FIDELITY D & D BANCORP INC
Form 10-K
March 12, 2009
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2008

COMMISSION FILE NUMBER 333-90273

FIDELITY D & D BANCORP, INC.

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

BLAKELY AND DRINKER STREETS

DUNMORE, PENNSYLVANIA 18512

TELEPHONE NUMBER (570) 342-8281

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

None

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

Common Stock, without par value

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

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

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 x No o

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

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

Aggregate market value of the voting common stock held by non-affiliates of the registrant equals $49,429,783, as of June 30, 2008, based on a market price of $29.25. The number of shares of common stock outstanding as of February 28, 2009, was 2,062,128.

DOCUMENTS INCORPORATED BY REFERENCE

Excerpts from the Registrant s 2008 Annual Report to Shareholders are incorporated herein by reference in response to Part I. Portions of the Registrant s definitive Proxy Statement to be used in connection with the 2009 Annual Meeting of Shareholders are incorporated herein by reference in partial response to Part II and Part III.

Table of Contents

Fidelity D & D Bancorp, Inc.

2008 Annual Report on Form 10-K

Table of Contents

Table of Contents

FIDELITY D & D BANCORP, INC.

PART I

Forward-Looking Statements

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

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

- the timing and occurrence or non-occurrence of events may be subject to circumstances beyond our control;
- there may be increases in competitive pressure among financial institutions or from non-financial institutions;
- changes in the interest rate environment may reduce interest margins;
- changes in deposit flows, loan demand or real estate and investment securities values may adversely affect our business;
- changes in accounting principles, policies or guidelines may cause our financial condition to be perceived differently;
- general economic conditions, either nationally or locally in some or all areas in which we do business, or conditions in the securities markets or the banking industry may be less favorable than we currently anticipate;
- legislative or regulatory changes may adversely affect our business;
- technological changes may be more rapid, difficult or expensive than we anticipate;

- success or consummation of new business initiatives may be more difficult or expensive than we anticipate;
- acts of war or terrorism; or
- natural disaster.

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

Readers should review the risk factors described in Item 1A, above, and in other documents that we file, from time-to-time with the SEC, including quarterly reports on Form 10-Q and any current reports on Form 8-K.

ITEM 1: **BUSINESS**

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

Table of Contents

The Bank has offered a full range of traditional banking services since it commenced operations in 1903. The Bank has a personal and corporate trust department and also provides alternative financial and insurance products with asset management services. A full list of services provided by the Bank is detailed in the section entitled Products and Services contained within the 2008 Annual Report to Shareholders, incorporated by reference. The service area is comprised of the Borough of Dunmore and the surrounding communities within Lackawanna and Luzerne counties in Northeastern Pennsylvania.

The banking business is highly competitive, and the profitability of the Company depends principally upon the Company s ability to compete in its market area. Competition includes, among other sources, the following:

- local community banks
- savings banks
- regional banks
- credit unions
- savings & loans
- insurance companies
- money market funds
- mutual funds
- small loan companies
- other financial service companies

The Company has been able to compete effectively with other financial institutions by emphasizing technology and customer service, including local decision making on loans. These efforts enabled the Company to establish long-term customer relationships and build customer loyalty by providing products and services designed to address their specific needs.

There are no concentrations of loans that, if lost, would have a materially adverse effect on the continued business of the Company. The Company s loan portfolio does not have a material concentration within a single industry or group of related industries that are vulnerable to the risk of a near-term severe impact. However, the Company s success is dependent, to a significant degree, on economic conditions in Northeastern Pennsylvania, especially Lackawanna and Luzerne counties which the Company defines as its primary market area. The banking industry is affected by general economic conditions including the effects of inflation, recession, unemployment, real estate values, trends in national and global economies and other factors beyond the Company s control. An economic recession or a delayed economic recovery over a prolonged period of time in the Company s primary market area could cause an increase in the level of the Company s non-performing assets and loan losses, and thereby cause operating losses, impairment of liquidity and erosion of capital. We cannot assure you that adverse changes in the local economy would not have a material effect on the Company s future consolidated financial condition, results of operations and cash flows. Refer to Item 1A, Risk Factors for material risks and uncertainties that management believes affect the Company.

The Company had 196 full-time equivalent employees on December 31, 2008, which includes exempt officers and part-time employees.

Federal and state banking laws contain numerous provisions that affect various aspects of the business and operations of the Company and the Bank. The Company is subject to, among others, the regulations of the Securities and Exchange Commission (the SEC) and the Federal Reserve Board (the FRB) and the Bank is subject to, among others, the regulations of the Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation (the FDIC). Refer to Part II, Item 7 Supervision and Regulation for descriptions of and references to applicable statutes and regulations which are not intended to be complete descriptions of these provisions or their effects on the Company or the Bank. They are summaries only and are qualified in their entirety by reference to such statutes and regulations. Applicable regulations relate to, among other things:

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

Table of Contents

Annually, the Bank is examined by the Pennsylvania Department of Banking and/or the FDIC. The last examination was conducted by the Pennsylvania Department of Banking as of December 31, 2007.

The Company s website address is http://www.bankatfidelity.com. The Company makes available through this website the annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K and amendments to those reports as soon as reasonably practical after filing with the SEC. You may read and copy any materials filed with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at (202) 551-8090. The SEC also maintains an internet site that contains reports, proxy and information statements and other information about the Company at http://www.sec.gov.

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

ITEM 1A: RISK FACTORS

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

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

Risks Related to the Company s Business

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

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

The Company is subject to lending risk.

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

As of December 31, 2008, approximately 56% of the Company s loan portfolio consisted of commercial, commercial real estate and real estate construction loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Company s loan portfolio contains a significant number of commercial, commercial real estate and construction loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from

Table of Contents

these loans, an increase in the provision for possible loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Company s financial condition and results of operations.

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

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

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

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

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

The Company s success depends primarily on the general economic conditions of the Commonwealth of Pennsylvania and the specific local markets in which the Company operates. Unlike larger national or other regional banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in Lackawanna and Luzerne Counties. The local economic conditions in these areas have a significant impact on the demand for the Company s products and services as well as the ability of the Company s customers to repay loans, the value of the collateral securing loans and the stability of the Company s deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, an outbreak of hostilities or other international or domestic occurrences, unemployment, changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Company s financial condition and results of operations. Currently, our Country is in a recession. The severity, depth and length of this recession is indeterminable. Job layoffs and eliminations continue to be announced throughout the United States, as well as locally. Reductions in the levels of income of both businesses and individual consumers could have a material impact on their ability to meet their loan payment obligations. This in turn could have a material adverse impact on the companies overall financial condition and earnings.

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

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

Table of Contents

that it can earn on loans and investments, increase the rates it must offer on deposits and other funds, and adversely affect its overall financial condition and earnings.

The Company is subject to extensive government regulation and supervision.

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

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

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

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

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

The Company s ability to pay dividends depends primarily on dividends from its banking subsidiary, which is subject to regulatory limits.

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

Table of Contents

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

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

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

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

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

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

The Company continually encounters technological change.

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

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

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

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

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on the Company s ability to conduct business. Such events could affect the stability of the Company s deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause the Company to incur additional expenses. Severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has

Table of Contents

established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on the Company s business, which, in turn, could have a material adverse effect on the Company s financial condition and results of operations.

Risks Associated with the Company s Common Stock

The Company s stock price can be volatile.

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

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

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

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

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

An investment in the Company s common stock is not an insured deposit.

The Company s common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in the Company s common stock is inherently risky for the reasons described in this Risk Factors section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire the Company s common stock, you may lose some or all of your investment.

The Company s articles of incorporation and by-laws, as well as certain banking laws, may have an anti-takeover effect.

Provisions of the Company s articles of incorporation and by-laws, federal banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire the Company, even if doing so would be perceived to be beneficial to the Company s shareholders. The combination of these provisions effectively inhibits a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of the Company s common stock.

Risks Associated with the Company s Industry

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

The Company is a registered bank holding company, and its subsidiary bank is a depository institution whose deposits are insured by the FDIC. As a result, the Company is subject to various regulations and examinations by various regulatory authorities. In general, statutes establish the corporate governance and eligible business activities for the Company, certain

Table of Contents

acquisition and merger restrictions, limitations on inter-company transactions such as loans and dividends, capital adequacy requirements, requirements for anti-money laundering programs and other compliance matters, among other regulations. The Company is extensively regulated under federal and state banking laws and regulations that are intended primarily for the protection of depositors, federal deposit insurance funds and the banking system as a whole. Compliance with these statutes and regulations is important to its ability to engage in new activities and to consummate additional acquisitions.

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

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

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

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

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

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

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as disintermediation, could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on the Company s financial condition and results of operations.

***The capital and credit markets have experienced unprecedented levels of volatility*.**

During 2008 the capital and credit markets experienced severe volatility and disruption. In the third and fourth quarters of 2008, the volatility and disruption reached unprecedented levels. This has continued into 2009 and the Country is presently in a recession. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced, and in some cases ceased to provide, funding to borrowers, including other financial institutions. Although to date we have not suffered liquidity problems, we are part of the financial system and a systemic lack of available credit, a lack of confidence in the financial sector, increased volatility in the financial markets and reduced business activity could materially and adversely affect our business, financial condition and results of operations.

In response to the turmoil in the banking system and financial markets, the U.S. government has taken unprecedented actions, including the U.S. Treasury s plan to inject capital and to purchase mortgage loans and mortgage-backed and other securities from financial institutions for the purpose of stabilizing the financial markets generally or particular financial institutions. There is no assurance that these government actions will achieve their purpose.

Table of Contents

The failure to help stabilize the financial markets and a continuation or worsening of the current financial market conditions could have a material adverse affect on our business, our financial condition, the financial condition of our customers, our common stock trading price, as well as our ability to access credit.

ITEM 1B: UNRESOLVED STAFF COMMENTS

None

ITEM 2: PROPERTIES

As of December 31, 2008, the Company operated 12 full-service banking offices, of which four were owned and eight were leased. None of the lessors of the properties leased by the Company are affiliated with the Company or the Bank and all of the properties are located in the Commonwealth of Pennsylvania. The Company is headquartered at its owner occupied main branch located on the corner of Blakely and Drinker Streets in Dunmore, PA.

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

Location	Owned / leased*	Type of use	Full service	Drive-thru	ATM
Drinker & Blakely Sts., Dunmore, PA	Owned	Main Branch (1) (2)	x	x	x
111 Green Ridge St., Scranton, PA	Leased	Green Ridge Branch (2)	x	x	x
139 Wyoming Ave., Scranton, PA	Leased	Scranton Branch	x		x
1311 Morgan Hwy., Clarks Summit, PA	Leased	Abington Branch (3)	x	x	x
Industrial Park Rd., Dunmore, PA	Owned	Keystone Industrial Park Branch	x	x	x
338 North Washington Ave., Scranton, PA	Owned	Financial Center Branch (4)	x		x
4010 Birney Ave., Moosic, PA	Leased	Moosic Branch	x	x	x
801 Wyoming Ave., West Pittston, PA	Leased	West Pittston Branch	x		x

1598 Main St., Peckville, PA	Leased	Peckville Branch	x	x	x
247 Wyoming Ave., Kingston, PA	Leased	Kingston Branch	x	x	x
511 Scranton-Carbondale Hwy., Eynon, PA	Leased	Eynon Branch	x	x	x
400 S. Main St., Scranton, PA	Owned	West Scranton Branch(2)	x	x	x

*All of the owned properties are free of encumbrances

(1) Executive and administrative, commercial lending, trust and asset management services are located at this facility.

(2) This office has two automated teller machines (ATMs).

(3) In addition, there is a banking facility located in the Clarks Summit State Hospital. The office is leased from the hospital under a lease-for-service-provided agreement with service limited to employees and patients of the hospital.

