bonds that were either non-rated or had a rating below A. There was one obligation of a state and political subdivision that had a rating below A at September 30, 2014. According to the independent credit analysis, this bond was considered investment grade at September 30, 2014. In addition, this bond is scheduled to mature by December 31, 2014.

Investments in FHLB and Federal Reserve Bank ("FRB") stock, which have limited marketability, are carried at cost and totaled \$5.7 million and \$3.5 million at September 30, 2014 and December 31, 2013, respectively. FRB stock of \$1.3 million is included in Other Assets at September 30, 2014 and December 31, 2013. Management noted no indicators of impairment for the FHLB of Pittsburgh and FRB of Philadelphia at September 30, 2014.

## Loans

During the first nine months of 2014, the Company experienced increased demand for its lending products, as new loan originations exceeded maturities and payoffs. As a result, net loans increased \$36.4 million, or 5.8%, to \$666.3 million and represented 67.8% of total assets at September 30, 2014, from \$629.9 million, or 62.7% of total assets, at December 31, 2013. Historically, commercial lending activities have represented a significant portion of the Company's loan portfolio. This includes commercial and industrial loans, commercial real estate loans and construction, land acquisition and development loans.

From a collateral standpoint, a majority of the Company's loan portfolio consisted of loans secured by real estate. Real estate secured loans, which include commercial real estate, construction, land acquisition and development, residential real estate loans and home equity lines of credit ("HELOCs"), increased \$21.7 million, or 5.6%, to \$408.7 million at September 30, 2014 from \$387.0 million at December 31, 2013. Real estate secured loans represented 60.3% of total gross loans at September 30, 2014 and 60.2% at December 31, 2013.

Commercial and industrial loans increased \$8.3 million, or 6.5%, during the year to \$135.3 million at September 30, 2014 from \$127.0 million at December 31, 2013. Commercial and industrial loans consist primarily of equipment loans, working capital financing, revolving lines of credit and loans secured by cash and marketable securities. Loans secured by commercial real estate increased \$18.9 million, or 8.6%, to \$237.4 million at September 30, 2014 from \$218.5 million at December 31, 2013. Commercial real estate loans include long-term commercial mortgage financing and are primarily secured by first or second lien mortgages. Construction, land acquisition and development loans decreased \$6.8 million, or 28.0%, during the year to \$17.6 million at September 30, 2014 from \$24.4 million at December 31, 2013. The Company continues to monitor its exposure to this higher-risk portfolio segment.

Residential real estate loans totaled \$124.4 million at September 30, 2014, an increase of \$9.5 million, or 8.3%, from \$114.9 million at December 31, 2013. The components of residential real estate loans include fixed-rate and variable-rate mortgage loans. HELOCs are not included in this category but are included in consumer loans. The Company primarily underwrites fixed-rate purchase and refinance of residential mortgage loans for sale in the secondary market to reduce interest rate risk and provide funding for additional loans. However, as part of the Bank's current asset/liability management strategy, fixed-rate residential mortgage loans with maturity terms of 15 years or less that are eligible for sale on the secondary market are being retained in the portfolio.

Consumer loans increased \$4.0 million, or 3.4%, to \$122.6 million at September 30, 2014, from \$118.6 million at December 31, 2013. The increase was concentrated in the Company's portfolio of indirect automobile loans. During the first quarter of 2014, the Company sold its education loan portfolio to a third party. This portfolio had a recorded investment of \$2.6 million at the time of sale and the Company realized a loss of \$13 thousand upon the sale, which is included in non-interest income in the consolidated statements of operations for the nine months ended September 30, 2014. This portfolio was sold due to the low outstanding loan balance as related to the current servicing costs which

reduced the yield on the portfolio to an unacceptable level.

Loans to state and municipal governments increased \$0.3 million, or 0.8%, to \$40.2 million at September 30, 2014 from \$39.9 million at December 31, 2013.

The following table summarizes loans receivable, net by category at September 30, 2014 and December 31, 2013:

| (in thousands)                                 | September 30,<br>2014 | December 31,<br>2013 |
|--|-----------------------|----------------------|
| Residential real estate                        | \$ 124,375            | \$ 114,925           |
| Commercial real estate                         | 237,437               | 218,524              |
| Construction, land acquisition and development | 17,561                | 24,382               |
| Commercial and industrial                      | 135,283               | 127,021              |
| Consumer                                       | 122,573               | 118,645              |
| State and political subdivisions               | 40,210                | 39,875               |
| Total loans, gross                             | 677,439               | 643,372              |
| Unearned income                                | (115 )                | (143 )               |
| Net deferred loan fees and costs               | 836                   | 668                  |
| Allowance for loan and lease losses            | (11,898 )             | (14,017 )            |
| Loans, net                                     | \$ 666,262            | \$ 629,880           |

The Company considers an industry concentration within the loan portfolio to exist if the aggregate loan balance outstanding for that industry exceeds 25.0% of capital. The following table summarizes industry concentrations within the Company's loan portfolio at September 30, 2014 and December 31, 2013:

| (in thousands)                               | September 30, 2014 |                     | December 31, 2013 |                     |
|--|--------------------|---------------------|-------------------|---------------------|
|  | Amount             | % of<br>Gross Loans | Amount            | % of<br>Gross Loans |
| Retail space/shopping centers                | \$ 36,739          | 5.42 %              | \$ 23,472         | 3.65 %              |
| Automobile dealers                           | 22,260             | 3.29 %              | 18,467            | 2.87 %              |
| Office complexes/units                       | 16,627             | 2.45 %              | 17,924            | 2.79 %              |
| Colleges and Universities                    | 14,890             | 2.20 %              | 12,671            | 1.97 %              |
| Land subdivision                             | 14,226             | 2.10 %              | 15,974            | 2.48 %              |
| 1-4 family residential investment properties | 13,869             | 2.05 %              | 18,889            | 2.94 %              |
| Physicians                                   | 13,397             | 1.98 %              | 13,932            | 2.17 %              |

### Asset Quality

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at the amount of unpaid principal, net of unearned interest, deferred loan fees and costs, and reduced by the ALLL. The ALLL is established through a provision for loan and lease losses charged to earnings.

