FIDELITY D & D BANCORP INC
Form 10-Q
August 03, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2016

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______________to______________________

Commission file number: 333-90273

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION:	IRS EMPLOYER IDENTIFICATION NO:
PENNSYLVANIA	23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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

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

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

Large accelerated filer [ ]	Accelerated filer [ ]
Non-accelerated filer [ ]	Smaller reporting company [X]
(Do not check if a smaller reporting company)	

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

[ ] YES [X] NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on July 31, 2016, the latest practicable date, was 2,453,805 shares.

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FIDELITY D & D BANCORP, INC.

Form 10-Q June 30, 2016

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PART I – Financial Information

Item 1: Financial Statements

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

(dollars in thousands)	June 30, 2016	December 31, 2015
Assets:		
Cash and due from banks	$ 10,801	$ 12,259
Interest-bearing deposits with financial institutions	17,052	18
Total cash and cash equivalents	27,853	12,277
Available-for-sale securities	129,760	125,232
Federal Home Loan Bank stock	1,140	2,120
Loans and leases, net (allowance for loan losses of $9,207 in 2016; $9,527 in 2015)	551,997	546,682
Loans held-for-sale (fair value $1,591 in 2016, $1,444 in 2015)	1,554	1,421
Foreclosed assets held-for-sale	1,555	1,074
Bank premises and equipment, net	16,455	16,723
Cash surrender value of bank owned life insurance	11,257	11,082
Accrued interest receivable	2,187	2,210
Other assets	12,718	10,537
Total assets	$ 756,476	$ 729,358
Liabilities:		
Deposits:		
Interest-bearing	$ 505,524	$ 477,901
Non-interest-bearing	157,776	142,774
Total deposits	663,300	620,675
Accrued interest payable and other liabilities	5,522	4,128
Short-term borrowings	7,258	28,204
Total liabilities	676,080	653,007
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-
Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 2,453,805 in 2016; and 2,443,405 in 2015)	26,992	26,700
Retained earnings	49,709	47,463
Accumulated other comprehensive income	3,695	2,188
Total shareholders' equity	80,396	76,351
Total liabilities and shareholders' equity	$ 756,476	$ 729,358

See notes to unaudited consolidated financial statements

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

(Unaudited)	Three months ended		Six months ended	
(dollars in thousands except per share data)	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Interest income:				
Loans and leases:				
Taxable	$ 5,796	$ 5,651	$ 11,611	$ 11,150
Nontaxable	193	162	384	301
Interest-bearing deposits with financial institutions	24	1	46	17
Investment securities:				
U.S. government agency and corporations	366	273	736	533
States and political subdivisions (nontaxable)	316	329	633	642
Other securities	20	22	41	99
Total interest income	6,715	6,438	13,451	12,742
Interest expense:				
Deposits	567	508	1,147	1,065
Securities sold under repurchase agreements	4	4	12	12
Other short-term borrowings and other	3	11	13	12
Long-term debt	-	124	-	255
Total interest expense	574	647	1,172	1,344
Net interest income	6,141	5,791	12,279	11,398
Provision for loan losses	275	150	425	300
Net interest income after provision for loan losses	5,866	5,641	11,854	11,098
Other income:				
Service charges on deposit accounts	515	412	1,003	827
Interchange fees	381	337	737	639
Fees from trust fiduciary activities	193	197	363	414
Fees from financial services	206	110	310	237
Service charges on loans	293	224	471	400
Fees and other revenue	195	215	392	411
Earnings on bank-owned life insurance	88	84	175	169
Gain on sale or disposal of:				
Loans	220	238	327	467
Investment securities	9	16	9	18
Premises and equipment	-	-	-	1
Total other income	2,100	1,833	3,787	3,583
Other expenses:				
Salaries and employee benefits	2,893	2,643	5,768	5,296
Premises and equipment	826	875	1,744	1,816
Advertising and marketing	203	263	458	650

Professional services	399	477	788	815
FDIC assessment	112	87	237	194
Loan collection	81	66	125	96
Other real estate owned	67	48	89	147
Office supplies and postage	123	112	242	213
Automated transaction processing	154	138	281	258
FHLB prepayment fee	-	570	-	570
Data processing and communication	271	103	459	208
PA shares tax	164	145	306	150
Other	76	217	260	418
Total other expenses	5,369	5,744	10,757	10,831
Income before income taxes	2,597	1,730	4,884	3,850
Provision (credit) for income taxes	669	(50)	1,255	497
Net income	$ 1,928	$ 1,780	$ 3,629	$ 3,353
Per share data:				
Net income - basic	$ 0.79	$ 0.73	$ 1.48	$ 1.38
Net income - diluted	$ 0.79	$ 0.73	$ 1.48	$ 1.37
Dividends	$ 0.29	$ 0.27	$ 0.56	$ 0.52