(4) Executive, mortgage and consumer lending, finance and operational offices are located in this building. A portion of the building is leased to a non-related entity.

Table of Contents

The Bank maintains several free-standing 24-hour ATMs located at the following locations in Pennsylvania:

- U.S. Mini Marts, Inc., 511 Main St., Childs
- Marywood University, 2300 Adams Ave., Nazareth and Regina Halls, Scranton
- Snö Mountain Ski Resort, 1000 Montage Mountain Rd., Moosic
- Shoppes at Montage, 1035 Shoppes Blvd., Moosic

During 2008, the Company closed its Pittston branch office located at 403 Kennedy Blvd., Pittston.

Other real estate owned includes all foreclosed properties listed for sale. Upon possession, foreclosed properties are recorded on the Company s balance sheet at the lower of cost or fair value.

ITEM 3: LEGAL PROCEEDINGS

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

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted during the quarter ended December 31, 2008 to a vote of our security holders through solicitation of proxies or otherwise.

PART II

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

The common stock of the Company is traded on the over-the-counter bulletin board under the symbol FDBC. Shareholders requesting information about the Company s common stock may contact Salvatore R. DeFrancesco, Jr., Treasurer. Requests may be mailed to:

Fidelity D & D Bancorp, Inc.

Blakely and Drinker St.

Dunmore, PA 18512

(570) 342-8281

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

	2008 Prices		Dividends	2007 Prices		Dividends
	High	**Low**	**paid**	**High**	**Low**	**paid**
1st Quarter	$ 31.00	$ 25.20	$ 0.25	$ 40.00	$ 32.50	$ 0.22
2nd Quarter	$ 30.00	$ 27.00	$ 0.25	$ 37.75	$ 32.00	$ 0.22
3rd Quarter	$ 33.50	$ 29.00	$ 0.25	$ 34.00	$ 27.10	$ 0.24
4th Quarter	$ 28.75	$ 21.75	$ 0.25	$ 34.00	$ 27.00	$ 0.25

Dividends are determined and declared by the Board of Directors of the Company. The Company expects to continue to pay cash dividends in the future; however, future dividends are dependent upon earnings, financial condition, capital needs and other factors of the Company. For a further discussion of regulatory capital requirements see Note 14, Regulatory matters, contained within the notes to the consolidated financial statements.

The Company has established a dividend reinvestment plan (DRP) for its shareholders. The plan is designed to make the Company s stock available at no transactional cost to our shareholders. Cash dividends, paid to shareholders who are enrolled in the DRP, are used to purchase shares directly from the Company or from shares that are available in the open market.

Table of Contents

The Company had approximately 1,323 shareholders at February 28, 2009 and also at December 31, 2008. The number of shareholders is the actual number of individual shareholders of record. Each security depository is considered a single shareholder for purposes of determining the approximate number of shareholders.

Securities authorized for issuance under equity compensation plans

The information required under this section is incorporated by reference herein, to the information presented in the Company s definitive Proxy Statement for its 2009 Annual Meeting of Shareholders to be filed with the SEC.

Purchases of equity securities by the issuer and affiliated purchasers

The following table summarizes the activity in the Company s stock repurchase program during the fourth quarter of 2008:

Period	**(a)** Total Number of shares (or units) purchased	**(b)** Average price paid per share (or unit)	**(c)** Total number of shares (or units) purchased as part as publicly announced plans or programs	**(d)** Maximum number of shares (or units) that may yet be purchased under the plans or programs
October 1, 2008 to October 31, 2008		$		37,000
November 1, 2008 to November 30, 2008	2,000	25.31	2,000	35,000
December 1, 2008 to December 31, 2008				35,000
Total	2,000	$ 25.31	2,000	35,000

In the second quarter of 2008 the Company s Board of Directors approved and publicly announced its intent to initiate a capital stock repurchase program covering up to 50,000 shares, or approximately 2.4% of its outstanding capital stock as of May 31, 2008. The Company has not made any purchases of its shares of capital that has not been publicly announced. Neither an expiration date nor a maximum dollar amount has been fixed to the program. The repurchases will be made from time-to-time in open-market transactions, subject to availability. The repurchased shares would become treasury stock and could be available for issuance under the Company s various stock-based compensation, employee stock purchase and dividend reinvestment plans and for general corporate purposes. No repurchase program has expired or has been subject to a determination to terminate during the period covered by the above table. In December 2008, 2,745 shares were reissued by the Company to participants in the dividend reinvestment plan at a re-issue price of $26.81 per share.

Performance graph

The following graph and table compare the cumulative total shareholder return on the Company s common stock against the cumulative total return of the NASDAQ Composite and the SNL index of greater than $500 million in-asset banks traded on the OTC-BB and Pink Sheet (the SNL index) for the period of five fiscal years commencing January 1, 2004, and ending December 31, 2008. The graph illustrates the cumulative investment return to shareholders, based on the assumption that a $100 investment was made on December 31, 2003, in each of: the Company s common stock, the NASDAQ Composite and the SNL index. All cumulative total returns are computed assuming the reinvestment of dividends into the applicable securities. The shareholder return shown on the graph and table below is not necessarily indicative of future performance:

Table of Contents

	Period ending					
Index	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**
Fidelity D & D Bancorp, Inc.	100.00	93.95	117.87	107.30	93.99	90.64
NASDAQ Composite	100.00	108.59	110.08	120.56	132.39	78.72
SNL > $500M OTC-BB and Pink Sheet Banks	100.00	116.97	124.48	136.58	125.85	91.32

Table of Contents

ITEM 6: SELECTED FINANCIAL DATA

Set forth below are our selected consolidated financial and other data. This financial data is derived in part from, and should be read in conjunction with, the Company s consolidated financial statements and related footnotes:

	2008	2007	2006	2005	2004
Balance sheet data:					
Total assets	$ 575,718,997	$ 587,412,555	$ 562,317,988	$ 544,060,698	$ 536,675,138
Total investment securities	84,187,579	122,984,160	100,410,736	97,678,573	115,668,818
Net loans	436,207,460	421,424,379	417,199,048	403,144,095	381,546,375
Loans available-for-sale	84,000	827,250	122,000	428,584	576,378
Total deposits	433,311,932	425,708,361	410,334,595	379,498,640	365,615,335
Short-term borrowings	38,129,704	39,656,354	33,656,150	28,772,997	50,534,046
Long-term debt	52,000,000	62,708,677	62,536,210	83,704,188	71,119,188
Total shareholders equity	48,960,651	55,191,294	51,611,863	48,846,029	46,366,760
Operating data for the year ended:					
Total interest income	$ 33,961,434	$ 35,279,357	$ 33,529,710	$ 29,020,261	$ 27,395,491
Total interest expense	14,684,133	17,660,075	16,361,109	11,720,986	11,180,135
Net interest income	19,277,301	17,619,282	17,168,601	17,299,275	16,215,356
Provision (credit) for loan losses	940,000	(60,000)	325,000	830,000	2,150,000
Net interest income after provision (credit) for loan losses	18,337,301	17,679,282	16,843,601	16,469,275	14,065,356
Other income	4,578,301	5,205,215	4,522,138	4,150,502	4,153,277
Other operating expense	18,210,683	16,636,760	15,878,376	14,561,968	13,818,565
Income before provision for income taxes	4,704,919	6,247,737	5,487,363	6,057,809	4,400,068
Provision for income taxes	1,068,971	1,636,165	1,362,080	1,466,112	1,035,594
Net Income	$ 3,635,948	$ 4,611,572	$ 4,125,283	$ 4,591,697	$ 3,364,474
Per share data:					
Net income per share, basic	$ 1.76	$ 2.23	$ 2.01	$ 2.26	$ 1.67
Net income per share, diluted	$ 1.76	$ 2.23	$ 2.01	$ 2.25	$ 1.67
Dividends declared	$ 2,068,680	$ 1,921,533	$ 1,801,361	$ 1,624,263	$ 1,610,423
Dividends per share	$ 1.00	$ 0.93	$ 0.88	$ 0.80	$ 0.80
Book value per share	$ 23.73	$ 26.62	$ 25.09	$ 23.95	$ 22.92
Weighted-average number of shares outstanding *	2,068,851	2,066,683	2,047,975	2,031,211	2,013,798
Number of shares outstanding at year-end *	2,062,927	2,072,929	2,057,433	2,039,639	2,023,529
Ratios:					
Return on average assets	0.62%	0.80%	0.73%	0.86%	0.61%
Return on average equity	6.81%	8.65%	8.31%	9.64%	7.51%
Net interest margin	3.60%	3.34%	3.31%	3.51%	3.20%
Efficiency ratio	72.98%	71.61%	71.67%	65.99%	64.45%
Expense ratio	2.25%	2.01%	2.02%	1.93%	1.69%
	1.08%	1.13%	1.29%	1.46%	1.54%

Allowance for loan losses to total loans					
Dividend payout ratio	56.90%	41.67%	43.67%	35.37%	47.87%
Equity to assets	8.50%	9.40%	9.18%	8.98%	8.64%
Equity to deposits	11.30%	12.96%	12.58%	12.87%	12.68%

* The number of shares and the weighted-average number of shares outstanding prior to 2006, have been adjusted to reflect the effect of a 10% stock dividend paid on February 15, 2006.

Table of Contents

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

Critical accounting policies

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

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at December 31, 2008 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company s allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

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

Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, management may obtain price quotes from more than one source. As described in Notes 1 and 3 of the consolidated financial statements, the large majority of the Company s investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheet, with unrealized gains and losses, net of income tax, reported separately within shareholders equity through accumulated other comprehensive income (loss).

The fair value of residential mortgage loans, classified as AFS, is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan and lease portfolio to loans AFS. Under these rare circumstances, pricing may be obtained from other entities and the loans are transferred at the lower of cost or market value and simultaneously sold. For a further discussion on the accounting treatment of AFS loans, see the section entitled Loans available-for-sale, contained within management s discussion and analysis. As of December 31, 2008 and 2007, loans classified as AFS consisted of residential mortgages.

All significant accounting policies are contained in Note 1, Nature of operations and summary of significant accounting policies, within the notes to consolidated financial statements and incorporated by reference in Part II, Item 8.

The following discussion and analysis presents the significant changes in the financial condition and in the results of operations of the Company as of December 31, 2008 and December 31, 2007 and for each of the years then ended. This discussion should be read in conjunction with the consolidated financial statements and notes included in Part II, Item 8 of this report.

Comparison of Financial Condition as of December 31, 2008

and 2007 and Results of Operations for each of the Years then Ended

Financial Condition

Overview

The national economy continued to falter with particular emphasis on the deterioration of the housing and real estate markets. The current economy has been marked by contractions in the availability of commercial and consumer credit, falling home

Table of Contents

prices, increasing home foreclosures and rising unemployment. In response, the Federal Open Market Committee (FOMC), reduced the federal funds rates seven times during 2008 to unprecedented levels, approaching zero and has resulted in a much more positively sloped yield curve during the current year. The shape of the yield curve will present opportunities, however the local economy is not insulated from the disruptions and volatility that continues to plague the national economy thereby requiring the Company to operate in a very difficult interest rate environment, the likes of which have been unseen for many decades. The management team of the Company is poised to address the issues at hand and will implement strategies to navigate through these uncertain times.

Consolidated assets decreased $11,694,000, or 2%, during the year ended December 31, 2008 to $575,719,000. The decline was the result of decreases in total borrowings of $12,235,000, or 12%, and a decrease in total shareholders equity of $6,231,000 partially offset by a 2%, or $7,604,000 increase in deposits. The decline in shareholders equity was primarily from increased unrealized net losses in the securities AFS portfolio, the declaration of cash dividends and the repurchase of the Company s capital stock (treasury stock). During 2008, the carrying amount of the investment portfolios declined by $38,797,000, or 32%, while the loan portfolios increased $14,040,000, or 3% to $436,291,000 as of December 31, 2008. Other increases included premises and equipment, the net deferred tax asset, bank owned life insurance, FHLB stock, the carrying value of the derivative contract and prepaid expenses. Cash increased $2,362,000 since 2007.