The Company has established and consistently applies loan policies and procedures designed to foster sound underwriting and credit monitoring practices. The Company manages credit risk through the efforts of loan officers, the loan review function, and the Loan Quality and the ALLL management committees, as well as oversight from the Board of Directors. The Company continually evaluates its credit risk management practices to ensure it is reacting to problems in the loan portfolio in a timely manner, although, as is the case with any financial institution, a certain degree of credit risk is dependent in part on local and general economic conditions that are beyond the Company's control.

Under the Company's risk rating system, loans that are rated pass/watch, special mention, substandard, doubtful, or loss are reviewed regularly as part of the Company's risk management practices. The Company's Loan Quality Committee, which consists of key members of senior management, finance and credit administration, meets monthly or more often as necessary to review individual problem credits and workout strategies and provides monthly reports to the Board of Directors.

A loan is considered impaired when it is probable that the Company will be unable to collect all amounts due (including principal and interest) according to the contractual terms of the note and loan agreement. For purposes of the Company's analysis, loans that are modified under a troubled debt restructuring ("TDRs"), loan relationships with an aggregate outstanding balance greater than \$100 thousand rated substandard and non-accrual, and loans that are identified as doubtful or loss are considered impaired. Impaired loans are analyzed individually to determine the amount of impairment. The Company utilizes the fair value of collateral method for collateral-dependent loans. A loan is considered to be collateral dependent when repayment of the loan is expected to be provided through the liquidation of the collateral held. For impaired loans that are secured by real estate, external appraisals are obtained annually, or more frequently as warranted, to ascertain a fair value so that the impairment analysis can be updated. Should a current appraisal not be available at the time of impairment analysis, other sources of valuation may be used including, current letters of intent, broker price opinions or executed agreements of sale. For non-collateral-dependent loans, the Company measures impairment based on the present value of expected future cash flows, net of disposal costs, discounted at the loan's original effective interest rate.

Loans to borrowers that are experiencing financial difficulty that are modified and result in the Company granting concessions to the borrower are classified as TDRs and are considered to be impaired. Such concessions generally involve an extension of a loan's stated maturity date, a reduction of the stated interest rate, payment modifications, capitalization of property taxes with respect to residential mortgage loans or a combination of these modifications. Non-accrual TDRs are returned to accrual status if principal and interest payments, under the modified terms, are brought current, are performing under the modified terms for six consecutive months, and management believes that collection of the remaining interest and principal is probable.

Non-performing loans are monitored on an ongoing basis as part of the Company's loan review process. Additionally, work-out efforts continue and are actively monitored for non-performing loans and OREO through the Loan Quality Committee. A potential loss on a non-performing asset is generally determined by comparing the outstanding loan balance to the fair market value of the pledged collateral, less cost to sell.

Loans are placed on non-accrual when a loan is specifically determined to be impaired or when management believes that the collection of interest or principal is doubtful. This generally occurs when a default of interest or principal has existed for 90 days or more, unless such loan is well secured and in the process of collection, or when management becomes aware of facts or circumstances that the loan would default before 90 days. The Company determines delinquency status based on the number of days since the date of the borrower's last required contractual loan payment. When the interest accrual is discontinued, all unpaid interest income is reversed and charged back against current earnings. Any subsequent cash payments received are applied, first to the outstanding loan amounts, then to the recovery of any charged-off loan amounts, with any excess treated as a recovery of lost interest. A non-accrual loan is returned to accrual status when the loan is current as to principal and interest payments, is performing according to contractual terms for six consecutive months and future payments are reasonably assured.

Management actively manages impaired loans in an effort to reduce loan balances by working with customers to develop strategies to resolve borrower difficulties, through sale or liquidation of collateral, foreclosure, and other appropriate means. Real estate values in the Company's market area have appeared to stabilize. However, a weakening of economic and employment conditions could result in real estate devaluations, which could negatively impact asset quality and, accordingly, cause an increase in the provision for loan and lease losses.

Under the fair value of collateral method, the impaired amount of the loan is deemed to be the difference between the loan amount and the fair value of the collateral, less the estimated costs to sell. For the Company's calculations for real estate secured loans, a factor of 10% is generally utilized to estimate costs to sell, which is based on typical cost factors, such as a 6% broker commission, 1% transfer taxes, and 3% various other miscellaneous costs associated with the sales process. If the valuation indicates that the fair value has deteriorated below the carrying value of the loan, either the entire loan is written off or the difference between the fair value and the principal balance is charged off. For impaired loans for which the value of the collateral less costs to sell exceeds the loan value, the impairment is considered to be zero.

The following table presents non-performing loans, including non-performing TDRs, OREO and accruing TDRs at September 30, 2014 and December 31, 2013:

| (in thousands)                                      | September 30,<br>2014 | December 31,<br>2013 |      |   |
|---|-----------------------|----------------------|------|---|
| Non-accrual loans                                   | \$ 5,539              | \$ 6,356             |      |   |
| Loans past due 90 days or more and still accruing   | 49                    | 19                   |      |   |
| Total non-performing loans                          | 5,588                 | 6,375                |      |   |
| Other real estate owned                             | 2,617                 | 4,246                |      |   |
| Total non-performing loans and OREO                 | \$ 8,205              | \$ 10,621            |      |   |
| Accruing TDRs                                       | \$ 5,326              | \$ 3,995             |      |   |
| Non-performing loans as a percentage of gross loans | 0.82                  | %                    | 0.99 | % |



Management continues to manage problem credits through heightened work-out efforts on non-performing loans and aggressively disposing of its holdings of foreclosed properties. The Company's asset quality continued to improve during the first nine months of 2014. Total non-performing loans and OREO decreased \$2.4 million, or 22.7%, to \$8.2 million at September 30, 2014 from \$10.6 million at December 31, 2013. The Company's ratio of non-performing loans to total gross loans improved to 0.82% at September 30, 2014 from 0.99% at December 31, 2013, as management continued to reduce the balance of non-accrual loans. The Company's ratio of non-performing loans and OREO as a percentage of shareholders' equity decreased to 16.3% at September 30, 2014 from 31.6% at December 31, 2013. Despite the decrease, the percentage remains elevated and further deterioration in economic conditions could lead to additional increases in impaired loans.