See notes to unaudited consolidated financial statements

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Fidelity D & D Bancorp, Inc. and Subsidiary				
Consolidated Statements of Comprehensive Income	Three months ended		Six months ended	
(Unaudited)	June 30,		June 30,	
(dollars in thousands)	2016	2015	2016	2015
Net income	$ 1,928	$ 1,780	$ 3,629	$ 3,353
Other comprehensive income (loss), before tax:				
Unrealized holding gain (loss) on available-for-sale securities	1,209	(1,476)	2,293	(1,241)
Reclassification adjustment for net gains realized in income	(9)	(16)	(9)	(18)
Net unrealized gain (loss)	1,200	(1,492)	2,284	(1,259)
Tax effect	(408)	507	(777)	428
Unrealized gain (loss), net of tax	792	(985)	1,507	(831)
Other comprehensive income (loss), net of tax	792	(985)	1,507	(831)
Total comprehensive income, net of tax	$ 2,720	$ 795	$ 5,136	$ 2,522

See notes to unaudited consolidated financial statements

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Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Changes in Shareholders' Equity
For the six months ended June 30, 2016 and 2015
(Unaudited)

(dollars in thousands)	Capital stock Shares	Amount	Retained earnings	Accumulated other comprehensive income	Total
Balance, December 31, 2014	2,427,767	$ 26,272	$ 43,204	$ 2,743	$ 72,219
Net income			3,353		3,353
Other comprehensive loss				(831)	(831)
Issuance of common stock through Employee Stock Purchase Plan	4,358	102			102
Issuance of common stock from vested restricted share grants through stock compensation plans	7,780				
Stock-based compensation expense		131			131
Cash dividends declared			(1,275)		(1,275)
Balance, June 30, 2015	2,439,905	$ 26,505	$ 45,282	$ 1,912	$ 73,699
Balance, December 31, 2015	2,443,405	$ 26,700	$ 47,463	$ 2,188	$ 76,351
Net income			3,629		3,629
Other comprehensive income				1,507	1,507
Issuance of common stock through Employee Stock Purchase Plan	3,695	111			111
Issuance of common stock from vested restricted share grants through stock compensation plans	6,205				
Issuance of common stock through exercise of stock options	500	14			14
Stock-based compensation expense		167			167
Cash dividends declared			(1,383)		(1,383)
Balance, June 30, 2016	2,453,805	$ 26,992	$ 49,709	$ 3,695	$ 80,396

See notes to unaudited consolidated financial statements

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

(Unaudited)	Six months ended June 30,	
(dollars in thousands)	2016	2015
Cash flows from operating activities:		
Net income	$ 3,629	$ 3,353
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	1,765	1,741
Provision for loan losses	425	300
Deferred income tax expense	1,110	453
Stock-based compensation expense	252	131
Proceeds from sale of loans held-for-sale	18,931	22,179
Originations of loans held-for-sale	(17,301)	(22,123)
Earnings from bank-owned life insurance	(175)	(169)
Net gain from sales of loans	(327)	(467)
Net gain from sales of investment securities	(9)	(18)
Net loss from sale and write-down of foreclosed assets held-for-sale	24	30
Change in:		
Accrued interest receivable	23	(112)
Other assets	(2,466)	2,484
Accrued interest payable and other liabilities	44	354
Net cash provided by operating activities	5,925	8,136
Cash flows from investing activities:		
Available-for-sale securities:		
Proceeds from sales	2,884	10,420
Proceeds from maturities, calls and principal pay-downs	9,301	10,593
Purchases	(15,231)	(46,959)
Decrease (increase) in FHLB stock	980	(682)
Net increase in loans and leases	(8,235)	(24,676)
Acquisition of bank premises and equipment	(802)	(1,028)
Proceeds from sale of foreclosed assets held-for-sale	332	1,019
Net cash used in investing activities	(10,771)	(51,313)
Cash flows from financing activities:		
Net increase in deposits	42,626	19,942
Net (decrease) increase in short-term borrowings	(20,946)	30,294
Repayment of long-term debt	-	(10,000)
Proceeds from employee stock purchase plan participants	111	102
Exercise of stock options	14	-

Dividends paid, net of dividends reinvested	(1,383)	(1,275)
Net cash provided by financing activities	20,422	39,063
Net increase (decrease) in cash and cash equivalents	15,576	(4,114)
Cash and cash equivalents, beginning	12,277	25,851
Cash and cash equivalents, ending	$ 27,853	$ 21,737

See notes to unaudited consolidated financial statements

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FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(Unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

Fidelity Deposit and Discount Bank (the Bank) is a commercial bank chartered under the law of the Commonwealth of Pennsylvania and a wholly-owned subsidiary of Fidelity D & D Bancorp, Inc. (collectively, the Company). Having commenced operations in 1903, the Bank is committed to provide superior customer service, while offering a full range of banking products and financial and trust services to both our consumer and commercial customers from our main office located in Dunmore and other branches located throughout Lackawanna and Luzerne Counties.