The following table is a comparison of condensed balance sheet accounts and percentage to total assets at December 31, 2008, 2007 and 2006 (thousands of dollars):

	2008		2007		2006	
	Amount	Percent	Amount	Percent	Amount	Percent
Assets:						
Cash and cash equivalents	$ 12,771	2.2%	$ 10,409	1.8%	$ 13,801	2.4%
Investment securities	84,188	14.6	122,984	20.9	100,411	17.9
Federal Home Loan Bank Stock	4,781	0.8	3,303	0.6	3,795	0.7
Loans and leases, net	436,291	75.8	422,252	71.9	417,321	74.2
Bank premises and equipment	16,056	2.8	12,965	2.2	11,324	2.0
Life insurance cash surrender value	8,808	1.5	8,489	1.4	8,178	1.5
Other assets	12,824	2.3	7,011	1.2	7,488	1.3
Total assets	$ 575,719	100.0%	$ 587,413	100.0%	$ 562,318	100.0%
Liabilities:						
Total deposits	$ 433,312	75.3%	$ 425,708	72.5%	$ 410,335	73.0%
Short-term borrowings	38,130	6.6	39,656	6.7	33,656	6.0
Long-term debt	52,000	9.0	62,709	10.7	62,536	11.1
Other liabilities	3,316	0.6	4,149	0.7	4,179	0.7
Total liabilities	526,758	91.5	532,222	90.6	510,706	90.8
Shareholders equity	48,961	8.5	55,191	9.4	51,612	9.2
Total liabilities and shareholders equity	$ 575,719	100.0%	$ 587,413	100.0%	$ 562,318	100.0%

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

	Assets	%	Earning assets *	%	Deposits	%	Short-term borrowings	%	Other borrowings	%

2008	$	(11,693,558)	(2)	$	(22,808,541)	(4)	$	7,603,571	2	$	(1,526,650)	(4)	$	(10,708,677)	(17)
2007		25,094,567	4		26,073,807	5		15,373,766	4		6,000,204	18		172,467	
2006		18,257,290	3		21,202,050	4		30,835,955	8		4,883,153	17		(21,167,978)	(25)
2005		7,385,560	1		2,784,580	1		13,883,305	4		(21,761,049)	(43)		12,585,000	18
2004		(38,540,328)	(7)		(35,884,098)	(7)		(35,827,211)	(9)		(4,222,932)	(8)		(756,846)	(1)

* Earning assets exclude loans placed on non-accrual status.

Table of Contents

Deposits

The Bank is a community-based commercial financial institution, member FDIC, which offers a variety of deposit accounts with varying ranges of interest rates and terms. Deposit products include savings accounts, interest-bearing checking (NOW), money market, non-interest bearing checking (DDAs) and certificates of deposit accounts. Certificates of deposit accounts, or CDs, are deposits with stated maturities ranging from seven days to ten years. The flow of deposits is significantly influenced by general economic conditions, changes in prevailing interest rates, pricing and competition. Most of the Company s deposits are obtained from the communities surrounding its 12 branch offices and all deposits are insured by the FDIC up to the full extent permitted by law. The Bank attempts to attract and retain deposit customers via sales and marketing efforts, new products, quality service, competitive rates and maintaining long-standing customer relationships. To determine deposit product interest rates, the Company considers local competition, market yields and the rates charged for alternative sources of funding such as short- and long-term borrowings. Though we tend to experience intense competition for deposits, our interest rate setting strategy includes consideration of the Company s liquidity needs, balance sheet structure and cost effective strategies that are mindful of the current interest rate environment.

The following table represents the components of total deposits as of December 31, 2008 and 2007 (thousands of dollars):

	2008		2007	
	Amount	**Percent**	**Amount**	**Percent**
Money market	$ 96,738	22.3%	$ 87,892	20.6%
NOW	50,124	11.6	54,695	12.9
Savings and clubs	41,326	9.5	40,125	9.4
Certificates of deposit	173,681	40.1	178,200	41.9
Total interest-bearing	361,869	83.5	360,912	84.8
Non-interest-bearing	71,443	16.5	64,796	15.2
Total deposits	$ 433,312	100.0%	$ 425,708	100.0%

Total deposits increased $7,604,000, or 2%, during 2008 to $433,312,000. The growth in deposits was mostly from increases in money markets $8,846,000 and DDAs of $6,647,000, or 10% each, partially offset by declines in NOW and certificates of deposit accounts of $4,571,000 and $4,519,000, respectively. The majority of the increase in DDAs was from a temporary deposit from a corporate trust account which has since been withdrawn. The new West Scranton branch office that opened during the third quarter of 2008 and the related bank-wide promotions, superior customer service, increased deposit business from our existing and new commercial customers all contributed to the net increase in deposits. The continued increases in money market accounts that the Company has experienced is from success in our deposit-gathering strategies in conjunction with promotional interest rates tailored to depositors needs. We attribute the decline in certificate of deposit accounts to the lower and highly volatile interest rate environment that exists today compared to a year ago.

The maturity distribution of certificate of deposit accounts at December 31, 2008 is as follows:

	Three months or less	**Three to six Months**	**Six to twelve months**	**Over twelve months**	**Total**
CDs of $100,000 or more	$ 20,438,339	$ 10,989,353	$ 29,534,467	$ 13,288,607	$ 74,250,766
CDs of less than $100,000	13,641,073	14,907,570	49,896,837	20,984,669	99,430,149
Total CDs	$ 34,079,412	$ 25,896,923	$ 79,431,304	$ 34,273,276	$ 173,680,915

Approximately 80% of the CDs are scheduled to mature within one year. Renewing CDs may re-price to lower or higher market rates depending on the direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative products. To help reduce the financial impact of the unpredictable and highly volatile interest rate environment, management intends to continue to deploy strategies that will diversify the deposit mix across the entire spectrum of products offered. As always, consideration will be afforded to customer retention and new customer relationships.

Short-term borrowings

In addition to deposits, other funding sources available to the Company are overnight funds purchased from the Federal Home Loan Bank of Pittsburgh (FHLB), fed funds purchased from correspondent banks and repurchase agreements with

Table of Contents

individuals, businesses and public entities. The Company uses overnight funding for asset growth, deposit run-off and short-term liquidity needs.

Repurchase agreements are offered in both sweep and fixed-term products. These agreements are non-insured interest-bearing liabilities that have a security interest in qualified pledged investments of the Bank. A sweep account is designed to ensure that on a daily basis, an attached DDA is adequately funded and excess DDA funds are transferred, or swept, into an interest-bearing overnight repurchase agreement account. In addition, the sweep is designed to transfer funds to the DDA as necessary to cover checks presented for payment. Due to the nature of the sweep product, they tend to be more volatile than the fixed-term product because the daily sweep is dependent on the level of available funds in depositor accounts. Customer liquidity and investment needs and changes in interest rates are the typical causes for variances in repurchase agreements, which during 2008 declined $11,412,000 from $20,504,000 at December 31, 2007. At December 31, 2008 and 2007, sweep accounts represented 93% and 62%, respectively, of total repurchase agreements. The low interest rate environment has caused our customers to seek higher rates in alternative products and as such the balances in the term-repurchase agreement declined by about 91%.

Overnight borrowings and repurchase agreements are included with short-term borrowings on the consolidated balance sheets. For a further discussion on short-term borrowings, see Note 7, Short-term borrowings, contained in the notes to consolidated financial statements in Part II, Item 8.

Long-term debt

Long-term debt consists of borrowings from the FHLB. The weighted-average rate in effect on funds borrowed at December 31, 2008 was 5.35% compared to 5.26% as of December 31, 2007. The 2008 weighted-average rate was 92 basis points below the tax-equivalent yield of 6.27% on the Company s portfolio of average interest-earning assets for the year ended December 31, 2008. Rates on $42,000,000 of the total long-term advances are currently fixed but are designed to adjust quarterly should market rates increase beyond the issues original or strike rates. Significant prepayment penalties are attached to the borrowings thereby creating a significant disincentive from paying off the relatively high cost advances. However, in the event underlying market rates drift above the rates currently paid on these borrowings, the FHLB rate will convert to a floating rate and the Company has the option, at that time, to repay or to renegotiate the converted advance rate. During December 2008, a $10,000,000 capped floating-rate long-term advance was paid off early. During February 2009, a $10,000,000, 5.32% fixed-rate advance was also paid off early. Whether or not the advance will be renewed will be predicated on the interest rate environment, demand for liquidity and relative cash-flows of deposits, demand for loan funding and prepayments of interest-earning assets.

At December 31, 2008, the Company had the ability to borrow an additional $117,348,000 from the FHLB, from their array of numerous funding products that are available at a varying terms and conditions.

Investments

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

At the time of purchase, management classifies investment securities into one of three categories: trading, AFS or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. Most of the securities purchased are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Securities AFS are carried at net fair values in the consolidated balance sheet with an adjustment to shareholders equity, net of tax, presented under the caption Accumulated other comprehensive income (loss). Securities designated as HTM represent debt securities that the Company has the ability and intent to hold until maturity and are carried at amortized cost. As of December 31, 2008 and December 31, 2007, the aggregate fair value of

Table of Contents

securities HTM exceeded their respective aggregate amortized cost by $31,000 and $33,000, respectively.

Total investments decreased $38,797,000, including an $11,893,000 decline in the market value of AFS investments. During 2008, the Company sold approximately $48.4 million of mortgage-backed and agency securities, the proceeds of which were used to pay-down long-term debt, fund loan growth and fund the expansion of the Company s branch network. The carrying value of investment securities, at December 31, 2008, was $84,188,000, or 15% of total assets compared to $122,984,000, or 21%, as of December 31, 2007.

The market values for corporate investment securities are very depressed relative to historical levels. For example, the yield spreads for the broad market of investment grade and high yield corporate bonds reached all time wide levels compared to treasury securities at the end of 2008 and remain near those levels today. Thus in today s market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general versus being an indicator of credit problems with a particular issuer.

As of December 31, 2008 the debt securities with unrealized losses have depreciated 27.4% compared to 2.4% at December 31, 2007. Management believes that the cause of the unrealized losses is related to changes in interest rates, instability in the capital markets or the limited trading activity due to recent debt market illiquid conditions and is not directly related to credit quality, which is consistent with its past experience. Nearly all of the securities in the portfolio have fixed rates or have predetermined scheduled rate changes, and many have call features that allow the issuer to call the security at par before its stated maturity without penalty.

Management performs a review of the investment portfolio quarterly to determine the cause of declines in the fair value of each security. The Company uses inputs provided by an independent third party to determine the fair values of its investment securities portfolio. Inputs provided by the third party are reviewed and corroborated by management. Evaluations of the causes of the unrealized losses are performed to determine whether impairment, if any, is temporary or other-than-temporary. Considerations such as the Company s intent and ability to hold the securities to maturity, recoverability of the invested amounts over the intended holding period, severity in pricing decline, the interest rate environment, receipts of amounts contractually due and whether or not there is an active market for the security, for example, are applied in determining whether a security is other-than-temporarily impaired. If a decline in value is deemed to be other-than-temporary, the amortized cost of the security is reduced by the impairment amount and a corresponding charge to earnings is recognized. If at the time of sale, call or maturity the proceeds exceed the security s amortized cost, the impairment charge may be fully or partially recovered and recorded as a gain on sale of investment securities.

At December 31, 2008, the securities with the most significant reductions in fair value and associated estimated unrealized losses were in the Company s corporate bond portfolio consisting of collateralized debt obligation (CDO) securities that are backed by pooled trust preferred term securities (preferred term securities) issued by banks, thrifts and insurance companies.