TDRs at September 30, 2014 and December 31, 2013 were \$9.1 million and \$8.1 million, respectively. Accruing and non-accruing TDRs were \$5.3 million and \$3.8 million, respectively at September 30, 2014 and \$4.0 million and \$4.1 million, respectively at December 31, 2013. There were 18 loans modified as TDRs during the nine months ended September 30, 2014, with an aggregate post-modification outstanding balance of \$1.3 million. In addition, two TDRs with an aggregate outstanding balance of \$0.1 million that were on non-accrual status at December 31, 2013 were transferred to accruing status during the nine months ended September 30, 2014. New modifications during the nine months ended September 30, 2014 included 12 residential real estate loans, 4 commercial real estate loans and 2 consumer loans. The terms of such modifications included one or a combination of the following: extension of term, capitalization of real estate taxes or principal forbearance.

The average balance of impaired loans was \$9.5 million and \$13.6 million for the nine months ended September 30, 2014 and 2013, respectively. The Company recognized \$62 thousand and \$173 thousand of interest income on impaired loans for the three and nine months ended September 30, 2014, respectively, and \$88 thousand and \$282 thousand of interest income on impaired loans for the respective periods in 2013.

The following table presents the changes in non-performing loans for the three and nine months ended September 30, 2014 and 2013:

| (in thousands)   | Three Months Ended<br>September 30, |          | Nine Months Ended September<br>30, |          |
|--|-------------------------------------|----------|------------------------------------|----------|
|  | 2014                                | 2013     | 2014                               | 2013     |
| Balance, beginning of period                                 | \$ 5,550                            | \$ 8,329 | \$ 6,375                           | \$ 9,709 |
| Loans newly placed on non-accrual                            | 584                                 | 344      | 1,621                              | 1,659    |
| Changes in loans past due 90 days or more and still accruing | 49                                  | (116)    | 30                                 | (50)     |
| Loans transferred to OREO                                    | -                                   | (96)     | (10)                               | (255)    |
| Loans charged-off  | (338)                               | (344)    | (881)                              | (1,316)  |
| Loans returned to performing status                          | -                                   | (162)    | (222)                              | (314)    |
| Loan payments received                                       | (257)                               | (732)    | (1,325)                            | (2,210)  |
| Balance, end of period                                       | \$ 5,588                            | \$ 7,223 | \$ 5,588                           | \$ 7,223 |

The additional interest income that would have been earned on non-accrual and restructured loans for the three and nine months ended September 30, 2014 had the loans been performing in accordance with their original terms approximated \$100 thousand and \$307 thousand, respectively, and \$138 thousand and \$457 thousand for the respective three and nine month periods of the prior year.

The following table presents accruing loan delinquencies and non-accrual loans as a percentage of gross loans at September 30, 2014 and December 31, 2013:

|                     | September 30,<br>2014 | December 31,<br>2013 |      |   |
|---------------------|-----------------------|----------------------|------|---|
| Accruing:           |                       |                      |      |   |
| 30-59 days          | 0.24                  | %                    | 0.46 | % |
| 60-89 days          | 0.09                  | %                    | 0.09 | % |
| 90+ days            | 0.01                  | %                    | 0.00 | % |
| Non-accrual         | 0.82                  | %                    | 0.99 | % |
| Total delinquencies | 1.16                  | %                    | 1.54 | % |

The decrease in total delinquencies as a percentage of gross loans at September 30, 2014 was primarily due to the more rigorous collections of delinquent loans. In its evaluation of the ALLL, management considers a variety of qualitative factors, including changes in the volume and severity of delinquencies.

### **Allowance for Loan and Lease Losses**

The ALLL represents management's estimate of probable loan losses inherent in the loan portfolio. The ALLL is analyzed in accordance with GAAP and is maintained at a level that is based on management's evaluation of the adequacy of the ALLL in relation to the risks inherent in the loan portfolio.

As part of its evaluation, management considers qualitative and environmental factors, including, but not limited to:

- Changes in national, local, and business economic conditions and developments, including the condition of various market segments;
- Changes in the nature and volume of the Company's loan portfolio;
- Changes in the Company's lending policies and procedures, including underwriting standards, collection, charge-off and recovery practices and results;
- Changes in the experience, ability and depth of the Company's management and staff;
- Changes in the quality of the Company's loan review system and the degree of oversight by the Company's Board of Directors;
- Changes in the trend of the volume and severity of past due and classified loans, including trends in the volume of non-accrual loans, TDRs and other loan modifications;
- The existence and effect of any concentrations of credit and changes in the level of such concentrations;

• The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Company's current loan portfolio; and  
• Analysis of its customers' credit quality, including knowledge of their operating environment and financial condition.

Evaluations are intrinsically subjective, as the results are estimated based on management knowledge and experience and are subject to interpretation and modification as information becomes available or as future events occur. Management monitors the loan portfolio on an ongoing basis with emphasis on weakness in both the real estate market and the economy in general and its effect on repayment. Adjustments to the ALLL are made based on management's assessment of the factors noted above.