Principles of consolidation

The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation.

For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Management is responsible for the fairness, integrity and objectivity of the unaudited financial statements included in this report. Management prepared the unaudited financial statements in accordance with GAAP. In meeting its responsibility for the financial statements, management depends on the Company's accounting systems and related internal controls. These systems and controls are designed to provide reasonable but not absolute assurance that the financial records accurately reflect the transactions of the Company, the Company's assets are safeguarded and that the financial statements present fairly the financial condition and results of operations of the Company.

In the opinion of management, the consolidated balance sheets as of June 30, 2016 and December 31, 2015 and the related consolidated statements of income and consolidated statements of comprehensive income for the three and six months ended June 30, 2016 and 2015, and consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the six months ended June 30, 2016 and 2015 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature. Certain reclassifications have been made to the 2015 financial statements to conform to the 2016 presentation.

In preparing these consolidated financial statements, the Company evaluated the events and transactions that occurred after June 30, 2016 through the date these consolidated financial statements were issued.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2015, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

Critical accounting policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at June 30, 2016 is adequate and reasonable. Given the subjective nature of identifying and estimating loan losses, it is likely that well-informed individuals could make different assumptions and could, therefore, calculate a materially different allowance amount. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. Fair values of investment securities are determined by pricing provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. All of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the

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consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (AOCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells residential mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these circumstances, pricing may be obtained from other entities and the residential mortgage loans are transferred at the lower of cost or market value and simultaneously sold. For other loans transferred to HFS, pricing may be obtained from other entities or modeled and the other loans are transferred at the lower of cost or market value and then sold. As of June 30, 2016 and December 31, 2015, loans classified as HFS consisted of residential mortgage loans.

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

Foreclosed assets held-for-sale includes other real estate acquired through foreclosure (ORE) and may, from time-to-time, include repossessed assets such as automobiles. ORE is carried at the lower of cost (principal balance at date of foreclosure) or fair value less estimated cost to sell. Any write-downs at the date of foreclosure are charged to the allowance for loan losses. Expenses incurred to maintain ORE properties, subsequent write downs to the asset's fair value, any rental income received and gains or losses on disposal are included as components of other real estate owned expense in the consolidated statements of income.

For purposes of the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. For each of the six months ended June 30, 2016 and 2015, the Company paid interest of $1.1 million and $1.3 million, respectively. The Company made an income tax payment of $0.2 million during the first half of 2016 and did not make any income tax payment during the first half of 2015. For the six months ended June 30, 2016 and 2015, the Company had a net change in unrealized gains on available for sale securities of $2.3 million and $(1.3 million), respectively.

Transfers from loans to foreclosed assets held-for-sale amounted to $0.8 million and $0.6 million during the six months ended June 30, 2016 and 2015, respectively. During the same respective periods, transfers from loans to loans held-for-sale amounted to $1.7 million and $1.8 million. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of premises and equipment.

2. New accounting pronouncements

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

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

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accounting standard update during the first quarter of 2016 and does not expect this amendment to have a material impact on its consolidated financial statements.

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

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP: identify the contract(s) with a customer; identify the performance obligations in the contract; determine the transaction price; allocate the transaction price to the performance obligations in the contract; recognize revenue when (or as) the entity satisfies a performance obligation. The standard is effective for annual periods beginning after December 15, 2017, and interim periods therein, using either of the following transition methods: a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). The Company is evaluating the impact of the adoption of ASU 2014-09 on its consolidated financial statements and has not yet determined the method by which it will adopt the standard effective in the first quarter of 2018.

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

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

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

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

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

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3. Accumulated other comprehensive income

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

As of and for the six months ended June 30, 2016

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities	Total
Beginning balance	$ 2,188	$ 2,188
Other comprehensive income before reclassifications, net of tax	1,513	1,513
Amounts reclassified from accumulated other comprehensive income, net of tax	(6)	(6)
Net current-period other comprehensive income	1,507	1,507
Ending balance	$ 3,695	$ 3,695

As of and for the three months ended June 30, 2016

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities	Total
Beginning balance	$ 2,903	$ 2,903
Other comprehensive income before reclassifications, net of tax	798	798
Amounts reclassified from accumulated other comprehensive income, net of tax	(6)	(6)
Net current-period other comprehensive income	792	792
Ending balance	$ 3,695	$ 3,695

As of and for the six months ended June 30, 2015

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities	Total
Beginning balance	$ 2,743	$ 2,743

Other comprehensive loss before reclassifications, net of tax	(819)	(819)
Amounts reclassified from accumulated other comprehensive income, net of tax	(12)	(12)
Net current-period other comprehensive loss	(831)	(831)
Ending balance	$ 1,912	$ 1,912