The Company owns 13 issues of preferred term securities. The market for these securities at December 31, 2008 was not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which preferred term securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive as no new preferred term securities have been issued since 2007. There are currently very few market participants who are willing and or able to transact for these securities. Given conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, fair value of the preferred term securities was determined as explained in Note 3, Securities Investments, contained within the notes to the consolidated financial statements in Part II, Item 8.

Based on the technique described in Note 3, the Company determined that as of December 31, 2008, the fair value of one of its preferred term securities had declined $430,000 below its cost basis and has been deemed to be other-than-temporarily impaired. Accordingly, this amount has been recorded as an impairment charge and is included as a component of other income in the consolidated income statements for the year ended December 31, 2008. The market value of the Company s investment in preferred term securities has declined by $9,958,000 since December 31, 2007. The Company intends to closely monitor the preferred term securities market and perform collateral sufficiency and cash flow analyses on at least a quarterly basis. Future analyses could yield results that may indicate further impairment has occurred and therefore require additional write-downs and corresponding other-than-temporary charges to current earnings. In addition to the impairment charge on the preferred term securities portfolio, the Company had an equity position in FNMA common stock whose fair value declined below its cost basis by $6,000 and has also been deemed to be other-than-temporarily impaired and written down as of December 31, 2008. There were no other-than-temporary impairment write-downs recorded in 2007 or 2006.

Table of Contents

A comparison of investments at December 31, for the three previous years is as follows:

	2008			2007			2006		
		Amount	Percent		Amount	Percent		Amount	Percent
U.S. government agencies	$	43,507,359	51.7%	$	35,243,890	28.7%	$	33,891,985	33.8%
Mortgage-backed securities		12,438,721	14.8		58,767,109	47.8		42,900,005	42.7
State & municipal subdivisions		17,552,729	20.8		12,133,443	9.8		12,576,684	12.5
Preferred term securities		10,260,196	12.2		16,335,486	13.3		10,570,993	10.5
Equity securities		428,574	0.5		504,232	0.4		471,069	0.5
Total	$	84,187,579	100.0%	$	122,984,160	100.0%	$	100,410,736	100.0%

The distribution of debt securities by stated maturity date at December 31, 2008 is as follows:

	One year or less	One through five years	Five through ten years		More than ten years		Total
U.S. government agencies	$	$	$	7,917,994	$ 35,589,365	$	43,507,359
Mortgage-backed securities				381,537	12,057,184		12,438,721
State & municipal subdivisions				2,788,460	14,764,269		17,552,729
Preferred term securities					10,260,196		10,260,196
Total debt securities	$	$	$	11,087,991	$ 72,671,014	$	83,759,005

AFS securities are stated net of unrealized gains and losses. As of December 31, 2008, AFS debt securities were recorded with a net unrealized loss in the amount of $13,486,000. At December 31, 2008, AFS equity securities were recorded at $428,000 which included a net unrealized gain of $106,000.

The tax-equivalent yield on debt securities by stated maturity date at December 31, 2008, is as follows:

	One year or less	One through five years	Five through ten years	More than ten years	Total
U.S. government agencies	%	%	5.07%	5.87%	5.74%
Mortgage-backed securities			6.01	5.44	5.45
State & municipal subdivisions			5.47	5.90	5.83
Preferred term securities				4.00	4.00
Total debt securities	%	%	5.21%	5.35%	5.34%

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

Federal Home Loan Bank Stock

Investment in FHLB stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB. Excess stock is typically repurchased from the Company at par if the level of borrowings declines to a predetermined level. In addition, the Company normally earns a return or dividend on the amount invested. In late December, the FHLB announced that it has suspended payment of dividends and the repurchase of excess capital stock to preserve its capital level. That decision was based on FHLB s analysis and consideration of certain negative market trends and the impact those trends will have on their financial condition. Based on the financial results of the FHLB for the year-ended December 31, 2008, management believes that the suspension of both the dividend payments and excess capital stock repurchase is temporary in nature. The Company will continue to monitor the financial condition of the FHLB and assess its ability to resume these activities in the future.

Table of Contents

Loans and leases

Gross loans and leases increased $14,704,000, or 3%, from $426,249,000 at December 31, 2007, to $440,953,000 at December 31, 2008. Gross loans represented 77% and 73% of total assets at December 31, 2008 and December 31, 2007, respectively.

In 2008, the Company originated $47,864,000 of commercial loans, $23,111,000 of residential mortgage loans and $21,354,000 of consumer loans. This compares to $32,919,000, $24,032,000 and $28,062,000, respectively, in 2007. Included in mortgage loans is $9,476,000 of real estate construction lines in 2008 and $12,515,000 in 2007. In addition for 2008, the Company originated lines of credit in the amounts of $50,664,000 for commercial borrowers and $11,866,000 in home equity and other consumer lines of credit.

The Company s origination activity increased 9% in 2008 over 2007 despite operating in a very difficult economy. Only the residential real estate portfolio recorded a decline compared to 2007 and was more than offset by growth in commercial lending. The hiring of a new senior lender has enabled the Company to grow its commercial and CRE portfolio. During 2009, the Company will continue to channel efforts to develop total banking relationships with new customers and strengthen relationships with our existing base of loyal customers.

Commercial and Commercial Real Estate Loans:

Originations in commercial and commercial real estate (CRE) were relatively strong, as they fully exceeded scheduled principal curtailments and pre-payments thereby resulting in a commercial loan increase of $29,422,000 to $245,480,000 from $216,058,000, or 14% during 2008. During most of 2008, the Company bolstered the origination activities in the commercial loan business. Commercial lending successfully restructured its team of commercial loan officers led by the experienced newly hired senior lender. This team has effectively penetrated our markets and successfully developed new business relationships and re-kindled relationships with our existing commercial customer base.

Residential Real Estate Loans:

Residential real estate loans declined $18,468,000, or 16%, to $98,511,000 in 2008. In the beginning of 2008, the Company transferred approximately $28,103,000 to the loans AFS portfolio. The loans were subsequently sold. From time-to-time, management will evaluate the composition of the residential loan portfolio and based upon liquidity needs, interest rate risk and other considerations may transfer loans to the available-for-sale portfolio, at the lower of cost or market value, and simultaneously sell them. Excluding this transfer, the residential real estate loan portfolio would have grown $6,900,000 as origination activity exceeded maturities and pay-downs. Operating in a lower interest rate environment throughout most of 2008 with expectations of a continued period of low rates into 2009, the Company expects higher levels of prepayment and refinance activity in 2009.

Consumer Loans:

Though consumer loan originations were lower in 2008 compared to 2007, this sector increased $3,093,000, or 4%, during the year. The increase was mainly from lower principal pay-downs and increased draw activity from customers accessing their home equity available credit. While interest rates remain low, the Company expects the home equity business to continue to increase into 2009. During 2008, the Company established a new relationship with a local automobile dealership which should provide increased origination activity in consumer lending in the years ahead.

Real Estate Construction Loans:

Real estate construction loans increased $724,000, or 7%, at December 31, 2008 compared to December 31, 2007. These loans fund residential and commercial construction projects and then convert to a residential mortgage or to a commercial real estate loan usually within one year from the origination date. Generally, the converted loans will bear similar terms as the terms during the construction period. The increase in 2008 was caused by more commercial construction projects that had not yet converted to permanent financing.

Direct Financing Leases:

The balance represents tax-free leasing arrangements provided to municipal customers. For 2008, the activity represents scheduled run-off.

Table of Contents

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

	2008	2007	2006	2005	2004
Commercial and CRE	$ 245,479,992	$ 216,057,882	$ 218,213,216	$ 216,288,597	$ 221,968,137
Residential real estate	98,510,562	116,978,378	112,742,692	103,920,613	91,294,401
Consumer	85,091,205	81,998,093	77,729,520	74,070,328	61,487,608
Real estate construction	11,426,978	10,703,249	13,369,712	14,198,858	10,620,472
Direct financing leases	443,957	511,178	588,211	650,348	2,211,978
Gross loans	440,952,694	426,248,780	422,643,351	409,128,744	387,582,596
Less:					
Unearned discount					48,423
Allowance for loan losses	4,745,234	4,824,401	5,444,303	5,984,649	5,987,798
Net loans	$ 436,207,460	$ 421,424,379	$ 417,199,048	$ 403,144,095	$ 381,546,375
Loans available-for-sale	$ 84,000	$ 827,250	$ 122,000	$ 428,584	$ 576,378

A comparison of gross loans by percent at year-end for the five previous periods is as follows:

	2008	2007	2006	2005	2004
Commercial and CRE	55.7%	50.7%	51.6%	52.9%	57.3%
Residential real estate	22.3	27.5	26.7	25.4	23.5
Consumer	19.3	19.2	18.4	18.1	15.9
Real estate construction	2.6	2.5	3.2	3.5	2.7
Direct financing leases	0.1	0.1	0.1	0.1	0.6
Gross loans	100.0%	100.0%	100.0%	100.0%	100.0%

The following table sets forth the maturity distribution of select components of the loan portfolio at December 31, 2008. Excluded from the table are residential real estate loans, consumer loans and direct financing leases (dollars in thousands):

	One-year or less	One to five Years	More than five years	Total
Commercial and CRE	$ 20,276	$ 57,026	$ 168,178	$ 245,480
Real estate construction	11,427			11,427
Total	$ 31,703	$ 57,026	$ 168,178	$ 256,907

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

The following table sets forth the sensitivity changes in interest rates for commercial and CRE loans at December 31, 2008 (dollars in thousands):

	One to five Years	More than five years	Total
Fixed interest rate	$ 38,807	$ 46,121	$ 84,928
Variable interest rate	64,070	56,801	120,871
Total	$ 102,877	$ 102,922	$ 205,799

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

There are no concentrations of loans to a number of borrowers engaged in similar activities exceeding 10% of total loans that are not otherwise disclosed as a category in the tables above. There are no concentrations of loans that, if resulted in a loss, would have a material adverse effect on the business of the Company. The Company s loan portfolio does not have a material concentration within a single industry or group of related industries that is vulnerable to the risk of a near-term severe negative business impact.

Table of Contents

Loans available-for-sale

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

Loans AFS at December 31, 2008 were $84,000 with a corresponding fair value of $85,000 compared to $827,000 and $843,000, respectively, at December 31, 2007. During 2008, residential mortgages with principal balances of $46,969,000 were sold into the secondary market and recognized net gains of approximately $261,000. Included in the sale was $28,103,000 of residential loans transferred from the loan and lease portfolio.

The Company retains mortgage servicing rights (MSRs) on loans sold into the secondary market. MSRs are retained so that the Company can continue the personal relationships they have established with their customers. At December 31, 2008 and 2007, the servicing portfolio balance of sold residential mortgage loans was $95,856,000 and $61,023,000, respectively.

Allowance for loan losses

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

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

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

- determination of homogenous pools by loan category and eliminating the impaired loans;
- application of historical loss percentages (five-year average) to pools to determine the allowance allocation; and
- application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio.

Allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company s credit risk evaluation process, which includes credit risk grading of individual commercial loans. Commercial loans are assigned credit risk grades based on the Company s assessment of conditions that affect the borrower s ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. The changes in allocations in the commercial loan portfolio from period to period are based upon the credit risk grading system and from periodic reviews of the loan and lease portfolios.

Each quarter, management performs an assessment of the allowance and the provision for loan losses. The Company s Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based on Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan, (SFAS 114). The Special Assets Committee s focus is on ensuring the pertinent facts are considered and the SFAS 114 reserve amounts are reasonable. The assessment process includes the review

Table of Contents

of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company s Credit Administration function have assigned a criticized or classified risk rating.

Total charge-offs, net of recoveries, for the year ended December 31, 2008, were $1,019,000, compared to $560,000 in 2007. The majority of the increase occurred in the commercial portfolio and was attributable to non-performing loan dispositions and write-downs before transfers to ORE.