For purposes of its analysis, all loan relationships with an aggregate balance greater than \$100 thousand that are rated substandard and non-accrual, identified as doubtful or loss, and all TDRs are considered impaired and are analyzed individually to determine the amount of impairment. Circumstances such as construction delays, declining real estate values, and the inability of the borrowers to make scheduled payments have resulted in these loan relationships being classified as impaired. The Company utilizes the fair value of collateral method for collateral-dependent loans and TDRs for which repayment depends on the sale of collateral. For non-collateral-dependent loans and TDRs, the Company measures impairment based on the present value of expected future cash flows discounted at the loan's original effective interest rate. With regard to collateral-dependent loans, appraisals are received at least annually to ensure that impairment measurements reflect current market conditions. Should a current appraisal not be available at the time of impairment analysis, other valuation sources including current letters of intent, broker price opinions or executed agreements of sale may be used. Only downward adjustments are made based on these supporting values. Included in all impairment calculations is a cost to sell adjustment of approximately 10%, which is based on typical cost factors, including a 6% broker commission, 1% transfer taxes and 3% various other miscellaneous costs associated with the sales process. Sales costs are periodically revised based on actual experience. The ALLL analysis is adjusted for subsequent events that may arise after the end of the reporting period but before the financial reports are filed.

The Company's ALLL consists of both specific and general components. At September 30, 2014, the ALLL that related to impaired loans that are individually evaluated for impairment, the guidance for which is provided by ASC 310 "Impairment of a Loan" ("ASC 310"), was \$349 thousand, or 2.9%, of the total ALLL. A general allocation of \$11.5 million was calculated for loans analyzed collectively under ASC 450 "Contingencies" ("ASC 450"), which represented 97.1% of the total ALLL of \$11.9 million. The ratio of the ALLL to total loans at September 30, 2014 and December 31, 2013 was 1.76% and 2.18%, respectively, based on total loans of \$677.4 million and \$643.4 million, respectively. The decrease in the ALLL as a percentage of total loans reflected asset quality improvements and lower levels of charge-offs than in the past, coupled with increased loan demand. See "Asset Quality" for further information.

The following table presents an allocation of the ALLL and percentage of loans in each category at September 30, 2014 and December 31, 2013:

**Allocation of the Allowance for Loan Losses**

|  | September 30, 2014 |            | December 31, 2013 |            |  |
|--|--------------------|------------|-------------------|------------|--|
|  | Allowance          | Percentage | Allowance         | Percentage |  |
| (in thousands)                                 | Amount             | of Loans   | Amount            | of Loans   |  |
|  |                    | in Each    |                   | in Each    |  |
|  |                    | Category   |                   | Category   |  |
|  |                    | Category   |                   | Category   |  |
|  | to Total           |            | to Total          |            |  |
|  | Loans              |            | Loans             |            |  |
| Residential real estate                        | \$ 1,747           | 18.36 %    | \$ 2,287          | 17.86 %    |  |
| Commercial real estate                         | 5,261              | 35.05 %    | 6,017             | 33.97 %    |  |
| Construction, land acquisition and development | 775                | 2.59 %     | 924               | 3.79 %     |  |
| Commercial and industrial                      | 1,805              | 19.97 %    | 2,321             | 19.74 %    |  |
| Consumer                                       | 1,727              | 18.09 %    | 1,789             | 18.44 %    |  |
| State and political subdivisions               | 583                | 5.94 %     | 679               | 6.20 %     |  |
| Total  | \$ 11,898          | 100.00 %   | \$ 14,017         | 100.00 %   |  |

The following table presents an analysis of the ALLL for the three and nine months ended September 30, 2014 and 2013:

**Analysis of the Allowance for Loan and Lease Losses**

|  | For the Three Months Ended |           | For the Nine Months Ended |           |
|--|----------------------------|-----------|---------------------------|-----------|
|  | September 30,              | 2013      | September 30,             | 2013      |
| (dollars in thousands)                         | 2014                       | 2013      | 2014                      | 2013      |
| Balance at beginning of period                 | \$ 12,175                  | \$ 18,588 | \$ 14,017                 | \$ 18,536 |
| Charge-offs:                                   |                            |           |                           |           |
| Residential real estate                        | 67                         | 98        | 152                       | 445       |
| Commercial real estate                         | -                          | -         | -                         | 48        |
| Construction, land acquisition and development | -                          | 65        | -                         | 175       |
| Commercial and industrial                      | 22                         | 116       | 172                       | 244       |
| Consumer                                       | 270                        | 74        | 637                       | 433       |
| State and political subdivisions               | -                          | -         | -                         | -         |
| Total charge-offs                              | 359                        | 353       | 961                       | 1,345     |
| Recoveries of charged-off loans:               |                            |           |                           |           |
| Residential real estate                        | 9                          | 9         | 79                        | 190       |
| Commercial real estate                         | -                          | 362       | 355                       | 471       |
|  | -                          | 5         | 3,539                     | 124       |

Edgar Filing: FIRST NATIONAL COMMUNITY BANCORP INC - Form 10-Q

|   |           |   |           |    |           |    |           |    |
|---|-----------|---|-----------|----|-----------|----|-----------|----|
| Construction, land acquisition and development  |           |   |           |    |           |    |           |    |
| Commercial and industrial   | 69        |   | 71        |    | 195       |    | 1,656     |    |
| Consumer  | 58        |   | 95        |    | 303       |    | 371       |    |
| State and political subdivisions  | -         |   | -         |    | -         |    | -         |    |
| Total recoveries  | 136       |   | 542       |    | 4,471     |    | 2,812     |    |
| Net charge-offs (recoveries)  | 223       |   | (189)     | )  | (3,510)   | )  | (1,467)   | )  |
| Credit for loan and lease losses  | (54)      | ) | (1,159)   | )  | (5,629)   | )  | (2,385)   | )  |
| Balance at end of period  | \$ 11,898 |   | \$ 17,618 |    | \$ 11,898 |    | \$ 17,618 |    |
| Net charge-offs (recoveries) during the period as a percentage of average loans outstanding during the period | 0.03      | % | (0.03)    | )% | (0.53)    | )% | (0.23)    | )% |
| Allowance for loan and lease losses as a percentage of gross loans at end of period                           | 1.76      | % | 2.69      | %  | 1.76      | %  | 2.69      | %  |

## Other Real Estate Owned

At September 30, 2014, OREO consisted of 18 properties with an aggregate carrying value of \$2.6 million, a decrease of \$1.6 million from \$4.2 million at December 31, 2013. There was one property with an aggregate carrying value of \$13 thousand foreclosed upon during the nine months ended September 30, 2014. During the nine months ended September 30, 2014, there were five sales and two partial sales of properties with an aggregate carrying value of \$1.2 million. The Company realized net gains on the sale of these properties of \$103 thousand, which is included in non-interest income.