As of and for the three months ended June 30, 2015

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities	Total
Beginning balance	$ 2,897	$ 2,897
Other comprehensive loss before reclassifications, net of tax	(974)	(974)
Amounts reclassified from accumulated other comprehensive income, net of tax	(11)	(11)
Net current-period other comprehensive loss	(985)	(985)
Ending balance	$ 1,912	$ 1,912

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Details about accumulated other comprehensive income components (dollars in thousands)	Amount reclassified from accumulated other comprehensive income				Affected line item in the statement where net income is presented
	Three months ended June 30,		Six months ended June 30,		
	2016	2015	2016	2015	
Unrealized gains on AFS securities	$ 9	$ 16	$ 9	$ 18	Gain on sale of investment securities
	(3)	(5)	(3)	(6)	Provision for income taxes
Total reclassifications for the period	$ 6	$ 11	$ 6	$ 12	Net income

4. Investment securities

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

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

Obligations of states and political subdivisions

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

The amortized cost and fair value of investment securities at June 30, 2016 and December 31, 2015 are summarized as follows:

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value

June 30, 2016				
Available-for-sale securities:				
Agency - GSE	$ 18,346	$ 202	$ -	$ 18,548
Obligations of states and political subdivisions	34,912	3,374	-	38,286
MBS - GSE residential	70,607	1,807	(31)	72,383
Total debt securities	123,865	5,383	(31)	129,217
Equity securities - financial services	295	248	-	543
Total available-for-sale securities	$ 124,160	$ 5,631	$ (31)	$ 129,760

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

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The amortized cost and fair value of debt securities at June 30, 2016 by contractual maturity are summarized below:

(dollars in thousands)	Amortized cost	Fair value
Available-for-sale securities:		
Debt securities:		
Due in one year or less	$ 2,002	$ 2,006
Due after one year through five years	15,331	15,529
Due after five years through ten years	2,662	2,871
Due after ten years	33,263	36,428
Total debt securities	53,258	56,834
MBS - GSE residential	70,607	72,383
Total available-for-sale debt securities	$ 123,865	$ 129,217

Actual maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Agency – GSE and municipal securities are included based on their original stated maturity. MBS – GSE residential, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total. Most of the securities have fixed rates or have predetermined scheduled rate changes and many have call features that allow the issuer to call the security at par before its stated maturity without penalty.

The following table presents the fair value and gross unrealized losses of investment securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of June 30, 2016 and December 31, 2015:

	Less than 12 months		More than 12 months		Total	
(dollars in thousands)	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
June 30, 2016						
Agency - GSE	$ -	$ -	$ -	$ -	$ -	$ -
Obligations of states and political subdivisions	-	-	-	-	-	-
MBS - GSE residential	5,939	(28)	1,263	(3)	7,202	(31)
Total	$ 5,939	$ (28)	$ 1,263	$ (3)	$ 7,202	$ (31)
Number of securities	3		1		4	
December 31, 2015						
Agency - GSE	$ 8,156	$ (24)	$ -	$ -	$ 8,156	$ (24)

Obligations of states and political subdivisions	3,656	(20)	485	(4)	4,141	(24)
MBS - GSE residential	36,899	(299)	-	-	36,899	(299)
Total	$ 48,711	$ (343)	$ 485	$ (4)	$ 49,196	$ (347)
Number of securities	32		1		33	

The Company had four securities in an unrealized loss position at June 30, 2016, and all four were mortgage-backed securities. The severity of these unrealized losses based on their underlying cost basis was 0.44% for total MBS-GSE at June 30, 2016. In addition, only one of these securities had been in an unrealized loss position in excess of 12 months. The changes in the prices on these securities are the result of interest rate movement and management believes they are temporary in nature.

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

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accounting guidance requires that credit-related OTTI be recognized in earnings while non-credit-related OTTI on securities not expected to be sold be recognized in other comprehensive income (OCI). Non-credit-related OTTI is based on other factors affecting market value, including illiquidity.

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

For all security types, as of June 30, 2016, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that more likely than not would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI in the Company's security portfolio. In addition, management believes the change in fair value is attributable to changes in interest rates.

5. Loans and leases

The classifications of loans and leases at June 30, 2016 and December 31, 2015 are summarized as follows:

(dollars in thousands)	June 30, 2016	December 31, 2015
Commercial and industrial	$ 97,720	$ 102,653
Commercial real estate:		
Non-owner occupied	88,932	95,745
Owner occupied	103,399	101,652
Construction	5,723	4,481
Consumer:		
Home equity installment	29,919	30,935
Home equity line of credit	49,680	48,060
Auto loans and leases	37,951	29,758
Other	6,430	6,208
Residential:		
Real estate	130,252	126,992
Construction	11,644	10,060
Total	561,650	556,544
Less:		
Allowance for loan losses	(9,207)	(9,527)

Unearned lease revenue	(446)	(335)
Loans and leases, net	$ 551,997	$ 546,682

Net deferred loan costs of $1.7 million and $1.5 million have been included in the carrying values of loans at June 30, 2016 and December 31, 2015, respectively.