Combined consumer loan and lease financing net charge-offs increased from $237,000 at December 31, 2007 to $320,000 through December 31, 2008. Commercial loan net charge-offs were $358,000 for the year 2007 compared to $654,000 for 2008. Mortgage loans showed net Charge-offs of $45,000 in 2008 compared to net recoveries of $35,000 in 2007. For a discussion on the provision for loan losses, see the Provision for loan losses, located in the results of operations section of management s discussion and analysis contained herein.

For a further discussion of delinquencies and net charge-offs, see the section entitled Non-performing assets. Additional discussion is in Note 1, Nature of operations and summary of significant accounting policies Allowance for loan losses, and Note 4, Loans and leases, contained in the notes to consolidated financial statements, incorporated herein by reference.

Management believes that the current balance in the allowance for loan losses of $4,745,000 is sufficient to withstand the identified potential credit quality issues that may arise and others unidentified but are inherent to the portfolio. At December 31, 2008, management was unaware of any potential problem loans that have not been reviewed. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status or past due 90 days or more. However, there could be certain instances which become identified over the upcoming year that may require additional charge-offs and/or increases to the allowance. The ratio of allowance for loan losses to total loans was 1.08% at December 31, 2008 compared to 1.13% at December 31, 2007.

Table of Contents

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

	2008	2007	2006	2005	2004
Balance at beginning of period	$ 4,824	$ 5,444	$ 5,985	$ 5,988	$ 4,997
Charge-offs:					
Commercial and all other	733	376	661	1,077	775
Real estate	45	90	109	21	266
Consumer	351	256	285	288	480
Lease financing				8	85
Total	1,129	722	1,055	1,394	1,606
Recoveries:					
Commercial and all other	79	18	64	395	226
Real estate		125	1	11	20
Consumer	31	19	124	155	178
Lease financing					23
Total	110	162	189	561	447
Net charge-offs	1,019	560	866	833	1,159
Provision (credit) for loan losses	940	(60)	325	830	2,150
Balance at end of period	$ 4,745	$ 4,824	$ 5,444	$ 5,985	$ 5,988
Net charge-offs to average net loans outstanding	0.24%	0.13%	0.21%	0.22%	0.30%
Allowance for loan losses to net charge-offs	4.66x	8.62x	6.29x	7.18x	5.17x
Allowance for loan losses to total loans	1.08%	1.13%	1.29%	1.46%	1.54%
Loans 30 - 89 days past due and accruing	$ 1,858	$ 4,698	$ 2,571	$ 1,609	$ 4,317
Loans 90 days or more past due and accruing	$ 604	$ 26	$ 81	$ 197	$ 557
Non-accruing loans	$ 3,493	$ 3,811	$ 3,358	$ 9,453	$ 9,904
Allowance for loan losses to loans 90 days or more past due and accruing	7.85x	189.41x	67.54x	30.39x	10.75x
Allowance for loan losses to non-accruing loans	1.36x	1.27x	1.62x	0.63x	0.60x
Allowance for loan losses to non-performing loans	1.16x	1.26x	1.58x	0.62x	0.57x
Average net loans	$ 416,438	$ 419,586	$ 412,523	$ 385,800	$ 381,366

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

Allocation of the allowance among major categories of loans for the past five years is summarized in the following table. This table should not be interpreted as an indication that charge-offs in future periods will occur in these amounts or proportions, or that the allocation indicates future charge-off trends. The portion of the allowance designated as unallocated is within the Company s policy guidelines.

Table of Contents

		2008	%		2007	%		2006	%		2005	%		2004	%
Category															
Residential real estate	$	710,981	15.0	$	636,899	13.2	$	578,117	10.6	$	595,092	9.9	$	451,349	7.5
Consumer		973,356	20.5		960,505	19.9		1,157,091	21.2		1,180,175	19.7		966,081	16.1
Commercial and commercial real estate		2,860,059	60.3		2,979,372	61.7		3,549,870	65.2		4,035,950	67.4		4,330,285	72.3
Direct financing leases		6,837	0.1		9,355	0.2		14,058	0.3		14,828	0.3		40,891	0.7
Real estate construction		67,141	1.4		52,634	1.1		59,617	1.1		59,953	1.0		46,465	0.8
Unallocated		126,860	2.7		185,636	3.9		85,550	1.6		98,651	1.7		152,727	2.6
Total	$	4,745,234	100.0%	$	4,824,401	100.0%	$	5,444,303	100.0%	$	5,984,649	100.0%	$	5,987,798	100.0%

The allocation of the allowance for the commercial loan portfolio comprised 60%, or $2,860,000, of the total allowance for loan losses at December 31, 2008, of which approximately 10% is reserved for specifically identified non-performing commercial loan relationships. Collateral values were prudently valued to provide a conservative and realistic value of the collateral supporting these loans. The allocations to the other categories of loans are adequate compared to the actual three-year historical net charge-offs.

Non-performing assets

The Company defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, restructured loans, other real estate owned (ORE) and repossessed assets. As of December 31, 2008, non-performing assets represented 0.96% of total assets compared to 0.67% at December 31, 2007.

The following table sets forth non-performing assets at December 31 (dollars in thousands):

		2008		2007		2006		2005		2004
Net loans, including loans available-for-sale	$	436,291	$	422,252	$	417,321	$	403,573	$	382,123
Loans past due 90 days or more and accruing	$	604	$	26	$	81	$	197	$	557
Non-accrual loans		3,493		3,811		3,358		9,453		9,904
Total non-performing loans		4,097		3,837		3,439		9,650		10,461
Restructured loans										
Other real estate owned		1,451		107		197				163
Repossessed assets								19		50
Total non-performing assets	$	5,548	$	3,944	$	3,636	$	9,669	$	10,674
Non-accrual loans to net loans		0.80%		0.90%		0.80%		2.34%		2.59%
Non-performing assets to net loans, foreclosed real estate and repossessed assets		1.27%		0.93%		0.87%		2.40%		2.79%
Non-performing assets to total assets		0.96%		0.67%		0.65%		1.78%		1.99%
Non-performing loans to net loans		0.94%		0.91%		0.82%		2.39%		2.74%

In the review of loans for both delinquency and collateral sufficiency, management concluded that there were a number of loans that lacked the ability to repay in accordance with contractual terms. The decision to place loans or leases on a non-accrual status is made on an individual basis after considering factors pertaining to each specific loan.

The majority of non-performing assets for the period is attributed to non-accruing commercial business loans and non-accruing real estate loans in the process of foreclosure. Most of these loans are collateralized, thereby mitigating the Company s potential for loss. In 2007, non-performing loans were $3,837,000 compared to $4,097,000 at year-end 2008. There were no repossessed assets at December 31, 2008 or 2007. ORE at December 31, 2008 consisted of four properties of which one had an agreement to sell pending at that time. ORE at year-end 2007, consisted of one property which was subsequently sold. The Special Assets Department had developed specific action plans for each of the Company s non-performing loans. During 2008, several of those plans were brought to a conclusion resulting in repayments of non-performing loans. The non-accrual loans aggregated $3,493,000 at December 31, 2008, a reduction of $318,000 from year-end 2007. During 2008, approximately $4,946,000 of loans were placed in non-accrual status. These were partially offset by reductions or payoffs of $2,426,000, charge-offs of $916,000, $1,562,000 of transfers to ORE and $360,000 of loans that

Table of Contents

returned to performing status. Loans past due 90 days or more and accruing totaled $604,000 at December 31, 2008 compared to $26,000, at December 31, 2007. The majority of the increase was attributable to one residential mortgage migrating to the over 90 day category. Non-accrual loans were reduced by 8% to $3,493,000. The ORE balance rose from $107,000 to $1,450,000. This sizeable increase is a result of the collections process as the collateral securing non-accruing loans are taken in the foreclosure process. These three items comprise the non-performing assets of $5,548,000 at December 31, 2008. The percentage of non-performing assets to total assets was 0.96% at December 31, 2008, an increase from 0.67% at December 31, 2007, primarily due to the aforementioned ORE increase. Non-performing loans to net loans were 0.94% at December 31, 2008, and 0.91% at December 31, 2007. The 30-89 day past due loans at December 31, 2008 were $1,858,000 reduced from $4,698,000 at December 31, 2007. Contributing to the reduction was the repayment of previously delinquent loans and others which had been brought current.

During the latter part of January 2009 the Company was notified by a customer of a significant adverse business event causing management to place the customer s $3,300,000 loan relationship on non-accruing status. Management does not expect this will have a material impact on income going forward.

Repossessed assets consist of previously financed vehicles held-for-sale. Subsequent to the loan or lease maturity, the borrower or lessee defaulted on their contract and the Company repossessed the unit. Repossessed assets are sold through either a private or public sale and any deficiency balance from the sale of the asset is charged to the allowance for loan losses. The Company terminated its automobile leasing business in 2005. There were no repossessed assets or restructured loans at December 31, 2007 or December 31, 2008.

Payments received on non-accrual loans are recognized on a cash basis. Payments are first applied against the outstanding principal balance, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of interest income. During 2008, the Company collected approximately $311,000 of interest income recognized on the cash basis. If the non-accrual loans that were outstanding as of December 31, 2008 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of $250,000 for the year ended December 31, 2008.

Bank premises and equipment, net

Net of accumulated depreciation and disposals, premises and equipment increased $3,091,000. The Company purchased fixed assets or transferred assets from construction in process, a component of other assets in the consolidated balance sheet, of approximately $4,489,000 during 2008 compared to $3,293,000 in 2007. The increase was principally from the construction and completion of the Company s West Scranton branch expansion project.

Foreclosed assets held-for-sale

Other Real Estate Owned

ORE was $1,451,000 at December 31, 2008 consisting of four properties, one of which was under an agreement to be sold. The remaining three properties were listed for sale with a realtor. The one ORE property which had been owned at year end December 31, 2007 was sold.

Cash surrender value of bank owned life insurance

The Company maintains bank owned life insurance (BOLI) for a chosen group of employees, namely its officers, where the Company is the owner and sole beneficiary of the policies. BOLI is classified as a non-interest earning asset. Increases in the cash surrender value are recorded as components of non-interest income. The BOLI is profitable from the appreciation of the cash surrender values of the pool of insurance and its tax-free advantage to the Company. This profitability is used to offset a portion of current and future employee benefit costs. The BOLI can be liquidated if necessary with associated tax costs. However, the Company intends to hold this pool of insurance, because it provides income that enhances the Company s capital position. Therefore, the Company has not provided for deferred income taxes on the earnings from the increase in cash surrender value.

Other assets

Other assets more than doubled in 2008 to $8,930,000 compared to 2007. The increase was caused predominately by the increase in the net deferred tax asst of $4,046,000 as a result of additional unrealized losses in the securities AFS portfolio. See Note 10, Income Taxes, for an analysis of the net deferred tax asset. Also contributing to the increase in other assets was an increase in the fair value of the Company s derivative contract which is more fully explained in Note 1, Nature of

Table of Contents

operations and summary of significant accounting policies, and Note 12, Fair value of financial instruments and derivatives, contained within the notes to consolidated financial statements in Part II, Item 8.

Results of Operations

Earnings Summary

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

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

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

Overview

Net income for the year ended December 31, 2008 was $3,636,000, compared to $4,612,000 for the year ended December 31, 2007. During the same periods, diluted earnings per common share was $1.76 and $2.23, respectively. For the year ended December 31, 2008, the Company s return on average assets (ROA) and return on average shareholders equity (ROE) were 0.62% and 6.81% compared to 0.80% and 8.65%, respectively, for the year ended December 31, 2007. The current year included a non-operating, non-cash, after-tax charge of $288,000 related to an other-than-temporary impairment (OTTI) in the Company s security AFS portfolio that did not occur in 2007. In addition, during 2008, the Company recorded a provision for loan losses in the amount of $940,000 compared to a credit for loan losses of $60,000 in 2007. The provision for loan losses in 2008 was recorded in anticipation of credit quality deterioration ensuing from accelerated declines in economic conditions during the fourth quarter of 2008, in addition to growth in the commercial loan portfolio. Further contributing to the lower net income were lower non-interest interest income and higher non-interest expenses. These items were partially offset by an improvement in net interest income of $1,658,000, or 9%, to $19,277,000 in 2008 compared to $17,619,000 in 2007. The decline in ROA and ROE was caused by the decrease in net income.