Due to a change in strategic purpose, the Company transferred the Stroudsburg office from bank premises and equipment to OREO for disposition during the nine months ended September 30, 2014. The deposits and loans of this branch were sold to ESSA as part of the Branch Purchase Agreement. The Company retained this facility and was initially planning to use it for other bank-related purposes. This property with a carrying value of \$1.7 million was written down to its appraised value less cost to sell of \$0.8 million at the time of transfer. A valuation adjustment of \$0.9 million, included in non-interest expense, was recorded at the time of transfer.

In the third quarter of 2013, the Company transferred three vacant lots from bank premises and equipment that were previously held for future expansion to OREO. One of the properties was subsequently sold during the nine months ended September 30, 2014. There was no gain or loss realized upon the sale. The Company had one of the properties located in Monroe County, Pennsylvania re-appraised during the third quarter of 2014 due to continued decline in real estate values, which resulted in a valuation adjustment of \$0.3 million and is included in non-interest expense for the three months and nine months ended September 30, 2014.

In addition, there are four properties that have been held in OREO for a significant amount of time and are approaching the regulatory holding period threshold of five years. In an effort to aggressively dispose of these properties, management requested independent appraisals using a liquidation value basis for each of the properties. Accordingly, the Company incurred valuation adjustments to these four properties totaling \$0.7 million for the nine months ended September 30, 2014. Total valuation adjustments to the carrying value of OREO included in non-interest expense for the nine months ended September 30, 2014 amounted to \$2.2 million.

The Company actively markets all OREO properties for sale through a variety of channels including internal marketing and the use of outside brokers/realtors. The carrying value of OREO is generally calculated at an amount not greater than 90% of the most recent fair market appraised value. A 10% factor is generally used to estimate costs to sell, which is based on typical cost factors, such as 6% broker commission, 1% transfer taxes, and 3% various other miscellaneous costs associated with the sales process. This market value is updated on an annual basis or more frequently if new valuation information is available. Further deterioration in the real estate market could result in additional losses on these properties.

The following table presents the activity in OREO for the three months and nine months ended September 30, 2014 and 2013:

| (in thousands)                    | Three Months Ended September 30, |          | Nine Months Ended September 30, |          |
|-----------------------------------|----------------------------------|----------|---------------------------------|----------|
|                                   | 2014                             | 2013     | 2014                            | 2013     |
| Balance, beginning of period      | \$ 3,182                         | \$ 2,778 | \$ 4,246                        | \$ 3,983 |
| Property foreclosures             | -                                | 96       | 13                              | 255      |
| Bank premises transferred to OREO | -                                | 1,819    | 1,749                           | 1,819    |
| Valuation adjustments             | (429 )                           | (152 )   | (2,199 )                        | (257 )   |
| Carrying value of OREO sold       | (136 )                           | (136 )   | (1,192 )                        | (1,395 ) |
| Balance, end of period            | \$ 2,617                         | \$ 4,405 | \$ 2,617                        | \$ 4,405 |

The following schedule presents the composition of OREO at September 30, 2014 and December 31, 2013:

| (in thousands)                | September 30, | December 31, |
|-------------------------------|---------------|--------------|
|                               | 2014          | 2013         |
| Land/lots                     | \$ 1,476      | \$ 3,549     |
| Commercial real estate        | 1,114         | 647          |
| Residential real estate       | 27            | 50           |
| Total other real estate owned | \$ 2,617      | \$ 4,246     |



## Liabilities

Total liabilities were \$931.8 million at September 30, 2014, a decrease of \$38.4 million, or 4.0%, from \$970.2 million at December 31, 2013. The decrease is primarily attributable to the decrease in total deposits, partially offset by an increase in total borrowed funds. Total deposits decreased \$81.5 million, or 9.2%, to \$803.2 million at September 30, 2014 as compared to \$884.7 million at December 31, 2013. The decrease in deposits reflected cyclical deposit trends of the Company's municipal customers, the Monroe County branch divestures and continued runoff of certificates of deposit in the low interest rate environment.

Specifically, non-interest-bearing demand deposits decreased \$9.1 million, or 5.8%, while interest-bearing deposits declined \$72.4 million, or 10.0%. The \$9.1 million decrease in demand deposits was due primarily to a \$22.0 million decline in non-interest-bearing business checking accounts, which resulted from a reduction in a deposit relationship with one large commercial customer. Partially offsetting this reduction were increases in personal, municipal, small business and not-for-profit demand deposits totaling \$12.9 million. The \$72.4 million decrease in interest-bearing deposits resulted primarily from a \$43.6 million decrease in certificates of deposit originated through a national listing service, coupled with decreases in NOW accounts and retail time deposits. As part of the Company's asset/liability management strategy, management focused on replacing these higher-costing, national listing service deposits as they matured with lower-costing core-customer deposits and advances through the FHLB of Pittsburgh.

Borrowed funds increased by \$41.7 million, or 66.8%, to \$104.1 million at September 30, 2014 as compared to \$62.4 million at December 31, 2013. The increase resulted entirely to an increase in advances from the FHLB of Pittsburgh to \$68.8 million at September 30, 2014 from \$27.1 million at year-end 2013.