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

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate unpaid principal balance of mortgages serviced amounted to $271.7 million as of June 30, 2016 and $269.5 million as of December 31, 2015. Mortgage servicing rights amounted to $1.1 million and $1.2 million as of June 30, 2016 and December 31, 2015, respectively.

Management is responsible for conducting the Company's credit risk evaluation process, which includes credit risk grading of individual commercial and industrial and commercial real estate loans. Commercial and industrial and commercial real estate loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed as the case may be. The credit risk grades may be changed at any time

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management feels an upgrade or downgrade may be warranted. The Company utilizes an external independent loan review firm that reviews and validates the credit risk program on at least an annual basis. Results of these reviews are presented to management and the board of directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

Non-accrual loans

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

Non-accrual loans, segregated by class, at June 30, 2016 and December 31, 2015, were as follows:

(dollars in thousands)	June 30, 2016	December 31, 2015
Commercial and industrial	$ 25	$ 30
Commercial real estate:		
Non-owner occupied	1,755	6,193
Owner occupied	2,811	988
Construction	207	226
Consumer:		
Home equity installment	71	167
Home equity line of credit	334	512
Auto loans and leases	21	45
Other	6	6
Residential:		
Real estate	688	836
Total	$ 5,918	$ 9,003

Troubled Debt Restructuring

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

Loans modified in a TDR may or may not be placed on non-accrual status. As of June 30, 2016, total TDRs amounted to $2.5 million, consisting of 9 loans (7 CRE loans, 1 C&I loan and 1 HELOC to 6 unrelated borrowers), of which 2 of the CRE loans, totaling $0.2 million, were on non-accrual status. The June 30, 2016 balance represented a $0.1 million increase over the December 31, 2015 balance, which amounted to $2.4 million (consisting of 7 CRE loans and 2 C&I loans to 5 unrelated borrowers), with none of these loans on non-accrual status. This increase in TDRs was attributed to the addition of one HELOC totaling $0.6 million partially offset by the payoff of one C&I loan in the amount of $0.5 million. Of the TDRs outstanding as of June 30, 2016 and December 31, 2015, when modified, the concessions granted consisted of temporary interest-only payments, extensions of maturity date, or a reduction in the rate of interest to a below-market rate for a contractual period of time. Other than the TDRs that were placed on non-accrual status, the TDRs were performing in accordance with their modified terms.

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

(dollars in thousands)	Loans modified as TDRs for the: Three months ended June 30, 2016			Three months ended June 30, 2015		
	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)
Commercial real estate - owner occupied	-	$ -	$ -	2	$ 158	$ -

(dollars in thousands)	Loans modified as TDRs for the: Six months ended June 30, 2016			Six months ended June 30, 2015		
	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)
Commercial and industrial	-	$ -	$ -	1	$ 500	$ 331
Commercial real estate - owner occupied	-	-	-	4	1,265	251
Consumer home equity line of credit	1	650	115	-	-	-
Total	1	$ 650	$ 115	5	$ 1,765	$ 582

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

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

Loans modified as a TDR within the previous twelve months that subsequently defaulted during the: (dollars in thousands)	Three months ended June 30, 2016		Six months ended June 30, 2016	
	Number of contracts	Recorded investment	Number of contracts	Recorded investment
Commercial real estate - owner occupied	-	$ -	2	$ 151

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

Loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment. Two CRE loans that were classified as TDRs in fourth quarter of 2015 subsequently defaulted during the first quarter of 2016. Both loans defaulted due to inability to meet contractual payments and the Company continued workout efforts to collect from the owners. There were no loans modified as a TDR within the previous twelve months that subsequently defaulted during the three and six months ended June 30, 2015.

The allowance for loan losses (allowance) may be increased, adjustments may be made in the allocation of the allowance or partial charge-offs may be taken to further write-down the carrying value of the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral is used to establish the allowance. As of June 30, 2016 and 2015, the allowance for impaired loans that have been modified in a TDR was $0.4 million and $0.6 million, respectively.