The following table reconciles net income, as reported to pro forma net operating income for the years indicated:

	2008		2007	
	Amount	**Per share**	**Amount**	**Per share**
Net income, as reported	$ 3,635,948	$ 1.76	$ 4,611,572	$ 2.23
OTTI	435,665	0.21		
Tax effect	(148,126)	(0.07)		
Net operating earnings	$ 3,923,487	$ 1.90	$ 4,611,572	$ 2.23

Table of Contents

Net interest income

The following table sets forth a comparison of average balances of assets and liabilities and their related net tax equivalent yields and rates for 2008, 2007 and 2006 (dollars in thousands):

	2008			2007			2006		
	Average balance	**Interest**	**Yield/ rate**	**Average balance**	**Interest**	**Yield/ rate**	**Average balance**	**Interest**	**Yield/ rate**
Assets									
Interest-earning assets									
Interest-bearing deposits	$ 233	$ 3	1.36%	$ 184	$ 9	4.81%	$ 240	$ 9	3.82%
Investments:									
U.S. government agencies	49,034	2,576	5.25	34,682	1,724	4.97	43,299	1,795	4.15
Mortgage-backed securities	35,294	1,833	5.19	51,781	2,540	4.91	42,999	1,944	4.52
State and municipal	15,813	1,014	6.41	12,267	780	6.36	14,485	927	6.40
Other	25,967	1,252	4.82	17,487	1,175	6.72	14,536	946	6.50
Total investments	126,108	6,675	5.29	116,217	6,219	5.35	115,319	5,612	4.87
Loans:									
Commercial	231,721	15,869	6.85	220,968	16,458	7.45	219,482	16,018	7.30
Consumer	71,089	4,872	6.85	68,395	4,625	6.76	65,011	4,200	6.46
Real estate	117,547	6,985	5.94	134,869	8,360	6.20	133,279	8,101	6.08
Direct financing leases	477	29	6.15	549	34	6.16	618	38	6.18
Total loans	420,834	27,755	6.60	424,781	29,477	6.94	418,390	28,357	6.78
Federal funds sold	3,342	91	2.73	1,948	103	5.28	2,479	123	4.97
Total interest-earning assets	550,517	34,524	6.27%	543,130	35,808	6.59%	536,428	34,101	6.36%
Non-interest earning assets	33,301			32,328			28,495		
Total Assets	$ 583,818			$ 575,458			$ 564,923		
Liabilities and shareholders equity									
Interest-bearing liabilities									
Deposits:									
Savings	$ 38,425	$ 331	0.86%	$ 41,055	$ 511	1.24%	$ 46,422	$ 620	1.34%
NOW	59,130	616	1.04	67,489	1,837	2.72	69,138	1,880	2.72
MMDA	93,465	2,460	2.63	84,000	3,658	4.35	68,476	2,948	4.30
CDs < $100,000	98,410	4,052	4.12	94,420	4,173	4.42	87,345	3,235	3.70
CDs > $100,000	80,389	3,638	4.53	66,998	3,168	4.73	67,129	2,791	4.16
Clubs	1,764	21	1.19	1,908	23	1.21	1,750	19	1.08

Total deposits	371,583	11,118	2.99	355,870	13,370	3.76	340,260	11,493	3.38
Repurchase agreements	12,074	103	0.85	19,580	465	2.38	23,391	624	2.67
Borrowed funds	74,530	3,463	4.65	71,573	3,825	5.34	79,627	4,244	5.33
Total interest-bearing liabilities	458,187	14,684	3.20%	447,023	17,660	3.95%	443,278	16,361	3.69%
Non-interest bearing deposits	67,717			70,606			68,224		
Non-interest bearing liabilities	4,503			4,499			3,771		
Total liabilities	530,407			522,128			515,273		
Shareholders equity	53,411			53,330			49,650		
Total liabilities and shareholders equity	$ 583,818			$ 575,458			$ 564,923		
Net interest income		$ 19,840			$ 18,148			$ 17,740	
Net interest spread			3.07%			2.64%			2.67%
Net interest margin			3.60%			3.34%			3.31%

Table of Contents

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

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

	Years ended December 31,					
	2008 compared to 2007			2007 compared to 2006		
	Increase (decrease) due to					
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Loans and leases:						
Mortgage	$ (1,040)	$ (336)	$ (1,376)	$ 97	$ 163	$ 260
Commercial	766	(1,305)	(539)	108	318	426
Consumer	178	66	244	219	203	422
Total loans and leases	(96)	(1,575)	(1,671)	424	684	1,108
Investment securities, interest-bearing deposits and federal funds sold	564	(211)	353	14	628	642
Total interest income	468	(1,786)	(1,318)	438	1,312	1,750
Interest expense:						
Deposits:						
Certificates of deposit greater than $100,000	611	(141)	470	(5)	382	377
Other	81	(2,803)	(2,722)	520	980	1,500
Total deposits	692	(2,944)	(2,252)	515	1,362	1,877
Other interest-bearing liabilities	(206)	(518)	(724)	(558)	(20)	(578)
Total interest expense	486	(3,462)	(2,976)	(43)	1,342	1,299
Net interest income	$ (18)	$ 1,676	$ 1,658	$ 481	$ (30)	$ 451

The slope of the yield curve has returned to a more normal, positive slope in 2008 compared to 2007, but at unprecedented low levels. In several efforts to stimulate a recessing economy, the FOMC reduced short-term interest rates seven times during 2008, in intervals ranging from 25 to 75 basis points, sometimes occurring twice in a single month. In response to these actions, the national prime rate also decreased during 2008. National prime, the benchmark rate banks use to set rates on various lending and other interest sensitive products, decreased seven times for a total decrease of 400 basis points from 7.25% at December 31, 2007 to 3.25% at December 31, 2008. As a result of the short-term rate reductions, the yield curve has become positively sloped thereby resulting in opportunities for the Company to improve its net interest margin. However, operating in a very low, highly volatile interest rate environment will also present challenges in the coming year.

While national prime decreased 400 basis points, the weighted-average national prime rate decreased to 5.09% in 2008 compared to 8.05% in 2007. The effect of this average decrease has been to exert extreme downward pressure on yields of the Company s interest-earning assets. With rate cutting beginning in January 2008, this pressure existed with increasing momentum throughout all of 2008. The Company was able to more than offset this pressure by periodically adjusting rates on its interest-bearing deposits. In response to the swift downward shift in rates, the Company s asset liability committee assessed, among other things, the impact the interest rate movements have had on its earning assets. Where necessary, rate adjustments to interest-bearing deposit and repurchase agreements were implemented and wholesale funding sources were utilized, all which helped minimize the effect rate changes have had on net interest income. The committee meets frequently and has successfully implemented rate setting strategies to mitigate the interest rate risk inherent in the balance sheet and has been able to preserve its net interest margin while always mindful of our customers needs.

Table of Contents

As market rates fall along with national prime, loan originations, renewing commercial and residential loans and lines of credit should price below the average 2008 portfolio yields. In addition, the decrease in the Treasury yields and other capital market rates, which largely began during the second half of 2008, could continue to have an unfavorable impact on the Company s total 2009 investment portfolio yield. The relative and predominantly lower interest rate environment of 2008 continued to have a negative impact on the Company s interest-earning assets. Total interest income declined 4%, or $1,318,000 from $35,279,000 in 2007 to $33,961,000in 2008 and further caused the tax-equivalent yield on earning assets to decrease 32 basis points. The Company should continue to experience a period of sliding yields on its interest-earning assets during 2009, and in what appears to be a prolonged low interest rate environment.

Interest expense decreased $2,976,000, or 17%, from $17,660,000 in 2007 to $14,684,000 in 2008. The fast-falling, lower interest rate environment that was prevalent throughout most of 2008, required the Company to periodically reduce offering rates on both its deposit and repurchase agreement products. Though the Company recorded a net increase in average interest-bearing liabilities, due to deposit growth, interest expense on deposits declined by almost $3,000,000 in 2008 compared to 2007 caused by a 77 basis point decline on rates paid. The effect of the $15,713,000 increase in average interest-bearing deposits was an additional $692,000 in interest expense. In an effort to maintain reasonable interest rate spreads to its earning-assets, throughout 2008 the Company s asset / liability committee has reduced rates paid on CDs as well as rates paid on transactional deposits. Rates on CD s should naturally price lower as they mature. However, whether or not the Company can continue to reduce rates on transaction deposits that are currently priced at unprecedented low levels to maintain its interest rate spread will be predicated on the interest rate environment, liquidity position and competition. Interest expense on borrowings, including repurchase agreements, declined $724,000 during 2008, mostly from lower rates.

The resulting performance of the mix of the Company s interest-sensitive assets and liabilities and the varying effects the severity of the yield curve slope has had during 2008, net interest income increased $1,658,000, or 9%, from $17,619,000 in 2007 to $19,277,000 in 2008. On a tax-equivalent basis, the net interest rate spread increased 43 basis points from 2.64% to 3.07% and the tax-equivalent margin improved 26 basis points, from 3.34% in 2007 to 3.60% in 2008, respectively. The improvement in spread and margin were due largely to lower rates paid on interest-bearing liabilities and more net interest income.

Provision for loan losses

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

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

- specific loans that could have loss potential;
- levels of and trends in delinquencies and non-accrual loans;

- levels of and trends in charge-offs and recoveries;
- trends in volume and terms of loans;
- changes in risk selection and underwriting standards;
- changes in lending policies, procedures and practices;
- experience, ability and depth of lending management;
- national and local economic trends and conditions; and
- changes in credit concentrations.

Provisions for loan losses of $940,000 were made for the year ended December 31, 2008. In 2007, the Company did not need to make provisions and reduced the allowance for loan losses due to a reduced level of internally criticized and classified loans. The $940,000 provision for loan losses was recorded for anticipated credit quality deterioration, ensuing from accelerated declines in economic conditions during the fourth quarter of 2008, together with providing for over $30 million of loan growth throughout 2008. The provision increase occurred to reinforce and fund the allowance for loan losses balance as of December 31, 2008 to safeguard against possible future losses. The allowance for loan losses was $4,745,000 at December 31, 2008, and was $4,824,000 at December 31, 2007.

Table of Contents

Other income

For the year ended December 31, 2008, total other income was $4,578,000, $627,000, or 12% less than the $5,205,000 recorded during the year ended December 31, 2007. In 2008, a non-cash OTTI charge of $436,000 was recorded. There was no similar charge in 2007. The OTTI charge is related to the Company s investment in a pooled preferred term security and a common stock equity position in FNMA. The carrying values of these securities were written down to their fair values during the third and fourth quarters as management has deemed the impairment to be other-than-temporary. Service charges on deposit related accounts declined $106,000, or 4%, in 2008 compared to 2007. Most of this decline was the result of lower volumes of overdraft transactions. During 2008, the Company recorded net losses from the disposal of premises and equipment of $36,000 compared to net gains of $98,000 recorded in 2007, or an adverse impact of approximately $134,000. The loss in 2008 was from the disposal of unused, obsolete capital equipment while in 2007 gains included the sales of two commercial facilities previously leased to non-related third parties. Further contributing to the non-interest income decline in 2008 were the gains recorded form the sale of foreclosed properties in 2007 of $144,000 compared to $43,000 in 2008. Partially offsetting these adverse changes in non-interest income were: $101,000 more gains from the sales of residential mortgages into the secondary market; fees earned from the Company s trust services business and an increase in the cash surrender value of BOLI.