Retail deposit growth is a chief priority for the Company given the strong demand for its lending products in 2014. Management implemented several deposit strategies during the nine months ended September 30, 2014, including a strategic objective focused on growing commercial and consumer demand deposit accounts. The Company began offering a \$100 cash bonus incentive to personal deposit customers for opening a new checking account. In order to receive the bonus, the checking account must be set up to receive one thousand dollars in direct deposits per statement cycle within 60 days of opening. In addition, in June 2014 the Company began offering an escalator certificate of deposit with maturity terms of 12, 24 and 30 months. The escalator feature provides customers a one-time option to increase the interest rate during the term, should the rate offered by the Company for a similar certificate increase. Since inception, the Company has opened approximately \$2.2 million in escalator certificates.

## Equity

Total shareholders' equity increased \$16.7 million, or 49.7%, to \$50.3 million at September 30, 2014 from \$33.6 million at December 31, 2013. Net income for the nine months ended September 30, 2014 of \$13.5 million and a \$3.2 million increase in accumulated other comprehensive income were the primary factors leading to the capital improvement. The increase in accumulated other comprehensive income was primarily attributed to appreciation in the fair value of securities held in the available-for-sale portfolio. Book value per common share improved to \$3.06 at September 30, 2014 compared to \$2.04 at December 31, 2013. At September 30, 2014, the Bank's total risk-based capital and Tier I leverage ratios were 15.28% and 10.05%, respectively, which exceeded the respective 13.00% and 9.00% ratios required by the OCC Consent Order.

## Liquidity

The term liquidity refers to the ability of the Company to generate sufficient amounts of cash to meet its cash flow needs. Liquidity is required to fulfill the borrowing needs of the Company's credit customers and the withdrawal and maturity requirements of its deposit customers, as well as to meet other financial commitments. The Company's liquidity position is impacted by several factors, which include, among others, loan origination volumes, loan and investment maturity structure and cash flows, deposit demand and certificate of deposit maturity structure and retention. The Company has liquidity and contingent funding policies in place that are designed with controls in place to provide advanced detection of potentially significant funding shortfalls, establish methods for assessing and monitoring risk levels, and institute prompt responses that may alleviate a potential liquidity crisis. Management monitors the Company's liquidity position and fluctuations daily so that the Company can adapt accordingly to market influences and balance sheet trends. Management also forecasts liquidity needs, performs stress tests its of liquidity levels and develops strategies to ensure adequate liquidity at all times.

The Company's statements of cash flows present the change in cash and cash equivalents from operating, investing and financing activities. Cash and due from banks and interest-bearing deposits in other banks are the Company's most liquid assets. At September 30, 2014, cash and cash equivalents totaled \$40.0 million, a decrease of \$63.6 million from \$103.6 million at December 31, 2013. Cash outlays for investing and financing activities used \$31.3 million and \$39.4 million, respectively, of cash and cash equivalents during the nine months ended September 30, 2014. The \$31.3 million in cash used in investing activities resulted primarily from a net increase in loans to customers of \$33.1 million. In addition, purchases of available-for-sale securities, net of proceeds received from sales, maturities, calls and principal reductions from securities, and FHLB of Pittsburgh stock used \$1.3 million and \$2.2 million in cash and cash equivalents, respectively. These outflows were partially offset by proceeds received from the sale of OREO and bank premises and equipment of \$1.3 million and \$2.5 million, respectively. The \$39.4 million used in financing activities resulted from an \$81.1 million net decrease in deposits, partially offset by proceeds from FHLB advances, net of repayments, of \$41.7 million.

Despite the decrease in cash and cash equivalents, management believes that the Company's liquidity position is sufficient to meet its cash flow needs as of September 30, 2014. The decrease in total deposits reflected cyclical deposit trends of the Company's municipal customers and the anticipated runoff of certificates of deposit with above market interest rates. As previously mentioned, the majority of this runoff was concentrated in certificates of deposit obtained through a national listing service. Management, in accordance with the Company's current asset/liability strategy decided to replace these certificates with short-term, lower-costing advances from the FHLB of Pittsburgh. Advances from the FHLB of Pittsburgh totaled \$194.2 million for the nine months ended September 30, 2014. These advances had a weighted average maturity of 0.5 years and a weighted-average interest rate of 0.37%. The Company made repayments of advances to the FHLB of Pittsburgh amounting to \$152.5 million during the nine months ended September 30, 2014. At September 30, 2014, the Company had available borrowing capacity with the FHLB of Pittsburgh and FRB of \$170.3 million and \$22.0 million, respectively.

## **Interest Rate Risk**

### *Interest Rate Sensitivity*

Market risk is the risk to earnings and/or financial position resulting from adverse changes in market rates or prices, such as interest rates, foreign exchange rates or equity prices. The Company's exposure to market risk is primarily interest rate risk associated with our lending, investing and deposit gathering activities, all of which are other than trading. Changes in interest rates affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. In addition, variations in interest rates affect the underlying economic value of our assets, liabilities and off-balance sheet items.

### *Asset and Liability Management*

The Company manages these objectives through its Asset and Liability Management Committee ("ALCO") and its Rate and Liquidity and Investment Committees, which consist of the members of senior management and certain members of the finance department. Members of the committees meet regularly to develop balance sheet strategies affecting the future level of net interest income, liquidity and capital. The major objectives of ALCO are to:

Manage exposure to changes in the interest rate environment by limiting the changes in net interest margin to an acceptable level within a reasonable range of interest rates;

Ensure adequate liquidity and funding;

Maintain a strong capital base; and

Maximize net interest income opportunities.

ALCO monitors the Company's exposure to changes in net interest income over both a one-year planning horizon and a longer-term strategic horizon. ALCO uses net interest income simulations and economic value of equity ("EVE") simulations as the primary tools in measuring and managing the Company's position and considers balance sheet forecasts, the Company's liquidity position, the economic environment, anticipated direction of interest rates and the Company's earnings sensitivity to changes in these rates in its modeling. In addition, ALCO has established policy tolerance limits for acceptable negative changes in net interest income. Furthermore, as part of its ongoing monitoring, ALCO has been enhanced to require periodic back testing of modeling results, which involves after-the-fact comparisons of projections with the Company's actual performance to measure the validity of assumptions used in the modeling techniques.