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Past due loans

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

June 30, 2016	30 - 59 Days past due	60 - 89 Days past due	Past due 90 days or more (1)	Total past due	Current	Total loans (3)		Recorded investment past due ≥ 90 days and accruing
Commercial and industrial	$ 294	$ 14	$ 52	$ 360	$ 97,360	$ 97,720		$ 27
Commercial real estate:								
Non-owner occupied	335	61	1,755	2,151	86,781	88,932		-
Owner occupied	729	-	2,813	3,542	99,857	103,399		2
Construction	-	-	207	207	5,516	5,723		-
Consumer:								
Home equity installment	263	92	71	426	29,493	29,919		-
Home equity line of credit	-	173	334	507	49,173	49,680		-
Auto loans and leases	173	18	44	235	37,270	37,505	(2)	23
Other	25	1	6	32	6,398	6,430		-
Residential:								
Real estate	81	855	688	1,624	128,628	130,252		-
Construction	-	-	-	-	11,644	11,644		-
Total	$ 1,900	$ 1,214	$ 5,970	$ 9,084	$ 552,120	$ 561,204		$ 52

(1) Includes $5.9 million of non-accrual loans. (2) Net of unearned lease revenue of $0.4 million. (3) Includes net deferred loan costs of $1.7 million.

December 31, 2015	30 - 59 Days past due	60 - 89 Days past due	Past due 90 days or more (1)	Total past due	Current	Total loans (3)	Recorded investment past due ≥ 90 days and accruing
Commercial and industrial	$ 38	$ 32	$ 42	$ 112	$ 102,541	$ 102,653	$ 12
Commercial real estate:							
Non-owner occupied	549	1,282	6,476	8,307	87,438	95,745	283

Owner occupied	-	85	988	1,073	100,579	101,652		-
Construction	-	-	226	226	4,255	4,481		-
Consumer:								
Home equity installment	189	92	167	448	30,487	30,935		-
Home equity line of credit	109	650	512	1,271	46,789	48,060		-
Auto loans and leases	394	44	76	514	28,909	29,423	(2)	31
Other	66	-	36	102	6,106	6,208		30
Residential:								
Real estate	46	131	836	1,013	125,979	126,992		-
Construction	-	-	-	-	10,060	10,060		-
Total	$ 1,391	$ 2,316	$ 9,359	$ 13,066	$ 543,143	$ 556,209		$ 356

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

Impaired loans

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

At June 30, 2016, impaired loans consisted of accruing TDRs of $2.3 million, $5.9 million in non-accrual loans and $2.4 million in accruing loans. At December 31, 2015, impaired loans consisted of accruing TDRs totaling $2.4 million, $9.0 million of non-accrual loans and a $1.2 million accruing loan. As of December 31, 2015, the non-accrual loans did not include any TDRs compared with two TDRs with a $0.2 million balance as of June 30, 2016. Payments received from non-accruing impaired loans are first applied against

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the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income. Payments received from accruing impaired loans are applied to principal and interest, as contractually agreed upon.

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

(dollars in thousands)	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance
June 30, 2016					
Commercial and industrial	$ 256	$ 218	$ 38	$ 256	$ 204
Commercial real estate:					
Non-owner occupied	3,730	3,110	489	3,599	1,161
Owner occupied	4,924	4,224	611	4,835	1,233
Construction	414	-	207	207	-
Consumer:					
Home equity installment	121	39	32	71	5
Home equity line of credit	1,096	650	334	984	115
Auto loans and leases	21	21	-	21	3
Other	6	6	-	6	1
Residential:					
Real estate	754	408	280	688	23
Construction	-	-	-	-	-
Total	$ 11,322	$ 8,676	$ 1,991	$ 10,667	$ 2,745

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

Real estate	891	433	403	836	95
Construction	-	-	-	-	-
Total	$ 13,306	$ 9,141	$ 3,472	$ 12,613	$ 2,009

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	June 30, 2016			June 30, 2015		
(dollars in thousands)	Average recorded investment	Interest income recognized	Cash basis interest income recognized	Average recorded investment	Interest income recognized	Cash basis interest income recognized
Commercial and industrial	$ 609	$ 9	$ -	$ 305	$ 15	$ -
Commercial real estate:						
Non-owner occupied	4,419	46	-	1,616	41	-
Owner occupied	3,383	78	-	2,500	26	-
Construction	225	-	-	257	-	-
Consumer:						
Home equity installment	163	3	-	334	2	-
Home equity line of credit	706	17	-	486	1	-
Auto	33	-	-	1	-	-
Other	6	-	-	19	2	-
Residential:						
Real estate	696	2	-	563	4	-
Construction	-	-	-	-	-	-
Total	$ 10,240	$ 155	$ -	$ 6,081	$ 91	$ -

Credit Quality Indicators

Commercial and industrial and commercial real estate

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

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

Pass

Loans in this category have an acceptable level of risk and are graded in a range of one to five. Secured loans generally have good collateral coverage. Current financial statements reflect acceptable balance sheet ratios, sales and earnings trends. Management is considered to be competent, and a reasonable succession plan is evident. Payment experience on the loans has been good with minor or no delinquency experience. Loans with a grade of one are of the highest quality in the range. Those graded five are of marginally acceptable quality.