In 2009, the Company projects continued decline in service fees from deposit accounts, which in 2008 declined by nearly 4% from 2007, as the expectation there will be an even lower volume of overdraft transactions. In the current environment, it is difficult to determine whether this trend will continue.

Other expenses

For the year ended December 31, 2008, other operating expenses grew $1,574,000, or 9%, from $16,637,000 for the year ended December 31, 2007. Merit and performance-based incentive increases, branch expansion and the related employee benefits, health care, and wider participation in the Company s 401(k) plan caused salaries and employee benefit costs to rise $1,164,000, or 13%, for the twelve months ended December 31, 2008 compared to the same period in 2007. Higher occupancy related expenses, a component of premises and equipment, increased $95,000, or 3%, due to a full year of depreciation and amortization on the Green Ridge branch relocation and the 2008 opening of the West Scranton branch. Branch expansion activities also included more advertising and marketing, up $33,000, or 5%, and other increased overhead including: office supplies, postage, data processing and FDIC premiums. Other expenses also increased by higher collection and ORE expenses associated with more legal and foreclosure costs.

As the Company enters 2009, management expects certain expenses to rise over and above normal expected inflationary increases. In 2009, the West Scranton branch will reflect a full year of operational expenses. For example occupancy related costs could amount to $230,000 more in 2009 than in 2008. The Company s FDIC premium, which grew 1.5 times the 2007 level, will significantly increase even further, by increased premiums and also from the Company s decision to voluntarily participate in the Temporary Liquidity Guarantee Program (TLGP). The Company anticipates up to $300,000 of additional premiums, but cannot quantify the effect of the TLGP premium impact as it will be determined by depositor sentiment for mitigating their personal risk.

In late February 2009, the FDIC voted to impose a special assessment of 20 basis points on all FDIC-insured banks to be collected on September 30, 2009. The Company anticipates that the special assessment will adversely affect earning by approximately $900,000 based on our current federally-insured deposit amounts. Furthermore, the FDIC has the authority, after June 30, 2009, to impose an additional 10 basis point emergency special assessment on all FDIC-insured banks if it estimates the reserve ratio of the Deposit Insurance Fund will fall to a level that it believes would adversely affect public confidence or to a level which would be close to zero or negative at the end of a calendar quarter.

At this time we cannot estimate the probability of this event; however, any additional FDIC assessment and/or premium would be adverse to our 2009 earnings.

The ratio of non-interest expense less non-interest income (expense ratio) to average assets at December 31, 2008 and 2007 was 2.25% and 2.01%, respectively. The overhead expense ratio of the Company drifted upward due to higher non-interest expenses.

Provision for income taxes

Income before provision for income taxes in 2008 decreased $1,543,000 from 2007. The effective federal income tax rate was 22.7% and 26.2% for the years ending December 31, 2008 and 2007, respectively. The decrease in the effective tax rate is attributable to the decrease in pre-tax income.

Table of Contents

Comparison of Financial Condition as of December 31, 2007

and 2006 and Results of Operations for each of the Years then Ended

Financial Condition

Overview

Consolidated assets increased $25,095,000, or 4%, during the year ended December 31, 2007 to $587,413,000. The increase resulted from increases in total deposits of $15,374,000, total borrowings of $6,173,000 and total shareholders equity of $3,579,000. During 2007, the carrying values of the investment and loan portfolios increased $22,573,000 and $4,931,000, respectively, while premises and equipment, net plus construction in process, a component of other assets in the consolidated balance sheet, increased $1,287,000. Cash decreased $3,392,000 since December 31, 2006.

Deposits

Total deposits increased $15,373,000, or 4%, during 2007 to $425,708,000. The growth in deposits was from increases in money market and certificate of deposit accounts of $15,533,000 and $24,389,000, or 21% and 16%, respectively, partially offset by declines in NOW, savings and DDAs of $10,427,000, $5,176,000 and $8,946,000, respectively. Certificate of deposit accounts continued to grow as customers locked in rates during the declining interest rate environment. The increase in money market accounts, net of the decline in savings and club accounts, was from success in our deposit-gathering strategies in conjunction with promotional interest rates tailored to depositors needs. DDAs decreased 12% compared to December 31, 2006; however, management believed this outflow was related to customer transaction timing and therefore temporary rather than permanent.

Short-term borrowings

During 2007, repurchase agreements declined to $20,504,000 from $22,224,000 at December 31, 2006. At December 31, 2007 and 2006, sweep accounts represented 62% and 70%, respectively, of total repurchase agreements. Investment security pre-refunding strategies and late-year deposit outflow resulted in an increase in overnight borrowings of $8,555,000 as of December 31, 2007 compared to December 31, 2006.

Long-term debt

The weighted-average rate in effect on funds borrowed at December 31, 2007, was 5.26% compared to 5.15% as of December 31, 2006. The 2007 weighted-average rate was 133 basis points below the tax-equivalent yield of 6.59% on average earning assets for the year ended

December 31, 2007. Rates on $42,000,000 of the total long-term advances are fixed but will adjust quarterly should market rates increase beyond the issues original or strike rates. As of December 31, 2007, the weighted-average rate on this convertible debt was 5.35%. To help reduce the Company s reliance on overnight funding, during 2007 $16,000,000 of advances that had matured or converted, and carried a weighted-average interest rate of 4.78%, were replaced with fixed- and capped floating-rate advances. The new advances aggregated $20,000,000 that mature in 2009 and carried an initial weighted-average interest rate of 5.40%. As of December 31, 2007, the weighted-average interest rate on these advances amounted to 5.13%.

Investments

As of December 31, 2007 and December 31, 2006, the aggregate fair value of securities HTM exceeded their respective aggregate amortized cost by $33,000 and $29,000, respectively. Total investments increased $22,574,000, net of a $23,000 decline in the market value of AFS investments. The increase in the investment portfolio during 2007 was the result of investing excess liquidity stemming from deposit inflows and late-year overnight borrowings used as a pre-refunding strategy. The carrying value of investment securities, at December 31, 2007, was $122,984,000, or 21%, of total assets compared to $100,411,000, or 18%, as of December 31, 2006. Mortgage-backed securities, which amortize and provide monthly cash flow, continue to dominate the composition of the total investment portfolio representing 48% at December 31, 2007, compared to 43% at December 31, 2006.

Table of Contents

The tax-equivalent yield on debt securities by stated maturity date at December 31, 2007, is as follows:

	One year or less	One through five years	Five through ten years	More than ten years	Total
U.S. government agencies	3.00%	4.83%	4.90%	5.99%	5.25%
Mortgage-backed securities	6.00	4.11	4.32	5.22	5.06
State & municipal subdivisions			5.55	5.71	5.69
Preferred term securities				6.25	6.25
Total debt securities	3.05%	4.54%	4.78%	5.59%	5.34%

Loans and leases

Gross loans and leases increased $3,606,000, or 1%, from $422,643,000 at December 31, 2006, to $426,249,000 at December 31, 2007. Gross loans represented 73% and 75% of total assets at December 31, 2007 and December 31, 2006, respectively.

In 2007, the Company originated $32,919,000 of commercial loans, $24,032,000 of residential mortgage loans and $28,062,000 of consumer loans. This compares to $17,152,000, $21,431,000 and $29,565,000, respectively, in 2006. Included in mortgage loans is $12,515,000 of real estate construction lines in 2007 and $11,111,000 in 2006. In addition for 2007, the Company originated lines of credit in the amounts of $18,564,000 for commercial borrowers and $6,296,000 in home equity and other consumer lines of credit.

Though loan originations increased in 2007 compared to 2006, and despite operating in an overall higher interest rate environment, payoffs and pay-downs were high in 2007 almost offsetting the originations. As a result, there was only a subtle increase in the loan portfolio.

Commercial and Commercial Real Estate Loans:

Though commercial and commercial real estate (CRE) originations were relatively strong, they were fully offset by scheduled principal curtailments and pre-payments, thereby resulting in a commercial loan decline of $2,155,000 to $216,058,000 from $218,213,000, or almost 1% during 2007. The Company hired a new senior lender and had restructured its existing team of commercial loan officers to better serve our existing customer base and strategically penetrate the markets for new business relationships.

Residential Real Estate Loans:

Residential real estate loans increased $4,235,000, or 4%, to $116,978,000 in 2007. Though operating in a higher interest rate environment, which tends to reduce the level of prepayment and refinance activity, the Company was able to continue to grow its residential real estate loan portfolio on the strength of its very dedicated staff of loan originators and transfers of construction loans to permanent financing.

Consumer Loans:

Consumer loans increased $4,269,000, or 6%, during 2007. The increase in this sector is mainly from less refinance and payoff activity caused by a relatively higher interest rate environment. This enabled the portfolio to grow despite a minor decline in loan originations.

Real Estate Construction Loans:

Real estate construction loans decreased by $2,666,000, or 20%, at December 31, 2007 compared to December 31, 2006. The decline in 2007 was caused by more residential construction loans converting to permanent mortgage loans; however, both categories remain strong.

Direct Financing Leases:

The balance represents tax-free leasing arrangements provided to municipal customers. For 2007, the activity represents scheduled run-off.

Table of Contents

Loans available-for-sale

Loans AFS at December 31, 2007, were $827,000, with a corresponding fair value of $843,000 compared to $122,000 and $123,000, respectively, at December 31, 2006. During 2007, residential mortgages and student loans with principal balances of $16,210,000 and $57,000, respectively, were sold into the secondary market and combined gains of approximately $159,000 were recognized. There were no sold SBA loans during 2007.

At December 31, 2007 and 2006, the servicing portfolio balance of sold residential mortgage loans was $61,023,000 and $53,112,000, respectively.

Allowance for loan losses

Total charge-offs, net of recoveries, for the year ended December 31, 2007, were $560,000, compared to $865,000 in 2006. Combined consumer loan and lease financing net charge-offs increased slightly from $161,000 at December 31, 2006 to $237,000 through December 31, 2007. Commercial loan net charge-offs were $597,000 for the year 2006 compared to $357,000 for 2007. Mortgage loans showed net recoveries of $35,000 in 2007 compared to net charge-offs of $108,000 in 2006. This reversal from net mortgage charge-offs in 2006 to net recoveries in 2007 was the result of recording one large mortgage loan recovery of $107,000 on a loan which had been charged-off in a prior year.

Non-performing assets

The majority of non-performing assets for the period was attributed to non-accruing commercial business loans and non-accruing real estate loans in the process of foreclosure. Most of these loans were collateralized, thereby mitigating the Company s potential for loss. In 2006, non-performing loans were $3,439,000 compared to $3,837,000 at year-end 2007. There were no repossessed assets at December 31, 2007 or 2006. ORE at December 31, 2007 consisted of one property which had an agreement to sell pending. At year-end 2006, five residential properties were owned, all of which were sold. The Special Assets Department had developed specific action plans for each of the Company s non-performing loans. During 2007, many of those plans came to a conclusion resulting in repayments of non-performing loans. The non-accrual loans aggregated $3,811,000 at December 31, 2007, an increase of $453,000 from year-end 2006. During 2007 approximately $3,075,000 of loans were placed in non-accrual status. These were partially offset by payoffs or pay-downs of $1,888,000, charge-offs of $236,000, $352,000 in transfers to ORE and $146,000 of loans that returned to performing status. Loans past due 90 days or more and accruing declined 68%, to $26,000, at December 31, 2007. The non-accrual loans rose by 14 % to $3,811,000 and ORE declined by 46 % to $107,000. These three items comprise the non-performing assets of $3,944,000. The percentage of non-performing assets to total assets was 0.67% at December 31, 2007, a minor change from 0.65% at December 31, 2006. Non-performing loans to net loans were 0.91% at December 31, 2007, and 0.82% at December 31, 2006.

During 2007, the Company collected $93,000 of interest income recognized on the cash basis. If the non-accrual loans that were outstanding as of December 31, 2007 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of $391,000 for the year ended December 31, 2007.