#### *Earnings at Risk and Economic Value at Risk Simulations*

##### *Earnings at Risk*

Earnings-at-risk simulation measures the change in net interest income and net income under various interest rate scenarios. Specifically, given the current market rates, ALCO looks at "earnings at risk" to determine anticipated changes in net interest income from a base case scenario with scenarios of + 200/-100 basis points changes to interest rates. The simulation takes into consideration that not all assets and liabilities re-price equally and simultaneously with market rates (i.e., savings rate).

*Economic Value at Risk*

While 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. ALCO examines this ratio regularly, and given the current rate environment, has utilized rate shocks of +200/- 100 basis points for simulation purposes. Management recognizes that, in some instances, this ratio may contradict the "earnings at risk" ratio.

While ALCO regularly performs a wide variety of simulations under various strategic balance sheet and treasury yield curve scenarios, the following results reflect the Company's sensitivity over the subsequent twelve months based on the following assumptions:

Asset and liability levels using September 30, 2014 as a starting point;

Cash flows are based on contractual maturity and amortization schedules with applicable prepayments derived from internal historical data and external sources; and

Cash flows are reinvested into similar instruments so as to keep interest-earning asset and interest-bearing liability levels constant.

The following table illustrates the simulated impact of a 200 basis point upward and a 100 basis point downward movement in interest rates on net interest income and the change in economic value. The impact of the rate movements were developed by simulating the effect of rates changing over a twelve-month period from the September 30, 2014 levels.

|  | Rates + 200 |    | Rates -100 |    | Policy Limits   |
|--|-------------|----|------------|----|-----------------|
| Earnings at risk:                          |             |    |            |    |                 |
| Percent change in net interest income      | 1.3         | %  | 0.1        | %  | (10.0)%/(5.0) % |
| Economic value at risk:                    |             |    |            |    |                 |
| Percent change in economic value of equity | (5.5        | )% | (5.7       | )% | (20.0)%/(10.0)% |

Under the model, the Company's net interest income is expected to increase 1.3%, while the Company's economic value of equity is expected to decrease 5.5%, under a 200 basis point upward movement in interest rates. The anticipated increase in net interest income reflects the composition of the Company's loan portfolio, which is comprised of a significant balance of variable-rate loans, which will re-price immediately or in the near term. In comparison, results for a similar model for the year ended December 31, 2013 simulated a 3.9% increase in net interest income under a 200 basis point upward movement in interest rates.

This analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These simulations are based on numerous assumptions: the nature and timing of interest rate levels, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, reinvestment/replacements of asset and liability cash flows, and other factors. While assumptions reflect current economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions, including changes in interest rates, customer preferences, competition and liquidity needs, or what actions ALCO might take in responding to these changes.

### **Off-Balance Sheet Arrangements**

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with U.S. GAAP, are not recorded in our consolidated financial statements, or are recorded in amounts that differ from the notional amounts. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used for general corporate purposes or for customer needs. Corporate purpose transactions are used to help manage credit, interest rate and liquidity risk or to optimize capital. Customer transactions are used to manage customers' requests for funding.

For the three- and nine-month periods ended September 30, 2014, the Company did not engage in any off-balance sheet transactions that would have or would be reasonably likely to have a material effect on its consolidated financial condition.

### **Item 3 - Quantitative and Qualitative Disclosures about Market Risk**

There have been no material changes in the company's exposure to market risk during the first nine months of 2014. For discussion of the Company's exposure to market risk, refer to Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations – Interest Rate Risk, hereof, and Item 7A, Quantitative and Qualitative Disclosure about Market Risk, contained in the Company's Form 10-K for the year ended December 31, 2013.

#### Item 4 - Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls and procedures were effective as of September 30, 2014.

There were no changes made to the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

#### Part II Other Information

##### **Item 1 - Legal Proceedings.**

On August 8, 2011, the Company announced that it had received document subpoenas from the SEC. The information requested generally relates to disclosure and financial reporting by the Company and the restatement of the Company's financial statements for the year ended December 31, 2009, and the quarters ended March 31, 2010 and June 30, 2010. The Company is presently cooperating with the SEC in this matter. Discussions have been conducted between the Company and the SEC seeking to resolve issues related to disclosure and financial reporting and the restatements of the Company's financial statements for the year ended December 31, 2009 and the quarters ended March 31, 2010 and June 30, 2010. There can be no assurance that these discussions will lead to the resolution of the issues in a matter acceptable to the Company.

On May 24, 2012, a putative shareholder filed a complaint in the Court of Common Pleas for Lackawanna County ("Shareholder Derivative Suit") against certain present and former directors and officers of the Company (the "Individual Defendants") alleging, inter alia, breach of fiduciary duty, abuse of control, corporate waste, and unjust enrichment. The Company was named as a nominal defendant. The parties to the Shareholder Derivative Suit commenced settlement discussions and on December 18, 2013, the Court entered an Order Granting Preliminary Approval of Proposed Settlement subject to notice to shareholders. On February 4, 2014, the Court issued a Final Order and Judgment for the matter granting approval of a Stipulation of Settlement (the "Settlement") and dismissing all claims against the Company and the Individual Defendants. As part of the Settlement, there was no admission of liability by the Individual Defendants. Pursuant to the Settlement, the Individual Defendants, without admitting any fault, wrongdoing or liability, agreed to settle the derivative litigation for \$5.0 million. The \$5.0 million Settlement payment

was made to the Company on March 28, 2014. The Individual Defendants reserved their rights to indemnification under the Company's Articles of Incorporation and Bylaws, resolutions adopted by the Board, the Pennsylvania Business Corporation Law and any and all rights they have against the Company's and the Bank's insurance carriers. In accordance, the Company had recorded a liability for this indemnification in other liabilities. In addition, in conjunction with the Settlement, the Company accrued \$2.5 million related to fees and costs of the plaintiff's attorneys, which was included in non-interest expense in the consolidated statements of operations for the year ended December 31, 2013. On April 1, 2014, the Company paid the \$2.5 million related to fees and costs of the plaintiff's attorneys and partial indemnification of the Individual Defendants in the amount of \$2.5 million, and, as such, as of September 30, 2014, \$2.5 million remains accrued in other liabilities related to the potential indemnification of the Individual Defendants. The Company settled any and all claims it had or may have had against Demetrius & Company, LLC, John Demetrius and Robert L. Rossi & Company in connection with the Shareholder Derivative Suit.