Special Mention

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

Substandard

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

Doubtful

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

Consumer and residential

The consumer and residential loan segments are regarded as homogeneous loan pools and as such are not risk rated. For these

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portfolios, the Company utilizes payment activity, history and recency of payment in assessing performance. Non-performing loans are considered to be loans past due 90 days or more and accruing and non-accrual loans. All loans not classified as non-performing are considered performing.

The following table presents loans including $1.7 million of deferred costs, segregated by class, categorized into the appropriate credit quality indicator category as of June 30, 2016 and December 31, 2015, respectively:

Commercial credit exposure

Credit risk profile by creditworthiness category

(dollars in thousands)	Commercial and industrial		Commercial real estate - non-owner occupied		Commercial real estate - owner occupied		Commercial real estate - construction	
	6/30/2016	12/31/2015	6/30/2016	12/31/2015	6/30/2016	12/31/2015	6/30/2016	12/31/2015
Pass	$ 91,073	$ 101,342	$ 79,975	$ 82,152	$ 97,028	$ 96,401	$ 5,517	$ 4,255
Special mention	6,118	189	1,604	1,480	643	657	-	-
Substandard	529	1,122	7,353	12,113	5,728	4,594	206	226
Doubtful	-	-	-	-	-	-	-	-
Total	$ 97,720	$ 102,653	$ 88,932	$ 95,745	$ 103,399	$ 101,652	$ 5,723	$ 4,481

Consumer credit exposure

Credit risk profile based on payment activity

(dollars in thousands)	Home equity installment		Home equity line of credit		Auto loans and leases		Other	
	6/30/2016	12/31/2015	6/30/2016	12/31/2015	6/30/2016	12/31/2015	6/30/2016	12/31/2015
Performing	$ 29,848	$ 30,768	$ 49,346	$ 47,548	$ 37,461	$ 29,347	$ 6,424	$ 6,172
Non-performing	71	167	334	512	44	76	6	36
Total	$ 29,919	$ 30,935	$ 49,680	$ 48,060	$ 37,505 (1)	$ 29,423 (2)	$ 6,430	$ 6,208

(1)Net of unearned lease revenue of $0.4 million. (2) Net of unearned lease revenue of $0.3 million.

Mortgage lending credit exposure

Credit risk profile based on payment activity

(dollars in thousands)	Residential real estate 6/30/2016	12/31/2015	Residential construction 6/30/2016	12/31/2015
Performing	$ 129,564	$ 126,156	$ 11,644	$ 10,060
Non-performing	688	836	-	-
Total	$ 130,252	$ 126,992	$ 11,644	$ 10,060

Allowance for loan losses

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

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

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

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

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

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

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

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

As of and for the six months ended June 30, 2016

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	$ 1,336	$ 5,014	$ 1,533	$ 1,407	$ 237	$ 9,527
Charge-offs	(169)	(343)	(265)	(60)	-	(837)
Recoveries	21	33	38	-	-	92

Provision	43	176	386	18	(198)	425
Ending balance	$ 1,231	$ 4,880	$ 1,692	$ 1,365	$ 39	$ 9,207
Ending balance: individually evaluated for impairment	$ 204	$ 2,394	$ 124	$ 23	$ -	$ 2,745
Ending balance: collectively evaluated for impairment	$ 1,027	$ 2,486	$ 1,568	$ 1,342	$ 39	$ 6,462
Loans Receivables:						
Ending balance (2)	$ 97,720	$ 198,054	$ 123,534 (1)	$ 141,896	$ -	$ 561,204
Ending balance: individually evaluated for impairment	$ 256	$ 8,641	$ 1,082	$ 688	$ -	$ 10,667
Ending balance: collectively evaluated for impairment	$ 97,464	$ 189,413	$ 122,452	$ 141,208	$ -	$ 550,537

(1) Net of unearned lease revenue of $0.4 million. (2) Includes $1.7 million of net deferred loan costs.

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As of and for the three months ended June 30, 2016

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	$ 1,640	$ 4,583	$ 1,678	$ 1,379	$ 104	$ 9,384
Charge-offs	(155)	(258)	(90)	-	-	(503)
Recoveries	12	29	10	-	-	51
Provision	(266)	526	94	(14)	(65)	275
Ending balance	$ 1,231	$ 4,880	$ 1,692	$ 1,365	$ 39	$ 9,207

As of and for the year ended December 31, 2015

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

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

As of and for the six months ended June 30, 2015

Commercial Residential

(dollars in thousands)	Commercial & industrial	real estate	Consumer	real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	$ 1,052	$ 4,672	$ 1,519	$ 1,316	$ 614	$ 9,173
Charge-offs	(26)	(138)	(151)	-	-	(315)
Recoveries	26	17	30	28	-	101
Provision	318	59	102	25	(204)	300
Ending balance	$ 1,370	$ 4,610	$ 1,500	$ 1,369	$ 410	$ 9,259