Bank premises and equipment, net

Net of accumulated depreciation and disposals, premises and equipment increased $1,640,467. During 2007, the Company purchased or transferred from construction in process approximately $3,293,000 compared to $852,000 in 2006. The increase was principally from the completion of the Company s Green Ridge branch relocation construction project.

Foreclosed assets held-for-sale

Other Real Estate Owned

ORE was $107,000 at December 31, 2007 consisting of one property, the sale of which is pending. The five residential properties which were owned at year end 2006 have all been sold.

Other assets

The decrease in other assets of $384,000, or 8%, from December 31, 2006 was due mostly to the reduction of capitalized interim construction costs for the Company s branch expansion and other projects and a decrease in the net deferred tax asset, partially offset by an increase in the market value of the Company s derivative contract. See Note 10, Income Taxes, for an analysis of the net deferred tax asset. For a further discussion on the Company s derivative contract, see Note 1, Nature

Table of Contents

of operations and summary of significant accounting policies, and Note 12, Fair value of financial instruments and derivatives, contained within the notes to consolidated financial statements in Part II, Item 8.

Results of Operations

Earnings Summary

Net income for the year ended December 31, 2007 was $4,612,000, compared to $4,125,000 for the year ended December 31, 2006. During the same periods, diluted earnings per common share was $2.23 and $2.01, respectively. For the year ended December 31, 2007, the Company s ROA and ROE were 0.80% and 8.65%, respectively, compared to 0.73% and 8.31% for the year ended December 31, 2006. The improvement in net income was primarily from a 3%, or $451,000, increase in net interest income, a 15%, or $683,000, rise in non-interest income, partially offset be a 5%, or $758,000, increase in operating expenses. Also contributing to the improvement was a credit for loan losses of $60,000 during the twelve months ended December 31, 2007 compared to a provision of $325,000 in 2006. The improvement in ROA and ROE was largely due to the improvement in net income.

Net interest income

The slope of the yield curve, which became inverted, or negatively sloped in 2006, had returned to a more normal, positive slope in 2007. An inverted yield curve presents challenges to banks because short-term rates are higher than long-term rates which tends to compress net interest income because deposit and borrowing terms are generally shorter than investment and loan terms. The FOMC reduced short-term interest rates three times during the second half of 2007. In response to these actions, national prime also decreased during 2007. National prime also decreased three times for a total decrease of 100 basis points from 8.25% at December 31, 2006 to 7.25% at December 31, 2007. As a result of the rate reductions, the yield curve had become more positively sloped thereby provided opportunities for the Company to bolster its net interest margin.

Though national prime decreased 100 basis points, the weighted-average national prime rate increased to 8.05% in 2007 compared to 7.96% in 2006. This phenomenon was caused by the first rate reduction occurring well into the third quarter. Thus, most of 2007 consisted of market rates that existed at the year-end 2006 level. The effect of this average increase pressured rates paid on interest-bearing liabilities and was only marginally offset by the effect rates had on interest earning-assets.

As expected, the relative and predominantly higher interest rate environment during 2007 continued to have a positive influence on the Company s interest-earning assets. Total interest income increased 5%, from $33,530,000 in 2006 to $35,279,000 in 2007 and further, caused the tax-equivalent yield on earning assets to increase 23 basis points. Interest expense increased $1,299,000, or 8%, from $16,361,000 in 2006 to $17,660,000 in 2007. The cost of interest-bearing liabilities increased 26 basis points in 2007. The higher interest rate environment that was prevalent throughout most of 2007, in conjunction with higher average interest-bearing deposit balances, necessitated the need for the Company to increase offering rates on its deposit products. As a result, interest expense on deposits increased $1,877,000 during 2007, of which approximately $1,362,000 was caused by a 38 basis point rise in average rates. Average balances in interest-bearing deposits increased by $15,610,000 during 2007, resulting in an additional $515,000 in expense. Interest expense on borrowings, including repurchase agreements, declined $578,000 during 2007, due almost entirely to lower average balances.

As a result of the mix of the Company s interest-sensitive assets and liabilities and the varying effects the slope of the interest rate yield curve has had during 2007, net interest income increased $451,000, or 3%, from $17,168,000 in 2006 to $17,619,000 in 2007. On a tax-equivalent basis, the net interest rate spread declined 3 basis points from 2.67% to 2.64% and the tax-equivalent margin improved 3 basis points, from 3.31% in 2006 to 3.34% in 2007, respectively. The decrease in spread was due to a larger increase in rates paid on interest-bearing liabilities than the increase in yields from interest-earning assets. The margin improvement was from more net interest income in 2007 compared to 2006.

Provision for loan losses

A credit for loan losses of $60,000 was made to the allowance during 2007 compared to a provision for loan losses of $325,000 for the year ended December 31, 2006. In 2007, the Company did not need to make provisions and reduced the allowance for loan losses due to a reduced level of internally criticized and classified loans. These reductions occurred as a result of some adversely rated loans which were either upgraded in rating due to credit improvement or were repaid. The allowance for loan losses was $4,824,000 at December 31, 2007, compared to $5,444,000 at December 31, 2006. The reduced level of the allowance was due to the improved quality of the portfolio.

Table of Contents

Other income

For the year ended December 31, 2007, total other income was $5,205,000, an increase of $683,000, or 15%, from the $4,522,000 recorded during 2006. In 2007, the Company experienced growth in service charges on deposit accounts of $376,000, or 14%, and also recognized net gains of $144,000 from sales of foreclosed properties held-for-sale. An increase in overdraft charges was the principal reason for growth in deposit service charges. The significant gain from the sale of foreclosed properties was the result of excess collateral value compared to the carrying value. Further contributing to the increase in non-interest income were: increased sales activities of residential mortgages into the secondary market resulting in $62,000 more of gains compared to 2006; increases in BOLI earnings; higher revenue from financial services activities; and the disposal of premises and equipment that produced net gains of $98,000 in 2007 compared to net losses of $20,000 in 2006. Included in 2007 were the sales of two commercial facilities previously leased to non-related third parties.

Other expense

For the twelve months ended December 31, 2007, other operating expenses were $16,637,000 compared to $15,878,000 for the twelve months ended December 31, 2006, a $758,000 or 5% increase. Merit and performance-based incentive increases caused salary and employee benefit costs to rise $377,000, or 5%, for the twelve months ended December 31, 2007 compared to the same period in 2006. Advertising and marketing related expenses were up $144,000, or 27%, due to activities associated with the grand opening and relocation project of Company s Green Ridge branch office. Other expenses increased $225,000, or 6%, in 2007 compared to 2006 caused by increased professional services, ATM expense and other branch related operating costs.

The expense ratio at December 31, 2007 and 2006 was 2.01% and 2.02%, respectively. The overhead expense ratio of the Company remained comparable to the Uniform Bank Performance Report peer comparison group ratio.

Provision for income taxes

Income before provision for income taxes in 2007 increased $760,000 from 2006. The effective federal income tax rate was 26.2% and 24.8% for the years ending December 31, 2007 and 2006, respectively. The increase in the effective tax rate is attributed to an increase in pre-tax income and a decrease in tax-free income.

Off-Balance Sheet Arrangements and Contractual Obligations

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers and in connection with the overall interest rate management strategy. These instruments involve, to a varying degree, elements of credit, interest rate and liquidity risk. In accordance with GAAP, these instruments are either not recorded in the consolidated financial statements or are recorded in amounts that differ from the notional amounts. Such instruments primarily include lending commitments, lease obligations and derivative instruments. For a further discussion on the Company s derivative instrument, see Note 1, Nature of operations and summary of significant accounting policies, and Note 12, Fair value of financial instruments and derivatives, contained within the notes to consolidated financial statements in Part II, Item 8.

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

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

The following table presents, as of December 31, 2008, the Company s significant determinable contractual obligations and significant commitments by payment date. The payment amounts represent those amounts contractually due to the recipient, excluding interest (dollars in thousands):

Table of Contents

	One year or less	Over one year through three years	Over three years through five years	Over five years	Total
Contractual obligations:					
Certificates of deposit	$ 138,896	$ 29,544	$ 4,433	$ 808	$ 173,681
Long-term debt	10,000	21,000	5,000	16,000	52,000
Repurchase agreements	11,412				11,412
Operating leases	368	666	682	3,844	5,560
Significant commitments:					
Letters of credit	2,053	1,190		725	3,968
Loan commitments*	25,613				25,613
Total	$ 188,342	$ 52,400	$ 10,115	$ 21,377	$ 272,234

*Available credit to borrowers in the amount of $68,379 is excluded from the above table since, by its nature, the borrowers may not have the need for additional funding, and, therefore, the credit may or may not be disbursed by the Company.

Related Party Transactions

Information with respect to related parties is contained in Note 15, Related party transactions, within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

Impact of Accounting Standards and Interpretations

Information with respect to the impact of accounting standards is contained in Note 18, Recent accounting pronouncements, within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

Impact of Inflation and Changing Prices

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

Capital Resources

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

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with prescribed risk weightings. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and certain off-balance sheet items. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I capital to total risk-weighted assets (Tier I Capital) of 4% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. Additional information with respect to capital requirements is contained in Note 14, Regulatory matters, within the notes to the consolidated financial statements, and incorporated by reference in Part II, Item 8.

In October 2008, the U.S. Department of Treasury (Treasury), the Board of Governors of the Federal Reserve System (FRB) and the FDIC issued a joint statement announcing a voluntary capital purchase program where the Treasury will purchase

Table of Contents

senior preferred stock of certain financial institutions. The Treasury had allocated $250 billion under the Troubled Asset Relief Program (TARP) created under the Economic Stabilization Act of 2008 (ESSA) to purchase senior preferred stock in banks through the Capital Purchase Program. The Company received preliminary approval from the U.S. Treasury Department to participate in the TARP, however because of the Company s strong capital position, the Company has decided not to participate as the effect of accepting the program was determined to not be in the best interest of the Company s shareholders. At December 31, 2008, the Company s total risk-based capital ratio was 13.6%, Tier 1 risk-based ratio was 12.6% and its leverage ratio was 9.9%. The Company currently exceeds the regulatory guidelines with the Company s capital adequacy levels above the well-capitalized regulatory requirements.

During the second quarter of 2008 the Company s Board of Directors announced its intent to initiate a capital stock repurchase program covering up to 50,000 shares of its outstanding capital stock. The repurchased shares would become treasury stock and could be available for issuance under the Company s various stock-based compensation, employee stock purchase and dividend reinvestment (DRP) plans and for general corporate purposes. The repurchases will be made from time-to-time in open-market transactions, subject to availability, pursuant to safe harbor rule 10b-18 under the Securities Exchange Act of 1934. Currently, the Company reacquired 12,255 shares, net of reissued shares to participants in the Company s DRP, at a weighted-average cost of $28.70 per share. For a further discussion about this program, see Unregistered Sales of Equity Securities and Use of Proceeds included in Part II, Item 5, Market for Registrant s Common Equity, Related Stockholder Matters and Issue Purchases on Equity Securities, above.

During the year-ended December 31, 2008, total shareholders equity decreased $6,231,000, or 11%, due principally from increased unrealized net losses in the securities AFS portfolio, the declaration of cash dividends and the repurchase of the Company s capital stock (treasury stock). Conversely, shareholders equity was enhanced by current year earnings, stock issued from the Company s Employee Stock Purchase and Dividend Reinvestment Plans, and an increase in the intrinsic value of the Company s cash flow hedge instrument. The Company s primary source of capital during the previous five years has been from the retention of equity in undistributed earnings of the Bank, as reflected below:

	Net Income	**Cash dividends declared**	**Earnings Retained**
2008	$ 3,635,948	$ 2,068,680	$ 1,567,268
2007	4,611,572	1,921,533	2,690,039
2006	4,125,283	1,801,361	2,323,922
2005			