On September 5, 2012, Fidelity and Deposit Company of Maryland ("F&D") filed an action against the Company and its subsidiary, First National Community Bank, as well as several current and former officers and directors of the Company, in the United States District Court for the Middle District of Pennsylvania. F&D has asserted a claim for the rescission of a directors' and officers' insurance policy and a bond that it had issued to the Company. On November 9, 2012, the Company and the Bank answered the claim and asserted counterclaims for the losses and expenses already incurred by the Company and the Bank. The Company and the other defendants are defending the claims and have opposed F&D's requested relief by way of counterclaims, breaches of contract and bad faith claims against F&D for the failure to fulfill its obligations to the Company and the Bank under the insurance policy. At this time, the matter is in the discovery stage and the Company cannot reasonably determine the outcome or potential range of loss in connection with this matter.

On August 13, 2013, Steven Antonik, individually, as Administrator of the Estate of Linda Kluska, William R. Howells, and Louise A. Howells, on behalf of themselves and others similarly situated, filed a consumer protection class action against the Company and Bank in the Lackawanna County Court of Common Pleas, seeking equitable, injunction and monetary relief to address an alleged pattern and practice of wrong doing by the Bank relating to the repossession and sale of the Plaintiffs' and class members' financed motor vehicles. This matter is in the discovery stage. At this time the Company cannot reasonably determine the outcome or potential range of loss.



On September 17, 2013, Charles Saxe, III individually and on behalf of all others similarly situated filed a consumer class action against the Bank in the Lackawanna County Court of Common Pleas alleging violations of the Pennsylvania Uniform Commercial Code in connection with the repossession and resale of financed vehicles. This matter is in the discovery stage. At this time the Company cannot reasonably determine the outcome or potential range of loss.

The Company has been subject to tax audits and is also a party to routine litigation involving various aspects of its business, such as claims to enforce liens, condemnation proceedings on properties in which the Company holds security interests, claims involving the making and servicing of real property loans and other issues incident to its business, none of which is expected to have a material adverse impact on the consolidated financial condition, results of operations or liquidity of the Company.

Item 1A. - Risk Factors.

Management of the Company does not believe there have been any material changes in the risk factors that were previously disclosed in the Company's Form 10-K for the year ending December 31, 2013.

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

None.

Item 3 - Defaults upon Senior Securities.

None.

Item 4 - Mine Safety Disclosures.

Not Applicable.

Item 5 - Other Information.

On October 29, 2014, the Board of Directors adopted the 2014 Employee Stock Grant Plan (the “2014 Stock Grant Plan”), pursuant to which the Board of Directors authorized the grant of up to 13,500 common shares in order to make one-time grants of 50 common shares to each active full and part-time employee of the Company, including executive officers. This one-time program was implemented to provide employees with a long-term financial interest in the Company’s future growth and profitability by providing them with Company ownership in the form of common shares. The grant recipients may not sell the shares granted under the 2014 Stock Grant Plan until after January 1, 2016. The grant recipients are also responsible for all tax obligations arising from the stock grant and ownership of stock. The Company has not granted any shares under the 2014 Stock Grant Plan.

Item 6 - Exhibits.

The following exhibits are filed herewith or incorporated by reference.

- EXHIBIT 3.1 Amended and Restated Articles of Incorporation dated May 19, 2010 — filed as Exhibit 3.1 to the Company’s Current Report on Form 8-K on May 19, 2010, is hereby incorporated by reference.
- EXHIBIT 3.2 Amended and Restated Bylaws — filed as Exhibit 3.2 to the Company’s Form 10-Q for the quarter ended September 30, 2013, as filed on November 12, 2013, is hereby incorporated by reference.

|                    |  |
|--------------------|--|
| EXHIBIT 4.1*       | Form of Common Stock Certificate.  |
| EXHIBIT 4.2        | Form of Subordinated Note — filed as Exhibit 4.1 to the Company’s Current Report on Form 8-K dated August 28, 2009, is hereby incorporated by reference. |
| EXHIBIT 10.1*      | 2014 Employee Stock Grant Plan.  |
| EXHIBIT 31.1*      | Certification of Chief Executive Officer   |
| EXHIBIT 31.2*      | Certification of Chief Financial Officer   |
| EXHIBIT 32.1**     | Section 1350 Certification — Chief Executive Officer and Chief Financial Officer   |
| EXHIBIT 101.INS    | XBRL INSTANCE DOCUMENT   |
| EXHIBIT<br>101.SCH | XBRL TAXONOMY EXTENSION SCHEMA   |
| EXHIBIT<br>101.CAL | XBRL TAXONOMY EXTENSION CALCULATION LINKBASE   |
| EXHIBIT<br>101.DEF | XBRL TAXONOMY EXTENSION DEFINITION LINKBASE  |
| EXHIBIT<br>101.LAB | XBRL TAXONOMY EXTENSION LABEL LINKBASE   |
| EXHIBIT<br>101.PRE | XBRL TAXONOMY EXTENSION PRESENTATION LINKBASE  |

\* Filed herewith

\*\* Furnished herewith