As of and for the three months ended June 30, 2015

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	$ 1,214	$ 4,515	$ 1,513	$ 1,343	$ 623	$ 9,208
Charge-offs	(2)	(71)	(59)	-	-	(132)
Recoveries	17	10	6	-	-	33
Provision	141	156	40	26	(213)	150
Ending balance	$ 1,370	$ 4,610	$ 1,500	$ 1,369	$ 410	$ 9,259

6. Earnings per share

Basic earnings per share (EPS) is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but also reflects the potential dilution that could occur from the grant of stock-based compensation awards. The Company maintains two active share-based compensation plans that may generate additional potentially dilutive common shares. For granted and unexercised stock options and stock-settled stock appreciation rights (SSARs), dilution would occur if Company-issued stock options or SSARs were exercised and converted into common stock. As of the three and six months ended June 30, 2016, there were 1,873

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and 1,940 potentially dilutive shares related to issued and unexercised stock options compared to 3,012 and 2,783 for the same 2015 periods. There were no potentially dilutive shares related to issued and unexercised SSARs. For restricted stock, dilution would occur from the Company's previously granted but unvested shares. There were 3,202 and 2,714 potentially dilutive shares related to unvested restricted share grants as of the three and six months ended June 30, 2016 compared to 2,593 and 4,759 for the three and six months ended June 30, 2015.

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

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

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
(dollars in thousands except per share data)				
Basic EPS:				
Net income available to common shareholders	$ 1,928	$ 1,780	$ 3,629	$ 3,353
Weighted-average common shares outstanding	2,453,620	2,439,905	2,452,196	2,437,906
Basic EPS	$ 0.79	$ 0.73	$ 1.48	$ 1.38
Diluted EPS:				
Net income available to common shareholders	$ 1,928	$ 1,780	$ 3,629	$ 3,353
Weighted-average common shares outstanding	2,453,620	2,439,905	2,452,196	2,437,906
Potentially dilutive common shares	5,075	5,605	4,654	7,542
Weighted-average common and potentially dilutive shares outstanding	2,458,695	2,445,510	2,456,850	2,445,448
Diluted EPS	$ 0.79	$ 0.73	$ 1.48	$ 1.37

7. Stock plans

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

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

In each of the 2012 stock incentive plans, the Company has reserved 500,000 shares of its no-par common stock for future issuance. The Company recognizes share-based compensation expense over the requisite service or vesting period. During 2015, the Company created a Long-Term Incentive Plan (LTIP) that awards restricted stock and stock-settled stock appreciation rights (SSARs) to senior officers based on the attainment of performance goals. The service requirement is the participant’s continued employment throughout the LTIP with a three-year vesting period. The restricted stock has a two-year post vesting holding period requirement. The SSAR awards have a ten year term from the date of each grant. The Company granted restricted stock and SSARs in February 2016 based on 2015 performance.

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The following table summarizes the weighted-average fair value and vesting of restricted stock grants awarded during the periods ended June 30, 2016 and 2015 under the 2012 stock incentive plans:

	June 30, 2016				June 30, 2015			
	Shares granted			Weighted-average grant date fair value	Shares granted			Weighted-average grant date fair value
Director plan	5,600	(1)	$	32.40	3,200	(1)	$	32.25
Omnibus plan	3,155	(3)		29.22	3,300	(2)		32.25
Omnibus plan	50	(1)		31.50	50	(1)		32.50
Omnibus plan	-			-	1,400	(2)		34.25
Total	8,805		$	31.26	7,950		$	32.60

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

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

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

	2012 Stock incentive plans				
	Director	Omnibus	Total		Weighted- average grant date fair value
Non-vested balance at December 31, 2015	3,200	8,840	12,040	$	29.50
Granted	5,600	3,205	8,805		31.26
Vested	(3,200)	(3,005)	(6,205)		29.69
Non-vested balance at June 30, 2016	5,600	9,040	14,640	$	30.47

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

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

	Awards	Weighted-average grant date fair value	Weighted-average remaining contractual term (years)
Outstanding December 31, 2015	-	-	-
Granted	19,341	$ 5.21	10.0
Exercised	-	-	
Forfeited	-	-	
Outstanding June 30, 2016	19,341	$ 5.21	9.6

None of the SSARs were exercisable at June 30, 2016. SSARs vest over a three year period – 33% per year.

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Share-based compensation expense is included as a component of salaries and employee benefits in the consolidated statements of income. The following tables illustrate stock-based compensation expense recognized on non-vested equity awards during the three and six months ended June 30, 2016 and 2015 and the unrecognized stock-based compensation expense as of June 30, 2016:

Three months ended	Six months ended